Clarifying the rules: Sustainable transfer pricing in the financial services sector

A practical guide to managing financial services transfer pricing.
Foreword

It is our pleasure to introduce this book on the topic of transfer pricing for the financial services sector. The collection of works it contains has been contributed by members of PwC’s extensive Financial Services Transfer Pricing network worldwide. Through its chapters, this book provides an outline of the key considerations, observations, and challenges arising from transfer pricing issues pertinent to the specific business models, operations, and resulting inter-company relationships that are prevalent in the financial services industry.

For some time now there has been growing recognition and concern among taxing authorities and taxpayers alike that the published transfer pricing legislation, regulations, and guidelines do not provide an adequate framework for analysing many of the inter-company transactions that arise as financial institutions go about their day-to-day business.

Moreover, while both the OECD and certain individual taxing authorities have made steady and concerted efforts to provide refined guidance in relation to the financial services industry, and while such efforts will no doubt continue, the concerns raised by this lack of direction have become ever more acute as a result of the global economic crisis of 2008 and the multiple regulatory changes that have been or will soon be implemented in the financial services sector. The crisis has also highlighted the growing interconnectedness of the global markets over recent years, and the increased sophistication and complexity of participants in those markets and of the transactions conducted between them.

From our experience working with taxing authorities and taxpayers to manage these issues, we have recognised this need to bring greater focus and direction to the issue of transfer pricing in the financial services industry. Therefore, in conjunction with the long-established and country-focused PwC publication International Transfer Pricing (www.pwc.com/internationaltp), which continues to expand each year as more jurisdictions globally enact transfer pricing legislation, Clarifying the rules: Sustainable transfer pricing in the financial services sector will provide an industry-specific reference point for financial institutions everywhere. In addition we hope that this book will also prove useful for multinational enterprises outside the financial services industry, specifically in the area of inter-company financing.

We believe this book continues our commitment to remain at the forefront of initiatives being undertaken by taxing authorities, the OECD, and taxpayers to reach acceptable and understandable application of the arm’s length principle to transactions involving financial institutions. We hope that it will prove equally useful as a guide for managing financial services transfer pricing at an operational level.

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Index of abbreviations and acronyms

The following list is provided as a reference for the abbreviations and acronyms used throughout this book.

ADR American Depository Receipt
AIV alternative investment vehicles
ALM Asset/liability management
AOA Authorised OECD Approach
APA Advance Pricing Agreement
ART alternative risk transfer
ATM automated teller machine
AV added value
BCM banking and capital markets
CAT catastrophe
CCA Cost Contribution Arrangements
CEO Chief operating officer
CPL cash pool leader
CPM Comparable Profits Method
CRA Canada Revenue Agency
CRM customer relationship management
CST controlled services transaction
CUP comparable uncontrolled price
CUSP comparable uncontrolled services price
CUT comparable uncontrolled transaction
EEA European Economic Area
EU European Union
EV estimated value
FCM full cost mark-up
FIN 48 Financial Accounting Standards Board Interpretation No. 48
FIO Federal Insurance Office
FS financial services
FTC foreign tax credits
GP general partnership
GST goods and services tax
HMRC Her Majesty’s Revenue and Customs
HR human resources
IME investment management exemption
IPO initial public offering
IR information technology
IRAS Inland Revenue Authority of Singapore
IRC Internal Revenue Code
IRD Inland Revenue Department of Hong Kong
IRS Internal Revenue Service
IT Information technology
KERT key entrepreneurial risk-taking
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>LANA</td>
<td>Lipper Analytical New Application</td>
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<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<td>LLC</td>
<td>limited liability corporation</td>
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<tr>
<td>LoC</td>
<td>letter of credit</td>
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<td>LOC</td>
<td>line of credit</td>
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<td>LP</td>
<td>limited partnership</td>
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<tr>
<td>M&amp;A</td>
<td>mergers and acquisitions</td>
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<td>MD</td>
<td>managing director</td>
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<td>MGA</td>
<td>managing general agent</td>
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<td>MNE</td>
<td>multinational enterprise</td>
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<td>NAV</td>
<td>net asset value</td>
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<td>NGO</td>
<td>non-governmental organisation</td>
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<td>NPV</td>
<td>net present value</td>
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<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<td>OECD Guidelines</td>
<td>Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators issued by the OECD</td>
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<td>OMB</td>
<td>Office of Management and Budget</td>
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<td>P&amp;C</td>
<td>property and casualty industry</td>
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<td>PE</td>
<td>permanent establishment</td>
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<td>P&amp;L</td>
<td>profit and loss</td>
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<td>PLI</td>
<td>profit level indicator</td>
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<td>PSM</td>
<td>Profit Split Method</td>
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<td>QCSA</td>
<td>Qualified Cost Sharing Arrangements</td>
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<td>R&amp;D</td>
<td>research and development</td>
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<td>REIT</td>
<td>real estate investment trust</td>
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<td>RPM</td>
<td>Resale Price Method</td>
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<td>RPSM</td>
<td>Residual Profit Split Method</td>
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<td>S&amp;P</td>
<td>Standard &amp; Poor's</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<tr>
<td>Section 482</td>
<td>§ 1.482 of the IRC</td>
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<td>SPF</td>
<td>significant people function</td>
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<td>SWF</td>
<td>sovereign wealth fund</td>
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<td>TNMM</td>
<td>Transactional Net Margin Method</td>
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<td>TP</td>
<td>transfer pricing</td>
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<td>TSR</td>
<td>total shareholder return</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>UN</td>
<td>United Nations</td>
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<td>US</td>
<td>United States</td>
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<tr>
<td>VaR</td>
<td>value at risk</td>
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<td>VAT</td>
<td>value added tax</td>
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<td>WA</td>
<td>wealth added</td>
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Part I: Model Treaty Framework
Chapter 1 – OECD Framework

1.1 Introduction
The work of the OECD has been pivotal in the field of transfer pricing. In the era of globalisation, where financial institutions venture into new markets, a common set of rules or approaches is an invaluable tool to simplify tax and transfer pricing compliance. The work of the OECD is geared towards creating that common ground that would enable global operations to operate by reference to a single and widely adopted transfer pricing standard. The arm’s length principle, as set out in Article 9 of the OECD Model Convention and further described in the OECD Guidelines, is still the preferred standard by which to allocate profits between related enterprises. The OECD Model Convention and the OECD Guidelines are not the only multilateral instruments with relevance in transfer pricing. The UN – both in the UN Model Tax Convention and in the UN Transfer Pricing manual released in draft form in October 2010 – also follows the arm’s length principle and the OECD transfer pricing methods. The OECD has also engaged in the dialogue between developing and developed nations, including many non-Member States in the discussions on transfer pricing matters. Because there seems to be a convergence in this area, with many developed and developing nations following the guidelines and the work of the OECD on transfer pricing, as well as the OECD guidance on attribution of profits to permanent establishments, this chapter focuses on the framework provided by the OECD and considers how it relates to financial services. The following subsections cover the arm’s length principle and the current projects on the OECD agenda with relevance to financial institutions and then go on to consider the concept of PEs and the attribution of profits to PEs.

1.2 Relevant OECD Framework
1.2.1 Overview of Article 9
1.2.1.1 The arm’s length principle
The arm’s length principle is defined in Article 9(1) of the OECD Model, which forms the basis of many bilateral tax treaties. Under the arm’s length principle, related taxpayers must set transfer prices for any inter-company transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. Where such arm’s length pricing is not used, the rule in Article 9 allows adjustments to be made to the pricing of transactions to deliver an arm’s length result.

Article 9(2) outlines the possibility of a so-called ‘secondary adjustment’ which can be invoked by an enterprise if its transfer prices are adjusted in one contracting State, leading to economic double taxation of the profit. In such a case, Paragraph 2 provides the ability to make an appropriate adjustment in the other State to relieve the double taxation. The adjustment can be made to the extent the other State agrees that the primary adjustment correctly reflects the application of the arm’s length principle. If there is a dispute over the adjustment, the mutual agreement procedure included in Article 25 of the OECD Model Convention can be invoked.

Guidance on the application of the arm’s length principle can be found in the OECD Guidelines, which are periodically updated by the OECD.1,2 The last update was approved by the Council of the OECD on 22 July 2010.

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1 This book applies the OECD Guidelines. It may also make references to the US IRC Section 482 and regulations promulgated thereunder which are meant to be applied consistent with the OECD Guidelines unless otherwise indicated.
2 The original version of that report was approved by the Council of the OECD on 27 June 1995.
1.2.1.2 Key areas of relevance of the arm’s length principle

The arm's length principle applies to taxpayers in all industries. The OECD Guidelines and other documents issued by the OECD provide guidance to activities of particular interest to financial institutions, such as traditional banking activities and global trading.

When determining group transfer pricing policies, specific attention should be paid to the OECD’s principles on the selection of the transfer pricing methods, notion of the ‘control over risk’, and business restructurings.

The 2010 update of the OECD Guidelines moves away from the ‘rigid’ hierarchy of the transfer pricing methods and provides for the most appropriate transfer pricing method for a particular case. Hence, the TNMM and Transactional Profit Split Method are no longer methods of last resort. Therefore, the update may require the review of transfer pricing policies currently in place or may, in some cases, provide more comfort to policies defined prior to the update. For example, the PSM is a method frequently applied to global trading activities.

The second issue that is likely to be analysed in the financial institutions sector is the notion of ‘control over risk’. This notion stems from Paragraph 1.49 of the OECD Guidelines and is further used in Part I, Section B.2.2.1, Chapter IX of the same Guidelines. The control over risk is one of the rules governing allocation of risk between related entities, and thus allocation of profits and losses, based on the assumption expressed in Paragraph 1.49 that “In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control.”

Given that risk management procedures are a cornerstone in managing financial institutions, it is now reinforced and hence critical to properly reflect the evolving risk management governance in the transfer pricing policies. Changes in the regulatory framework may amplify the need for the review and revisions.

With the release of the new Chapter IX, more guidance is now available on the allocation of risk between related entities. The starting point for the allocation of risk is the contractual allocation of risk between the related parties. Tax authorities can challenge the contractual allocation of risk if it is not consistent with the “economic substance of the transaction.” Ideally, the latter should be tested by reference to how independent parties allocate the risk in comparable transactions. Often such information is not available. In such cases, the OECD Guidelines indicate that, although there are no prescriptive criteria, independent parties would often take on a risk if they have the control of risk and they have the financial capacity to assume the risk. The ‘control over risk’ concept refers to the “capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider.” Correspondingly, “[w]hile it is not necessary to perform the day-to-day monitoring and administration functions in order to control a risk (as it is possible to outsource these functions), in order to control a risk one has to be able to assess the outcome of the day-to-day monitoring and administration functions by the service provider (the level of control needed and the type of performance assessment would depend on the nature of the risk).”

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3 The most important recent document is the Report on Attribution of Profits to Permanent Establishments, discussed in the next section.
5 Ibid. Section 9.23.
Part I: Model Treaty Framework

With respect to the allocation of risk, it is important to note that the above is applicable to transactions between related legal entities. For dealings between a head office and its permanent establishments, the guiding principle is that the risks should be allocated according to the people functions managing these risks, as described in the next section. In particular, “[t]he significant people functions relevant to the assumption of risks are those which require active decision making with regard to the acceptance and/or management (subsequent to the transfer) of those risks.” The active decision making seems to refer more to the day-to-day risk-taking function. Within a context of PEs, it is thus not possible to allocate the risk differently from the location of the risk-taking functions in the absence of a specific and recognised risk transfer dealing.

Finally, the business restructurings may be of particular interest to financial institutions, as the OECD Guidelines adopted a wholly new Chapter IX dedicated to this topic. An important item to consider is whether a restructuring itself requires compensation or indemnification. The new Chapter IX of the OECD Guidelines comments in detail on the elements to be considered in such an analysis. According to Section C, Paragraph 9.65 of this chapter,

“[t]he arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits. When applying the arm’s length principle to business restructurings, the question is whether there is a transfer of ‘something of value’ (rights or other assets) or termination or substantial renegotiation of existing arrangements and that transfer, termination or substantial renegotiation of existing arrangements would be compensated between independent parties in comparable circumstances.”

In other words, the transfer of profit potential does not require compensation by default. Whether such compensation is required depends primarily on whether ‘something of value’ has been transferred (e.g. intangible assets) and on the options the parties have had, for example, stemming from the contractual arrangements.

1.2.2 The relevance of PE issues
In addition to the OECD approach to transfer pricing in relation to transactions between related-party entities, it is also necessary to touch on the approach to how profits are allocated between different parts of the same legal entity – e.g. between a head office in one country and branch of the same legal entity in a different country. This is particularly important in the context of the financial services industry where branches – technically known as PEs have been widely used, especially in the banking sector.

However, before it is possible to look at how profits are allocated within the same legal entity, it is useful to consider the circumstances in which a PE may be regarded as existing. This involves a consideration of the PE ‘threshold’ rules of Article 5 of the OECD Model Tax Convention.

1.2.3 Overview of Article 5
This section provides a brief overview of the concept of PE under Article 5 of the OECD Model Convention and touches upon the most relevant implications of the Article 5

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8 The OECD Guidelines, supra note 5 at Chapter IX, Part II.
9 OECD continues its work on the intangibles project. Although no publication has been announced, the OECD has set the scope of this paper in January 2011.
rule for the FS sector, with the purpose of highlighting the issues financial institutions should be considering when conducting business in jurisdictions other than their country of residence.\footnote{2010 OECD PE Report, Part I, Section D-5, Paragraph 227.}

The concept of a PE under Article 5 is the international tax treaty rule that determines when a taxable presence is created in a foreign jurisdiction. In essence, this rule is designed to ensure that business activities are not taxed by a State, other than the country of residence, unless and until they have created significant economic bonds between the enterprise and that State. The consequence of engaging in business abroad through a permanent establishment is full taxation by the country of source of the business profits attributable to the permanent establishment.

The threshold of activity that achieves a PE status within the OECD Model Convention is determined by the following two tests:

- Fixed place of business test or objective presence.
- Dependent agent test or agency PE.

### 1.2.3.1 Fixed place of business test (Article 5(1))

The basic conditions for the fixed place of business test are as follows:

- **Place of business** – this includes premises, facilities, installations, machinery, or equipment.
- **Fixed** – there must be a link between the place of business and a specific geographical point with a degree of permanence.
- **Carrying on the business through this fixed place of business** – typically via employees or other personnel.

In addition to these tests, additional requirements and considerations include:

- The business activities carried on through the place of business must be more than preparatory or auxiliary in nature.
- No formal legal right to use the place of business is required. The mere fact that an enterprise has a certain amount of space at its disposal that is used for business activities may be sufficient to constitute a place of business.
- A PE is deemed to exist geographically if there is both commercial and geographic coherence.
- A PE may exist even though a place of business exists for a short period of time. This is usually reflected in a six-months test, although a PE may exist even if the place of business exists for less than six months in certain circumstances.

Banks often operate internationally through branch structures due to regulatory capital constraints; such structures clearly are PEs. Other examples in which the fixed place of business threshold may be crossed are the use of ATMs or other computer equipment, such as servers through which the business of the financial institution is carried on. Another key area of concern for financial institutions is the movement of employees to conduct cross-border business transactions. This movement can lead to the creation of an inadvertent fixed place of business PE if the above criteria are met (particularly in areas such as investment banking and private banking, which may involve multiple client visits together with the use of the offices of a local subsidiary of the bank).
Offices with regional management functions may also be a place of management that constitutes a PE.

1.2.3.2 Dependent agent test (Article 5(5))

The conditions for the creation of a dependent agent PE are as follows:

- A person, other than an independent agent of independent status, who:
  - is acting on behalf of another enterprise
  - has authority to conclude contracts in the name of the principal that are binding on that principal, and
  - habitually exercises such authority.
- The relevant contracts are in relation to the essential business operations of the enterprise, rather than ancillary activities.

The material exception to this rule is given in Art 5(6), which specifically excludes ‘independent’ agents acting within the ordinary course of their business from constituting a dependent agent PE. To be independent, it is necessary to be independent, both legally and economically, and it is also necessary that the agent is acting in the ordinary course of the agent’s activities when acting on behalf of the enterprise.

The independent/dependent agent test is of critical importance in an FS context. For example, many large FS firms, and particularly securities and derivatives dealers, operate on a global basis through separate subsidiaries that reside and operate in a number of countries. These separate dealer subsidiaries often originate new deals and book in other dealer affiliates, which then act as centralised booking sites for global trading businesses. The crucial question of whether these dealer subsidiaries create a PE for the booking affiliate entity in the countries where they act is far from clear. The specific facts and circumstances should be closely scrutinised to assess whether the independent agent exception is applicable.

1.2.4 Taxation of services at source

Some OECD Member States are reluctant to adopt the principle of exclusive residence taxation of services that are not attributable to a PE situated in their territory, but that are performed in that territory. The OECD Model Convention addresses the position relating to services.

The taxation-of-services rule is not included in the text of the PE rules in Article 5, but is discussed in the OECD Model Commentary on that Article. This provides a possible services PE rule for States that want to use it in their treaties. According to the OECD Model Commentary, a person is deemed to create a services PE if:

1. those services are performed in that other State by an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any 12-month period, and more than 50% of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual in that other State; or
2. the services are provided in that other State for a period or periods exceeding in the aggregate 183 days in any 12-month period, and these services are performed for
the same project or for connected projects through one or more individuals who are present and performing such services in that other State.\footnote{OECD Model Commentary, Paragraph 42.23.}

A number of Asian countries have incorporated the concept of a service PE in their double-tax treaties for some time. Other examples are the tax treaties between the US and Canada and between the US and Bulgaria. Travelling employees in the investment management industry and other financial services industries should carefully monitor their activities so they do not inadvertently cross the services PE threshold.

1.2.5 Current work on PE threshold

The OECD acknowledges the complexities faced by taxpayers when dealing with PE issues, and to address some of these challenges, the OECD is revising the Commentary to Article 5 of the OECD Model. The project does not include changes to the wording of the Article itself.

Particular issues being addressed with these revisions include clarifying the meaning of ‘at the disposal of’; the treatment of the presence of secondees and other foreign enterprise personnel in the host country; the meaning of ‘to conclude contracts in the name of the enterprise’; the treatment of fund managers; whether a main contractor that subcontracts all aspects of a contract can be considered a PE; and whether a home office can be considered a PE.

1.2.6 Overview of Article 7 and attribution of profits to PEs

This section highlights the key considerations regarding income attribution to a PE on the basis of the 2010 OECD PE Report\footnote{In December 2006, final versions of Parts I, II, and III of the PE Report dealing with general considerations in relation to the taxation of permanent establishments and application of these principles to banks and in the context of global trading were issued. This was followed on 22 August 2007 by a revised Part IV dealing with insurance. A final version of the combined parts to the PE Report was finally issued on 17 July 2008. Also in 2010, an amended and updated version (but not fundamentally altered from 2008) of the PE Report was issued to reflect minor amendments to make the report consistent with the 2010 version of Article 7.} and the new Article 7 along with its updated Commentary.

1.2.6.1 General considerations

Article 7 has been subject to recent and major revisions: the Commentary to Article 7 was revised in the 2008 version of the OECD Model Convention and again in 2010. The 2010 changes introduced a new Article 7 along with new commentary in an attempt to give full effect to the Report on Attribution of Profits to Permanent Establishments without the constraints of the previous version of Article 7 (hereinafter the ‘old’ Article 7).

The old Article 7 contains two cardinal rules: (1) an enterprise of a contracting State is to be taxed in another contracting State only if it conducts business through a PE there; and (2) if there is such business being conducted through a PE, the profits that may be taxed in that other State are those attributable to that PE. In addition, the old Article 7(2) provides additional guidance for the determination of such attributable profits (i.e. whether the profits attributable to a PE should be the profits that it would expect to make if it were a separate and distinct entity engaged in the same or similar activities under the same or similar circumstances).

The new Article 7 retains Article 7(1), and its cardinal rule regarding the determination of taxable profits remains largely unchanged, except that it now contains a reference to Article 7(2) as governing the attribution standards for PEs.
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A significant addition is introduced by the new Article 7(3), which provides a mechanism for resolving double-taxation disputes where different methods are used by the source and residence states to determine, for example, the level of interest deduction and the attribution of free capital for PEs.

The 2010 OECD PE Report is based on the Functionally Separate Entity Approach also referred to as the AOA. Under the AOA, a two-step process is followed to attribute profits to a PE:

1. The PE is hypothesised as a functionally separate entity from the rest of the enterprise to which it belongs.
2. The profits of the PE are determined by applying, by analogy, the arm's length principle embedded in the OCED Transfer Pricing Guidelines, including its comparability analysis of dealings between the PE and the rest of the enterprise.

The fundamentals of the new approach to the interpretation of Article 7 involve developing the two-step process referred to above as follows:

Step 1 – Hypothesise the PE as a distinct and separate enterprise.

Following the principles of the OECD Guidelines, a functional and factual analysis is conducted to determine the activities that take place in the PE. Broadly, this involves:

- Hypothesise (i.e. treat) the PE as a distinct and separate enterprise.
- Identify the KERT functions SPFs relevant to the business being undertaken. These people functions are the most important people functions in the conduct of the business (with financial sector business, for example, the KERTs typically relate to the assumption and management of risk).
- Allocate the assets of, and risks in, the business based on the (geographical) location of the KERTs – e.g. as between a PE and head office or between multiple PEs in different countries.
- Attribute appropriate capital to support the assets and risks.
- Recognise and determine the nature of dealings between the PE and other parts of the same enterprise that can be appropriately recognised.

Upon completion of the above steps, it would then be possible to undertake the second step for attributing the appropriate profits to the PE.

Step 2 – Determine the profits attributable to the PE.

The determination of profits attributable to a PE is achieved using the principles of the OECD Guidelines as follows:

- Identify uncontrolled transactions comparable to the dealings of the PE with the other parts of the same enterprise.
- Draw on the functional analysis relating to the dealings of the PE with the other parts of the same enterprise, and using such analysis to guide the selection and application of the most appropriate method, arrive at an arm's length compensation for such dealings.

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13 The KERT functions alluded to in Parts II through IV of the 2010 OECD PE Report are described as SPFs in Part I of the report. From a practical standpoint, it seems unlikely that any major distinctions in meaning between the two terms were intended.
1.2.6.2 Practical considerations

Part I of the 2010 OECD PE Report elaborates on the new approach to Article 7 for enterprises operating outside of the specific situations considered in Parts II to IV (i.e. banks lending business, global trading of financial instruments, and insurance business, respectively). As such, the new approach is considered equally applicable for advisory services, asset management activities, and all other businesses, even though these areas are not explicitly addressed within the 2010 OECD PE Report.

Given the lack of legal consequences relating to the dealings between a PE and other parts of the enterprise of which it is a part, the 2010 OECD PE Report suggests that a greater degree of scrutiny is required for intra-enterprise transactions and encourages enterprises to prepare relevant documentation, including accounting records, contemporaneous documentation (similar to what would be prepared for inter-company transactions), and internal documents. The enterprise may then use such documentation as a starting point to allocate the profits to the PE.

The 2010 OECD PE Report further states that tax administrators should give effect to such documentation for intra-enterprise dealings, notwithstanding its lack of legal effect, to the extent that (i) the documentation is consistent with the economic substance of the activities taking place within the enterprise; (ii) the arrangements documented in relation to the dealing, viewed as a whole, do not differ from those which would have been adopted by comparable independent enterprises; and (iii) the dealing presented in the taxpayer’s documentation does not violate the principles of the AOA.14

Therefore, while each part of the 2010 OECD PE Report discusses a variety of considerations in different financial services businesses, the actual application of the principles heavily depends on the facts and circumstances of each case, and needs to be corroborated by appropriate documentation and transfer pricing analysis.

1.2.6.3 Banks

For banks, KERT functions relate to the creation of financial assets (e.g. loans) and the subsequent management of the risks associated with these assets. Attribution issues can then arise when the creation and management of such assets are managed in more than one location. In addition, non-KERT functions, such as back-office activities, can also be performed and fully integrated with the inter-company transactions. As such, while the 2010 OECD PE Report relies on the location of KERT functions to attribute the relevant assets and risks and the capital required to support those assets and risks, it also clearly emphasises that the profits attributable to PEs are expected to reflect all functions of the PE, including non-KERT functions.

An important difference between the new and old approaches of Article 7 of the OECD Model Convention is also highlighted in relation to head office and support costs. Specifically, the new approach relies on the arm’s length principle to determine the reward for performing such services, which may or may not include a profit element, whereas, under the old approach, head office and support costs would typically be allocated without a profit element.

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Related to the transfer of assets and risks from a PE to another PE or a head-office location, the 2010 OECD PE Report stipulates that the effects of such dealings should be reflected fully such that, for example, the acquirer or owner of a financial asset in this situation is treated as receiving interest income and paying any expenses associated with the economic ownership of the financial asset.

With respect to lending activities, the 2010 OECD PE Report recognises that the ability of a bank to borrow at one rate of interest and lend at another, higher rate is fundamental to the banking business. In this context, all other things being equal, the interest rate charged to a borrower by the lender generally correlates directly with the creditworthiness of the borrower. Bank branches typically enjoy the same creditworthiness of the bank as a whole, enabling them to borrow and on-lend at a profit on the same terms. The 2010 OECD PE Report states that PEs would typically be expected to have the same creditworthiness as the enterprise as a whole, except in unusual situations. As such, separate payments for credit support (e.g. from a head office to a PE) would not be respected.

1.2.6.4 Global trading of financial instruments (global trading)
While Part III of the 2010 OECD PE Report draws on the definition of global dealing under the global dealing regulations, it analyses situations where all or some of the activities engaged in as part of a global trading operation of a financial instruments business take place in more than one jurisdiction. For the purposes of this part, a global trading operation is one in which functions relating to the global trading business are performed in more than one tax jurisdiction, including within the same time zone (i.e. not necessarily over the course of 24 hours.)

Part III clarifies the nature of the parameter-setting function of the senior management within global trading. It rejects the idea that such activity can qualify as a KERT function, specifically rejecting the premise that such initial parameter setting is tantamount to setting risk management policies. The Report states that such parameter setting is unlikely to involve an active monitoring and adjustment of risks on an ongoing basis. The setting of parameters does not necessarily imply that the limits put in place will be utilised. Additionally, regulators do not view capital as being placed at risk until the enterprise is contractually committed to particular transactions. As such, Part III of the 2010 OECD PE Report suggests that setting parameters would not place capital at risk in the absence of active decisions with respect to the acceptance and management of risk.

Under Part III of the 2010 OECD PE Report, the hedge fund model is not applicable in the context of a PE for the purposes of determining the location of capital and assets. The premise of the hedge fund model is that capital can be assigned without regard to where the people functions are performed. This is contrary to the AOA, which starts from the premise that assets and risks follow functions, and capital then follows risk. However, the 2010 OECD PE Report goes on to examine the viability of the hedge fund model in the context of transfer pricing for associated enterprises under Article 9. According to this discussion of trading activities between associated enterprises, the traders employed by a bank to manage the bank’s risks are in a position similar to the manager of a hedge fund that has found investors who are willing to delegate the management of their capital to the manager in return for what they believe will

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15 Under the 1998 Proposed Global Dealing Regulations [Prop. US Treas. Reg. Section 1.482-8(2)(i)], a global dealing operation consists of the execution of customer transactions, including marketing, sales, pricing, and risk management activities, in a particular financial product or line of financial products, in multiple tax jurisdictions, and/or through multiple participants.

16 This is consistent with the 1998 US Proposed Global Dealing Regulations.
be a higher overall return. The discussion concludes that the hedge fund model may provide an appropriate comparable for the purposes of determining a reward to capital, especially in the context of proprietary trading. In that context, the hedge fund model may be of relevance.

With respect to treatment of operational risks within the PE context, the 2010 OECD PE Report draws on discussions from the The Basel Committee\(^\text{17}\) to describe these risks and considers a number of approaches. Accordingly, the risk should first be borne by the party best able to prevent it; second by the party that can manage, diversify or hedge it efficiently; and third by the party that can absorb the loss. In the context of a PE, to the extent that both the PE and the head office have equal ability to absorb the loss, the approach of attributing costs from operational risk follows from the relevant location of the people functions. A number of other risks, (e.g. market and credit risks that similarly might lead to losses) are also examined and a similar conclusion drawn. Alternatively, it is noted that operational risk can be allocated proportionately to other risks attributable to the PE on the basis that the part of the enterprise with the greatest exposure to credit and market risks has also the greatest exposure to operational risk.

1.2.6.5 Insurance

For insurance enterprises, the assumption of an insurance risk creates the need to hold an amount of assets sufficient to support the reserves and surplus relevant to that risk. In the case of an insurance PE, Part IV of the 2010 OECD PE Report treats the assumption of insurance risk as a KERT function. Consequently, investment assets are attributed to the PE to meet the reserve and surplus needs created by the insurance risk assumed by the PE. Until such time as the assets are called upon to meet any claims for which reserves have been established, to meet any excess of claims over reserves, or to meet any other liabilities, they are invested and the income from these investments is attributed to the PE. The 2010 OECD PE Report evaluates a number of potentially acceptable methods to attribute investment assets, including a capital allocation approach, a thin capitalisation approach, and a quasi-thin capitalisation approach.

The 2010 OECD PE Report further identifies two approaches to determining the investment yield from investment assets: the top-down and bottom-up approaches.

Under the top-down approach, to the extent that the amount of investment assets attributable to the PE exceeds the amount of investment assets actually held in the host country, the PE should be attributed an investment return equal to the return earned on all investment assets held by the company that are not required to be held in trustee accounts in other countries to support business (referred to as 'uncommitted investment assets'). Part IV acknowledges that this may give rise to practical problems with the measurement of returns for uncommitted assets and allows for variations, including the use of a rate of return equal to all the investment assets, with appropriate adjustments for investments in underperforming/non-performing assets or in assets denominated in other currencies.

The bottom-up approach assumes that the rate of return earned on investment assets held in the host country of the insurance PE is also earned by the uncommitted investment assets notionally attributed to the PE to satisfy its investment asset attribution requirement. The results under this approach or the top-down approach necessarily constitute proxies for the actual return on free investment assets.

\(^{17}\) The Basel Committee provides a forum for regular cooperation on banking supervisory matters on a global basis to enhance understanding of key supervisory issues and improve the quality of banking supervision. Source: http://www.bis.org/bcbs/about.htm, visited in January 2012.
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Part IV notes that in an overwhelming majority of cases, the risk management function of deciding whether to reinsure externally or retain risks internally will not result in an internal reinsurance dealing. However, it is recognised that risk management, including asset/liability management, is an important factor in determining the profitability of insurance enterprises and should be rewarded accordingly, in line with an appropriate transfer pricing policy between associated enterprises.

Another important practical consideration relates to the situation where the enterprise of which the PE is a part obtains reinsurance from a separate entity. This can have several potential effects on the profit determination of the PE, including whether costs of reinsurance should be allocated to the PE, the impact on the reserves and related investment assets held in the PE, and the allocation of recoveries on the external reinsurance obtained by the enterprise to the PE. Part IV concludes that a pragmatic and flexible approach aimed at arriving at an arm’s length result and avoiding double taxation should be adopted in making any attribution to the PE.
Chapter 2 – Future work of the OECD

2.1 Introduction
The OECD recently launched a number of projects relevant to transfer pricing. The following is a synopsis of the most relevant projects, from the perspective of the financial services industry.

2.2 Project on intangibles
On 22 July 2010, the OECD invited observers to submit comments on the transfer pricing aspects of intangibles. The request was published at the time of issuance of the new Chapters I-III and Chapter IX of the OECD Guidelines. The OECD stated that “[i]n these two projects, transfer pricing issues pertaining to intangibles were identified as a key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification, and valuation of intangibles for transfer pricing purposes.”

The project is led by Working Party 6 of the Committee on Fiscal Affairs and aims at a substantial revision and clarification of the current Chapter VI, Special Considerations for Intangible Property, of the OECD Guidelines, as well as a consistency check of Chapter VII, Special Considerations for Intra-Group Services, and Chapter VIII, Cost Contribution Arrangements, to ensure that the terminology and concepts in all chapters are applied consistently. The project focuses on issues, such as definitional aspects of intangibles, valuation, and guidance on specific transaction categories involving intangibles (e.g., R&D activities, marketing intangibles, and service provision using intangibles), and economic versus legal ownership. This project is still in the early stages, but the OECD has already made clear that, although the definitional issues regarding intangibles are still an important part of the project, the focus of the OECD is shifting towards providing guidance on whether a transfer has occurred and the corresponding pricing or valuation of those intangibles that have been transferred.

We believe that certain issues being addressed in this project may be relevant to financial institutions. In particular, aspects related to sharing expertise and best practices between affiliates, cost sharing arrangements, and (re)branding costs may be of particular relevance, both in the context of regular transactions and business restructurings.

2.3 Project on the administrative aspects of transfer pricing
On 9 March 2011, the OECD launched a project on the administrative aspects of transfer pricing. By commencing this project, the OECD seems to recognise the challenges that complying with the myriad transfer pricing legislations and documentation requirements poses to multinationals doing business in a large number of countries. Particular challenges in this area include inconsistent documentation requirements and information requests by tax administrations in different jurisdictions; lack of consistent treatment of inter-company services cost allocations; insistence on the use of the PSM when intangibles are involved; insistence by certain tax administrations for local comparables; and the lack of consistency among jurisdictions with respect to basic definitions. Therefore, the OECD has decided to revisit the issue of

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simplification measures and the guidance on safe harbours contained in Chapter IV of the OECD Guidelines.

According to the most recent guidance provided by the OECD, the project focuses on:

• various transfer pricing simplification measures and their effectiveness
• types of safe harbour regimes and how best to describe them and differentiate among them
• advantages and disadvantages of safe harbour rules and other forms of transfer pricing administrative simplification, in practice and from a tax policy perspective, and
• whether the existing guidance in Chapter IV of the OECD Guidelines on safe harbours should be revised, and if so how.

If, as a result of this project, the OECD endorses safe harbours or other simplification measures in the OECD Guidelines, it could set the stage for a more harmonised approach among domestic transfer pricing rules to these issues. This would certainly simplify compliance with the myriad transfer pricing requirements that financial institutions face on a daily basis and reduce the risk of double taxation.

2.4 Other projects
The OECD has also been focusing on a number of other projects likely to affect the financial services industry. Two important projects in direct taxation revolve around (i) tax cooperation and tax transparency, and (ii) exchange of information and confidentiality.19

With respect to tax cooperation, the OECD has created in 2010 an Informal Task Force on Tax and Development. The Task Force fosters the cooperation and dialogue between the OECD and developing countries, as well as other key stakeholders, such as NGOs, business representatives, and other international organisations. The Task Force focuses on four issues: aid effectiveness, transparency in financial reporting, transfer pricing, and exchange of information. The work on transfer pricing aims to build capacity in transfer pricing among developing countries’ tax administrations; protect developing countries’ tax revenues against non-arm’s-length pricing of transactions within multinationals; and provide a business environment conducive to cross-border trade.

The arm’s length principle has been under heavy scrutiny by NGOs and certain emerging nations. However, it is still endorsed by several major players in the global arena, such as the OECD and the United Nations. The most recent consensus seems to be that developing countries would benefit from more effective transfer pricing regimes. The involvement of the OECD and the creation of a common forum for discussion between the various stakeholders is a positive development likely to render more harmonised transfer pricing legislation and compliance requirements between developed and emerging nations.

Another important topic in the context of tax and development is country-by-country reporting of income and operating profit, advocated by several NGO representatives. As the discussion progresses, financial services institutions are encouraged to engage in this dialogue, to share best practices, and reiterate the need for common standards in an increasingly globalised world.

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Regarding cooperation among tax authorities, the increasing internationalisation of the review of multinationals' transfer pricing has raised the need for improved communication procedures between tax authorities, which, in turn, has resulted in a significant increase in the use of the exchange of information article included in most bilateral tax treaties. In addition, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, created under the auspices of the OECD and the Council of Europe and amended with effect as of 1 June 2011, is particularly relevant in transfer pricing because it provides for a single legal framework for joint tax audits, a new trend in tax administration. The amended version of the Convention applies to members of the OECD and the Council of Europe and non-members as a way to foster cooperation with developing countries and create a multilateral approach to the exchange of information.

Also, there is today a wide network of signed Agreements on Exchange of Information on Tax Matters between OECD and non-OECD countries, based on the model developed by the OECD Global Forum Working Group on Effective Exchange of Information. The model grew out of the OECD work on harmful tax practices.

These initiatives are applicable to all cross-border tax matters; however, given the particular focus by tax authorities on transfer pricing issues, the increase in cooperation between tax authorities is particularly relevant in the area of transfer pricing.
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Chapter 3 – Insurance

3.1 Introduction
In general, an insurance policy is a contract that binds an insurer to indemnify the insured party against a specified loss in exchange for a set payment, or premium. Insurance enables individuals and businesses to achieve economic security when faced with risks. An insurance company is a financial entity that assumes these risks and receives premiums as the compensation.

The insurance company uses the premiums to make investments and promises to compensate the insured for a specified uncertain event when it occurs.

The insurance company has two main sources of gross income associated with an insurance policy: premiums received from the insurers and investment income from the assets held. The insurance company's main expenses include loss and loss adjustment expenses, underwriting expenses, and expenses related to investments.

3.2 Overview
The insurance industry is typically distinguished into three categories:

1. The life and health industry (usually referred to as the ‘life’ or ‘long-term' insurance industry)
2. The property and casualty industry (usually referred to as the ‘P&C’ or ‘general’ industry)
3. The reinsurance industry

Life and health insurers concentrate on providing financial remuneration in the event of the policyholder’s death or illness. Life and health insurers also provide insurance-related services for which the insurer earns fees (e.g. large group health plans) and savings products with no or negligible elements of insurance risk.

P&C insurers generally insure the risk of financial loss arising from damage or loss of property through fire, theft, or third-party liability.

Within both insurance segments, a secondary industry has developed based on the concept of reinsurance. Reinsurance is best thought of as insurance for insurance companies, a way for a primary P&C or life/health insurer to protect against unforeseen or extraordinary losses. Essentially, reinsurance is coverage that a primary insurer (or ‘reinsured’) purchases from another company to protect itself from losses beyond a monetary amount that it believes it can safely disburse. This amount is normally called the reinsured’s net line. The reinsurance company, in turn, can engage in an activity known as ‘retrocession’. Retrocession is defined as a transaction in which a reinsurer cedes to another reinsurer all, or part, of the reinsurance it has previously assumed.

3.2.1 Structure
An insurance enterprise may be organised in one of many possible legal forms. The enterprise can take the form of stock insurers (those with share capital), mutual insurers (no share capital where policyholders are effectively the owners), cooperatives

\[20\] The expenses associated with settling losses, including salaries of claims adjusters, and legal fees.
(such as farmer cooperatives), and fraternal or affinity benefit societies (typically created by athletic associations, religious or ethnic groups).

The way in which insurance groups organise themselves, legally and operationally, as well as the way in which insurance group entities interact with each other (intra-group transactions), is of interest to insurance regulators, who seek to protect the interests of policyholders. Capital required in excess of the other liabilities and reserves in order to assume the risks described above is commonly referred to as ‘surplus’, and the surplus of assets over liabilities is commonly referred to as the ‘solvency margin’. Minimum levels of surplus are required by regulatory agencies based upon the lines of business of the insurer.

### 3.2.2 Functions, assets, and risks

The OECD provides practical guidance on the functions, assets, and risks of the insurance industry in Part IV of the 2010 OECD PE Report. A summarised overview follows.

#### 3.2.2.1 Product management/product development

This process comprises the design and structuring of the insurance product. Important components of product development include:

- Market research.
- Gathering and maintaining (claims) statistics.
- Legal stipulation of the extent of coverage.
- Mathematical calculation of the premium, depending on the features of insurance coverage (geographical, temporal, demographics, policy surrender and settlement options, investment returns guaranteed or anticipated in the pricing of the premium, and insurance excess options). As it relates to the general industry, the pricing/setting of premiums for the insured risks to be underwritten for new lines of insurance or products may be performed by the underwriters. However, this is generally not the case for life insurance products where premium rate tables are developed by actuaries.

In some cases, third parties may perform some of these functions by providing specialist services to insurance companies. Some third-party organisations compile claim statistics and make them available to member institutions. Other organisations use proprietary mathematical models and processes to produce data for use by their insurance clients in estimating the cost of claims resulting from the weather (e.g. flooding, hurricanes, hail) or other events. External brokers may provide market analysis and research and structure programmes to meet client needs.

#### 3.2.2.2 Sales and marketing

The sales and marketing function comprises various sub-processes, such as acquiring clients, assessing requirements, advising clients, and providing quotes and proposals. These functions can be carried out through a variety of channels that are both internal and external to the insurance company, including agents and brokers.

Insurance agents and brokers are intermediaries that insurance companies traditionally rely on to undertake sales and marketing functions by trying to cultivate potential clients and to create client relationships. The exact nature of the sales and marketing functions depends on the type of insurance. Generally, these intermediaries must be licensed to sell insurance in the jurisdiction in which they operate.
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- Agents consists of internal sales agents (internal sales force employed by the insurer), captive agents (or exclusive agents that represent a single insurer but are technically not its employees), and independent agents (which perform the same functions as captive agents but work for a number of insurers). An insurer may use one or a combination of these types of agents to distribute insurance products.

- An insurance broker may be retail or wholesale and deal with many insurers. A wholesale broker acts as an intermediary between a retail broker or agent and an insurance company underwriter. Wholesale brokers may also work with other wholesale brokers to secure coverage, or may be given authority by insurers to underwrite and ‘bind’ insurance companies (i.e. provide temporary coverage until an insurance policy can be issued by the insurer), provided that the prospective insured satisfies a specified profile. Generally, brokers are responsible for finding appropriate insurance coverage for their clients (i.e. purchasers of insurance) and obtaining the best overall price, terms, and conditions. Brokers may also suggest to clients other ways to transfer risk, such as self-insuring and other non-traditional insurance products. A broker may also have an agreement with an insurer to find potential policyholders. Companies in the international P&C business and the reinsurance business rely heavily on brokers to source or provide insurance. In many cases, these brokers are under fiduciary obligations to act on behalf of clients and buy insurance from many insurance companies. Such brokers may perform underwriting-related functions to facilitate the underwriting (e.g. by gathering information relevant to the insured risk, preparing the preliminary terms of a contract, and managing any claim). Thus, in many cases, brokers perform functions that go beyond sales and marketing.

- Comparatively, a MGA may perform tasks normally performed by an insurer, including subcontracting with independent agents for placement of business, negotiating commissions, handling claims, issuing policies, processing endorsements, and collecting premiums. In Canada and the US, MGAs act as a fronting system for insurers, allowing regulatory filings to be made and proof of insurance to be given in each other’s jurisdictions. They may also help in the placement of reinsurance contracts. MGAs may also arrange ‘programme’ business (i.e. specialty insurance for groups of policyholders, such as members of a specific industry). These programmes are often offered by trade associations and may cost less to the insured than individual policies. Typically, MGAs market more unusual coverage (e.g. professional liability) for which specialised expertise is required to underwrite policies. Such expertise is not always available within an insurer and is costly to develop in house. Currently, most MGAs focus on the excess and surplus insurance markets.

- The CRM functions serve to strengthen client relationships irrespective of whether claims payments are made in a certain period. Functions in the CRM field include ongoing analysis of the client’s insurance needs, adjusting requirements, preventing termination of policies, using cross-selling opportunities, and handling complaints. As a result of various economic and market factors, most notably innovations in technology and communication across the insurance sector, business today is generated through non-face-to-face marketing and sales. Aggregators have appeared (i.e. similar to brokers, but gather insurance quotes online), and consumers can generally purchase an insurance policy directly online (i.e. from an insurer) without the aid of an intermediary. Other virtual marketing activities include kiosk stands (e.g. travel insurance terminals at airports or bus stations) and mobile advertising. These methods are converging globally in many markets. For example, in the US, some companies offer face-to-face servicing through their personal digital assistants; in South Africa,

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21 P&C insurance sold to consumers through state-regulated insurance markets.
customers can receive policy information and quotes by text; in Canada, home insurance quotes for tenants can be obtained through smartphone applications.

Another distribution channel prevalent in almost all countries is ‘bancassurance’, the industry term for selling insurance products through a bank. Banks have bought hundreds of insurance agencies and brokerages or formed alliances with such entities, with the result that bank sales of insurance have grown significantly. However, bancassurance takes on different forms in each country, based on limitations imposed by banking and insurance regulations and cultural norms.

Life insurers have expanded to financial planning and wealth management services. Further, a large portion of variable annuities, which are based on securities, and a smaller portion of fixed annuities are now sold by stockbrokers, wealth managers, and financial advisers, some of whom are affiliated with insurers.

Insurers are also now partnering with entities such as workplaces/worksites, associations, car dealers, real estate brokers, pet shops, travel agents, and funeral homes to make their products available. Specialised insurance products (e.g. travel, funeral, and professional liability insurance) are typically marketed and sold through these entities.

3.2.2.3 Underwriting insured risk
Underwriting is the process of classifying, selecting, and pricing the insured risks to be accepted. Again, the exact nature and importance of these functions (and who performs them) varies depending on the type of insurance product and the facts and circumstances of the insurer.

A number of activities can be part of the underwriting process, including:

- Setting the underwriting policy.
- Risk classification and selection.
- Pricing.
- Risk-retention analysis.
- Acceptance of insured risk.

Factors that may influence the underwriting practice are:

- Financial capacity of the company, essentially its surplus.
- Regulatory framework concerning the maximum risk capacity.
- Technical skills and abilities of personnel.
- Availability and cost of third-party reinsurance.
- Strategic business goals.

The basic requirements are the classification of insured risks based on selected criteria and the use of relevant statistics. For standardised products, this procedure may be, to a certain extent, automated. In the case of complex contracts, the process is complicated (i.e. comprehensive insured risk verification) and requires strong specialist skills (e.g. insured risk engineering, explanation of judicial, medical, and physical implications).

3.2.2.4 Risk management and reinsurance
Risk management involves insurance risk and investment risk. It also may take place on a strategic level or a more active, operational level. Insurance risks are often the most important risk elements, although risks associated with investment may be just
as (or more) important, particularly in the case of longer-term business. To manage these risks, insurers have a comprehensive range of risk management tools (including claims adjustment policy, portfolio policy, reinsurance policy, and investment policy, such as ALM).

The risk management function also comprises capital management, i.e. establishing and maintaining a capital management process (including the setting of target rates of return on capital and monitoring progress against those targets), and performing the capital allocation to the various lines of business and parts of the organisation (considering, among others, the solvency regulations and capital requirements). Accordingly, capital management and allocation is a highly complex area.

Of central importance to the risk management process is the decision whether to use reinsurance to manage the insurance risk exposure of an insurance company.

From the reinsurer’s perspective, its functions relative to insurers are broadly similar to those of primary insurers relative to policyholders. Thus, the reinsurer diversifies the risks that are ceded to it by multiple insurers and, in turn, may cede risks to other reinsurers. The reinsurer has a sales function (e.g. through performing marketing activities), performs underwriting activities (e.g. by accepting ceded risks from insurance companies and determining reinsurance premiums), and performs pooling activities (e.g. by pooling the risks ceded to it by multiple insurance companies and undertaking similar risk management activities as described for insurance companies herein). A reinsurance company may decide to (retro)cede risks that it does not want to bear.

New methods of risk financing (ART) are aimed primarily at overcoming the barriers to insurability, and secondarily at optimising the management of the insurance risk from the point of view of diversification and cost. The most common form of ART is the catastrophe (CAT) bond. This offers a high coupon subject to a specified but infrequent insurance event (e.g. an earthquake). If the event occurs, the investor’s return is reduced or eliminated; and, in the riskier bonds, part or all of the coupon (and possibly part of the principal) may be lost.

3.2.2.5 Contract and claims management
This function includes the monitoring of a contract over its life cycle, as well as maintaining accounts on premiums, claims reserves, and commissions. Claims management includes all the activities related to a client’s claim, including processing the claims report, examining coverage, handling the claim, and seeking recovery.

3.2.2.6 Asset management
Investment managers carry out the asset management functions of the insurance business. They make investments out of the reserves and surplus that the company maintains and monitor the risks associated with those investments. Insurance companies invest mainly in fixed-income-type of assets.

Asset management may be carried out in whole or in part by third parties. This may be the case even for large insurance companies with their own in-house asset management group.
3.2.2.7 Support processes
An insurance business must also undertake a number of support functions, some of which are particular to the industry, while others are of a more general nature. Important support functions include:

- The Treasury function may hedge investments to make sure that cash flow is secure and to make sure that the timing of investment income meets cash flow requirements. It is responsible for cash management, such as borrowing funds on the most advantageous terms possible.
- Regulatory compliance (e.g. monitoring assets and liabilities, often on a daily basis to make sure that the surplus requirements of regulators are met).
- Systems and development of intangibles (e.g. development of information technology and systems that can be used to determine pricing and calculate reserves, advertising, and claims experience data).
- Other back-office activities (e.g. premium handling, accounting, auditing, legal services, and training).
- Loss control tries to prevent those losses that can be prevented, minimise those that cannot be prevented, and verify valid claims or deny claims for uninsured losses. The loss control department provides input to the underwriters and marketers.
- Credit analysis assesses the creditworthiness of the enterprise’s various counterparties, including reinsurers, policyholders, and persons in whom investments are made.

3.2.3 Key assets
For insurance companies, the most important assets used are investment assets that generate a return in the form of interest, dividends, rents, and capital gains. Investment assets include debt instruments, stocks, derivatives, real estate, policy loans, and cash. Certain assets are technically not investment assets but are receivables that will be converted to cash in the short term, such as due and accrued premiums to the extent included in the calculation of reserves, investment income due, and accrued and reinsurance recoverable.

Common intangible assets include marketing intangibles (such as brand name and trademarks) and licenses to sell insurance in various markets obtained at the cost of complying with regulatory licensing procedures.

Intangible assets may also include trade intangibles, such as underwriting tools and proprietary accounting and risk monitoring systems.

3.2.4 Key risks
Significant risks to insurers are generated from technical liabilities that relate to the actuarial or statistical calculations used in estimating liabilities. Risks also arise from performing functions relating to underwriting, investment, and risk management. Risks that arise from investment and financial operations include market and credit risk.

Other risks include:

- Foreign exchange rate risk arising from writing international business.
- Liquidity risk – The risk that assets need to be liquidated at unfavourable conditions if cash is needed immediately to meet unexpected obligations to policyholders.
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- Reputation risk – In many markets intermediaries serve as important distribution channels of insurance; as an interface between consumers of insurance and providers of insurance, their conduct may affect the insurer.

Some risks particular (or more significant) to the life and health insurance lines include:

- Asset default risk – The risk of loss resulting from on-balance-sheet asset default and from contingencies in respect of off-balance-sheet risks and related loss of income.
- Mortality and morbidity risk – The amount and timing of death and disability benefits paid.
- Longevity risk – Increase in longevity increases aggregate payouts on annuities with life contingencies.
- Interest rate risk (i.e. asset/liability mismatch risk) – Changes in interest rates that may cause an insurer’s assets to lose value or yield relative to its liabilities.
- Persistency/lapse risk – Occurs if policyholders surrender their policies before prepaid (front-end loaded) expenses are recovered.
- Cash flow risk – Policies contain embedded options (e.g. to offset minimum interest payment guarantees).
- Guarantee and option risk – The risk of loss arising from guarantees and options.

3.3 Transfer pricing considerations

3.3.1 Attribution of profits to insurance branches

In general, attributing profits to insurance branches should follow the principles outlined within Part IV of the 2010 OECD PE Report. The most important aspect of the 2010 OECD PE Report is the recognition of the underwriting function, which results in the assumption of insurance risk, as the only KERT function for insurance companies. Premium income arising under the policy and the claims paid out under the policy are attributed to the location that performs this function in respect of a policy or a reinsurance treaty. Consequently, it is necessary to attribute the required reserves to that location to meet the expected claims along with attribution of adequate surplus to cover the risk that actual claims may exceed the reserves. In addition, the investment income on assets equal to the reserves and surplus must also be attributed to the PE.

3.3.1.1 Reinsurance and branches

Internal reinsurance is not recognised as a risk transfer within a single legal entity. The performance by one entity of the risk management function does not transfer the economic ownership of the insurance contract to that entity; rather, it is viewed as a service that should be compensated on an arm’s length basis.

3.3.1.2 Asset management and branches

The KERT function of underwriting requires the attribution of investment assets to the location of the PE performing this function in whole or in part. It follows that a branch that does not manage its own assets should provide arm’s length compensation to the entity that provides investment management services. The investment management function is further discussed in Part III.

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Note: The underwriting may be performed in more than one location and, therefore, the KERT function may be split among multiple entities.
3.3.1.3 **Intra-group services and branches**
The methodology used for charging intra-group services to branches should be consistent with that used for charging related subsidiaries, which may include a mark-up or profit element.

3.3.1.4 **Intra-group financing and branches**
In contrast to subsidiaries, branches share the same credit rating as the insurance company as a whole. The OECD does not recognise capital arrangements where a head office has provided an internal guarantee to a PE. Branches are attributed capital to support their activities.

3.3.1.5 **Intangibles and branches**
Part IV of the 2010 OECD PE Report recognises that branches may benefit from brands and other intangibles and thus should be charged accordingly. This approach is not consistent with certain domestic legislation and jurisprudence, which does not allow the deduction of notional expenses, such as royalties, paid to the head office.

3.3.2 **Intra-group reinsurance**
Reinsurance tends to be one of the most material intra-group transactions within insurance groups.

If the insurance company that issued the insurance policy does not want to keep all of the risk it assumed, it transfers a portion of it to a reinsurer or several reinsurers. A reinsurer, in turn, may choose to limit the risk it carries by purchasing reinsurance from another reinsurance company. This mechanism is called ‘retrocession’.

There are various types of reinsurance, each tailored to meet a particular need. Reinsurance participation falls under one of two categories: proportional and non-proportional reinsurance. The pattern of loss coverage sharing under proportional and non-proportional reinsurance is very different. Participation in proportional reinsurance is predetermined. Participation in non-proportional reinsurance depends on the size of the loss or a time event.

Insurers and reinsurers typically choose to transfer part of their responsibility to manage a portfolio of risks based on four basic purposes:

- Increase a company’s capacity to write business.
- Stabilise underwriting results.
- Protect against catastrophic losses.
- Finance growth.

In a group situation, the commercial motivation to enter into a reinsurance arrangement with another group company can also include:

- Capital efficiency.
- Pooling/diversification of risks.
- Coordination of external reinsurance procurement.
- Ratings agency requirements.
- Centralisation of specialty underwriting/risk management.
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Determination of the most appropriate transfer pricing methodology is determined by:

- commercial objectives of the reinsurance
- relative bargaining position of the cedant and reinsurer
- type of reinsurance, and
- availability of CUPs.

It is important that the insurer document the business purpose or commercial rationale supporting the decision to internalise reinsurance activities (i.e. rather than use external reinsurance), including the rationale for transferring the specific portfolio of risk or policies covered by the reinsurance contract. Tax authorities may attempt to re-characterise such a transaction if it is clear that third parties would not enter into such an arrangement. The importance of this principle is highlighted in the OECD’s Report on the Transfer Pricing Aspects of Business Restructurings, published 22 July 2010.

CUPs are seldom available in the case of reinsurance transactions. Although internal and external contracts may be of the same type of reinsurance and cede similar percentages of risks (e.g. 70-30 quota share), the portfolio of risk being transferred, capital needs of the cedant, and the economic circumstances (at the time a contract is negotiated and entered into) differ in every transaction. As such, the assumptions used in pricing the reinsurance and the pricing terms negotiated under each contract often differ and may not be comparable to other contracts. Any CUPs to be used must be closely reviewed for comparability and, if possible, reasonably reliable adjustments must be made to improve comparability.

3.3.3 Insurance group financing methods

Owing to the legal and regulatory framework surrounding the insurance sector, a number of financing methods common within the insurance sector are much less common in other industries.

Balance sheet strength is clearly paramount for an insurance company, particularly for products/customers where a minimum threshold credit rating is required to compete in the market. Balance sheet support may be provided by one (or more) insurance company to another in a variety of ways, including:

- Claims/performance guarantees, whereby an insurance company of superior financial strength makes a contractual commitment to guarantee the performance of an affiliate in relation to a specific insurance contract. The benefits enjoyed from such a guarantee can vary. The guarantee might be a prerequisite for doing business (i.e. no business could be written without it) or it might increase the attractiveness (and potentially the volume/prize/profitability) of the insurance being written. The guarantee may also tie up the capital of the provider, which will have an opportunity cost that also needs to be taken into account in considering an appropriate transfer price for this kind of guarantee fee.

- Net worth maintenance agreements, whereby an insurance company of superior financial strength makes a contractual commitment to ensure that the capital levels of an affiliate will not be allowed to fall below a threshold level, thus guaranteeing a minimum financial strength of the affiliate. In principle, the benefits enjoyed from this type of support might be considered to be equivalent to those of the claims/performance guarantee above. However, as the form of support is specific to the maintenance of capital, it is not uncommon for these types of arrangements to be categorised as ‘shareholder support’.
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- **LoC**, whereby a bank provides a letter of credit to an insurer, which may qualify as (contingent) capital for regulatory purposes, in return for a LoC fee. LoCs are common in the Lloyd’s market and are increasingly being considered as ‘innovative’ capital elsewhere in the insurance sector. In many cases, the LoC arrangements are centralised within the group. Transfer pricing issues arise when considering the on-charging for centralised LoC facilities, where the ultimate recipient enjoys a different credit strength than the centralised provider. The LoC ‘arranger’ may or may not provide collateral for the LoCs. The issues arising from these credit strength differentials, in combination with the contingent off-balance-sheet nature of the LoC arrangements, make them a particular challenge to define and resolve.

- **Contingent loans**, whereby an insurer borrows money from another company and makes principal and interest repayments only from surplus (or profit) as it accumulates in the insurer’s accounts, or in a defined book of business held by the insurer. In this way, loan repayments are contingent on the emergence of future surpluses and the insurer is able to ignore that contingent repayment obligation in valuing its liabilities.

- **Quota share reinsurance**, whereby an insurance company of superior financial strength makes a contractual commitment to reinsure a proportion of the original business written by an affiliate. For certain types of insurance requiring a particularly strong balance sheet, the proportion might be in excess of 90%. Such reinsurance raises a number of issues, including the calculation of ceding commission or profit commission, consideration of the potential capital inefficiency of such high levels of reinsurance, evidencing the commercial imperative (e.g. from ratings agencies or analysts) of such high levels of reinsurance, and evidencing the overall capital/commercial optimisation.

### 3.3.4 Sales, marketing, distribution, and origination

Insurance companies sell insurance to customers through a number of marketing channels. In the context of cross-border activities, the transfer pricing considerations are varied and potentially complex, depending on the route to market, the type of product, and the business operating model.

Some examples of the types of business operating models that affect the consideration of insurance sales, marketing, distribution, and origination are:

- **Decentralised model** in which each jurisdiction operates independently.
- **Centralised underwriting and sales** with limited overseas marketing and advertising.
- **Centralised underwriting and sales** with overseas call centres.
- **Centralised underwriting with overseas sales via independent brokers** – overseas activity of the insurer is limited to liaison with the independent brokers.
- **Centralised underwriting with overseas distribution by subsidiaries and affiliates**.
- **Centralised provision of capital with overseas delegated underwriting authority** (equivalent to a coverholder at Lloyd’s or an MGA).

The type of product is also an important consideration, with some products requiring highly specialised underwriting and, at the other end of the spectrum, commoditised products that are heavily dependent on marketing and brand differentiation.

Internal comparables may exist, but care should be taken in comparing different jurisdictions, where the regulatory environment and the market forces can vary considerably from country to country. For example, to determine whether an insurer’s independent agents are comparable to the internal sales force, factors to consider include respective market segments, products sold, and the amount of support.
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received from the insurer. Functions performed also must be compared. If they are similar, the pricing for third-party intermediaries may be used as an internal CUP for benchmarking purposes. Where no CUPs are available, the distribution function may be compensated using a cost plus or a commission arrangement, derived and calculated by reference to a TNMM approach.

Traditionally, most insurance products have been sold directly (i.e. one-to-one) by an agent or broker. However, with continuing development of telecommunications, it is becoming more common for one part of the enterprise to advertise or ‘market’ products on behalf of the entire enterprise or other specific parts of it. The customer may be directed to approach a part of the enterprise other than the marketer in order to contractually commit to purchase the product and, if the business is underwritten by the other part of the entity, the ‘sale’ is generally booked there (although the same effect could be achieved if the premium payments are received by the marketer and passed on to the underwriter less a commission to reward the marketing function). Subsequent premium payments may similarly be made to parts of the enterprise other than the ‘marketer’.

Potential transfer pricing issues with respect to such distribution models include the use of technology platforms or information systems that are developed and maintained in one jurisdiction and used by entities located in other jurisdictions; or when a specific distribution model developed for a particular market is subsequently exported to another market.

With respect to bancassurance, functions of the related-party arrangements (between insurance and banking business units of a conglomerate) and arm’s length arrangements must be compared and investigated regarding whether they can be used as internal CUPs for benchmarking purposes. Further, under arrangements in which entities are sharing their customer base, consideration should be given to whether ownership of the customer base is transferred from one business unit to another, or shared with one or more entities managing customer relationships, and whether compensation is appropriate for sharing this intangible. In the absence of a CUP, contributions by each party to the distribution arrangement should be carefully analysed as to the level and value of contributions to determine the appropriate transfer pricing methodology to be applied.

An insurance company that sells insurance in a country through agents may have a PE in that country if the activities conducted by those agents fall within the definition of a ‘dependent agent’ under Article 5(5) of the OECD Model Tax Convention. However, an insurance company that sells insurance through an agent of ‘independent status’ would not be deemed to have a PE in that country through the agent’s activities, provided it is ‘independent’ within the meaning of Article 5(6) of the OECD Model Tax Convention. Some bilateral conventions include a provision that stipulates that insurance companies have a PE if they collect premiums in that country through an agent.

As a final point, it is necessary to consider fronting. Fronting is a term that describes a specialised form of reinsurance frequently used in the captive insurance marketplace. Fronting occurs with third parties where an insurance company (the insurer or captive insurer) asks a third-party insurer (the fronter) to write an insurance policy, typically in a country in which the insurer does not have the requisite license. The fronter then reinsures up to 100% of the risk to the insurer, typically receiving a fronting commission in return. However, the fronter assumes a credit risk because it is required to honour the obligations imposed by the issued policy if the insurer fails to
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indemnify it. Fronting may also occur within groups, particularly where there is heavily centralised and/or specialised underwriting.

**Figure 1**

**Forms of fronting**

<table>
<thead>
<tr>
<th>Reinsurance captive</th>
<th>Direct captive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner/insured</td>
<td>Owner/insured</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Reinsures to captive</td>
<td>Captive issues policies, arranges claims-handling services and retains risk at agreed level</td>
</tr>
<tr>
<td>Captive (owned by insured)</td>
<td>Reinsures risk in excess of its desired retention</td>
</tr>
<tr>
<td>Retrocedes risk in excess of its desired retention</td>
<td></td>
</tr>
</tbody>
</table>

In its most common form, known as the ‘reinsurance captive’, a third-party commercial insurance company (i.e. the direct insurer or fronting company) licensed in the jurisdiction where the risk to be insured is located issues its policy to the insured. That risk is then fully transferred to a captive insurance company (domiciled in another jurisdiction) through a reinsurance agreement. Thus, the insured obtains a policy issued on the paper of the fronting company. However, economically, the risk of that coverage resides with the captive insurance company. The captive insurance company is ultimately owned by the insured.

Another form of fronting involves a captive serving as the fronting company and issuing a policy directly to the insured parent company; the risk is then fully reinsured to one or more domestic or foreign reinsurers. Consequently, the fronting captive does not retain any of the risks and the parent company has gained access to the reinsurance market. In this case, the reinsurers would not have been legally able to write the risk directly.

The functions of the fronter can vary, depending on the relationship between the fronter and the insurer. Regardless of the existence of a third-party fronting company, transactions among the parties to a fronting arrangement can potentially present a transfer pricing issue. A fronting arrangement is often scrutinised by revenue authorities, as captives are normally located in tax haven or low-tax jurisdictions, putting into question the soundness and reasonableness of the arrangement. As such, the business rationale of a fronting arrangement should be considered and documented for all parties involved. Further, care should be taken in considering the comparability of potential internal CUPs from third-party fronting arrangements.
3.3.5 Insurance and support services

3.3.5.1 Actuarial support and modelling
Actuarial support and modelling involves the provision of services such as evaluating and managing insurance risk exposure, modelling of insurance risks and financial projections, pricing of insurance and reinsurance transactions, and serving as expert witnesses in the event of litigation.

Additional services include assisting regulatory entities with the examination of insurance operations and risk transfer programmes, financial/cost analyses of existing insurance programmes, formation of captive insurance programmes, risk-retention groups and self-insurance programmes, and testing the adequacy of loss and loss-expense reserves.

Insurance companies may have a service company within the insurance company that provides these services or may outsource them to third parties.

Issues may arise from the pricing of insurance and reinsurance transactions in ensuring that the appropriate remuneration for these services is paid or received.

3.3.5.2 Product development
Products are often developed in the insurance industry based on clients’ needs; however, the aim of product development is to develop or modify products at a faster rate and in a more cost-effective manner than one’s competitors.

Unlike other industries, new products in the insurance industry often begin with drawing up new contracts, which have to be read and written from a legal and transfer pricing compliance perspective.

If the insurance contracts are not drawn in compliance with the relevant tax jurisdictions, penalties could result as the transactions may not be at arm’s length.

3.3.5.3 Policy and claims management
Insurance companies either establish a claims department or outsource claims management to third parties. Matters relating to claims and policies are handled via phone, Internet, fax, or email.

The claims management team also collaborates with insurance underwriters to analyse loss trends and perform cost analysis. Where necessary and when requested, the insurance company may also modify clients’ policies.

In cases where claims involving related-party cross-border transactions are paid out, there could be potential transfer pricing issues regarding the arm’s length nature of the claims paid.

3.3.5.4 Asset and liability management
Insurance companies receive premiums from their customers and invest these premiums to ensure that the policyholders’ claims can be paid. Some companies may have a division that performs asset management functions or companies may outsource these functions to third parties. Insurance companies often manage assets acquired from their core business or other sources, such as the acquisition of real estate.

Real estate properties are the most common assets acquired by insurance companies. Prior to purchasing a property, research is conducted on the best location based on the
preferred criteria. Most insurance companies focus on the purchase of large-scale real estate for commercial and residential purposes.

Due to the large size and complex nature of assets held and managed by insurance companies, customised solutions are often created on a case-by-case basis to adequately manage these assets.

In managing liabilities, on the other hand, insurance professionals develop customised strategies to help clients manage their liabilities with the aim of minimising risks.

Issues may arise from ensuring that the appropriate remuneration for asset management services are paid or received. As publicly available data on insurance companies are mainly for small companies, it is sometimes difficult to benchmark the appropriate remuneration to be paid or received for the assets managed. The transfer pricing aspects of asset management are discussed in detail in Part III.

3.3.5.5 Financial risk management
Risk management is often undertaken by a team of specialised professionals in insurance companies that develop strategies to manage financial risks specific to the business.

Risk management also involves human capital consulting, insurance and reinsurance brokerage consulting, and often takes the form of advice, benchmarking, and the provision of the latest information and insights.

Issues may arise in ensuring that the appropriate remuneration for these services is paid or received.

3.3.5.6 Non-insurance-specific services
Insurance companies often provide non-insurance services, for example, investment in financial instruments such as annuities. Insurance companies customise these products to their clients’ tastes.

Companies should ensure that the rates charged on annuities and other investments relating to related-party cross-border transactions are at arm’s length.

3.4 Recent developments
3.4.1 European regulatory environment
The move towards consolidated capital regulation, particularly in the EU, has forced insurers to consider their underlying capital requirements and legal structure more carefully. In 2009, the EU decided on a directive (Solvency II), which introduces economic risk-based solvency requirements. The new solvency regime is expected to become effective in 2013. A number of other jurisdictions are considering Solvency II equivalence.

As the insurance industry becomes more global and insurance groups are revisiting their operational structures with the focus on optimal use and deployment of capital, an increasing number of groups are choosing to exploit the advantages of an international branch network. A branch structure provides additional strategic leverage in the case of local customers, placing a premium on having the capital of the head office support the risks insured by the local branch. In certain jurisdictions, branches of foreign insurance companies are typically treated as corporations for tax purposes, but may be subject to separate tax rules, depending on local regulations. Within Europe,
under the European insurance passport regime, an insurer can have a home office in one of the countries of the EEA and have access to the market throughout the entire EEA subject to only one regulator, one capital requirement, and one set of audited financial statements. For an insurer domiciled in one of the EEA countries, no separate licences are required to establish branches in other EEA host states.

The capital required under the single passport entity is generally less than that required by operating in a separate corporate form in each jurisdiction, and the costs associated with multiple regulators are reduced.

3.4.2 Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173)

On 21 July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) (the Act), which has important implications for financial institutions. The legislation prohibits financial institutions from engaging in proprietary trading activities, grants the government the tools necessary to aid troubled financial institutions, and increases federal oversight of the regulation of financial activities. Although much of the Act is focused on the banking industry, there are changes that impact the US insurance industry as well. The Act established the FIO, a body that monitors the P&C insurance and reinsurance markets. The FIO also is responsible for identifying regulatory gaps, dealing with international insurance matters, and monitoring the extent to which underserved communities have access to affordable insurance. Although the FIO does not have supervisory or regulatory powers, it does have the power to work with other countries and preempt certain state regulations with respect to specific international insurance matters.

3.4.3 Proposed disallowance of deduction for non-taxed reinsurance premiums paid to affiliates

The OMB released a proposed federal budget for fiscal year 2012 (the Budget), and the US Treasury Department released its General Explanation of the Administration’s Fiscal Year 2012 Revenue Proposals (the Greenbook) on 14 February 2011. One of the proposals under the Greenbook limits deductions for reinsurance premiums paid by a US insurance company to its foreign affiliates. This proposal is similar to the earlier released budget proposal by Congressman Richard Neal on 31 July 2009, known as the Neal Bill.

The proposal would (i) deny an insurance company a deduction for reinsurance premiums paid to an affiliated foreign reinsurance company to the extent that the foreign reinsurer or its parent company is not subject to US income tax with respect to the premiums received; and (ii) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to the reinsurance policies for which the premium deduction is wholly or partly denied.

A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of trade or business in the US and attributable to a PE for tax treaty purposes. If passed into the law, this provision would be effective for policies issued in taxable years beginning after 31 December 2011.
3.5 Conclusion

Insurance groups may be involved in several inter-company transactions. Depending on the structure and composition of the groups, transfer pricing issues may arise with regard to the appropriation of profits among branches, the pricing of intra-group reinsurance, or the determination an arm's length price for support services. This chapter has outlined key functions performed by insurance companies and discussed various factors that can assist in establishing transfer pricing policies for such entities.
Part III: Investment management
Chapter 4 – Traditional funds

4.1 Introduction
The investment management industry comprises a highly developed range of businesses operating within the financial services sector. In broad terms, these businesses are involved in the management of investments made by different types of investment vehicles, each with their own defined investment objectives. The aim of these investment vehicles is to obtain capital from investors and to generate profitable returns on that capital for those investors. The investment objectives of the vehicles vary according to such factors as the type of market the vehicles operate in, the amount of capital the investment vehicles are seeking from investors, and the type of investor.

The investment vehicles are managed by an investment manager. Although, more frequently now, a number of other entities provide services to the investment vehicles.

The main categories of investment vehicles covered by this section are traditional investment management funds (traditional funds), private equity/venture capital funds, hedge funds, real estate funds, and sovereign wealth funds. More specifically, this chapter provides an overview of the transfer pricing issues associated with the operation of traditional funds.

4.2 Overview
4.2.1 Key features
Traditional fund vehicles include pooled funds sold to individual investors (i.e. retail funds or mutual funds), funds sold to corporate investors (i.e. institutional funds), and funds sold to high-net-worth individuals. Features common to all types of traditional investment management funds include:

- Investments are typically made on the basis that long-term returns are anticipated.
- The use of short positions or leverage is limited or explicitly banned in fund prospectuses.
- The aim is to achieve good returns with moderate risk.
- Funds are regulated by financial authorities (although generally more so in the case of retail funds than other types of funds).

The key types of assets that investment managers of traditional funds manage are:

- **Equities** – Over an extended period of time, equities have historically produced higher returns than other forms of investment, while the equity markets as a whole are generally less volatile than individual equities.
- **Bonds** – The various types of bonds can be broadly categorised into government bonds and other forms of bonds (corporate bonds, foreign bonds, and Eurobonds). They are generally considered to produce a safe, relatively low return.
- **Commodities** – Investments in commodities are primarily focused on energy or precious metals (e.g. gold, silver), and are almost always investments in commodity futures, as it is usually less costly than purchasing and storing the actual commodities themselves. Other commodities, such as agricultural products (e.g. wheat, soybeans) or metals used for industrial purposes (e.g. copper) tend to be less popular for investment purposes.
The two basic strategies for traditional funds are:

- **Active funds** – Aim to beat the market index by picking the best performing assets (whether measured in growth, value, or through some other indicator).
- **Passive funds** – Aim to match the performance of an index by tracking the assets that comprise that index.

Regulatory requirements and restrictions for traditional fund products exist throughout the world. Such regulations typically govern a range of matters relating to investment management, which may include:

- Products that may be sold.
- Classes of investor to which products may be sold.
- Activities for which a license is (is not) required from the regulatory body.
- Number of licenses that may be issued.
- Local compliance requirements, including internal procedures and reporting to investors.
- Minimum capital requirements for entities engaged in certain types of activities.

Where there are transactions between related parties in relation to a particular traditional fund (e.g. between the portfolio manager and the distributor of a particular fund), the differences in each of the features listed above – namely type of investor, asset class, strategy, and regulatory environment – have an impact on the transfer pricing. For example, the role of the distributor may have greater importance for retail funds than institutional funds, given that investors in the latter case tend to be more sophisticated and knowledgeable about the investment management industry and the types of available products. Indeed, there may even be no distributor in an institutional fund situation, whereas there is generally at least one distributor – or even more – in the case of retail funds.

Likewise, the fee paid for the portfolio management function may be greater in the case of an active fund than a passive fund, given the greater focus on decisions made by the portfolio manager as to which assets to select.

### 4.2.2 Key participants

Within the investment management industry, and particularly for traditional funds, a number of parties are involved in the investment process, including:

- **Portfolio managers** – A portfolio manager manages the investments of a fund. A fund may appoint a single portfolio manager, or may appoint a range of portfolio managers with specialist expertise in particular areas of investment where the asset class of the fund is varied. The portfolio manager can be an individual, a firm, or a committee that is responsible for making day-to-day decisions to buy, hold, or sell assets.

  Portfolio managers can have considerable influence on the financial markets because of the weight of money behind them. If they decide to move funds out of a sector, or out of a company in a sector, their decision can affect the price of shares in a way that the decisions of private investors rarely do (except for the smallest stocks).

- **Sub-advisers** – A sub-adviser provides investment advice to the portfolio manager or client investor and in some cases may even place trades on the portfolio manager’s behalf in securities and other investment products.
Part III: Investment management

- **Fund administrator** – A fund administrator may contract with the portfolio manager and conducts all administrative functions involved in managing the investment, including calculation of monthly NAV and reporting to investors.
- **Broker** – A broker is an agent who executes trade orders from the portfolio manager (or in some cases the sub-adviser) to buy and sell assets in the fund, and charges a commission for this service.
- **Custodian** – A custodian is a bank or other institution that holds the assets purchased by the fund (i.e. the securities) on behalf of investors. Custodians are typically used by funds or institutional investors that do not wish to leave their securities on deposit with their broker-dealers or portfolio managers. By separating the duties of the participants in this manner, the use of custodians reduces the risk of fraud.
- **Investor** – The typical investment sources for traditional funds include:
  - Retail investor – An individual. Funds that market to retail investors are heavily regulated, with strict reporting and management criteria to protect the public.
  - Institutional investors – Entities with significant funds to invest, such as investment companies, insurance companies, pension plans, investment banks, and endowment funds.
  - Private clients – High-net-worth individuals. Many private client portfolios are managed by investment management companies through separate accounts.

Among these participants, there may be a greater or lesser degree of inter-company transactions requiring transfer pricing analysis. For example, a custodian is often unrelated to the portfolio manager simply by definition of the role of the custodian, which – as noted above – is to reduce the risk of fraud through separation of responsibilities. In contrast, the portfolio manager and sub-adviser of a traditional fund often (although not always) share a controlled relationship for transfer pricing purposes.

### 4.2.3 Typical fund structure

An example of a simple structure of a typical traditional fund and the investment management group responsible for managing that fund is outlined in Figure 2.

The lead portfolio manager has an investment management agreement with the fund and is therefore ultimately responsible for all fund management and operational decisions. Even if the lead portfolio manager is also the promoter of the fund, in most jurisdictions the fund and the lead portfolio manager should not be considered to be related parties for transfer pricing purposes, due to separate ownership and separate boards.

Depending upon the size and scope of the investment management business, the lead portfolio manager may outsource various functions, such as portfolio management (i.e. to a sub-adviser), distribution, and administration activities, to affiliates based in jurisdictions within which it invests.

Where the activities of an investment management group are decentralised, the transfer pricing between the lead portfolio manager and those local affiliates based in key investment jurisdictions will likely be a primary focus for tax authorities.
Part III: Investment management

Outline of structure

- ‘Entrepreneur’ company houses key decision makers, who are responsible for the management, direction and control of the fund management business (both the distribution and investment management elements of the business)
- Fund has investment management agreement with entrepreneur company
- Local related-party distributor performs day-to-day selling activities
- Local related-party sub-advisor provides sub-advisory services to the entrepreneur company in relation to a specific mandate or portion of assets

4.2.4 Remuneration received by the portfolio manager

Fees for managing funds are typically charged by the portfolio manager on an ad valorem basis (i.e. as a percentage of NAV) depending on:

- asset class
- nature of the funds in which the investment is made
- investment profile of the fund
- investment objectives/strategy, and/or
- agreed ratio in the prospectus.

This can give rise to a number of charges for investors, including:

- **Front-end loads** – A charge made on the monies committed by an individual investor upon entering the fund and paid by the investor (sometimes called upfront commissions).
- **Management fees** – Remuneration for investment management functions performed by the portfolio manager, and usually, but not always, paid directly by the fund to the portfolio manager. Fees vary depending on the underlying assets and investment strategy of the fund, and are generally higher for retail investors (typically between 0.5% and 2% of NAV) than for institutional investors (typically up to 1% of NAV).
- **Performance fees** – Fees paid in addition to management fees as an incentive to the portfolio manager for performance, usually expressed as a percentage of increase in value of the fund. Performance fees are less common in the traditional investment management sphere than for alternative investment management (such as hedge funds and private equity/venture capital funds).
Chapter 4 – Traditional funds

Part III: Investment management

4.3 Investment management value chain

The following diagram provides a broad overview of key components of the value chain of a traditional investment management group.

![Investment management value chain](image)

Each of the above activities is discussed in further detail in the following sections.

4.3.1 Functions involved in a traditional fund

Typically, a traditional fund raises capital from external sources, invests that capital in equities or bonds, sells those investments, and returns the proceeds to the external investors.

The transfer pricing arrangements between the portfolio manager of such a fund and its worldwide affiliates ultimately depends on the functions performed, risks assumed, and capital or other assets used in each of the jurisdictions in which the investment management group operates.

The following sections outline some of the key functions performed, risks assumed, and assets used within an investment management group for traditional funds, before moving to consider the transfer pricing analyses available for transactions between the members of such a group.

4.3.1.1 Fund administration

Fund administration includes accounting and daily NAV valuation services, administrative, and other corporate services associated with the fund. In recent years, fund administration has become increasingly complex due to the increase in regulatory requirements for traditional funds. However, fund administration is still generally regarded as a low-risk function.

4.3.1.2 Trade execution

Once a portfolio manager has made a decision as to which assets to invest in or dispose of, he or she places an order with a broker to buy or sell those assets. While the function of trade execution requires precision and care in ensuring that each order is placed as
instructed by the portfolio manager, generally the broker has no discretion to amend or adjust that order (although they do have some limited discretion as to how the order is placed, i.e. timing and pricing of the order). Accordingly, as with fund administration, trade execution is generally regarded as a routine function in the investment management value chain.

4.3.1.3 Portfolio management

The actual undertaking of management or advisory activities is generally considered to be one of the two main value drivers of an investment management business (the other being capital raising).

Broadly, portfolio management refers to the execution of the fund’s strategic aims to generate returns for investors (functions relating to the identification and selection of assets and the execution of investment decisions).

However, the term ‘portfolio management’ covers a wide range of sub-functions ranging from less value-adding functions, such as research, through to key value-driving functions, such as development of trading strategy and asset selection. As with all transfer pricing analyses, the first step is to determine the relative value of the portfolio management activity being undertaken, before determining an appropriate method to reward entities engaging in such activity.

4.3.2 Categories of portfolio management sub-functions

Portfolio management is often comprised of the following sub-functions

- **Strategic fund management** – The process of setting the overall investment strategy for the fund; generally considered to be a key value-driving function.
- **Asset allocation** – The allocation of assets of the fund among the various strategic objectives, as well as making day-to-day decisions about which assets to invest in or dispose of; generally considered to be a key value-driving function.
- **Sub-advisory** – The provision of tailored investment advice to the portfolio manager or client investor, typically in relation to a specific asset; sub-advisory services may be a high- or low-value function, depending on the scope of the sub-adviser’s mandate.
- **Research** – The provision of general economic or market research, typically about an asset class, sector, or geography; may depend on the type of research, but generally considered to be less valuable in the investment management value chain than the other portfolio management sub-functions.
- **Cash management** – The management of monies into and out of the fund, so as to be able to meet redemptions from outgoing investors, or to make new investments; although this function has gained in importance as a result of the global financial crisis, it is still generally considered to be a relatively routine function.
- **Risk management** – Ensures that the assets of the fund are being managed appropriately, within stated regulatory requirements and according to the investment instructions of the relevant investors (i.e. that the trading strategy is maintained appropriately). Thus, the risk management function is responsible for ensuring that investors are sufficiently protected against the actions of the portfolio manager. As with cash management, the importance of risk management is growing in the investment management industry, particularly as a result of the global financial crisis. However, on balance it is still likely to be classified as a less valuable function for transfer pricing purposes.
4.3.2.1 Capital raising/marketing
Capital raising/marketing refers to the sourcing of investors, and thus of monies, to invest in the fund (i.e. the ‘distribution’ of a fund). As discussed above, capital raising/marketing is generally considered to be one of the two key value drivers of a traditional fund business – clearly, if there are no investors for a fund (and thus, no monies to invest in assets), then all other functions become irrelevant.

However, the relative importance of the capital-raising/marketing function depends heavily on the following factors:

- **Type of investor** (i.e. institutional, retail, or private clients) – As noted earlier, there may be little to no distribution function with institutional clients in comparison to retail clients.
- **Fund type, asset class, and/or investment style** – Particularly for retail clients, who may be less sophisticated about investment management in general and more likely to follow fund ‘trends’, a greater or lesser level of effort may be required to distribute certain funds (e.g. funds based on complex asset classes, such as derivatives, convertible bonds, or structured products may require more effort; funds focused on the tracking of a specific index that are becoming more popular with the general public may require less effort).
- **Geography** – In countries where investors may be less experienced (e.g. in Asia), the role of a distributor may have greater significance than in countries such as the US and UK, where even retail investors are generally more confident about making their own investment decisions. In the former case, the distributor may have to spend some time with new investors, perhaps explaining the various types of funds, how fees are structured or what the likely return on investment will be. In the latter case, the role of distributor may be more akin to a marketer, by simply providing sufficient information about the fund into the wider marketplace, so that investors can research such information themselves and, in some cases, even make direct investments (e.g. through the Internet).
- **Brand** – Obviously, the role of the distributor is made simpler where the funds being distributed carry a well-recognised investment management brand name. However, as the value of a brand differs from country to country, even for the same investment management group, and as retail investors are particularly susceptible to negative publicity about a particular fund or portfolio manager, the role of brand in the capital-raising/marketing function is often difficult to clearly define.
- **Performance fees** – Historically, performance fees have not played a large role in the traditional fund industry (in contrast to alternative funds). However, with the global financial crisis causing investors to demand more accountability from their portfolio managers, the push for a reduction in flat management fees – together with a corresponding increase in the adoption of performance fees – is having a greater impact on the ease of capital raising/marketing.

4.3.3 Key assets
Portfolio managers of traditional funds do not generally provide any of their own capital into those funds, and therefore do not manage any of their own investments but rather only the investments of independent investors. Exceptions may occur where small amounts of seed capital of the investment management group are used to launch a new fund product.

Consequently, the key assets used within the traditional fund business tend to be key investment personnel and certain intangible assets, including:
Chapter 4 – Traditional funds

• **Investment approach/track record** – The value of a fund and its ability to successfully raise sufficient capital for future funds is based on the success of its past investment approach and track record; this may be particularly relevant where there is a well-recognised ‘key person’, usually a portfolio manager, involved in the setting of fund strategy/asset allocation.

• **Brand** – The brand of an investment management company develops over time and is likely based on the past successes, reliability, and longevity of the company.

### 4.3.4 Key risks

The key risks faced by investment management companies focused on traditional funds are:

**Market risks**

- **Entrepreneurial market risk** – Risk that losses can arise as a result of fund outflows due to uncertainty in the structure of the market, demand patterns, and needs of customers, costs, and pricing.
- **Performance risk** – Risk that expected investment management fees are not sufficient to cover expenses, due to external events, such as a significant downturn in the global economy, or due to internal events, such as poor performance by the portfolio manager.
- **Brand risk** – Risk of damage to the reputation of the investment management company arising from bad publicity, regulatory risk, and performance risk.

**Regulatory risk:**

- Risk of being prevented from trading by a regulatory body or being suspended from accepting new business. Regulatory bodies can also have the power to penalise companies that are deemed to be non-compliant with the relevant regulations.

**Financial risks:**

- **Dealing risk** – Risk that trade executions do not take place in accordance with the instructions given by the fund investors or the portfolio managers on behalf of the funds.
- **Pricing risk** – Risk that the pricing of a fund’s shares or units (for mutual funds) is incorrect and that the fund may therefore incorrectly report returns to investors.

### 4.4 Transfer pricing considerations

The fees paid directly by the fund to the investment management company are generally not subject to transfer pricing, as the fund and company should not typically be considered to be related parties for transfer pricing purposes.

However, if the management of a fund is undertaken by a controlled investment management group with different activities/functions being undertaken in various locations, each of the activities requires an appropriate arm’s length return, which depends on where each function is undertaken and its relative importance to the group as a whole.

A brief overview of common methods for rewarding the various functions of the traditional investment management group follows. However, it should be noted that a number of transfer pricing methods may be applied to the same function, and the selection of which methodology is most appropriate depends on the available public data, the facts and circumstances of the investment management group (such as the degree of integration of activities, the relative importance of different functions, and the size of assets under management), and the stage of development of both the
industry and the tested party in a particular jurisdiction. Thus, while the sections that follow provide some broad guidelines on the commonly adopted approaches for certain functions, these should not be considered definitive for all investment management groups in all situations.

### 4.4.1 Back-office support services

As with most businesses, various back-office support services are required to successfully operate an investment management business, including accounting, finance, tax, legal, human resources, and information technology. Given that these back-office support services are not customer facing, the Cost Plus Method or TNMM using FCM is generally applied, as in any other industry.

### 4.4.2 Fund administration

Because fund administration can also be performed by third parties, and is not client facing, often the Cost Plus Method or TNMM using the FCM is applied. However, fund administration is often outsourced to third-party fund administrators and therefore internal and external CUPs may be available.

In addition, from time to time certain industry reports have analysed the fees paid to fund administrators. In some (although not all) jurisdictions, such market research may be useful in providing guidance as to an arm's length price.

It is also worth noting that, even where fund administration is centralised internally (in the head office or another specific location within the investment management group), the regulatory agencies in many jurisdictions require mutual funds to report in local language. Thus, certain aspects of fund administration may still be performed locally (and thus require remuneration under the transfer pricing policy), even where there is a centralised fund administration platform for the investment management group.

### 4.4.3 Trade execution

As with fund administration, trade execution is often outsourced to third-party brokers (as well as related-party brokers) as part of the portfolio manager's fiduciary obligation to investors to ensure 'best execution'. Thus, there may be internal comparable data from which an arm's length transfer price for brokerage functions can be determined. However, as brokerage fees – even with third parties – are extremely sensitive to differences in volume (including local and global volume) or type of security, it may be difficult to use the fees paid to third-party brokers to determine the fees paid to related-party brokers. Moreover, larger global investment management companies are increasingly crossing trades internally, leveraging their large global pool of assets and different portfolio mandates to eliminate brokerage costs. Thus, the TNMM by way of the FCM is also often adopted as a fall-back methodology for determining arm’s length prices for trade execution. Alternatively, for investment management groups with a high degree of integration between trade execution and portfolio management, this function may be included in a PSM.

In addition, as for fund administration, there may be industry studies available to describe the general range of execution fees paid to brokers by investment managers. Depending on the jurisdiction, these studies may also be useful in determining an appropriate arm's length price.
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4.4.4 Portfolio management
External CUPs are potentially available for the combined portfolio management activities undertaken by investment management groups, and in some cases even for specific portfolio management sub-functions. Data to benchmark these activities may be available from the following sources:

- **Fund prospectuses** – Where funds are regulated by a financial agency in a particular jurisdiction, prospectuses or annual reports of the fund are generally required to be made publicly available. These documents typically outline the fee structure adopted by the fund, in many cases including any fees paid to sub-advisers.
- **Industry databases** – Certain information about the fees paid by traditional funds may be obtained from third-party research companies, such as Lipper Analytical Services Inc. through its LANA database.

For larger investment management groups, internal CUP data may be available to benchmark the fees paid for related-party investment sub-advisory services, where the group uses third-party and related-party sub-advisers.

In contrast, where a function is considered less valuable to the investment management group, such as research or sub-advisory activities in some cases, an arm's length return may potentially be benchmarked by applying the TNMM (with a FCM profit level indicator) using external company databases.

Finally, where two or more of the portfolio management sub-functions are both considered to be key value-adding functions for an investment management group, where those sub-functions are sufficiently integrated, and where regulatory restrictions permit, a profit split approach may be adopted. In such cases, the profits of the investment management group are shared among the relevant entities engaged in the portfolio management functions using an appropriate allocation factor, such as assets under management or compensation of portfolio management staff. Profits in these cases are typically calculated as fees received from investors, less transfer pricing payments not forming part of the profit split (e.g. a cost plus mark-up fee paid for fund administration or a distribution fee based on CUP data for capital raising), less the expenses of the portfolio management function.

4.4.5 Capital raising/marketing
Determination of an appropriate pricing strategy for capital-raising and marketing activities depends on the distribution channel (i.e. retail or institutional investors) and the level of involvement by related parties/extent to which some activities are outsourced. Distribution is often outsourced in jurisdictions where the investment management group does not have any, or sufficient, presence to conduct its own distribution, and, therefore, internal CUPs may be available in some cases. Likewise, the external CUP data sources that provide fee data for portfolio management activities described above also provide detailed information about fees paid for distribution functions.

However, care must be taken to ensure sufficient comparability between the (internal or external) third-party CUP data and the tested transaction. Distribution fees paid to third-party distributors are often scalable based on volume (i.e. as the volume of funds secured by the capital raiser increases, the fees paid may decrease), and the fees may also have a finite life (i.e. paid only for a fixed-year period from the beginning of an investor's investment in a particular fund).
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Alternatively, if there is no suitable (internal or external) third-party CUP data available, and the investment management group operates as an integrated business or the capital-raising/marketing function is considered to be a sufficiently important value driver of the business, some form of profit split may be more appropriate. Less commonly, it may be considered appropriate to conduct a transfer pricing analysis using the TNMM by way of full cost plus mark-up, although this depends on the circumstances. Because capital raising/marketing is almost always considered one of the value drivers of the traditional fund industry, this option must be weighed carefully.

4.5 Conclusion
While the transfer pricing issues raised in the traditional fund industry are generally considered less complex than many of those arising in the alternative asset management sphere (see following chapters), and although the availability of internal and external CUP data may be more widespread in the traditional fund industry, it should still be borne in mind that the entire investment management industry, including traditional funds, is not static but rather changes over time. Thus, functions that may not have been considered a significant part of the value chain historically, such as risk management, may increase in prominence due to changes in the global or local markets, the economic climate, or the increasing sophistication of investors (particularly retail investors) globally.

Consequently, the first step in developing a transfer pricing policy for an investment management group focused on traditional funds should still always be to develop a clear understanding of the functions performed by each separate entity within the group in each jurisdiction, and to understand the importance of those functions relative to the investment management value chain. Once this analysis has been completed, the most appropriate transfer pricing methodology – based on that functional analysis – can be selected. Moreover, changes in the relative value of certain functions should be more clearly delineated through the functional analysis. Cases requiring new methodologies or alternative approaches for determining transfer prices should thus be more easily identified.
Chapter 5 – Private equity

5.1 Introduction
Transfer pricing has historically been a low priority when compared with other tax risks associated with the private equity business model. In part, this has been due to the partnership structure and centralised management of private equity firms, and often their predominantly single-country focus. However, as private equity firms grow and expand their teams to take advantage of investment opportunities in jurisdictions and regions beyond their origin, there is an obvious increase in the transfer pricing challenges and risks associated with international operating models.

The growth of private equity as an asset class, and the media’s attraction to its role in corporate actions, has increasingly focused tax authorities’ attention on the amount of tax a private equity fund (and its owners) pays in the jurisdiction in which a portfolio company is headquartered or substantially located, with several tax controversies generating significant publicity.

This growth and visibility, together with the overall attention on transfer pricing aspects of international business more generally, has raised transfer pricing as a tax risk management issue for the owners, partners, and managers of private equity firms.

5.2 Business model
Private equity is generally an industry that invests fund or investment capital in private companies. The nature of the business model has evolved over time and there are now several categories of private equity, largely identified by the underlying investment strategy. These include venture capital, growth capital, leveraged buyouts, distressed investments, and special situations.

While there are subtle differences in the activities associated with each of these investment or sector strategies, the general model remains broadly the same. Typically, a private equity firm raises capital from external sources, invests that capital – with some of its owners or partners – in private companies, sells those investments, and returns the proceeds to the external capital providers. As reward for its efforts in this process, a private equity firm typically charges its investors’ fees, including annual management fees and transaction fees (collectively, management fees). In addition, if the investment reaches a minimum level of return (i.e. hurdle), the private equity firm also receives a percentage of the profits earned on the investment in excess of the hurdle (often referred to as carried interest).

5.3 Typical structure
Typically, a private equity firm raises an investment fund in the form of one or a series of limited partnerships, often supplemented with various layers of partnerships and/or corporations, both onshore and offshore, to segregate investors from liability and other expenses (i.e. fund). Private equity firms generally provide their own equity through a GP interest or as a special limited partner. The GP role entitles the private equity firm to control the activities of the fund and receive the carried interest. The GP is typically a special-purpose entity (company or partnership) established to fulfil this specific role and to provide the private equity firm with limited liability with respect to the fund.

External investment capital raised by the fund is often in the form of LPs, with those LPs having some, albeit limited, control or supervisory rights over the fund. However,
as primary investors in the fund, the LPs receive the major part of returns generated by the fund’s investments.

The GP is generally responsible for the management and operation of the fund, although in many cases the GP outsources this responsibility under a management agreement with the principals of the private equity firm, and forms an investment committee to advise on key decision making. Depending upon the size and scope of the private equity firm’s investment activities, it may further outsource advisory services to affiliates based in jurisdictions within which it invests. For example, an Asian-focused private equity fund may have affiliates located in Tokyo, Hong Kong, and Singapore to source and investigate opportunities in those markets. Recommendations are made directly or indirectly to the investment committee formed by the GP, which advises on and recommends investment decisions to the board of the GP. The board then makes decisions for the fund within the terms of the fund’s constitutional documents.

The structure of a typical private equity fund is outlined in the following diagram.

Where the activities of a private equity fund are decentralised, the transfer pricing between the principal office and the affiliates based in key investment jurisdictions will likely be a primary focus for tax authorities.

Further, where the activities of a local affiliate are considered by the tax authorities in that jurisdiction to be the carrying on of the fund’s business (directly or indirectly as an agent), permanent establishment issues may also arise. Although this issue is not the subject of this book, it must be carefully considered in conjunction with any transfer pricing study, as the presence of a permanent establishment would normally give rise to significant tax exposure for the private equity firm or the fund.

5.4 Key functions

The transfer pricing arrangements between the private equity firm and its affiliates ultimately depends on the functions performed, risks assumed, and capital or other assets used in each of the jurisdictions in which the private equity firm operates. The following sections outline some of the key functions performed within a private equity firm.
5.4.1 **Capital raising and investor relations**  
Capital raising for a private equity fund involves not only successful marketing of the investment strategy to investors, but also a number of commercial, legal, and tax considerations. The success or failure of the capital-raising activity typically rests on the reputation of the private equity firm, the past experience of key individuals, the strength of the investment strategy, and the skill with which the private equity firm markets the opportunity to its target investors. Generally, the marketing of the investment opportunity is undertaken by the private equity firm directly. However, private equity firms sometimes hire an independent placement agent to help identify potential investors and mediate negotiations on the terms and conditions of the fund. In-country affiliates may also be involved in identifying or targeting potential investors in their jurisdiction.

The legal structure of a fund and the legal relationship between the private equity firm and its investors may also have an impact on the marketability of the fund, and private equity firms often engage professional services firms to provide advice on the offering, the structure, and the arrangement or coordination of investors. This is typically coordinated centrally.

Language, cultural, and regulatory issues may also impact who performs the capital-raising and investor-relations functions.

5.4.2 **Deal sourcing and origination**  
Typically, the deal identification process relies on the private equity firm developing and maintaining strong networks of advisers, consultants, and investment bankers. However, many private equity investment opportunities have also arisen through intermediaries, who may be engaged by the seller to assist with the sale process and obtain the highest possible price, or by the private equity firm to identify opportunities (e.g. through the use of senior advisers).

Due to the nature of the relationships required for successful origination, this function is often performed by in-country affiliates with local expertise in assessing opportunities, sometimes together with specific sector specialists, wherever those may be located within the private equity firm.

5.4.3 **Research and due diligence**  
Before agreeing to acquire an interest in a portfolio company, a private equity firm almost always conducts a detailed review of the general economic conditions, the industry within which the target operates, and the target’s position and potential within its industry. This process also involves a financial, legal, information technology, and tax due diligence, and often with larger funds, an anti-trust review.

Many aspects of the due diligence process is outsourced to third-party professional services firms, although some may also be conducted in-house; however, overall management and coordination is generally managed by the members of the private equity firm.

Private equity firms often employ sector or industry specialists to provide thought and market analyses. These specialists may be employed centrally or located throughout the firm and may be involved in deals on a fly-in/fly-out basis. Alternatively, such industry specialists may be supported by employees of in-country affiliates. Language and cultural issues may dictate who carries out in-country reviews.
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5.4.4 Investment management
The investment committee is generally responsible for providing advice or making investment recommendations for the fund. The investment committee typically comprises senior executives from the private equity firm, and meetings of the investment committee are generally held centrally.

Investments that involve a conflict of interest for the private equity firm may be referred to an advisory board consisting of key LPs for review.

5.4.5 Structuring of investments
In making investments, private equity firms seek to establish an efficient acquisition structure. Such structuring often needs to take into account the local legal and tax rules, and advice may be sought both from professional advisers and the in-country affiliate.

5.4.6 Portfolio company management
Depending upon the investment strategy of the private equity firm, there may be active or passive involvement in the ongoing management and operation of the business of the portfolio companies that are acquired. This may include representation on a portfolio company’s board of directors, or negotiating and dealing with third-party providers on behalf of the company (e.g. lenders). Depending on the nature and level of the involvement, this activity may be carried out centrally or through an employee of the in-country affiliate.

Ongoing portfolio management may be delegated to a committee or team of the private equity firm that is given responsibility for monitoring the performance of portfolio companies and making recommendations and/or changes to improve performance.

5.5 Key assets
Principals of a private equity fund may contribute capital, in addition to soliciting funds from external investors. Accordingly, portfolio managers operate with personal assets and independent investors’ assets, in addition to other intangibles, such as:

- **Investment strategy** – The ability of a fund to pursue an opportunistic strategy in which the fund has known competitive capabilities and a prior track record; may be driven by key individuals.
- **Reputation** – A history of outstanding fund performance and longevity earns the confidence of investors.
- **Network** – Strong relationships with prestigious industry, governmental, and academic experts contribute to superior deal-sourcing and due-diligence capabilities.

5.6 Key risks
Private equity funds have exposure to many of the risks of other investment management companies; however, private equity funds face a few central risks, including:

- **Liquidity risk** – Risk that the fund will not be able to execute its exit strategy and may need to hold a particular portfolio company longer than expected; this risk may present capital constraints and opportunity costs on other investments.
- **Entrepreneurial market risk** – Risk that losses can arise as a result of fund outflows due to uncertainty in the structure of the market or capabilities of a prospective investment’s management team.
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- **Reputational risk** – Risk of damage to the reputation of the investment management company arising from bad publicity of a portfolio company.
- **Operational risks** – Risk that deal executions do not take place in accordance with the instructions given by the fund investors or the portfolio managers on behalf of the funds.

### 5.7 Transfer pricing considerations

The functions typically performed by the private equity firm, as described in the section above, are summarised in the following chart.

**Figure 5**

Functions typically performed by the private equity firm

![Diagram showing functions performed by the private equity firm]

Depending on who has responsibility for the various functions and where these functions are carried out, the following transfer pricing issues may need to be considered:

- What share of the management fees, if any, should a local affiliate receive for the functions it performs (typically related to deal sourcing and origination or research and due diligence)?
- Should any part of that share of the management fees be paid directly to the local affiliate by the portfolio companies in its jurisdiction?
- Should a local affiliate share in the carried interest earned, if any, by the private equity firm? If so, how should that share be determined?

The balance of this chapter addresses these three fundamental questions. It should be noted however, that transfer pricing issues may also arise in relation to cross-border related-party loans or other financing transactions that form part of any investment made by a private equity firm. However, as these issues are not particular to the private equity industry, they are not specifically addressed in this chapter. Instead, they are covered by the general discussion in relation to related-party financial transactions contained in Chapters 18-20.

### 5.7.1 Management fees

As in any transfer pricing policy, the starting point for determination of an arm’s length price for related-party transactions is the identification of the party with the least complex functions, risks, and assets (i.e. the tested party). In the case of a private equity firm, this is likely to be the local affiliates, given that the majority of the functionality and direction almost always remains with the centre (i.e. with the entity within the private equity firm that entered into the management agreement with the fund or GP). Even so, the extent of the functions performed by local affiliates varies across firms, depending on the level of expertise and experience of the local professional staff. For example, local affiliates in emerging markets may initially assume a supporting role only with respect to sourcing of potential deals or research
and due diligence. However, as the local team develops, those affiliates generally expand the scope of their responsibilities for those activities. In addition, they may also take on new responsibilities, for example, the introduction of local investors and serving as the liaison with the central fundraising team.

In order of frequency observed, the functions performed by the local affiliates typically include deal sourcing and origination; research and due diligence; and, to a much lesser degree, indirect support capital raising. Thus, these activities are most likely to require benchmarking to determine an arm’s length price when developing a transfer pricing policy. In contrast, it is rare that the investment and portfolio management function requires such benchmarking, because this function should retain the residual of the management fees received from the fund or GP after all other functions performed by the local affiliates have been remunerated on an arm’s length basis.

Implicit in the previous paragraph is the idea that the functions performed by the local affiliates should be rewarded through a transfer pricing policy that allocates to them a share of the management fees. Moreover, as the level of functionality at the local affiliate increases, the share of the management fees allocated should also increase. However, while this sounds simple in theory, in practice it is often difficult to determine exactly what an arm’s length fee for the activities performed in a private equity firm should be, as there is little publicly available information about fees charged within the industry or about the profitability of its participants.

Moreover, even in the development of a relatively simple transfer pricing policy, exceptions invariably arise. For example, where a dedicated transaction fee is paid for the completion of an investment in a particular jurisdiction (in addition to the base management fees), consideration should be given to whether a larger portion of that transaction fee than the transfer pricing policy ordinarily prescribes should be paid to the in-country affiliate. Certainly, the tax authorities of the jurisdiction in which the deal is completed are likely to take such a position. Consequently, a private equity firm should be prepared to respond to such a position if it believes otherwise based on its own analysis of the functions performed by the relevant local affiliate.

Likewise, it is also important to remember that the value of certain functions may change over time, or even on a deal-by-deal basis. Thus, the implementation of a transfer pricing policy in one year or for one deal is not the end of the transfer pricing process for the following years or for subsequent deals. Instead, it is important to monitor the applicability of the transfer pricing policy on a regular basis. For example, the value of the capital-raising function may not be constant over time. If a private equity firm’s first fund is successful, it may be much easier for that firm to raise capital for subsequent funds, particularly if the existing investors of the first fund are given priority to invest in future funds. In such cases, the capital-raising activity may be facilitated by the reputation of the firm as a whole. In contrast, the capital-raising function may become much more valuable to a private equity firm in difficult economic times, particularly when there is a liquidity shortage in global or regional financial markets. In such cases, it may be necessary to consider the impact on the transfer pricing of the additional time and effort spent on capital raising as the investment period becomes longer and more complex (e.g. where there are multiple closures).

Notwithstanding these potential complications, some of the commonly adopted methodologies for rewarding local affiliates in the private equity industry are outlined in the following sections.
5.7.1.1 **Comparable uncontrolled price**

At the simplest level, the arm’s length price for a function performed by a local affiliate may be determined by the price paid to third parties performing the same functions (e.g. in jurisdictions where the private equity firm does not have its own presence). Thus, if the private equity firm uses third-party deal originators or advisers for deal-sourcing services, or third-party placement agents for capital-raising services, the fees paid to those third parties may be potential proxies for the fees to be paid to the captive-deal originator or capital raiser (i.e. the local affiliate). Alternatively, there may be some publicly available data about fees paid to such third-party advisers in the private equity industry that could be used for this purpose.

As in any situation where CUP data is used to determine an arm’s length price, consideration must be given to whether economic or cultural variances between countries and markets undermine the usefulness of such data. Typically, CUP data from the same jurisdiction is preferable to CUP data from a different jurisdiction. This is particularly relevant for the private equity industry, where some jurisdictions have mature private equity industries, while others are relatively immature. However, if such differences have no material impact, or if adjustments can be made to account for those differences, even CUP data from outside the jurisdiction may be an appropriate and relatively easy way to identify the arm’s length price for one or more functions.

5.7.1.2 **Target profit margin**

If specific fee data is not available (internally or externally), another simple way to determine an arm’s length price is to identify the target profit margin for a local affiliate, based on the profit margins of third-party companies engaged in similar activities. Ideally, these would be third parties performing the same functions in the same jurisdiction in the private equity industry; however, if such specific data is not available, a broader functional, geographic, or sector search may be required.

When using the profit results of third-party companies to determine an appropriate target profit level for a local affiliate, private equity firms have frequently relied on the cost plus mark-up methodology as a blanket approach, regardless of the functions performed by the local affiliate or the jurisdiction in which they were located. However, as in any transfer pricing situation, it is important to understand the range and level of all functions performed before determining whether the Cost Plus Method can be reasonably applied to any of those functions. In addition, care should also be taken to understand the practice of the tax authorities in the jurisdiction where the local affiliate is located. For example, there are now a number of jurisdictions where remuneration by way of a cost plus mark-up methodology is more likely to be challenged when applied to deal origination or capital-raising activities.

Finally, if it is determined that the Cost Plus Method can be applied to one or more of the functions performed by a local affiliate, while other functions are remunerated in some other way (e.g. using CUP data as previously described or through profit sharing as subsequently outlined), it is necessary to identify the costs that relate to each of these separate functions (i.e. it is necessary to prepare a segmented profit and loss statement for the local affiliate). Although this would appear to be a relatively mechanical process, it is not uncommon for tax authorities to challenge the segmentation if it is not conducted with some degree of care and with some logical underlying basis.
5.7.1.3 Profit sharing
As a final alternative, if the functions performed by the local affiliate are of significant value to the private equity firm as a whole, and it is not possible to separately determine the appropriate reward to the local affiliate (or the parent company), a profit-sharing methodology may be the most appropriate approach to adopt. In this case, the entire profits earned by the private equity firm would be allocated among the centre and key local affiliates, usually based on some internal measure. Although there are no prescriptive guidelines for what allocation measures are most appropriate for the private equity industry in such cases, commonly used factors include headcount, staff compensation payments, or total expenses incurred.

5.7.2 Payments by portfolio companies
Payments by portfolio companies to the in-country affiliate may include that affiliate’s share of transaction fees earned, as discussed in 7.1 above. In addition, the portfolio company may pay a fee for consulting services provided in relation to ongoing operations (i.e. the functions described in 4.6 above). Again, while such consulting fees may be paid to the GP or private equity firm, they may also be paid directly to the in-country affiliate if that affiliate is providing the consulting services.

If this type of domestic transaction occurs between a portfolio company and an in-country affiliate, it would generally not be subject to transfer pricing rules in many jurisdictions. However, it is nevertheless important to consider these payments when designing the cross-border transfer pricing policy.

Firstly, simply as a matter of general tax practice, many tax authorities challenge transactions between domestic parties that are conducted in a manner that reduces the overall taxable income in the relevant jurisdiction.

Secondly and more specifically for the private equity firm, the total fees payable by the fund or portfolio companies to the GP or private equity firm are generally capped in the fund prospectus documents as the total of management fees, or may be restricted by lenders covenants when paid from a portfolio company. Thus, any fees paid by portfolio companies directly to an in-country affiliate must reduce the overall amount of management fees available for allocation among the private equity firm and all local affiliates for all other functions performed.

If it is determined that a separate fee should be paid by a particular portfolio company to the in-country affiliate, the calculation of an arm’s length price for that fee will most likely follow the CUP or target profit margin approaches described above at 7.1. In such cases, comparable data may be identified from fees paid to third-party management and consulting companies (CUP analysis) or from profit margins earned by those same companies (target profit margin approach). Moreover, as noted above in relation to the use of the Cost Plus Method for remuneration of other functions, this approach requires the segmentation of the costs incurred by the local affiliate to perform each of its functions.

5.7.3 Carried interest
When developing a transfer pricing policy for a private equity firm, the final question to address is whether the local affiliates should share in any carried interest earned by the firm, and if so, to what degree. Although this would appear to be exactly the same issue as covered by the discussion on management fees, it is in fact far more complex.
As a starting point, it may not be clear whether any carried interest earned should be classified as part of the revenues of the private equity firm, or whether it is in fact a return on equity (which is outside the scope of transfer pricing). In the most difficult cases, it is possible that the carried interest may not be paid to the private equity firm or the GP at all. In such cases, there may be difficulties in identifying a transaction form under which payment of (some of) the carried interest can be made to the private equity firm – let alone its local affiliates – if the transfer pricing policy so requires. The question of how carried interest should be treated in such circumstances differs from one firm to another, depending on the firm and carried interest structures adopted, as well as on the position taken by the tax authorities of the jurisdictions in which the firm operates.

If the decision is made to classify carried interest as revenue of the private equity firm, the next question is how to determine which entities, having regard to their functional profile, should share in this additional payment. Although carried interest is directly calculated from the performance of the fund, which suggests a close relationship to portfolio management and thus possibly deal origination, it may be that the performance of the fund has also been improved by the capital-raising function (i.e. to a certain degree the more capital raised, the more flexibility there is when making investment decisions).

A number of timing and cash flow difficulties can arise when considering carried interest in the transfer pricing context. At a theoretical level, when considering comparable data for benchmarking purposes, the timing (at closure of the fund) and manner of payment (internal hurdle) of the carried interest may not be consistent with the arrangements in a third-party transaction – in the timing (often at closure of a deal) and manner of payment (fixed fee or percentage of capital raised) of a performance fee paid to a third-party placement agent (for the capital-raising function). This could create cash flow issues if third-party fees are used to determine the price for certain inter-company transactions under the CUP Method described above.

Difficulties of timing and cash flow may also arise in implementation of the transfer pricing policy. For example, if employees receive a portion of the carried interest as discretionary incentive payments, a question arises as to how this should be reflected in the calculation of the transfer price used to compensate the legal entity that employs them. Bonus payments to employees are typically paid annually, while carried interest is generally earned on closure of the fund (or less commonly on a deal basis). Consequently, tax and cash flow issues may arise if a local affiliate must account for these employee costs before the revenue to which they relate has been recognised. Likewise, timing differences are also relevant when the fund documents provide for the clawback of carried interest paid on a periodic basis that, at the close of the fund, exceeds the agreed percentage for carried interest over the life of a fund. This is particularly the case where the carried interest to which that provision relates has already been paid out to local affiliates through the transfer pricing policy in prior fiscal years. In such cases, it may be difficult to apply the clawback to the transfer pricing calculation in the same way as it is applied by the fund to the carried interest calculation.

5.8 Conclusion
Although, historically, transfer pricing has not been of high priority to many private equity firms, this position is changing as the private equity industry expands. For the private equity firm faced with establishing a transfer pricing policy for the first time, this chapter has endeavoured to highlight the key concerns to be addressed and major
points to be considered. Chief among these should be that no single approach to transfer pricing works for the entire private equity industry. Instead, as outlined in this chapter, the approach selected varies from firm to firm.

Thus, the first step in developing a transfer pricing policy must be a clear understanding of the functions performed by each entity and the importance of those functions to the firm as a whole. In addition, the impact of other tax risks (e.g. permanent establishment exposures for the fund or the income tax characterisation of carried interest at the entity as well as employee level) on the transfer pricing policy should be considered. Only after an understanding of all these factors is complete, can decisions be made about the most appropriate transfer pricing policy for a private equity firm.
Chapter 6 – Hedge funds

6.1 Introduction
Hedge fund managers differ from other asset managers in a number of ways. They are typically small boutique operations, in the same way as private equity firms or real estate investment managers. Moreover, unlike mutual fund managers, investment strategies tend to be more exotic and often incorporate leverage or shorting; funds are generally distributed only to sophisticated investors, such as institutional investors or high-net-worth individuals; and hedge fund managers are typically paid performance fees as well as management fees. These differences mean that the transfer pricing challenges faced by hedge fund managers are not always the same as the transfer pricing challenges facing other fund managers. These differences also mean that the transfer pricing approaches and benchmarking analyses that may be appropriate for traditional asset managers are not always appropriate for hedge fund managers. Finally, these changes can mean that it is easier for hedge fund managers to use transfer pricing planning opportunities than it is for larger asset managers.

6.2 Common hedge fund structures
Although there is no legal definition of a hedge fund, it typically involves a private, unregistered pool of capital that is invested according to a strategy determined by the hedge fund manager. This strategy may or may not include ‘hedging’ activities (i.e. making counter-balancing investments to protect against loss), but would generally involve something more than simple long-term investment. In addition, the hedge fund manager is usually compensated by way of a performance fee based on profits in addition to a management fee based on total assets.

Originally, investors in hedge funds tended to be more sophisticated, wealthy investors and institutions. Over time, as the hedge fund industry has grown, so has the variety of funds and investors, leading to calls for further regulation in this area. However, so far hedge funds have been able to avoid much of the regulation imposed upon the rest of the investment community, which allows them to buy distressed assets, or use increased leverage, short selling or other relatively sophisticated methods to generate higher returns for their investors.

As Figure 6 shows, most US hedge fund managers are structured as an LP or LLC, either of which may sign a contract with a fund, receive management fees, and employ most employees engaged in the investment management activity. This entity may then own overseas subsidiaries, typically as ‘check-the-box’ entities that are tax transparent for US purposes.
On the other hand, as Figure 7 shows, many hedge fund managers focused on Asian or European investments are actually established in offshore locations, such as the Cayman Islands, the British Virgin Islands, Jersey, or Guernsey. These companies own onshore subsidiaries in financial centres, such as the UK, Hong Kong, or Singapore, which perform sub-advisory services for the parent companies. Both the offshore investment manager and the onshore sub-adviser pay local tax on their own income only.

6.2.1 Hedge fund life cycle and transfer pricing challenges
For US-based hedge fund managers, transfer pricing issues usually arise for the first time as the manager begins expanding overseas. Often, the initial international expansion begins with an existing staff member being transferred to a new country to establish the group presence in that jurisdiction. Frequently, although not always, US-based groups establish their European offices in London and their first Asian offices in Hong Kong or Singapore.
New offices are generally tasked with identifying, researching, and analysing investments in the relevant time zone and market. In many cases, the local offices perform only limited-scope sub-advisory functions for the first year or two, but as they develop and prove themselves, they may begin to take on broader investment management activities. In addition, overseas satellite offices typically do not start with the capacity to execute transactions, but this may be added over time.

From a transfer pricing perspective, the evolution of the overseas office or offices raises a number of challenges for hedge fund managers, namely:

- How to reward the overseas office in its start-up phase.
- How to reward the overseas research/sub-advisory functions.
- How to reward an overseas execution function.
- How to reward overseas portfolio management and discretionary advisory services.

Unfortunately, it is rarely possible to use the same transfer pricing method in all of these scenarios.

Unlike US fund managers, Asian and European fund managers must often engage in transfer pricing from Day One. The reason for this is the difference in structure of Asian and European fund managers to US fund managers, as shown in Figures 6 and 7. In particular, in Asia and Europe it is common for new groups to establish their lead investment management company offshore, as described above. These offshore investment managers typically contract an onshore affiliate in the UK, Hong Kong, or Singapore to perform advisory and sub-advisory, back-office, and marketing services for them. In these cases, as well as addressing all of the transfer pricing challenges detailed above, the hedge fund group must also decide how the offshore fund manager should be remunerated for the functions it performs, the risks it assumes, and the assets it owns.

In setting a transfer pricing policy to deal with the common issues outlined above, the hedge fund group evaluates available comparable data and selects the most appropriate transfer pricing method in the same way as any other fund management group. However, unlike other fund managers, the hedge fund manager has other challenges to take into account: typically, it has a smaller tax department and its organisation may change more rapidly than traditional asset managers.

### 6.3 Transfer pricing methods

The transfer pricing methods used by hedge fund managers cover a range of methodologies.

#### 6.3.1 Comparable Uncontrolled Price Method

Where it can be applied, the CUP Method is the simplest and most intuitive of the transfer pricing methods applied by hedge fund managers. The CUP Method benchmarks the price for the related-party transaction under review by comparison to the fees charged on transactions between unrelated parties. For example, if the taxpayer engages third parties and related parties to provide it with sub-advisory services, then the fees paid to those third parties might be used to benchmark the transfer price that should be paid to the related parties.

However, in assessing the applicability of any available CUP data, it is important to take into account factors that might affect comparability with the taxpayer concerned. These include the scale of the transaction, the geographic coverage, whether the
services were discretionary or non-discretionary, when the transaction occurred, and the strategy to which the sub-advisory services related. Moreover, in the absence of internal CUP data arising from transactions with the relevant taxpayer themselves, it may be difficult to apply this methodology using external CUP data; most hedge fund managers are small, private organisations disclosing little public information.

6.3.2 Resale Price Method
A form of the RPM may be applied by subtracting a commission margin from the resale price of a product or service. Thus, in the hedge fund management industry, a taxpayer performing capital-raising or distribution services might be rewarded using the RPM if suitable third-party data could be identified to benchmark that commission margin.

6.3.3 Transactional Net Margin Method
In the hedge fund management industry, the TNMM is generally applied to services provided by onshore sub-advisers or capital-raising affiliates by targeting a FCM, which is benchmarked by examining the mark-ups achieved by independent companies performing broadly comparable functions. However, in applying the FCM, taxpayers need to be comfortable that this method is appropriate for their facts and circumstances. In particular, taxpayers need to be aware that the tax authorities in a number of countries are reluctant to accept an FCM as the reward for taxpayers performing value-adding capital-raising or sub-advisory functions.

6.3.4 Profit Split Method
The fourth transfer pricing method that may be used in the hedge fund management industry is the PSM. Often, this method is used in conjunction with one or more of the other methods described above, in which case it is described as a RPSM. The PSM tends to be most useful where the related parties both engage in high-value-adding functions or where it is not possible to accurately apply any of the other transfer pricing methods. However, the practical application of the PSM is often more complicated than application of any of the other transfer pricing methods.

6.4 Transfer pricing planning
Several attributes of European and Asian hedge fund managers mean that they are often particularly well placed to engage in transfer pricing planning. These attributes include high profitability, the concentration of key value-adding functions in a small number of employees, quick decision-making, and flat structures. In most cases, these attributes apply equally to US headquartered fund managers; however, US headquartered groups may not be able to take advantage of the benefits of transfer pricing planning because of the US tax on worldwide incomes.

Where it is possible, planning is necessarily a custom-made exercise and the options available to each manager depend on their individual fact pattern and circumstances. Nevertheless, it is possible to generalise and to note that planning often involves identifying high-value-adding functions and concentrating those functions in low-tax jurisdictions, such as Hong Kong, Singapore, or Switzerland. Alternatively, in countries applying a territorial basis of taxation, such as Hong Kong, it may be that part of the hedge fund group’s income is offshore sourced and not taxable in the relevant local jurisdiction.

As in any transfer pricing analysis, it should be noted that planning activities are not usually sustainable unless they are supported by real commercial substance.
6.4.1 Tax authority activity

Tax authority investigations of a hedge fund manager’s transfer pricing arrangements typically focus on confirming the substance of the related-party transactions, validating the transfer pricing method used, and examining the implementation of the method. The starting point for a review of the substance of related-party transactions is a functional analysis that outlines the functions performed, assets employed, and risks managed/assumed by each of the related parties to the tested transaction or transactions. The taxpayer often collates the functional analysis information; however, even in such cases, the tax authorities may want to validate those records by talking to employees of the group, by reviewing the cost base of the offshore company, or by asking for travel records.

The fact that hedge fund managers are disproportionately concentrated in a small number of financial hubs means that it is possible in this chapter to talk in more detail about the approach that specific tax authorities typically take to reviewing transfer pricing for hedge funds. Because most hedge fund managers are based in the UK, US, Singapore, or Hong Kong, we discuss each of these jurisdictions in turn.

- The UK’s HMRC is perhaps the most experienced tax authority at investigating hedge fund managers. In the last 5 to 10 years, HMRC has launched a wave of investigations of the industry. This is particularly relevant because transfer pricing is not just a statutory requirement in the UK, it is also incorporated as one of the tests of the IME, which allows hedge fund managers to operate in the UK without their fund profits being taxed in the UK. Thus, the key risk for fund managers with UK offices is that if they fail the IME because their transfer pricing is considered incorrect, the profits due to the fund investors could be subject to tax in the UK. In investigating transfer pricing issues, HMRC often first asks to see the taxpayer’s own transfer pricing documentation and then seeks to understand the division of functions between the UK taxpayer and the rest of the group, and thus the appropriateness of the methodology used. HMRC does not shy away from asking questions to understand the substance of offshore affiliates, and it is knowledgeable about the transfer pricing methods and benchmarking data available in the industry.

- The US is a mature market for transfer pricing, with sophisticated transfer pricing rules and an experienced tax authority in the form of the IRS. Traditionally, the IRS has not been that active in auditing hedge fund managers’ transfer pricing arrangements, since most managers elect to treat their overseas entities as tax transparent for US purposes. Nonetheless, even when the overseas entities have ‘checked the box’, transfer pricing has some effect on the overall taxable position in the US, so there is an incentive for the IRS to examine transfer pricing nevertheless. In fact, there is speculation that the IRS is beginning to focus on this area in more detail than it has done previously.

- Hong Kong has traditionally been a relatively benign location for transfer pricing, but in 2009 the IRD published two circulars of more than 50 pages, each discussing in detail transfer pricing methods, adjustments, and other related issues. Also during 2009, the Court of Final Appeal issued a ruling in a case that essentially reworked a transfer pricing matter. As a result of these developments, transfer pricing is a much higher-profile issue in Hong Kong, and the IRD is expanding its resources in this area. Guidance from the tax authorities and some recent cases suggest that IRD enquiries in the hedge fund sector will focus on the substance of offshore companies as well as the selection and implementation of the most appropriate transfer pricing method.
Part III: Investment management

• Singapore has also traditionally been a relatively benign tax location for hedge fund managers, but during 2006 to 2010 the IRAS published a number of transfer-pricing-related circulars explaining how it expected taxpayers to apply transfer pricing principles. Moreover, in 2010, the Singapore tax legislation was amended to introduce a transfer-pricing-specific clause.

6.5 Recent developments
The hedge fund industry is dynamic, which means that new issues regularly arise that can affect existing transfer pricing policies. Some of the recent external issues that have arisen or may arise, for the industry or for a particular jurisdiction, include the following:

• **Losses** – The global financial crisis in 2008 and 2009 caused many hedge funds to suffer redemptions and consequential reductions in their asset values. This, in turn, led many hedge fund managers to incur losses themselves for the 2008 and 2009 tax years. The distribution of these losses between group companies through transfer pricing is an important issue, and the application of certain transfer pricing methods in a loss-making year can have unforeseen consequences. In short, careful consideration should be given to the outcome of applying an existing transfer pricing method in a loss-making year.

• **Reorganisations** – As a response to the global financial crisis, many groups have gone through a period of accelerated change, with many individuals parting company with their employers, many fund managers deciding to reduce their overseas operations, and many others deciding to refocus their investments on markets that are outperforming. Since transfer pricing policies must be based on a functional analysis, and because functional analyses change as reorganisations occur, transfer pricing policies may also have to change following a reorganisation.

• **Tax changes** – A number of recent or proposed tax changes will affect the context within which hedge funds design their transfer pricing policies. For example, plans in the UK to levy the bank bonus tax on hedge fund employees, the higher UK top rate of (personal) tax, possible changes to the taxation of carried interest in the US, and the expected publication of tax authority guidance on carried interest in Hong Kong may change the way that fund managers organise their operations going forward.

6.6 Conclusions
Transfer pricing has been an important issue for hedge fund managers for a number of years. This focus on transfer pricing is likely only to grow as tax authorities become increasingly sophisticated and experienced in relation to the hedge fund industry. With this context in mind, hedge fund managers should not only design their transfer pricing policies carefully to start with, but also should maintain and update those policies as their businesses or the environment they operate in changes over time.
Chapter 7 – Real estate funds

7.1 Introduction
Real estate was once a local activity, one dominated by local players and with relatively few cross-border transactions. In recent years, however, the business has changed. Global investors now play an increasingly active role – buying properties, modernising asset management, and pioneering investment techniques. Despite some bumps from the recent financial turmoil, real estate is a local game no more. Given this growing internationalisation, tax authorities have started to spend more time examining real estate transactions. As a result, cross-border real estate investors now face a greater chance of being audited. As the industry sophistication of the tax examiners in various countries increases, this level of interest will continue to grow.

In the following sections, we look at the transfer pricing issues facing real estate investment managers and the transfer pricing methods commonly used by international players in the industry.

7.2 Business model
Real estate investment can take several forms, depending on the investment strategy. Based on the investor’s risk profile, the investment can be categorised as core, core plus, value added, or opportunistic. Investors may also target specific types of investments, such as residential, hotel, logistics, retail, office, or multi-use. While each of these investment strategies has its own flavour, the general investment model remains broadly the same: the purchase, management, rental, and sale of real estate for a profit.

In this section, we focus on real estate investment funds, and only indirectly address the issues for private investment or for club deals. Moreover, in using the term ‘real estate investment fund’, we refer to a collective investment vehicle whereby a real estate investment firm (sponsor) forms a fund (fund) as an investment vehicle for unrelated investors. In this model, the sponsor then retains an affiliate (investment manager) to advise the fund and to manage its investments.

As a reward for its efforts, the investment manager charges a management fee, typically a percentage of committed or invested capital. In addition, if the fund earns a minimum level of return, the investment manager may receive a percentage of the profits earned on that investment. This success fee is often referred to as a performance fee, incentive fee, or carried interest. The carried interest may be determined investment by investment or may be based upon the fund’s overall profitability.

7.3 Typical structure
The fund may be structured as a limited partnership, corporation, or investment trust. In addition, feeder funds are often formed, if necessary, to meet the needs of particular investors (e.g. separate feeders may be formed for tax-exempt investors or for investors wanting to invest in a particular currency).

Beneath the fund, there are often a number of special-purpose companies (e.g. companies formed to own assets, provide financing or meet particular investment needs). The need for special-purpose companies depends on the investment, but they may serve several functions, including helping to limit investor liability, facilitating co-investment, and simplifying tax-filing requirements. The special-purpose vehicles may also make it possible for the property-owning investment vehicles to satisfy
lenders’ financing requirements in connection with potential cross-collateralisation and bankruptcy remoteness.

If the fund is a partnership, the general partner makes fund decisions, often with support from the investment manager. If the fund is a trust or a corporation, the decisions are generally made by the investment manager itself. In most cases, the general partner or the investment manager receives the management fee and carried interest, although, this varies by fund. Although there are many structures, for ease of explanation we refer to the carried-interest-receiving, decision-making entity as the investment manager.

If the investment manager does not have employees or expertise in a particular investment jurisdiction, it may obtain advisory services from affiliates based in jurisdictions within which it invests (each a local affiliate). For example, an Asian-focused fund may have its investment manager in New York and affiliates located in Tokyo, Hong Kong, and Singapore. The local affiliate’s role includes the sourcing and investigation of investment opportunities. Although the local affiliate may make recommendations to the investment manager (or, where appropriate, the general partner), the investment manager (or general partner) alone has decision-making authority.

Once an investment decision is made by the investment manager (or general partner), the investment manager causes the fund to form one or more special-purpose holding companies to complete the acquisition of the property (the real-estate-owning company, Property OwnCo). The Property OwnCo often enters into an agreement with the relevant local affiliate to provide it with asset management services.

The structure of a typical real estate fund is outlined in Figure 8:

In addition to the capital-raising and investment management services, the investment manager also performs other services, including investor relations, treasury, tax, and legal services. Although these are all essential value-adding services, they generally do not give rise to significant transfer pricing issues because they are provided primarily by the investment manager (with routine support by the local affiliates).
Where the investment manager and local affiliate both contribute to an investment (e.g. if the local affiliate sources the investment and performs a liaison role with onshore third parties), two issues arise: (i) the amount of the compensation to be paid to the local affiliate (transfer pricing) and (ii) whether the activities of the local affiliate cause the fund or investment manager to have a taxable presence in the investment jurisdiction (permanent establishment). Although permanent establishments are not the subject of this book, they must be carefully considered in conjunction with any transfer pricing analysis, as the presence of a permanent establishment could give rise to significant tax exposure for the investment manager or the fund.

7.4 Key functions
The transfer pricing arrangements between the investment manager and its local affiliates ultimately depend on the functions performed, risks assumed, and capital or other assets used in each of the relevant jurisdictions. For this reason, the following sections outline the key functions performed within a real estate investment group.

7.4.1 Capital raising and investor relations
To launch the fund, the sponsor must raise capital. The capital raising may take several months and includes not only the marketing of the fund’s investment strategy, but also the design of an investment structure that meets the investor’s commercial, legal, and tax requirements.

The success or failure of the capital-raising activity typically rests on the reputation of the sponsor, past experience of key individuals, the strength of the investment strategy, and the skill with which the sponsor markets the opportunity to its target investors.

Generally, the marketing of the investment opportunity is undertaken directly by the sponsor. However, in some cases an independent placement agent may assist the sponsor in identifying potential investors and in mediating negotiations on the terms and conditions of the investment. Local affiliates may also be involved in identifying and targeting potential investors, or in explaining the investment opportunities in the target jurisdiction to investors in their own jurisdiction.

7.4.2 Fund and investment management
The fund management activities performed by the investment manager include making or advising the general partner on major decisions, such as investment strategy, portfolio management, consideration of investment opportunities, determination of purchase price of assets, and the negotiation of key contract terms.

To assist in identifying opportunities for specific acquisitions, many investment managers rely on a network of advisers, consultants, and banks in local jurisdictions. Due to the nature of the relationships required for successful origination, local affiliates are often active, as they may have expertise in assessing opportunities in a specific market. However, real estate investment opportunities may also arise through brokers or other intermediaries.

The investment manager also relies on this network to assist it in due diligence on the financial, legal, environmental, structural, and planning aspects of the particular investment. Although part of the due diligence process may be outsourced to third-party professional services firms, some may also be conducted in house. In such cases, the due diligence is likely to involve significant input from local affiliates.
Part III: Investment management

Finally, once a decision is made to dispose of a property, the investment manager may also invite input from its local affiliate, which may also serve as a point of contact for potential buyers of the property. Depending on resources, however, some investment managers outsource the disposition process to a third party.

7.4.3 Development project management
For development projects, the investment manager typically has control over the development design, selection of contractors, budgets, timing, and the like. The local affiliate is also likely to be involved in a project management capacity, liaising with local contractors and ensuring that the development project is of a suitable quality and is completed on time and on budget. The local affiliate may also be a liaison to local government offices.

7.4.4 Financing and re-financing services
It is common for property acquisitions to be partly financed by debt. In many cases, this debt is obtained by the Property OwnCo from local providers of finance. Although final decisions as to the financing terms are generally made by the investment manager, a local affiliate is often involved in the discussion of the financing arrangements between the Property OwnCo and the local financier, as well as future refinancing.

7.4.5 Asset management
The asset manager is responsible for maximising the return earned from a property. This can involve advising on improvements to the property that increase re-sale value or rental income, advising on the appropriate mix of tenants for the property, marketing and advertising the property to the identified target rental market, determining lease fees, and liaising with and monitoring of third-party service providers.

Due to the operational nature of such activities, asset management services almost always require the involvement of a local entity. Where the investment manager has no affiliate in the relevant jurisdiction or where the local affiliate does not have the capability to perform such services, they may be provided by a third-party asset manager. However, in either case, the activities of the local entity are generally subject to the decision-making authority of the investment manager.

7.4.6 Property management
Property management covers the day-to-day operation of the property, such as cleaning, security, and the provision of utilities. It is common for these services to be outsourced to specialist third-party property managers; however, in rare cases property management may also be performed by a local affiliate.

7.5 Key assets
Various tangible and intangible assets are employed by real estate funds. Among the tangible assets are equity and debt financing, residual/commercial properties, and other real estate holdings. Intangibles may include a proven investment strategy and an extended network of professionals.

Sponsors raise capital, used in the launch or expansion of the funds’ holdings, from independent investors. Additionally, special development projects or acquisitions may require further financing, which can be facilitated by lending institutions. Local affiliates may be involved in securing some of the financing.
Notable intangibles include an investment strategy with proven results, helping to attract investors to contribute to the fund. The extended network also proves beneficial. Such benefits include applying knowledge of local experts in the due diligence process and working with trusted development partners – contractors, architects, project managers.

### 7.6 Key risks

Real estate investment funds carry investment strategy and reputational risks, as do private equity and hedge funds. Other risks also affect real estate funds, including development risks, general market risks (e.g. interest rate risk), and credit risks.

Due to the nature of the investments, a local affiliate responsible for new projects bears development risks. Projects must achieve promised specifications within budget and time constraints in order to meet projected returns of the fund managers.

Funds may drive new developments or acquisitions through debt financing – issuing bonds or loans. As long-term interest rates fluctuate, costs of financing and re-financing change; thus, real estate funds' returns are subject to general market risks.

Property managers maintain the funds' physical holdings and are responsible for collecting rents. Consequently, real estate funds are exposed to credit risks of tenants, although on a smaller scale than other risks.

### 7.7 Transfer pricing methods

#### 7.7.1 Issues

Transfer pricing for real estate investment tends to focus on cross-border transactions relating to the investment management and asset management functions with which local affiliates are most commonly involved. For example, the local affiliate may identify the potential investment, assist with due diligence and financial modelling, and then make an investment recommendation to the investment manager. The investment manager, with input from the local affiliate, then conducts the negotiations and makes the decision whether to invest. Similarly, the local affiliate may make recommendations about how to profitably operate the property, suggest capital improvements, and position the property for resale, with the investment manager deciding which plans should be implemented and how. In contrast, there is generally little local affiliate involvement in the fund management and capital-raising functions, as both of these functions are typically performed in the investment manager's home jurisdiction.

With this background in mind, the remainder of this chapter describes in more detail the transfer pricing policies most applicable for real estate investment management. For a discussion of the transfer pricing process and potential issues relating to financial transactions as they may be applicable to real estate management, please see Chapters 15-17.

#### 7.7.2 Approach and methods

##### 7.7.2.1 CUP Method

Under the CUP Method, the price charged between two third parties, or between one related party and a third party, for a particular service may be used to determine the price to be paid between two related parties for the same service. For real estate investment, if the investment manager receives the same kind of services from third parties as from local affiliates, or if there is data available on what two third parties pay for the same services, the prices paid in such transactions may serve as a reference...
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point from which the prices paid to local affiliates can be determined. If the services are sufficiently comparable to each other with respect to functions performed, geography, timing, and contract terms, the price of the third-party uncontrolled transaction may be applied directly to the transaction with local affiliates. Alternatively, if the services are largely the same in both transactions but have some differences as to certain characteristics (e.g. the type of real estate investment involved), it may be necessary to make adjustments to the third-party prices to derive an arm’s length price to be paid to the local affiliates. Nevertheless, such third-party comparable data may provide a reasonable starting point from which to determine arm’s length pricing.

The availability of comparable data in the real estate investment industry from which such price comparisons can be drawn depends on the specific function being performed. For capital-raising activities, such data may arise only if the investment manager uses a third-party distributor in one or more jurisdictions, as there is less likely to be publicly available data on the fees paid between third parties for capital raising for real-estate-specific fund products. In such cases, consideration may need to be given to using a broader range of comparable data, such as the fees paid to distributors of other types of fund products (as far as those products have similar characteristics to real estate funds).

On the other hand, third-party comparable data for deal sourcing and origination, asset management, and other functions performed in relation to specific investments may well be publicly available. This is particularly the case in jurisdictions where there is a listed REIT market, as such information is often found in a REIT’s financial statements and prospectus documents. As a general rule, public data on REIT fees typically falls into the following categories, which broadly map to the functions described above: acquisition and disposition fees (fund and investment management), asset management fees, development fees, and refinancing fees.

Although this publicly available comparable data is helpful, in most transfer pricing situations, further analysis is still required. As mentioned above, the contract terms or responsibilities of the local affiliate seldom match those of a third-party contract, and some adjustments may be required to take into account the differences. Some of the issues that arise in the transition from theory to practice are outlined in more detail in the following sections.

7.7.2.2 Calculation of comparable fees
The most prominent of these issues relates to the manner in which the comparable fee data is calculated. In almost all cases, the fees are expressed as a percentage rather than a fixed amount. However, the base upon which that percentage is calculated may differ widely.

To start with, the base may be the value of the property or the income earned from that property (i.e. asset value as opposed to income). Moreover, in the former case, the ‘value’ used may differ between purchase price, book value, market value, or disposal value. Likewise, in the latter case, the income base may differ depending on how income is calculated and on the revenue measures used. Given that the selection of the base upon which the comparable fee is calculated has as great an impact on the total fee as the percentage rate used, it is always important to ensure that there is consistency across the CUP data and the related-party transaction in terms of base

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23 Alternatively, but less commonly, if local affiliates provide similar services to third-party real estate investment groups as those provided to the investment manager, the third-party fees paid to those local affiliates may be used to derive the fees to be paid by the investment manager.
adopted. This may be simple where there is a standard approach across the industry – such as acquisition fees based on a percentage of purchase price – but more difficult where there is not such consistency (e.g. development fees).

**7.7.2.3 Bifurcated pricing models**

In addition, in some cases, fees paid to a local affiliate may be paid by a Property OwnCo rather than by the investment manager, in order to obtain deductions in the investment country or to satisfy tax considerations in the investment country. Although there are good reasons for this in-country payment, this can add to the transfer pricing complexity.

Although domestic transactions are not covered by transfer pricing regulation in many countries, it is still recommended to identify an arm’s length fee for the services performed by a local affiliate where those services are remunerated by the Property OwnCos. This is because, even if not covered by the transfer pricing legislation, in most cases tax examiners have authority to investigate domestic transactions if they believe that the fee structure causes the overall taxable income in the group to be reduced.

The position may be further complicated by the fund’s organisation documents. To avoid duplication of fees, many funds require that fees paid by the Property OwnCos to local affiliates be offset against any fees paid by the fund to the investment manager. In these cases, the impact of the domestic pricing methodology on the total fees paid needs to be understood, both from the perspective of the investment manager and from the perspective of the local affiliate. This relationship between domestic and cross-border transactions is illustrated in Figure 9.

![Figure 9: Potential domestic and cross-border inter-company transactions in a real estate investment group](image-url)
7.7.2.4 Profit volatility at the local affiliate
As described above, the use of comparable fee data may result in a number of fees being paid to a local affiliate, e.g., acquisition fees, disposition fees, and asset management fees. Given the sporadic nature of some of these classes of fees, particularly acquisition and disposition fees, the result may be a certain degree of volatility in the profitability of the local affiliate.

In such circumstances, it may be useful to conduct a reasonableness check on the overall profitability of the local affiliate, even if comparable fee data is identified for one or more of the services performed by that local affiliate. Although the OECD Guidelines clearly state that the arm’s length principle does not require the application of more than one method,24 good transfer pricing risk management includes conducting an analysis of the total profitability of the local affiliate to ensure that it is reasonable given the business conditions under which it operates and the type of functions it performs and risks it assumes. That is, where it performs functions of a more value-added nature and assumes greater risk, it may be appropriate for that local affiliate to absorb larger fluctuations in profitability (and possibly even bear losses).25

7.7.2.5 Cost Plus Method
Where the functions performed by a local affiliate are clearly routine services, a transfer pricing methodology based on a cost plus approach (typically full cost plus mark-up) may be considered an appropriate choice. However, in many jurisdictions the functions most commonly performed by a local affiliate, such as sourcing and origination, may be considered by the relevant tax authorities to be fundamental to the overall real estate investment management process. In those jurisdictions, it may create greater risk to apply the Cost Plus Method in all but the most limited cases (e.g., where the local affiliate provides general real estate industry research only).

If a Cost Plus Method is adopted, other issues related to implementation need to be borne in mind. For example, the cost base against which a particular cost plus fee is to be calculated must be segmented if the local affiliate also provides services to other related parties (whether onshore or offshore). This is the case even if the fees earned by the local affiliate are all based on the Cost Plus Method as far as (i) they have different mark-up rates or (ii) they are charged to different parties.

At the other end of the calculation process, the mark-up (i.e., the profit attributable to the local affiliate’s activities) in theory should be determined using the results of companies performing comparable services. However, it is likely to be difficult to obtain publicly available data from suitable real estate investment comparables for this purpose. Consequently, as with the analysis of CUP data, it may be necessary to cast a wider net over a broader range of investment management sectors when determining an arm’s length mark-up.

7.7.2.6 Profit Split Method
Depending on the degree of contribution of the local affiliate to the overall profits, the local affiliate may be compensated using an appropriate allocation methodology (before or after deduction of expenses of the two entities). This approach is likely to be appropriate where the functions performed by the investment manager and its local affiliates are so closely intertwined as to make it difficult to ascertain the individual contributions of each to the overall profit of the group. Allocation methodologies

24 OECD Guidelines, Paragraph 2.11.
25 Note that this type of analysis may also be useful for non-transfer pricing purposes, such as entity or group cash flow analyses.
in such cases are typically based on comparable revenue split data or quantitative allocation factors, such as headcount or compensation costs. For a detailed explanation of the issues surrounding the choice of such allocation factors, refer to Chapter 9.

This profit split approach has been less common in the real estate investment industry. However, as the real estate industry continues to globalise, it is possible that this methodology may become more commonly adopted in the future.

7.7.3 Transfer pricing considerations
Although certain issues arising from the implementation of each transfer pricing methodology are described in the preceding sections, a number of other complicating factors must be considered before the transfer pricing policy is finalised.

7.7.3.1 Carried interest
The publicly available data on carried interest is inconclusive as to whether third-party advisers charge a performance fee. Consequently, whether a share of any carried interest earned is paid to local affiliates depends on the facts and circumstances of the specific case. First, it is important to consider the nature of the services being performed by each local affiliate. The more routine the services are, the less likely it is that a share of the carried interest is warranted. Second, it is necessary to consider what form the share of carried interest should take, given there is little guidance from the market as to a standard structure. For example, consideration must be given to how the share of carried interest is measured and whether a cap is required. Any number of such factors could have a significant impact on the size of the share of carried interest that may fall due.

Notwithstanding these uncertainties, it is critical to think about these issues and develop logical support for the decisions made before the tax authorities raise these points in an audit. For example, if the local affiliate does not receive any carried interest, then it is necessary to explain to the tax authorities the basis for that decision in terms of the functions performed and risks undertaken by such local affiliates. On the other hand, if a share of carried interest is paid, it is important to be able to explain to the tax authorities the basis for calculation of that share. Given the time limits usually imposed for responding to questions raised by the tax authorities during an audit, it may be difficult to develop or demonstrate clearly the transfer pricing approach adopted for carried interest without prior preparation.

7.7.3.2 Guaranteed minimum payments to investors
In addition, the transfer pricing position must also take into account the profit distribution waterfall, as a specified return may need to be paid to investors before the investment manager can receive its fees.

From a transfer pricing perspective, this requirement can be difficult to manage because, even if payments to the investment manager are limited in this way, transfer pricing principles may still dictate that local affiliates be compensated on a current basis. Obviously, this would have tax and cash flow implications for the group as a whole.
7.8 Conclusion
In addition to outlining the primary transfer pricing options available in the real estate investment management industry, this chapter has also highlighted a number of difficulties involved in the implementation of such options. Nevertheless, despite the difficulties that arise, it is clear that developing a principled approach to transfer pricing should be the goal of all international real estate investment groups. With the increasing focus of tax examiners in every country on transfer pricing, real estate investment groups should no longer expect that their industry size, obscurity, or complexity, relative to other investment management or financial services industries, will protect them from notice.
Chapter 8 – Sovereign wealth funds

8.1 What is a sovereign wealth fund?

SWFs have been around for many years. By some accounts, the first SWF was established in 1953 in the middle east as a commodity fund from oil revenues. Over the last decade, however, as nations become richer and increasingly wiser about financial planning, the number and the wealth of the SWFs have dramatically increased. This was naturally followed by increased public scrutiny, including official regulatory scrutiny, tax laws and regulations, and media coverage. The Wall Street Journal, the Financial Times, and The Economist regularly publish articles about the investment activity of various SWFs.

From an international tax standpoint, there is no conventional definition of an SWF. Generally, the term refers to a state-owned fund invested into a variety of financial assets (stocks, bonds, real estate, commodities, and other financial instruments). The term SWF is often used interchangeably with the term ‘sovereign investment corporation’, which is the actual investment vehicle used to manage the sovereign wealth. Conceptually, the SWF is only one of the types of investment vehicles used by sovereign states to invest their accumulated wealth, along with public pension funds, state-owned enterprises, or sovereign wealth corporations.

The legal basis under which sovereign wealth funds are created varies from country to country, and can be one or a combination of the following: constitutive law, fiscal law, company law, and other laws and regulations. The source of capital for the SWF also varies and may be state savings (budgetary surpluses), national assets (industrial or financial holdings), and positions held by the state central bank/monetary authority (foreign currency deposits, gold). In contrast to the foreign exchange reserves held by central banks as an instrument for short-term currency stabilisation and liquidity management, sovereign wealth funds try to maximise the long-term return of their shareholder (the sovereign state) and, generally, have no (significant) role in the monetary policy of the respective state.

Public information for sovereign investment vehicles and their asset holdings is scarce.

8.2 Transfer pricing and sovereign wealth funds

As the global footprint of SWFs is expanding, the tax laws applicable to SWFs in countries around the world are also becoming increasingly sophisticated. There is no consistent global approach to the taxation of SWFs. Certain jurisdictions have regimes that allow SWFs to obtain an exemption from tax, generally restricted to passive income derived in the respective country. These exemption provisions exist due to specific provisions in the domestic law, administrative practice, or through reciprocal treaty provisions. To the extent that the SWFs do not fall under foreign government exemptions or invest in countries that do not offer special concessions, they are effectively on equal footing to any other foreign investor. However, an overview of the

30 A survey of the 10 largest SWFs as of the end of 2009 was provided by Financial Times in their article “India’s Sovereign Wealth Fund”, published 17 March 2010.
general taxation framework of SWFs is outside the scope of this chapter, because the primary goal of this chapter is to present a framework for cross-border transfer pricing analysis and to highlight transfer pricing matters specific to SWFs.

### 8.2.1 The functional profile of sovereign wealth funds

An understanding of the functional profile of the sovereign wealth funds is fundamental to the understanding of transfer pricing matters for SWFs. Generally, in the asset management market, SWFs are unique in that they are established, funded by, and managed under mandates designed by a sole shareholder, the sovereign state. Each fund has its own unique reasons for creation, source of funds, and objectives. Depending upon the tax laws of the home country or the structure of the investments, some SWFs may be tax exempt. Given state ownership, many SWFs do not publically report investment activity.

In contrast to these ‘unique’ characteristics, as players in the asset management market, the SWFs are managed on commercial principles to create and maximise long-term value to their shareholders, and are subject to the same competitive market pressures as any other player. However, there is little information available in the public domain to illustrate this point. The majority of sovereign investment corporations do not make available to the public information on their legal structure, governance, portfolio holdings, or investment performance. The instances where sovereign investment corporations are transparent, offer financial reports, and provide some insight into their functional profile are rare.

Based on some of the publicly available information, it is observed that some SWFs have similar operating models as many ‘regular’ investment houses. For example, they may employ a large multinational staff with a legal presence in multiple jurisdictions and is credit rated by agency’s such as Moody’s and Standard & Poor’s. Furthermore, the SWF may be run independently by a board of directors and a management team, with the key objective of maximising shareholder returns from its investments, with full commercial discretion and flexibility. Key attributes potentially similar to a non-sovereign investment manager is illustrated below:

- **Investment style** – An SWF may take a long-term perspective, have the flexibility to take concentrated positions, invest with a long or short horizon, and invest remaining funds in cash. Investments may be funded primarily by dividends from portfolio companies, divestment proceeds, and commercial leverage.

  Investment and divestment decisions may be based on value tests and market opportunities. The boards and management of its portfolio companies may be responsible for their own day-to-day operations and commercial decisions, with reviews conducted by the management company.

- **Risk management** – An SWF is generally exposed to risks faced by any other investment house, such as strategic risks (funding and liquidity, political, structural foreign exchange, and industry risk); financial risks (investment, market, and credit risk); and operational risks (people, process, systems, legal and regulatory, reputation, and business disruption risks).

  In this way, the strategic, financial, and operational risks faced by the company as a whole are generally managed at the enterprise level. Each risk category may have a designated owner. The investment teams and corporate units, such as Legal & Regulations, Finance, Human Resources, Strategic Relations, Corporate Affairs,
Information Technology, Operations, and Risk Management, manage specific transaction or enterprise risk elements under their respective domains. Relevant approval authorities may have been established and company policies and standard operating procedures documented to drive the end-to-end process controls. These procedures also cover the reporting requirements to the board, board committees, and senior management to apprise them of relevant risk issues. Furthermore, similar to many financial institutions, there may be processes for tracking and reporting its annual VaR as well as various stress tests and recalibrations of those tests to understand its exposures and amount of risk undertaken.

The overall guidance and policy direction on the risk management framework and functions may be provided by the board. Together with the CEO and senior management team, the board determines the risk management objectives and policies.

- **Compensation** – The compensation system would generally include a combination of base salaries and incentive plans that are subject to performance hurdles and time horizons to account for risks over market cycles and the sustainability of returns. The cash portion of the incentive plan may be linked to individual, unit, or company annual targets, and risk-reward sharing incentives over the longer term linked to wealth added or total shareholder return. In turn, senior management may have the bulk of their performance incentives deferred for three or more years, while for junior staffers their incentives are comprised proportionately more in cash.

### 8.2.2 Sovereign investment companies – What makes them different?

Sovereign investment corporations have certain unique features that make them different from non-sovereign investment houses – they are established, funded by, and managed under mandates designed by a sole shareholder (the sovereign state), have large pools of assets under management, and may receive special tax treatment. They also have features that make them similar to non-sovereign investment managers – they operate as independently managed commercial investment companies, are managed on commercial principles to create and maximise long-term value to their shareholders, and are subject to the same competitive market pressures as any other player. Given their global investment footprint, as with mainstream investment managers, sovereign investment corporations operate through affiliates established around the world, as relevant to their mission, to enhance their visibility into the opportunities offered by the regional markets and to facilitate their investments.

From a business operational standpoint, the relationships between affiliates and the parent sovereign investment companies are structured in the same way as the inter-company relationships of any other multinational. These transactions may consist of one or a combination of business management services, business support services, market research services, investment advisory services, loan origination services, licensing of intellectual property, inter-company financing, and other types of inter-company transactions.

The methods, concepts, and principles available to the transfer pricing consultant to perform an economic analysis of the inter-company pricing of an SWF are no different than those available for the analysis of mainstream investment managers. These methods can be the CPM/TNMM, the RPSM, the CUP method, or other unspecified method, depending on the facts and circumstance and available data for benchmarks. The challenge is often how to select and use the pricing data available in the public
domain, assuming the CUP method is the best/most appropriate method, and how to
determine the necessary adjustments. Take as an example inter-company investment
advisory services, which are fundamental to the operation of any SWF. While the
substance of the inter-company service is non-unique, the structure under which
the service is provided is unique – similar to a giant separate account manager with
a single investor. Unlike any other asset management company, sovereign wealth
corporations operate under the mandate of a sole sovereign principal. This unique
operational profile requires careful selection of publicly available price data on
investment management services. This selection is primarily because public data on
pricing structures used by sovereign wealth companies is practically non-existent
and such pricing data is available only for mainstream asset managers, across a
variety of investment strategies, pricing structures, mandate management styles, and
mandate sizes. A possible venue of transfer pricing analysis, including a description
of adjustments to the pricing data to increase robustness, is presented in the
following sections.

8.2.3 Benchmarking the pricing for inter-company advisory
services under the principles of the Comparable Uncontrolled
Price Method

The following illustrates a hypothetical example whereby the transfer pricing
consultant is called to benchmark the inter-company pricing for advisory services
provided by an affiliate of a sovereign corporation. The example was tailored to
highlight the use of pricing data from multiple public sources and the application of the
necessary adjustments to increase comparability.

8.2.3.1 Hypothetical example of inter-company investment management
services

For the purposes of this section, assume Sovereign Corporation (Parent) is an
investment management company managing assets owned by a foreign sovereign
(Sovereign). Parent establishes a Hong Kong affiliate (Affiliate), 100% owned by
Parent, to provide investment advisory services for the Asia-Pacific region in the
alternative energy market. In its role of investment manager, Affiliate identifies,
recommends, and tracks the performance of investment managers in the alternative
energy market. However, Affiliate does not perform any capital-raising activities,
marketing, distribution, investor reporting, or other related investment management
functions. Since the sole investor is the Sovereign, little capital-raising or distribution
activities are required. Acting through the Affiliate, Parent invests in AIVs in
Asia-Pacific. The AIVs are minority-owned limited liability companies operated and
managed by a third-party manager (Manager). The Manager is given autonomy to
invest in certain assets within the guidelines of an investment agreement with the
limited liability company. The Manager has an economic interest in the AIV (as general
partner or managing member) and is compensated by the AIV with asset management
fees and incentive fees based on the performance of the AIV. Affiliate does not directly
own any financial assets. As consideration for the services provided, Affiliate is
compensated with an investment advisory fee (expressed in basis points on the net
asset value).

32 Treas. Reg. Section 1.482-9(c) and OECD Guidelines, Part II, Paragraphs 2.13-2.20.
33 The term ‘alternative investments’ refers to investment vehicles subject to limited regulation, typically serving
high-net-worth individuals and institutions, often structured as limited liability partnerships and limited liability
companies, with investment management fee structures that include incentive fees. These vehicles are often highly
illiquid.
Part III: Investment management

From a functional standpoint, the Parent-Affiliate structure hypothesised above has similarities to both the separate account and fund-of-funds structures. Similar to a separate account, the portfolio is managed for the benefit of a single client (i.e. Sovereign), which establishes the investment objectives of the mandate (asset diversification, geographical diversification, risk exposures, targeted returns). Similar to a fund of funds, the Parent is an umbrella vehicle that, acting through its affiliates, invests into AIVs in the Asia-Pacific region.

8.2.3.2 Data available for the benchmarking analysis
An understanding of the Affiliate business model is the first step in selecting the relevant uncontrolled service price data available in the public domain. From a conceptual standpoint, the business model of Parent is a hybrid between the business models for investment managers of separate account vehicles and those of fund-of-funds vehicles. First, the investment advisory services provided by Affiliate are comparable to the investment management services provided by managers of separate accounts, as Affiliate, similar to separate account managers, has its mandate designed by, approved by, and reports to a sole client, namely the Sovereign. Second, the investment advisory services provided by Affiliate resemble the investment advisory services provided by the investment managers of fund-of-funds investment vehicles. Similar to fund-of-funds managers, Affiliate identifies, recommends, and tracks the performance of alternative investment managers of AIVs in the alternative energy market space. However, in contrast to fund-of-funds managers, Affiliate does not perform any capital-raising activities, marketing, distribution, or other related investment management functions as a manager of managers. As such, Affiliate performs only a sub-set of the broader investment management function performed by fund-of-funds managers.

Therefore, two distinct types of investment management services pricing data from the public domain may be appropriate for the analysis of the inter-company advisory fee that arises in such cases:

- Investment management services pricing data for separate account investment vehicles invested into various asset classes with global or geographic defined mandates. 34
- Investment management services pricing data for fund-of-funds vehicles invested in various asset classes with global or geographic mandates, coupled with the fund-of-funds investment management expenses apportionment data, which includes investment advisory fee apportionment data. Several public databases report investment management fee data for fund of funds. 35 These databases collect data on alternative investment vehicles (mostly offshore vehicles), with sophisticated/accredited investors, not subject to regulations and disclosure requirements with the SEC or other regulatory bodies. The alternative investments are open only to persons/entities that meet the accredited investor requirement in accordance with Rule 501(a) of Regulation D promulgated under the US Securities Act of 1933, as amended.
- Investment management expense/fee apportionment data, such as the data provided by Lipper 36 published by Reuters Group Plc. At the time this chapter was written, Lipper reports the expense apportionment for several investment

34 As of the date this chapter was written, the Nelson Marketplace Database published by Thomson Financial contains data on separate accounts. Source: http://www.nelsons.com/nelson_products/mpweb.asp.
35 As of the date this chapter was written, Barclay Hedge Fund-of-Funds DataFeeder database (Barclay Hedge DataFeeder), published by Barclay Hedge Plc., contains fee data on fund of funds. Source: http://www.barclayhedge.com/products/fund-of-fund-datafeeder.html.
Part III: Investment management

management sub-functions, such as advisory, sub-advisory, marketing, administration, legal, custodian, and others. Lipper, however, reports the expense apportionment data only for funds registered with the SEC and is therefore subject to strict disclosure requirements. Furthermore, most of the funds contained in Lipper are open to retail clients and may be distributed via broker-dealer channels. These facts are in contrast to the hypothetical facts surrounding the provision of investment advisory services by Affiliate, which is an alternative investment adviser not subject to regulations and disclosure constraints of the SEC, with a sole client.

Although the level of a fund-of-funds management fee may not be directly comparable to the manager-of-manager-type fees of Affiliate, the relative share of fees for solely the advisory function, as a percentage of the total expenses, represents the portion of fees collected by the fund-of-funds managers for only advisory activities, excluding capital raising, advertising, marketing, and reporting to multiple investors. Expense apportionment data provides a reliable measure (in relative terms) of the relative size of the advisory fees to the total fees paid by the investors to the fund managers. To construct benchmark ranges, under the principles of the CUP Method, the data identified above can be used in the benchmarking analysis of the advisory fee by pursuing two separate and complementary venues:

- **Benchmark I** – A range of uncontrolled service prices can be constructed based on the investment management fees paid by investors for comparable separate account investment vehicles. The controlled investment advisory fee is then compared against this range of uncontrolled fees.

- **Benchmark II** – A range of uncontrolled service prices can be constructed based on the investment advisory fees charged for fund-of-funds investment vehicles. This analysis starts with the total investment management fees retained by the fund-of-funds manager for the broader investment management function (including but not limited to investment advisory, capital raising, marketing and distribution, management of the underlying fund managers, and other related services). These fees are then adjusted to account for only the advisory function (part of the broader investment management function) using the expense/fee apportionment data. The controlled investment advisory fee is then compared against this range of adjusted uncontrolled fees.

As a private company with a Sovereign investor, Affiliate is not subject to the SEC provisions and therefore the share of advisory fees from the investment management fees may be different from that which would be relevant to the services performed by Affiliate if the regulatory compliance portion were eliminated. An adjustment to the advisory fees to eliminate the regulatory compliance costs is difficult to perform given the lack of data available to perform such an adjustment.

37 The use of adjustments to improve reliability and comparability when differences between the controlled and uncontrolled services exist is prescribed by Treas. Reg. Section 1.482-3(b)(2)(iii)(B), which provides that: “If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of Section 1.482-1(d) (2)”. Specific examples of factors that may be particularly relevant to the application of this method include the services transferred in the transaction (Treas. Reg. Section 1.482-1(d)(3)(v)). The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter I, Paragraph 1.35 also notes: “Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison.”
8.3 Conclusion

Sovereign investment corporations have certain unique features that differentiate them from non-sovereign investment managers. The challenge presented to the transfer pricing consultant in analysing pricing for inter-company advisory services of sovereign corporations is how to select and use the data available in the public domain to construct relevant benchmark ranges. Various public databases provide industry-specific data for separate accounts and fund of funds to construct robust benchmark ranges of advisory fees, and to appropriately adjust these ranges (if such adjustments are possible) to reflect primarily the substance of the inter-company advisory functions for a single sovereign investor.
Part III: Investment management
Part IV: Banking and capital markets
Chapter 9 – Global trading

9.1 Introduction
The determination of an arm’s length transfer price within the context of global trading requires a clear understanding of the unique elements related to these businesses, including evaluating how and where key functions are performed, how capital is utilised and exposed to risk, and how profits are shared between participants. Given the recent credit issues in the financial markets, there are more pressures from taxing authorities to challenge existing policies adopted by taxpayers. In addition, taxpayers have become more sensitive and sophisticated in determining transfer prices involving global trading transactions.

The evaluation of global trading transactions can be complex and is typically subject to facts and circumstances unique to the taxpayer’s business. The descriptions presented in this chapter are organised to focus initially on presenting key terms and concepts with respect to global trading. This is followed by descriptions of transfer pricing and application factors that affect the selection of an arm’s length method or approach for compensating the participants (which may be legal entities or branches) in a global trading business.

9.1.1 Key terms and concepts

9.1.1.1 Global trading
Global trading refers to financial products offered to customers in more than one jurisdiction, which requires the determination of transfer prices between associated enterprises or, where trading is conducted through PEs, the attribution of profits. Part III of the 2010 OECD PE Report is the most important transfer pricing guidance available on this issue. The 2010 OECD PE Report also contains guidance on applying the arm’s length principle to global trading conducted between legal entities. With respect to the US, the IRS issued, but never finalised, Proposed Treas. Reg. Section 1.482-8 regarding the Global Dealing Regulations (released March 1998).\textsuperscript{38}

Although global trading of financial instruments refers primarily to entities that engage in market making on a global or 24-hour basis, it also includes situations where some part of the business takes place in more than one jurisdiction. Emphasising this relatively low threshold, the 2010 OECD PE Report notes that the term ‘global trading’ may refer to the dealing or brokering of financial instruments in customer transactions where some part of the business takes place in more than one jurisdiction. This is consistent with the Global Dealing Regulations. Under Proposed Treas. Reg. Section 1.482-8(a)(2), a global dealing operation need not be conducted around the world or on a 24-hour basis to be considered global dealing. Instead, the operation need only perform one of the enumerated functions in more than one tax jurisdiction.

9.1.1.2 Definition of proprietary and customer trading
Consideration of the risks assumed and the capital required to support those risks in a regulated financial institution is dependent on whether the trading is characterised as customer trading or proprietary trading. For instance, although the OECD and many tax authorities accept some analogy of a hedge fund model (with capital getting a higher return) for a proprietary trading business, they do not accept (without fully

\textsuperscript{38} This proposed regulation has never been reissued as a temporary or final regulation and it is not binding upon taxpayers.
explaining) such an approach for a customer trading business. However, in reality, the distinction between customer and proprietary trading is not always straightforward, and there may be circumstances where some variation of the hedge fund model may be appropriate for customer trading of high-risk assets.

Proprietary trading, defined as a “deliberate exposure of the portfolio to the market variables” (2010 OECD PE Report, Part III, Paragraph 9), involves trading as a principal on behalf of the financial institution. In proprietary trading, the strategy of a financial institution is to earn a significant proportion of the income by taking un-hedged 'proprietary' positions to generate significant trading gains (2010 OECD PE Report, Part III, Paragraph 162). Such strategies involve higher risk, since they may result in significant losses to the financial institution.

In contrast, the customer trading business involves a trading book run on a more conservative basis, incurring little in the way of un-hedged risks, and earning most of its income from the dealer spread between bid and ask prices. Customer business tends to be driven primarily by commissions and spreads rather than trading gains (2010 OECD PE Report, Part III, Paragraph 162). In the customer trading business, it is also important to determine whether it is a customer 'flow' trading book or customer 'structured' trading book, since that would impact the determination of the value of the sales, marketing, structuring, and trading functions, and the type of third-party comparables that may be applied.

According to the proposed 1998 US Global Dealing Regulations, “A global dealing operation consists of the execution of customer transactions, including marketing, sales, pricing and risk management activities, in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants.” (Prop. Treas. Reg. Section 1.482-8(2)(i)). The proposed US Global Dealing Regulations do not apply to proprietary trading businesses.

The 2010 OECD PE Report recognises that, in practice, there may be situations where the business strategy is to leave a significant percentage of positions un-hedged, which may be described as quasi-proprietary trading (2010 OECD PE Report, Part III, Paragraph 163). In these situations, a trader may engage in directional trading and leave un-hedged positions, or the trading entity may act as a principal to client-driven trades. Each situation must be evaluated separately to determine whether the trades are part of the same strategy and cannot be evaluated separately, or whether different trading strategies exist in one book and may need to be evaluated separately.

To the extent the business is a combination of customer trading and proprietary trading, one must consider the relative size and materiality of the customer trading portion in comparison to the proprietary trading portion.

- Determine if the business is predominantly customer trading or proprietary trading (Predominant test).
- IRS perspective is that, where possible, the books should be split and separated to reflect customer and proprietary trades.
- If it is not practical to have separate books for customer trading and proprietary trading and the value of the transactions are large, then a taxpayer can consider getting certainty through (i) an IRS ruling or (ii) an APA.
9.1.2 Integration of global trading

The 2010 OECD PE Report addresses the issue of integration in relation to global trading by referencing the various structures used to manage the market risks of trading books. The typical trading structures can be represented along a continuum, with what has become known as the ‘Integrated Trading’ model at one end, the ‘Separate Enterprise Trading’ model at the other end, and the ‘Centralised Product Management’ model in the middle. It should be noted that the models are defined only by reference to the organisation of the particular trading and risk management activities. Other functions, such as sales, do not necessarily follow the models. There is some overlap among the models such that companies should focus on the key characteristics of each model to assess their relative positions.

<table>
<thead>
<tr>
<th>Integrated trading</th>
<th>Centralised product management</th>
<th>Separate enterprise (Standalone)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Trading activities are seamless and traders in more than one location are involved in trading positions in the same book.</td>
<td>• All market risk for a particular product is managed centrally.</td>
<td>• Each location employs traders and manages separate books.</td>
</tr>
<tr>
<td>• Trading limits and risk management policies are set by a committee and apportioned to each location or head trader in each jurisdiction.</td>
<td>• Booking functions and credit risk management are centralised in one location.</td>
<td>• Each location can undertake trading positions to assume market risk and may pursue different trading strategies.</td>
</tr>
<tr>
<td>• Each location has trading discretion.</td>
<td>• Any hedging activities are centralised in one location.</td>
<td>• A central committee sets the overall trading limits but does not intervene or control trades within the set limits.</td>
</tr>
<tr>
<td>• Individual compensation is based on the performance of the total book/pool and traders cooperate to maximise the total profit of the book.</td>
<td></td>
<td>• Each location has the ability to hedge positions in complex securities and products.</td>
</tr>
</tbody>
</table>

In relation to an integrated model, responsibility for market risk passes from location to location in different time zones. When the markets close in a particular location, responsibility for trading the ‘book’ is passed to the next trading location where the open positions form the starting point for trading. Traders in the new location may close positions passed to them and open new ones. Trading is conducted on a cooperative basis with the objective of maximising the profit of the global book.

In a centralised model, all market risk of a particular product is centralised and managed in one location. Although there will be salespersons and marketers in various locations, the responsibility for managing the market risk rests with the centralised trading location through ‘back-to-back transactions’.
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At the other end of the spectrum is the separate enterprise model, which is the simplest to account for because trades in each location are booked locally and each location is treated as a separate profit centre. In this case, the only requirement may be to ensure that all back-office functions have been charged.

9.2 Key transfer pricing and application factors

9.2.1 Functionally separate entity approach and two-step analysis

The 2010 OECD PE Report recognises the ‘functionally separate entity’ approach as the ‘authorised OECD approach’ or the preferred interpretation of Paragraph 1 of Article 7 of the OECD Model Treaty. The 2010 OECD PE Report relies on hypothesising the PE as a distinct and separate enterprise. That is, “the authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”

Under the authorised OECD approach, a two-step process is required to attribute profits to a PE: (i) determine the activities and conditions of the PE based upon functional and factual analysis, including the attribution of assets, risks, and free capital as well as the identification of dealings to be recognised between the PE and the home office; and (ii) determine the profits of the PE based on a comparability analysis and application of transfer pricing methods premised on the allocation of risks, assets, and other attributes undertaken in (i).

9.2.2 Functional analysis

A functional analysis would be performed in the same manner as with separate legal entities, where the focus is on high-value-added functions as those that will attract a greater portion of the profit. A defining characteristic of the financial services industry is the special relationship between risk and financial assets. Risk and assets are inextricably linked such that the 2010 OECD PE Report uses unique terminology (i.e. KERT) to refer to the function of risk assumption and risk management that results in the creation and economic ownership of a financial asset (2010 OECD PE Report, Part II, Section B-1 (iii)). Banks have sophisticated risk measurement tools not seen in other industries. Transfer pricing analysis for non-financial services industries is less focused on risk and more focused on people functions.

In the PE context, the focus is on KERTs (2010 OECD PE Report, Part I, Paragraph 19), which require active decision-making with regard to the acceptance and/or management of individual risks or a portfolio of risks (2010 OECD PE Report, Part II, Paragraph 9, and Part III, Paragraph 68). Active decision-making refers to day-to-day operational risk management activities rather than the strategic policy setting activities related to risk management (2010 OECD PE Report, Part II, Paragraph 181, and Part III, Paragraphs 74-85).

A detailed functional analysis needs to be performed to determine the role of the various functions performed by the personnel of a PE in the business (i.e. whether these functions can be considered a KERT). Thus, for instance, the role of the sales, trading, or risk management functions can vary from routine information dissemination, execution, or policy setting to complex price setting, structuring, and day-to-day active involvement in the business.

Ibid. Part I, Paragraph 8,12.
A role that the functions play in the business is relevant to the selection of the transfer pricing method and reward for these functions. For instance, where based on a detailed analysis it is determined that sales and marketing functions performed by a PE are similar to general sales functions, market data is available to reward these functions with a fee (e.g. commission) applying the traditional transaction methods (e.g. CUP, resale minus) (2010 OECD PE Report, Part III, Paragraphs 127-130).

If, however, through a detailed analysis it is determined that the sales and marketing functions performed by the PE are highly specialised and involve the assumption of the credit risk and some aspects of carrying out trading functions, these functions may be attributed some share of the profit (2010 OECD PE Report, Part III, Paragraphs 130-132).

9.2.3 Profit Split Method

The choice of transfer pricing method for global trading is based on the same criteria that apply for other transfer pricing cases. In recognition of the unique characteristics of global trading operations, the OECD (in Part III of the 2010 OECD PE Report) and the US IRS (in the proposed Global Dealing Regulations) have modernised the traditional methods and specifically sanctioned the application of the PSM.

High-value-added activities within financial services are often integrated and cannot be evaluated and priced on a standalone basis. This integration often leads to the application of the PSM. One of the key differences between the CPM/TNMM and PSM is that although the CPM/TNMM generally analyses financials of one side of the transaction (the tested party, which is often the entity performing the simplest functions and assuming lower risks; it also does not usually own valuable intangibles), PSM instead rely on an analysis of combined profits of the transacting parties. The purpose of any profit split analysis is the allocation of combined profits. From a computational aspect, these methods therefore require the preparation of segmented profit and loss and balance sheet statements.

The RPSM relies on a characterisation of functions, risks, and assets according to which ‘routine’ functions are distinguished from non-routine/entrepreneurial functions. Routine functions are presumably relatively simple functions (that could be sub-contracted, for example). These functions should require no valuable intangibles and involve limited risks. In this respect, they fit both with the conditions for the application of the CPM/TNMM and the availability of comparable companies. Once the first step of attributing arm’s length returns to routine functions has been performed, residual profits are split between affiliates based on one or more split factors. On the other hand, entrepreneurial functions and/or risks involve, for example, trading, structuring, risk management, and highly specialised sales. In some cases, these high-value functions involve valuable intangibles such as proprietary pricing models or highly specialised know-how.

Although it is clear that many high-value-added financial services incorporate valuable know-how intangibles, these intangibles are usually reflected in the compensation of the individuals, e.g. traders, portfolio managers, or actuaries, and for this reason do not establish the need for a PSM. For financial services, the key criteria for applying the PSM becomes demonstrating the level of integration.
9.2.4 Capital

With respect to global trading operations, it is often necessary to evaluate separately the role of capital. These cases often occur where arrangements exist between the associated enterprises whereby the capital necessary to support the risks resides in a legal enterprise different from that which performs the functions giving rise to the risks actually assumed as a result of the global trading activity. The enterprise that possesses the capital often books the transactions directly onto its own balance sheet or enters into back-to-back transactions with the second enterprise, mirroring the transactions the second enterprise has with its customers.\(^{45}\)

When the entity possessing the capital has assumed relatively little risk, traditional transaction methods (e.g. CPM/TNMM) may be suitable, whereas some form of risk-based return might be appropriate in cases where the entity possessing the capital has assumed higher levels of risk.\(^{46}\)

Based on the losses stemming from the global credit crisis, it is clear that capital plays an important role in global trading operations. The question that needs to be answered is whether capital should be rewarded on a routine or non-routine basis. Fundamental economics would suggest that capital should be rewarded depending on the level of risk to which it is exposed, on a spectrum from risk-free to highly risky. The arm’s length reward for capital will typically be determined on a case-by-case basis.\(^{47}\)

The 2010 OECD PE Report expressly emphasises that in profit splits involving associated enterprises, the reward for capital goes only to the enterprise(s) that have the capital. It is hard to dispute the arguments raised on this issue based upon on logic or technical merit; however, it does create the potential for tax authorities to challenge profit-splitting arrangements on the basis of multiple PEs, even though capital was not formally located in the PEs’ respective jurisdictions.

From a US jurisdiction perspective, an example in the proposed Global Dealing\(^{48}\) Regulations suggests that capital is a routine contribution that should be compensated prior to splitting residual profits or losses among participants providing other, non-routine contributions. An unstated implication is that the provider of capital in a global dealing operation should be compensated by the other participants, mainly those that employ traders and marketers, should any net trading losses be incurred. This seems to conflict with the regulatory view that capital assumes the risk of loss. It seems that there are examples, in the case of hedge funds, where the owners of capital bear all trading losses and receive in compensation the lion’s share of trading gains. Economically, the share of income and loss attributable to the provision of capital depends on the legal arrangements between the participants. In principle, parties dealing at arm’s length could agree that the capital provider bears none, some or all of the risk of loss, provided that the capital provider was adequately compensated for whatever amount of risk was assumed.

9.3 Other considerations
9.3.1 Allocation factors

Once the routine functions have been compensated, a RPSM will incorporate allocation factors to apportion the remaining (i.e. residual) profits to the relevant entities based on their relative contribution. In the absence of external comparable data to provide

\(^{46}\) Ibid, Paragraph 159.
\(^{47}\) Capital is benchmarkable.
\(^{48}\) Prop. Treas. Reg. Section 1.482-8(e)(8), Ex. 5(iv).
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evidence or an indication as to how third parties may split profits, this selection of allocation factors is a highly subjective exercise. Validating the results through scenario and sensitivity testing is essential.

Although companies need to evaluate the suitability of various factors, there is widespread use of compensation as an allocation factor (and sometimes the only allocation factor) for both sales and trading and other potential key middle-office functions. Use of compensation factors should cause some reflection in today’s environment where bank compensation models are under attack and revision. Establishing the correlation between compensation and performance may prove to be even more difficult if an increasing amount of incentive compensation is deferred.

9.3.2 Allocation of losses

The magnitude of losses the industry has suffered due to the credit crisis pushes to the forefront the issue of how to deal with these losses. The void in guidance has left many companies to their own devices in determining whether their existing policies make economic sense when there are losses and what modifications may be required.

An initial consideration must be the reason for the losses, which will reveal either that losses were incurred in ‘business as usual’ conditions or that exceptional circumstances, such as unauthorised trading, were to blame. This examination of facts will either provide support for continuing to apply a Profit Split Methodology with some modifications or conclude that the losses should be attributed solely to the particular location where the losses originated.

When a PSM is appropriate, the 2010 OECD PE Report states that the same principles should be applied to attribute losses to a PE as would be used to attribute profits. The regulations promulgated under US Internal Revenue Code Section 482 state that “even if two controlled taxpayers realise an overall loss that is attributable to a particular controlled transaction, an allocation [by the IRS district director] under Section 482 is not precluded.” Additionally, the application of the PSM describes the allocation of profits and losses concurrently. It is certainly the case that the transfer pricing rules never considered the extent of losses that have been reported over the last few years, and that the consideration of losses was likely an afterthought. There is also little to glean from audit controversies, as the audit cycles of most North American and European financial institutions still pre-date the credit crisis.

Using compensation as an allocation factor for losses seems counterintuitive if one assumes a correlation between performance and compensation. The highest-performing locations will be allocated the greatest share of the loss. As such, it would likely lead to challenges by tax authorities in locations that have a large allocation of losses under such a model. It is also the case that compensation as an allocation key in an economic downturn can lead to problems in other respects (e.g. where guaranteed bonuses are paid in some locations but not in others). It is not just compensation as an allocation key in profit splits that can lead to problems. It is likely that tax authorities will challenge the basis of profit splits on any allocation key used if large losses are allocated to their jurisdictions, which seems inevitable given the scale and impact of the downturn in global financial services.

49 Examples include joint venture arrangements or loan syndicate groups.
52 Ibid.
9.3.3 Losses and regulated enterprises

Another loss-related issue, particularly in a global trading context, arises when one or more of the enterprises involved is a regulated entity that is not permitted to bear significant risk and hence not capitalised to support such risk. In these circumstances, regulatory constraints may prevent the regulated enterprise from sharing in losses booked in a non-resident enterprise, despite that the traders managing such risk are employed by the regulated entity. In this case, problems arise when the transfer pricing policy results in a loss allocated to an enterprise that is legally not permitted to incur such a loss.

The 2010 OECD PE Report suggests that tax and regulatory results need not be consistent, however:

“whether or not an enterprise is prohibited by regulations from performing functions which may create significant losses is not determinative of where profits and losses are attributed for tax purposes. This is because an enterprise may in practice, either accidentally or otherwise, perform functions that are prohibited by the regulator. In such circumstances, the enterprise would be taxed on what it actually did not on what it was supposed to do if it had kept within regulatory limits as profits and losses are attributed by applying the authorised OECD approach based on a functional and factual analysis of all the circumstances of a particular case.”

The analysis of this issue is crucially dependent on whether the losses arise intra-company and the allocation is to a branch or head office, or arise in one legal entity and the allocation is to another entity. In the latter case, a tax authority will find it harder to ignore which balance sheet actually incurs the loss.

One potential option to address the tax/regulatory conflict is to use a ‘clawback’ provision within the transfer pricing policy. A clawback entails the loss in excess of the limit required by regulatory bodies being borne by the unregulated entities operating within the global dealing enterprise during the year of the loss. This loss would then be carried forward to future years and recouped by the unregulated entities. As such, the unregulated entities would recover the loss in later years when the business becomes profitable.

But a clawback provision presents other issues that need to be resolved. The clawback typically adds an additional risk to the unregulated entities that they may not recover the excess losses if the business does not become profitable in later years. Accordingly, the unregulated entities may have to be compensated by the regulated entity for the additional risk assumption. The potential amount of the additional compensation, appropriate to cover such risk, however, cannot be estimated without a significantly detailed analysis to determine an appropriate risk-adjusted return.

Chapter 10 – Investment banking

10.1 Introduction
Inter-company/inter-branch transactions in the investment banking industry raise complex and challenging transfer pricing issues. In seeking an efficient allocation of resources (including people, capital, and technology), investment banks have a breadth of inter-company transactions that extend across numerous countries. Further, investment banks often operate under a regulated environment, which adds further challenges in structuring inter-company/inter-branch transactions.

Recently, the industry has been experiencing global or regional consolidation to improve efficiency, or global coordination of operations to accommodate clients with international operations. These often accompany reorganisations and create a need for a transfer pricing review of new inter-company/inter-branch transactions.

10.1.1 Industry overview
The investment banking industry is involved in the provision of securities underwriting services and advisory services. Investment banks act as capital allocation intermediaries between investors and issuers of securities. Investment banks also advise issuers on the terms and timing of the public offering, purchase new securities from the issuer, and distribute the issue to the public. In addition, investment banks provide strategic and general financial advice to corporate and institutional clients. Typically, this will involve advice on the merits of participating in M&A, divestitures, takeover defences, or other financial restructurings.

The demand for these advisory services varies depending on macroeconomic conditions, with a general increase in M&A services demand during periods of strong economic growth, when companies have higher levels of cash generation and access to capital is easier, whereas, demand for restructuring services, for the most part, is counter-cyclical. Global M&A deal volumes have been on a downward trend since a peak in activity in 2007, as the liquidity crisis in the financial industry and the downturn in the housing market caused the economy to enter into a recession. At the same time, demand for restructuring services increased, as companies have used the recession as a time to revitalise their reporting structures and improve operational performance. However, the revenue from and the margins on M&A services are generally superior to restructuring services, so overall advisory service revenue has declined over the past few years.

10.1.2 Industry participants
Major customers of investment banks issuing equity, fixed income, and hybrid securities are typically corporations, US government agencies, state and local governments, and foreign entities (corporations and sovereigns) that require long-term capital funding. Corporations and institutional clients seek advice regarding a buy/sell decision on a sale, M&A deal, restructuring, or general financial advice from investment banks.

Since the liquidity crisis in 2007, many of the larger investment bank players have failed or were acquired by commercial banks, altering the competitive landscape of the industry. The remaining two independent ‘bulge bracket’ investment banks, Goldman Sachs, Inc. and Morgan Stanley, converted into bank holding companies in

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54 ‘Bulge bracket’ is a term commonly used to indicate the top-ranked investment banks in terms of size, prestige, influence, and profitability.
order to maintain access to the US Federal Reserve’s discount window in exchange for more oversight by the federal government. These changes have enabled boutique investment banks to emerge and gain more market share in the industry. However, the foundation for success in the investment banking industry is the ability to attract and retain ‘rainmakers’ who have a network of relationships and have the talent to establish connections with potential clients.

10.2 Business model
Investment bankers render services to companies seeking to raise debt/equity capital in the (global) capital markets or to obtain advisory services. Generally, these services include origination, due diligence, marketing, and general client relationship management. Investment banks generally have a central purpose of raising capital for businesses to expand, merge, and acquire other businesses. Under the provision of advisory services, the common goal of investment banks, irrespective of deal type, is to provide the client with quality advice that is expected to ultimately cultivate the client relationship.

While there are subtle differences in the activities associated with the type of investment banking services or sector strategies, the general model remains broadly the same. Typically, transactions are originated through the diligent and strategic cultivation of client relationships. Transaction ideas are then shared with the client in hopes of closing the deal and signing a mandate. The next steps involve the execution and completion of the transaction under the agreed-upon terms of the engagement. Once completed and upon undergoing due diligence, the deal is formally announced to the public.

The primary revenue sources of the investment banking industry are from fees associated with the provision of advisory or underwriting services. Investment banks also gain revenue from actively trading financial instruments and placing new debt and equity issues with public and private investors. The type of revenue received for services varies according to each situation. Fees earned for restructuring and capital markets transactions are typically paid upon completion of the deal. Fees from an M&A deal are typically received as up-front fees, monthly retainers, and/or success fees at project completion.

10.3 Structure
Typically, an investment bank is split among front-office, middle-office, and back-office activities. These activities are generally supported within a central legal entity, through separate business units.

Front activities, such as advisory services, can be provided through integrated efforts in a fluid global team structure of related foreign affiliates. For example, a global operating structure functions as a collaborative venture among related entities where all entities are responsible for fluid contributions to successful origination and execution of deals and the provision of high-quality advisory services to their clients around the world. Thus, under this structure, each entity operates a domestic and cross-border business in the provision of advisory services. The separate activities conducted by each of the entities in developing critical client relationships and providing high-quality execution services on transactions for clients may result in purely domestic deals in which the transaction is originated and executed solely by the respective local personnel, as well as cross-border deals in which personnel from multiple entity locations contribute to the transaction. Smaller branches lacking resources may also outsource certain middle- or back-office support activities.
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to related affiliates or third parties. Tax authorities are likely to focus on such cross-border transactions.

As investment banks continue to expand their businesses into new foreign markets, this global structure will be more visible.

10.4 Key functions
The transfer pricing arrangements between the investment banking firm and its affiliates ultimately depend on the functions performed, risks assumed, and capital or other assets used in each of the jurisdictions in which the investment bank operates. The following sections outline some of the key functions performed within an investment bank.

10.4.1 Deal sourcing and origination
Typically, the deal identification process relies on the investment bank developing and maintaining a strong network of clients. Due to the nature of the relationships required for successful origination, it is often a function that is performed by in-country affiliates with local expertise in assessing opportunities, sometimes together with specific sector specialists, wherever those may be located within the investment bank.

The investment bank negotiates a mandate to ‘do the deal’ with the potential issuer and prepares the offering memorandum or prospectus after performing a due diligence investigation of the issuer.

10.4.2 Execution
Execution is the actual work performed in delivering the project under the agreed-upon terms and objectives of the client project once the deal has been won and the investment bank has been formally engaged. The precise nature of the work varies by deal and depends on such aspects as the type of transaction (e.g. M&A, capital markets, restructuring), client’s sector, requirements, and objectives. The execution team is responsible for performing the requisite underlying analysis, such as research and financial modelling, and preparing the final deliverable for the client as agreed. Execution teams typically consist of a wider range of staff levels, from an MD to an analyst, compared to that of origination teams, which typically comprise one or two MDs.

10.4.3 Syndication and distribution
Negotiations between the issuer and the underwriting syndicate\textsuperscript{55} take place to evaluate the terms of the offering. The underwriting agreement between the issuer and the syndicate is then signed to set the terms under which the underwriter will purchase and resell the securities from the issuer. The issues of securities are distributed either by a sole underwriter or through a distribution syndicate.\textsuperscript{56} A selling group\textsuperscript{57} may also be formed.

10.4.4 Structure of underwriting
Investment bankers provide support service to the equity and debt underwriting business units by performing origination, general client relationship management, limited due diligence, and marketing support services. The equity and debt

\textsuperscript{55} In instances where there is more than one underwriter, a group of underwriters is formed to purchase a new issue of securities and offer it for resale to the public.

\textsuperscript{56} In a distribution syndicate, one or more underwriters act as lead managers and all syndicate members are allocated a portion of the securities to be sold in such a transaction.

\textsuperscript{57} A selling group is formed of non-syndicate members that receive compensation for assisting in the sale of securities.
underwriting businesses, which are predominantly ‘local’ businesses, rely on the knowledge of investment bankers to provide consistent services to clients around the globe.

Equities capital markets encompass products such as IPOs, trust units, retail structured products, preferred shares, and convertible bonds. Debt capital markets has a more involved structure of business, providing corporations, financial institutions, supranational, sovereigns, and agencies with customised solutions for their financial needs through an integrated coverage for capital markets, foreign exchange, and derivative products.

10.5 **Key assets**
An investment bank typically does not have a large array of assets that are crucial to the success of the business. Given that the major source of revenue for investment banks is from fees for services provided to clients, an investment bank's ability to attract new clients and retain old clients is important. Thus, the key asset of an investment bank is a strong network of ‘rainmakers’, generally MDs, who have the necessary skill set to attract clients, as further described as follows.

10.5.1 **Human capital**
The value that an investment bank provides to its clients is based primarily on the reputation, experience, and know-how of the bankers and analysts it recruits. In that regard, the members of the deal teams are the sole determinants of an investment bank's success or failure in originating and executing transactions in the manner that best services its clients. The integration of experience into a cohesive trusted advisory relationship is valuable to the client.

10.6 **Key risks**
The primary risks incurred by investment banks with global operations are market risk, credit risk, and operational risk. Market risk is the risk to earnings from adverse movements in market variables (e.g. interest rates, foreign exchange). Since most investment banks are engaged in the business of providing financing transaction structures and solutions to their clients, market volatility greatly impacts the type, volume, and timing of client transactions. Credit risk is the risk that a party to a contract will not honour a financial obligation and that the investment bank will consequently suffer a loss. Given the nature of the business and the fee income that it generates, the credit risk is generally restricted to the ability and/or willingness of the customer to pay fees and/or cost reimbursements, as applicable, when they become due. Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems, or from external events. Investment banks assume operational risks associated with their own operation as they may lose revenue or income.

10.7 **Transfer pricing considerations**
As aforementioned, the globalisation of the investment banks is creating the need for reorganisations and transfer pricing studies within the industry. In light of these challenges and opportunities, investment banks face a need to formulate creative solutions. In addition, global tax authorities have become more sophisticated on transfer pricing matters, and leading companies are now aware of the need to adopt and document defensible transfer pricing policies and strategies. As unprecedented turbulence in the world's financial markets has increased the transfer pricing challenges faced by financial firms, existing inter-company pricing arrangements that may have
passed muster in prior years are likely to be highly scrutinised by tax authorities whose goal is to preserve the local country income base.

10.7.1 Questions and issues
The unprecedented turbulence in the world’s financial markets has led to historical events with consolidation, mergers, and even the demise of what were considered well-established financial institutions. Tax directors are faced with the daunting task of preserving capital and maximising cash flow within the organisation, and, in this environment, the transfer pricing challenges faced by financial institutions continue to be extraordinary. The myriad issues facing financial institutions include attribution of losses among separate group entities and within a single trading entity, structuring of internal financing/treasury operations, compensation of investment managers/sub-advisers when an underlying fund is no longer profitable, and the appropriate allocation of head office and other central costs.

10.7.2 Approach and methods
The standard for determining the best method, or most appropriate method is the result obtained from the controlled transaction using that method. Among the factors to be taken into account in determining the best method are ‘the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis’. The most appropriate transfer pricing policy will vary from firm to firm, and even among business units within one firm.

The methods for services transactions as proscribed by the OECD Guidelines and the US Treasury Regulations\(^{58}\) are applicable, such as the CUSP or the CUP. When suitable comparables cannot be found, a profit based method, including the RPSM, may be more appropriate.

10.7.3 Practical considerations
As mentioned above, the move towards globalisation within the investment banking industry has created the need for new or stronger transfer pricing policies. Thus, it is important for companies to manage their transfer pricing risks and implement a comprehensible, cost-effective, and long-term transfer pricing policy that is defensible upon audit and consistent with their international tax objectives and strategies. This requires developing, implementing, and documenting cross-border pricing strategies that comply with the requirements of local jurisdictions in which affiliates operate.

10.8 Recent developments
Although, historically, transfer pricing has not been of high priority to many investment banking firms, this position is changing as the investment banking industry expands at a global level. The US and OECD member countries have issued transfer pricing regulations that are directly applicable to the banking and capital markets industry, including the following: (i) the US proposed rules on global dealings, which are scheduled to be re-proposed; (ii) recent US regulations for services transactions; (iii) recent US regulations for cost sharing arrangements; (iv) the 2010 OECD PE Report, and (v) the draft revised Commentary on Article 7 of OECD Model Tax Convention, relating to the attribution of business profits to a PE.
In addition, the introduction of FIN 48 requires companies to identify any relevant risks regarding uncertain tax positions for financial statement purposes. Transfer pricing is among the most common sources of uncertainty in tax reporting.

10.9 Conclusion
The investment banking industry’s move towards global consolidation to improve efficiency and global coordination of operations to accommodate clients with international operations has increased the need for transfer pricing reviews. As global tax authorities become more sophisticated and increase the number of audits within the industry, it is highly recommended that members of the industry develop a principled approach to transfer pricing.
Chapter 11 – Loan origination and syndications

11.1 Introduction
Agreeing on an arm’s length price for new loans and syndicates involves an understanding of factors that drive the business. Profiling the key functions and roles performed, the capital employed and its associated risks, and how proceeds are split among participants is required. Because tax authorities are under pressure to identify revenue sources, taxpayers have adopted more sophisticated methods to identify proper transfer prices for inter-company loans and services.

The syndicate loan market has rebounded from an extended lull during the credit crisis. Volumes and new issuances are up to 2007 levels globally. Also, in the past decade, international markets for syndicated loans have become increasingly more integrated, as foreign lenders tend to dictate emerging market borrowers. As large banking institutions resurrect their loan issuance business, tax authorities will seek to ensure that compensation of the participants meets the guidelines of the banks’ particular jurisdiction.

This chapter focuses on the key concepts in the loan origination and syndication market, the typical structure in a syndication arrangement, the typical transfer pricing issues that arise in the business, and the factors that contribute to selecting a proper method for remunerating participants.

11.2 Business model
Loan issuance and syndication is a business in which banks structure, arrange, and administer credit to a particular issuer from a group of lenders. A loan issuance involves structuring the terms and the pricing and extending the proper funds to the issuer. In syndicated cases, two or more banks are involved. In addition to commercial and investment banks, institutional investors may be involved in leveraged situations. Arrangers serve the central role of raising the credit for the issuer, although other parties may be involved.

There have been evolutions as the lending business has scaled, yet syndications fit into a few key classifications: an underwritten deal, a best-efforts syndication, and a club deal. In an underwritten deal, the arranger guarantees the entire loan and then syndicates parts of the loan to other parties. In a best-efforts syndication, the arranger assures a portion of the commitment, allowing open subscription for the remainder of the credit. The club deal occurs for loans of smaller size, in which a group of lenders arrange a loan of equal share, where each participant receives a full share of fees.

The syndication process generally follows a typical format, although several complexities can be introduced depending on the participants involved and the terms of the loan. The issuer solicits bids and mandates a lead arranger. This lead arranger prepares an information memorandum and identifies proper pricing by inquiring prospective investors. The lead arranger may involve other arrangers to assist with filling subscriptions. Final terms, including covenants and collateral arrangements, are then documented, although the loan can be amended later.

After the loan closes, creditors may trade their commitment. These large transactions may involve large investment banks. Selling the loan in the secondary market typically
takes two forms – assignments and participations. In an assignment, the lender passes rights to another signatory, who receives direct principal and interest payments from the borrower. This agreement typically requires consent of the issuer. Assignments are common for offshore investment vehicles, which commit to an assignment from the arranger after the loan closes. Participations are agreements with the lender in which the participant serves as the creditor to the lender.

Revenues from the origination and syndication business are fee-based in addition to any interest income from assuming the role of lender. For its service, the arranger receives an arrangement fee from the issuer, with the lead arranger typically claiming the largest amount. Other types of fees may be tied to terms of the loan or to its administration.

11.3 Pricing, terms, and fees
The primary types of syndicated loans are revolving credit, term loans, and LOCs. A revolving credit line enables borrowers to draw down, repay, and borrow additional funds. Borrowers are charged a commitment fee at some defined interval, typically annually, on the unused funds, in addition to interest on the borrowed credit. Term loans extend a particular amount to the borrower to be repaid in scheduled instalments or in one payment at maturity. LOCs are commitments by the arranger to cover a borrower’s liabilities in the future, if the borrower cannot. LOCs are repaid over a period of time, and the borrower pays a fee for the commitment.

Lending institutions may specify covenants in the loan agreements to protect against increased risks during the life of the loan. Maintenance covenants state that the borrower must meet certain financial requirements on a periodic basis to keep the terms of the loan. Covenants may be affirmative, requiring the borrower take an action, or negative, establishing limits on the borrower. Such requirements may be keeping leverage below a certain level or maintaining a particular credit rating. Breaching a covenant would lead to a technical default.

Lenders collect interest and principal payments on the loan. A loan’s interest rate is often tied to some reference rate, such as LIBOR or the local prime rate, plus a spread based on the borrower’s financial criteria, management strength, and positions in its industry, among other factors. These rates reset at some agreed interval – e.g. monthly or annually.

There are several types of fees associated with originated loans. The arrangement fee is collected by the arranger from the issuer services provided. Lenders may receive an upfront fee, akin to a small discount spread on the loan offering, from the issuer, with the mandated arranger collecting the larger portion. Commitment fees are paid on undrawn amounts. A usage fee is paid to the arranger when the utilisation of the credit line falls below a minimum level. Facility fees are applied to the full committed amount. Prepayment fees may be assessed on term loans to compensate the lending institution for reinvestment risk. Participants may receive a fee from the mandated arranger for helping to fund the loan; likewise, arrangers may assess a fee for negotiating terms of the loan and liaising between the borrower and the participant.

Other fees cover routine services associated with the loan. Administrative fees are paid annually by the borrower for services, such as interest payment distributions to participants. Legal fees remunerate legal advisers or those who documented the loan agreement.
11.4 Typical structure
The borrower selects a bank as the mandated arranger, which is responsible for syndicating, structuring, and servicing the loan. Typically, the mandated arranger has an existing relationship with the borrower and established presence in the borrower’s sector and geographical area. Together with the borrower, the mandated arranger agrees to the terms and finds other creditors. The role further entitles the bank to establish assignments, participations, or delegate duties of the administrative loan servicer. Depending on the terms, the mandated arranger may engage affiliated participants within or outside its tax jurisdiction to offset potential risks.

An illustrative structure of a syndicate loan transaction is outlined in the diagram below:

![Figure 11](image.png)

Borrower XYZ, Inc.
$200 million two-year revolving credit, signed 1 August 2011
Stated purpose: Working capital needs
Pricing: Canadian Prime Rate + 150 bps; Commitment Fee: 20 bps

Mandated arranger
Bank ABC Canadian, Inc.

Assignments
European Bank, Inc.

Participants
Bank ABC UK, Ltd.
US Bank, Inc.

Loan servicer
Bank ABC Canadian, Inc.

Tax authorities in key tax jurisdictions may concentrate on the transfer pricing of participant agreements and administration services.

11.5 Key functions
The transfer pricing arrangements between parties involved in loan issuance hinge on the functions performed, risks assumed, and capital or other assets used in each of the tax jurisdictions in which business has occurred. The following sections outline some of the key functions performed within the loan origination and syndication business.

11.5.1 Origination
The syndication loan process is initiated by the issuer soliciting bids from arranger banks as to their go-to-market strategy and credentials. Upon awarding of the mandate to its preferred arranger – often the issuer’s relationship banks – the arranger, along with its group of lead managers and agents, is involved in the origination, structuring, and syndication of the transaction. The arranger is responsible for advising the issuer as to the type of facilities it requires and then negotiating the broad terms of those facilities. For the services provided, the issuer pays the arranger a fee commensurate with the complexity and the risk factors of the loan.
When originating a loan, several factors may induce senior lenders to arrange a syndicated agreement, such as raising capital, circumventing disproportionate exposure to a particular type of borrower, complying with regulatory capital and loss reserve commitments, or ensuring non-interest income.

11.5.2 Marketing
The marketing of the loan is undertaken by the arranger or its agents by way of an information memorandum that illustrates the terms of the transactions. The arranger assists the issuer in writing the memorandum based on the information provided by the borrower during the due diligence process. The memorandum usually consists of an account of the borrower’s business, management, and financial statements. It also contains details of the proposed loan. The arranger issues invitations to potential syndicate members, usually qualified banks and accredited investors, to participate in the syndication. The achievement of the syndication depends on the ability of the arrangers to access capital markets and to successfully market the loan to investors.

11.5.3 Participation
Participants provide capital for the loan to banks serving as arrangers. The participant’s counterparty is not the issuer but the arranger itself. Occasionally, a participant receives a fee from the issuer or arranger, but typically its compensation is in the form of interest and principal payments. In some cases, participants are charged a fee by the arranger for its service in negotiating the loan. Participants typically are other banking institutions, but may include institutional investors in leveraged situations. Participants are without voting rights on any amendments to the loan agreement.

11.5.4 Loan servicing
Loan servicers serve to monitor the loan during its life. Activities include supervising the compliance of the issuer with certain terms and conditions of the facility, collecting and distributing interest and principal payments to participants, preparing any necessary documentation, and handling correspondence between the issuer and the rest of the syndicate. The arrangers use the servicing agent to advance funds to the issuer. The agent is paid a fee under the terms of the syndicated loan agreement for the services it provides the syndicate.

11.6 Key risks
11.6.1 Credit risk
Lenders are exposed to credit risk, defined simply as the borrower’s inability to repay interest or principal as scheduled. The probability of a default, where the borrower is unable to repay the loan, is factored into a borrower’s public credit rating. Accordingly, the degree of credit risk is factored into the loan agreement. Lenders are conscious of potential losses in case of a default and provision for reserves to meet internal or regulatory capital requirements. While arrangers have direct credit-risk exposure to the borrower, participants have indirect exposure, as they face off with the arranger. Should the arranger become insolvent, the participant may not have a claim on the loan. Likewise, should the participant become insolvent, the arranger may have to locate another funding source for the loan.

11.6.2 Interest rate risk
Lenders are also exposed to interest rate risk, to a lesser degree than to credit risk. Loan rates are often tied to floating base rates, which, due to various macroeconomic factors, can increase or decline during the life of the loan. As this base rate resets, the actual interest rate paid by the issuer fluctuates.
11.6.3 Country risk
The incidence of foreign lenders extending loans to emerging markets is increasing. As loans are extended across borders, lenders and participants are exposed to a blend of risks associated with providing funding to a borrower in another jurisdiction. Among the risks are political risk, exchange rate risk, and sovereign risk.

11.7 Transfer pricing considerations
Depending on the characteristics of the transactions, and where they occur, the following transfer pricing issues may need to be considered:

- How should fees be allocated to a local, affiliated participant?
- Where a local affiliated branch originates loans, how should the parent broker-dealer compensate the branch for its arrangement services?
- At what rate should an affiliate serving as a loan servicer be remunerated?

Transfer pricing issues may arise in the relationships set forth in loan agreements. The remainder of this chapter addresses methods to answer the above questions. It should be stated that comparability issues in identifying similar loan terms and benchmarking cross-border loans between affiliated parties are primary challenges of the loan syndication business. Although this chapter covers the business of originating or syndicating a loan, it does not cover cross-border financing transactions between related borrowers and lenders, because they affect many other industries. These inter-company loan relationships are addressed along with other financial transactions in Chapters 15-17.

11.7.1 Arm’s length principle
A controlled transaction meets the arm’s length principle if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in comparable transactions under comparable circumstances.\(^{59}\) To be ‘comparable’ to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must only be sufficiently similar that it provides a reliable measure of an arm’s length result.\(^{60}\)

To meet the arm’s length principle, a controlled taxpayer’s results need only be within the range of results determined by the results of two or more comparable uncontrolled transactions.\(^{61}\) It is provided in Paragraph 3.55 of the OECD Guidelines that “transfer pricing is not an exact science and therefore, there will be many occasions when the application of the most appropriate method or methods produces a range of figures, all of which are relatively equally reliable”. These concepts of comparability, reliability, and range are critical to the application of the arm’s length standard.

In practice, it is often difficult to determine an arm’s length fee for the activities performed in loan arrangements. Even with few publicly available benchmarks for fees charged within the industry or about the segmented profitability of loan businesses, some methods can be applied for substantiation.

11.7.2 Comparable Uncontrolled Price Method
One method employed is to identify a CUP Method. The arm’s length price for a function performed by a local related party should be comparable to that which a

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\(^{59}\) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, Paragraphs 1.1 to 1.13, 22 July 2010.

\(^{60}\) Ibid. Paragraphs 1.33 to 1.58.

\(^{61}\) Ibid. Paragraphs 3.55 to 3.66.
third party would receive for completing the same function. If the mandated arranger identifies a third party for its loan administrative duties in a particular jurisdiction, the fees paid to that third party may serve as a proxy for fees paid to the affiliated loan servicer. Should there not be an internal benchmark, then some publicly available data on similar fees may be used to determine a price for administrative services.

An outlook on macroeconomic or cultural differences among countries and markets must be factored into any use of CUP data to determine an arm’s length price. Local CUP data, e.g. from the same jurisdiction, is preferable to regional CUP data, as local country risks can affect loan pricing and related fees. As per the OECD:

“...an uncontrolled transaction is comparable to a controlled transaction...for purposes of the CUP Method if one or two conditions is met: a) none of the differences (if any) between the transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate material effects of such differences.”

Accordingly, if adjustments can be made to ensure comparability, the CUP Method is a reasonable way to identify the arm’s length price for loan fees and other functions.

11.7.3 Resale Price Method
The RPM may be applied by subtracting a commission margin from the resale price of a product or service. A taxpayer serving as an arranger or participant might be compensated using the RPM if suitable third-party data is identified to benchmark commission margins, e.g. a percentage of all bundled interest and principal payments. Finding suitable benchmarks may be difficult, as the specific comparable data is not always available. Broader functional, geographic, or sector searches may be required, although are not directly applicable.

11.7.4 Comparable Profits Method/Transactional Net Margin Method
The CPM or TNMM may be applied for administrative services by comparing some PLI, such as a FCM, e.g. operating income as a percentage of total costs. Application of the method would imply analysing FCMs realised by comparable independent entities. As an example, an offshore affiliate in the Cayman Islands that serves as the loan servicer for a large domestic banking institution; the taxpayer justifies the affiliate’s FCM by analysing third-party loan servicers. This method may be challenged by tax authorities, so taxpayers must be certain the benchmark set is applicable to their businesses.

11.7.5 Profit Split Method
An alternative to the methods outlined above is the PSM. Where functions performed by affiliates contribute significant value to the syndication, this method may be the most appropriate. Likewise, in cases where other methods cannot be applied by way of comparability constraints, this method can be used in conjunction with one or more of the other methods described, in which case the method is called RPSM. Essentially, the pool of proceeds – fees and non-fee income – would be allocated among the primary party and its affiliates based on some consistent measure, such as relative staff compensation, percentage of expenses, or time invested in the function. The application of the PSM is often quite complex and more difficult to substantiate than the application of other transfer pricing methods.
11.8 Conclusion

Firms are becoming more aware of transfer pricing issues in the loan origination and syndication business, as tax authorities increase pressure and focus. This chapter was meant to cover the key considerations for lending institutions faced with establishing transfer pricing policies. As outlined in this chapter, the transfer pricing approach selected depends on specific factors of the lending business.
Chapter 12 – Securities lending

12.1 Introduction

Securities lending/borrowing refers to the temporary loan/transfer of securities from a lender to a borrower against specified collateral, in return for a fee. The borrower is expected to return the securities based on the terms of the agreement, on demand, or at the end of the agreement. Although legally classified as a loan, the transaction in substance involves the absolute transfer of title against an undertaking to return equivalent securities.

The lender earns a fee for the loan of securities. The pricing negotiated between the counterparties typically takes into account various factors like supply and demand for the securities, collateral flexibility, size of manufactured dividends, and the likelihood of early recall of securities by the lender.

There are two types of securities lending markets: international and domestic. Domestic markets involve the lending of domestic securities between domestic and cross-border counterparties. International markets involve the lending of international securities between domestic and cross-border counterparties.

Participants in both domestic and international securities lending markets include beneficial owners, lenders, and borrowers. Lenders of securities comprise entities that hold a large inventory of securities (on behalf of the beneficial owners or in their own investment pool) and are seeking an extra return on their portfolios or need to finance their inventory. The largest supply of securities for loans comes from buy-side institutions, which include mutual funds, pension funds, endowments, and insurance companies. The lending programmes for these institutions are normally run by large custodians. A significant amount of assets are also loaned by security firms from their client base that trade on margins. Proprietary trading firms also lend out securities to self-fund their long positions.

Borrowers may include major securities dealers, market makers, arbitrageurs, and the securities trading arms of major banks, merchant banks, and hedge funds. Generally, they enter into securities lending transaction(s) to cover failed trades or short positions, execute certain investment strategies to obtain increased returns, or engage in dividend arbitrage.

Entities can engage in securities lending transactions in a principal or agent capacity. In a principal capacity, the arranger assumes full risk for the restitution of the borrowed securities and the payment of fees and other proceeds towards its counterparties. The agency structure involves substantially less risk for the arranger in that the agent does not bear financial risks associated with owning the asset, is not a party to the contract, and is responsible only for the professional handling of the business and does not assume any other risks. Transfer pricing issues can arise for global financial services organisations as they likely organise themselves geographically to service the local 'supply' side of the securities lending equation (lenders that hold significant securities positions) as well as the 'demand' side (trading shops, arbitrageurs, hedge funds). To get the proper security from lender to borrower may require the use of two or more affiliates of the global financial services organisation.

A similar (though reverse) arrangement is the repo, which is a means of borrowing money by selling securities to the lender and simultaneously entering into an
agreement to repurchase the same securities at a later date, with the difference in price representing the interest. This is essentially a secured form of short-term lending in which the securities transferred represent the collateral for the cash loan. Under a repo, the seller (of securities) retains the market risk on the position during the repo and receives cash and pays the buyer a repo rate on the cash. Similarly, the buyer (of securities) compensates the seller for income (e.g. dividends/coupons) paid during the transaction by making a substitute payment.

12.2 Business model

The simplistic model/transaction flow for a securities lending transaction can be illustrated in the following figure:

In the securities lending transaction, the lender is provided with collateral in the form of cash or securities, usually valued equivalent to or greater than the value of the loaned securities (varying around 105% to 110% of the value of securities, depending on type of collateral and credit quality of the borrower).

The lender earns a ‘loan fee’ for the loan of securities that varies on the basis of the number of days that the securities are on loan. The fee is negotiated based on various criteria that include, for example, type and amount of the security, market demand for that security, the expected term of the loan, the type of collateral offered, and the credit quality of the borrower.

63 Referred to as ‘haircuts’.
Although there is a transfer of title to the securities, the lender retains the economic benefits of ownership, has a secured position in the collateral, and earns a fee on the loan. To illustrate, securities lending with non-cash collateral involves the borrower compensating the lender for income (e.g. dividends, coupons) paid on securities during the loan period by making a substitute payment. In a similar fashion, a portion of the cash collateral’s reinvestment return is also paid to the borrower in the form of a ‘rebate’.

During the loan term, the securities loaned and the collateral posted are subject to the market price fluctuations and therefore are marked-to-market to monitor market movements and the entitlements of the parties involved in the transaction. A shortfall in the value of the collateral in relation to the value of the securities lent requires a collateral call on behalf of the lender, while the reciprocal event entitles the borrower to a return of collateral from the lender. Dividend and interest payments or a corporate action affecting the securities may also occur during the loan period.

### 12.3 Key functions

#### 12.3.1 Sourcing of securities and marketing

Securities lending involves matching a lender in possession of securities with a borrower in need of the same, for a set period of time. A certain degree of human intervention is still required despite the systems involved being highly automated.

Following the receipt of a request from a customer, the agent/trader determines how to source the security. This could be from a client’s account, proprietary positions held by the entity, or from third-party lenders. In a principal capacity, this generally involves the lender identifying parties that would be interested in borrowing the stock available in its possession. These tasks could be conducted by phone, by email, or via a system portal.

Sourcing securities may also involve some level of liaison activities and using the entity’s network of contacts to identify potential counterparties that may be interested in undertaking a securities lending transaction. These marketing activities may involve attending calls, meetings, and relevant industry events to market the entity as a provider of securities. In such situations, especially from a transfer pricing perspective, it becomes important to ascertain the role that a marketer plays – for example, does the marketer play a limited role, with the final responsibility for pricing and accepting the trade resting with the trading personnel and not with the marketer? It should also be established if the marketing of securities lending transactions involves any more functions besides introducing the trade.

#### 12.3.2 Negotiation and agreement

The negotiation process involves finalising the actual terms of the transaction, which includes, for example, the spread, collateral, haircuts and margins, the security lending fee, the rebate rate, the duration of the loan, and the dividend reclaim rate.

Consideration should be given to which party enters into the Master Securities Lending Agreement with the borrower and the risk associated with the same. This again depends on whether the entity is engaged in the security lending transactions as a principal or agent.
12.3.3 Execution
Execution involves actual delivery of the collateral from the seller to the borrower, sending delivery instructions to the sub-custodian, and arranging for the movement of securities.

The accounting records of the borrower and the lender also should reflect the following transactions: fee, rebate, repo accruals, and the receipt or payment of the securities lending fee.

The end of the transaction, when securities are returned, involves a reversal of the initial functions performed at the collateral and securities delivery stage (e.g. delivery of collateral back to lender or agent, providing delivery instructions).

This also involves obtaining clearances from the tax, regulatory compliance, and credit departments, where necessary.

12.4 Key risks
Risk is a significant factor in the securities lending business and can take a number of forms. The nature and extent of risk involved varies based on the roles performed (i.e. if the entity engaged in the securities lending transaction is acting in the capacity of an agent or a principal). The principal typically assumes significantly more financial risks than the agent, however, the quality of the underlying collateral should be taken into account. The main risks that may be involved in the process are listed next.

12.4.1 Credit risk
Credit risk is the primary risk associated with the securities lending transaction. This risk arises due to the possibility that counterparties (lenders and borrowers) may fail to satisfy their trading obligations (lent securities, fees, and dividends) in full or in a timely manner. Failures in settlement could also give rise to interest claims by market counterparties. Lenders generally attempt to mitigate this risk by monitoring the creditworthiness of their counterparties and measuring the potential credit exposure associated with various products.

12.4.2 Market risk
Because the securities loaned and the collateral posted are subject to market price fluctuations, the securities lending transactions are also subject to the risk that adverse changes may occur to the value of the position booked by an entity, including the financial exposure of the value of collateral versus securities loaned due to the potential mispricing of assets.

12.4.3 Operational risk
Operational risk refers to the risk of delayed/non-timely processing of transactions due to inadequate or failed internal processes, personnel resources, and/or systems, resulting in legal action. Because securities lending/borrowing is a highly automated process, a breakdown of the hardware, software, or crucial communication systems could adversely affect an entity’s ability to trade or process transactions. Operational risk also includes the risk that external events, such as failures or frauds, could result in loss to the business. This may also result in a negative impact on an entity’s reputation due to quality defects.


12.5 Key assets

12.5.1 Key relationships

According to the OECD Guidelines, marketing intangibles include, among other things, the distribution and availability of goods and services being marketed and advertising and marketing expenditures incurred to develop a network of supporting relationships with distributors and agents. The success of a securities lending business or brokerage relies on access to securities that are available for onward lending, and this depends on the presence of reliable contacts and relationships that are normally built over a period of time.

12.6 Key considerations/scenarios

12.6.1 Principal versus agent

As previously mentioned, entities can engage in securities lending transactions in a principal or agency capacity. In such a scenario, the allocation of the functions/activities can take on various forms, such as:

i. a global investment bank where entities located in key financial markets, such as London, New York, and Tokyo, participate in securities lending transactions and assume one or more roles, such as the primary lending agent, asset gatherer, and trading office;
ii. an agency or entity where the collateral activities are consolidated into one centralised entity (as opposed to a decentralised structure where securities lending and repurchase markets may involve hundreds of entities that hold securities); or iii. a variety of other structures involving anything else in between.

To cover a similarly wide range of potential arrangements in the context of the global trading of financial instruments, the OECD categorises these trading activities into the following models: integrated trading, centralised product management, and separate enterprise, or a hybrid model that does not distinctly fall into any one of the above categories.

12.6.2 Apportionment of fees

In an agency transaction, the lender pays the agent a lending fee that has to be apportioned between the agent and the borrower.

The key transfer pricing issue is the fee allocation between the parties. To ascertain a prudent allocation, the following points should be considered in the analysis:

i. an assessment of routine and non-routine contributions associated with the securities lending operations;
ii. the identification of factors and weights to measure the relative functions performed, risks assumed, and resources employed by the affiliates in the securities lending operations; and
iii. the application of the factors identified above to split the operating profits associated with securities lending activities.

The available guidance followed by tax authorities requires that the allocation factors:

64 2010 OECD PE Report, Part III, Paragraph 135. The approach under this part is applicable by analogy to securities lending. Although securities lending on a standalone basis may not be global trading as defined by the OECD under this part.
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i. correlate with the profitability of the business (in this case the securities lending operation);
ii. include elements of the operation that exist for business or management purposes rather than tax purposes; and
iii. are relatively easy to measure and quantify.\(^{65}\)

Non-routine contributions are described in the OECD Report, in the context of a global trading operation, as complex marketing, trading, and risk management functions performed by highly skilled personnel,\(^{65}\) and are integral to the securities lending business. Accordingly, the same should be appropriately remunerated.

12.6.3 Methods

Given the variety of business models that can be in place, the functions performed, assets employed, and risks assumed in the securities lending business need to be considered on a case-by-case basis to enable the identification of an appropriate methodology for establishing/testing the arm's length principle. The main comparability considerations may include the nature of lending transaction (i.e. domestic versus international), the type of security, and the duration of loan and transactions terms (e.g. haircut, lending fee).

Although external comparable data is rare, entities may have available internal transactions/rates facilitating the application of the CUP Method. However, where the key contributions to the business are spread between a numbers of entities, a residual profit split may be the most practical arrangement. Centralised groups may also set prices to implement a Cost Plus Method.

12.6.4 Middle- versus back-office functions

As mentioned earlier, an important part of a securities lending transaction are the necessary processes that run for the execution of the transaction (i.e. the middle- and back-office functions). As per the OECD guidance for pricing of middle- and back-office activities, the first step in the process is to determine if traditional transaction methods can be reliably applied. In practice, it is common that these functions are rewarded a cost plus return.

However, while determining the remuneration for such functions, care should be taken to establish the real nature of the services, because what might seem like a routine function at the first glance may in fact be a valuable function. To illustrate, if the group has developed an automated process that delivers best-in-class performance in minimising transaction time and errors, this may represent a value driver for the business rather than a routine support activity.

12.7 Conclusion

This chapter endeavours to highlight key concerns to be addressed and major points to be considered while establishing a transfer pricing approach for securities lending transactions. As is evident from our discussion, there is no standard/single approach for the entire set of transactions.

\(^{65}\) Prop. Treas. Reg. Section 1.482-9(e)(6)(iii) provides that “the relative value of the non-routine contributions of each participant in the global dealing operation should be measured in a manner that most reliably reflects each non-routine contribution made to the global dealing operation and each participant’s role in the non-routine contributions”. The OECD Report, Part III, Paragraph 176 states that “[a] common approach to applying the PSM (a multi-factor formula) is to select factors to represent one or more of the relevant functions, to weight the factors to determine the relative contribution of the function(s) represented by each factor, and to use the factors to allocate the profit to the locations performing those functions”.

\(^{66}\) The OECD Report, Part III, Paragraph 171.
Chapter 13 – Custody banking

13.1 Introduction
Custody banks are specialised banks engaged primarily in safeguarding the financial assets of individuals or entities, and in provisioning transaction support services to institutional investors, including hedge funds, mutual funds, insurance companies, and pension funds as well as asset managers. Although custody may be undertaken on a domestic basis, activities are often now being undertaken as part of a global network, which allows a global custodian to service a client across multiple jurisdictions. These global custodians typically use their own local subsidiaries or branches or contract with other local custodian banks, dependent on the custodian’s structure and strategic position. With the increased focus on transparency and cost containment, custodians are expected to receive a boost from companies outsourcing their transaction processing.

13.1.1 Industry overview
In contrast to the general focus of wholesale or commercial banks (lending) or investment banks/banking arms (M&A and trading), custody banks are engaged in the provision of a wide array of complementary services, including:

- Custody and sub-custody services.
- Foreign exchange services.
- Securities lending services.
- Cash management.
- Investment operations back-office/outsourcing.

These services can be considered in two categories. First, the core services would typically include custody and sub-custody services, although they would be dependent on the exact nature of the functions performed. Typically, for the core services, only a limited margin can be generated due to the level of market competition. Custodians generally levy a fee on the assets they hold under custody, based on a certain percentage of the asset value.

The second category is non-core services, which may be considered as ‘value-added services’. These services are offered in conjunction with the core services, adding more breadth to the service offering and generating further business within the same client base. These services may be able to generate a more generous margin in comparison to the core services. It is common for the value-added services to be bundled together in a variety of combinations to address the client’s requirements. There may be an overall fee charged in respect of the service bundle to reflect the integral nature of these services to the core business or fees for additional services may be negotiated on a client-by-client basis, dependent on the relationship and other service fee levels.

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67 Custody services relate to the safe-keeping and processing of the world’s securities trades and servicing the associated portfolios.
68 In general, the sub-custodian or agent bank is contracted by the custody bank to execute and provide related services. However, the custody bank retains and manages the customer relationship and also retains the primary contractual risk against the customer. Sub-custodians can be affiliated or un-affiliated to the custody banks, and tend to be contracted/engaged in order to provide services in locations where the custodian does not directly operate.
13.1.2 Industry participants
Custodian banks can generally be categorised into (i) global custodian banks and (ii) local custodian banks. Global custodian banks provide services throughout the world and employ their own local branches, separate enterprise affiliates, or other custodian banks to manage the assets and accounts of their customers. Local custodian banks manage the ADRs that are traded in the US stock markets by companies headquartered outside the US.

13.2 Business model
Growth and profitability in the custody business is dependent on the following key business value drivers:

• Achieving scale in the business – Scale may be achieved internally with a network of subsidiaries or branches or through alliances with other market participants that have access to other geographical regions or customer bases. The business requires a high level of investment in key assets, for example in IT systems. It is necessary to spread the cost of the investments in people and technology over a larger base. The high fixed costs and perceived ‘non-differentiated’ nature of basic custody services requires the banks to continually evaluate how they can achieve cost savings and increase productivity to respond to client fee pressures. Consolidation in the industry has further played a significant role in achieving these objectives.

• The sale of value-added services – In addition to basic custody/safe-keeping offerings, it is necessary for custody banks to maintain or grow profit margins, which is achieved through service diversification. Significant value-added services include foreign exchange trading, cash management, and securities lending. Co-ordination and collaboration across various business units can be used to sell the bundled offering of services to custody clients, and this approach is critical for custody banks to capture a larger (and potentially more profitable) share of their clients’ fees.

• The implementation of a central relationship management structure – This allows custody banks to provide a ‘one-stop shop’ for its global client base as it expands into new markets, while retaining control over the client relationship. A client would typically have one key relationship location, while services are potentially provided in local jurisdictions to take advantage of access to markets or an internal service centre.

• The development of key technology – Because the global custody and support service business is operationally intensive, the development of key information technology systems is a key factor that can help to integrate the business globally, adding key value and assisting in distinguishing a custodian in the market.

13.3 Key functions
Functions performed under the two service categories are further described below.

13.3.1 Core services
Core services typically include custody and sub-custody services, depending on the exact nature of the functions performed. Typically, for the core services, there is a limited margin that can be generated due to the level of market competition. Generally, a market participant chooses between performing these core services itself using its own resources or using a custodian bank that can offer the same work at a reduced cost. Custodians typically levy a fee on the assets they hold under custody, based on a certain percentage of the asset value. Core custodian services include safekeeping and asset servicing. Safekeeping involves maintaining record of title to the investor’s securities. Proper record of title allows the custodian bank to deliver the securities pursuant to a customer order. Asset servicing involves the day-to-day logistics of servicing
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13.3.2 Value-added services
The remaining non-core services may be considered as value-added services. These services are offered in conjunction with the core services, adding more breadth to the service offering and generating further business within the same client base. These services may be able to generate a more generous margin in comparison to the core services. It is common for the value-added services to be bundled together in a variety of combinations to address the client’s requirements. There may be an overall fee charged in respect of the service bundle to reflect the integral nature of these services to the core business, or fees for additional services may be negotiated on a client-by-client basis, dependent on the relationship and other service fee levels. Value-added services include fund servicing, banking, and acting as a pay agent. Fund servicing involves offering detailed services for investment portfolios. Naturally, banking involves the receipt of deposits and the extension of credit. Acting as a paying agent involves the custodian distributing, on behalf of the issuer, dividends, interest, or principal redemptions to the investors owning the securities.

13.4 Key risks
In most cases, custodian banks face similar risks to those of traditional banks and are subject to risks related to the provision of custody services provided to their clients.

13.4.1 Operational risk
Operational risk relates to the risk of financial loss from inadequate or failed internal processes as a result of human error, system failure, or external events. It also includes the risk of failure to comply with applicable regulations, contractual agreements, and a firm’s own internal policies. One common example of operational risk is corporate actions. A corporate action can be any action initiated by the issuer of a security that results in a right to the investor. The risk faced by custodian banks with regard to corporate actions mainly involves clerical mistakes, such as crediting the incorrect account or withholding an improper amount.

13.4.2 Credit risk
Credit risk is the risk that a party to a contract will fail to satisfy its financial obligations under the contract. Custodian banks may face credit risk when they extend credit to clients to fund or partially fund purchases of securities. Additionally, custodian banks face credit risk when advancing money to clients on the due date of interest or dividend payments when those payments have not yet been received from the issuer of the securities. Custodian banks may also provide clients with intra-day liquidity, exposing the custodian bank to credit risk. Intra-day liquidity may involve the custodian bank making a payment to a client’s counterparty in the morning, before the funds expected for credit have arrived (which is generally later that day). Should the funds not be delivered as expected, the custodian bank generally lends the client the funds overnight.

13.4.3 Legal and regulatory risk
Legal and regulatory risk is the risk that a business faces restrictions on its operations from external sources that may limit or change the rights it currently enjoys and may adversely restrict its operations. These regulations and restrictions may limit a custodian’s flexibility in structuring its operations worldwide. The chief legal and
regulatory risk faced by custodian banks is conflicting national laws and regulations in the international context. Uncertainty as to whether the preferred legal/regulatory rule will apply leaves custodian banks in a vulnerable position, depending on the degree of difference between the applicable law or regulation of the two (or more) jurisdictions and the willingness of the jurisdictions to cooperate in reaching a fair conclusion. For instance, when a custodian bank must liquidate collateral used to secure a loan to a client, the laws and regulations of several countries may come into play, depending on whether the collateral is cross-border or if the underlying securities are foreign. As a result, the custodian bank’s right to liquidate the collateral may be delayed or perhaps be completely unenforceable in the absence of detailed planning and knowledge of the applicable laws and regulations. At the extreme, governments may expropriate local branches or subsidiaries.

13.5 Transfer pricing considerations
A global service model integrated across various business units combined with local expertise – local market or specialised product knowledge – inherently leads to transfer pricing considerations. The key business drivers discussed above provide the direction for identifying how and where value is created in the business as the starting point for addressing which intra-group transactions need to be understood and priced. With relevance to transfer pricing support, there are key areas that should be considered which may influence how the support is approached.

13.5.1 Geography
First, consideration should be given to whether the key value drivers above are geographically or jurisdictionally isolated or integrated. Due to the trend of service bundling, a high level of integration may be exhibited, which, coupled with a potential lack of transparency of the bundled fees, may lead to challenging circumstances in which to apply traditional transaction methods. It is also key to ascertain how management evaluate success and whether this is in terms of service lines, clients, or markets, as any policy will need to exhibit consistency or address the gaps generated to operational behaviours.

13.5.2 Transfer pricing method
The chosen transfer pricing approach also needs to address and take account of differences in margins and cost structures between the core custody services versus the value-added services. There may also be key implementation issues to consider in the selection of any model, including financial data accessibility and consistency (e.g. availability of consistent financial data at an operating and global level) and the availability and characteristics of third-party transactional comparables.

Overall, consideration of the above key areas may lead to various alternative transfer pricing models for different custody banks. For example, a low level of integration will allow the prices for each component to be considered in a more isolated way; however, a globally integrated business that offers its services as a bundle will need to consider more carefully where the value drivers are located. Additionally, the core services offer the custodian the key access to market, and so the interaction of these services with the value-added services also needs to be addressed. Further, tax authority views and preferences for certain models may require a balancing act between what the economics dictate versus what can be easily defended in any particular jurisdiction.
13.6 Custody banking – inbound perspective
From an inbound perspective, the transfer pricing challenges faced by subsidiary custody operations may differ from those faced when considering the global viewpoint. Understanding how the profile of the local subsidiaries varies from the global footprint will provide direction for the transfer pricing methodology.

13.6.1 Market dynamics
For inbounds, it is relevant to understand the local market dynamics for custody services, particularly factors that may impact the pricing of local custody services, composition of the customer base, and regulatory requirements. The local custody environment can differ due to a range of external factors, and this will impact how operations are structured locally and how the transfer pricing will be informed by the conditions. Local environmental considerations include:

• Level of local regulatory requirements.
• Number of global custodians in operation.
• Level of concentration holdings of local assets.
• Level of product and service differentiation between custody providers.
• Level to which the custodian’s role is key in underpinning the financial environment domestically.

For example, in a jurisdiction where the financial services industry and custody market are highly concentrated, the market would be competitive due to the small number of global service providers. Also, where there is a high level of concentration of control of domestic assets by a small number of asset holders, these asset holders would constitute the custody banks’ largest clients. This places significant emphasis on client retention while exposing the banks to dictated terms and pricing. Conversely, where there is a more open market with a higher level of participants, focus will be upon the level of service provided and differentiation that can be gained from the market by way of reputation, enhanced overall service offering, or price. In a market where there is a more diversified control of assets, external pricing is likely to be driven by these differentiating factors.

13.6.2 Scale business
Significant investment is required to develop and maintain the information technology processes supporting the business. Subsidiary operations leverage global technology investments to provide local custody services as part of the global custodian network. Certain subsidiaries may have more significant roles and operate dedicated global services centres to take advantage of local cost advantages. The transfer pricing method selected should address the value contributed by technology.

13.6.3 Practical challenges for tax authority audits
The extent of integration in the business will again have consequences for the preferred transfer pricing method when focusing on the inbound subsidiary. Whether a transactional method or a profit split approach is used to reflect arm’s length remuneration for subsidiary operations, local tax authorities will want to identify the services and intangibles provided to the local subsidiary and the related charges. Understanding the margins associated with custody, which is provided by the subsidiaries, and the value-added services, which may not be provided by the subsidiaries, is complicated by the pricing for ‘bundles’ of services. Verification of the margins attributed to subsidiary operations is a particular challenge for tax authorities.
13.7 Conclusion
Whether considering the appropriate methodology to apply to the pricing of a custody bank from the global perspective or that of an inbound, the extent of integration in the business will have key consequences for the preferred transfer pricing method. Where there is a high level of integration, a profit split approach will address the values of the contributions made by the separate service lines to the overall position. In application of a profit split, consideration should be given to appropriate allocation keys to drive the split of the profit and these will need to be considered in conjunction with the structure of the client relationship locations. However, where the business is undertaken on a more discrete (i.e., non-integrated) basis, this may be best reflected by the use of traditional pricing methods for individual activities.

When considering the applicable methodology, it may be relevant to assess the informational systems in operation within the global custodian and how in practice this may be used to evaluate and consider the functional and entities at the level required on a jurisdictional basis. More broadly, as when considering cross-jurisdiction service payments, transactional taxes, such as VAT and GST, may have an absolute cost impact, depending on the structure and characterisation of transaction flows. Overall, custody services are easily understood but not easily priced between global affiliates due to the global integration and interdependencies between the various service offerings.
Chapter 14 – Sales credits

14.1 Introduction and background

14.1.1 The use of sales credits
Sales credits are often used internally by businesses to remunerate the sales force appropriately, from an internal management reporting perspective and sometimes as a basis for determining an appropriate arm’s length reward for the sales function. The use of sales credits can help to drive performance and efficiency and to encourage goal congruence between the functions in the business.

14.1.2 Occurrence of sales credits
The use of sales credits as a management tool is found across a range of businesses in the financial services industry. Some examples of areas where sales credits are commonly seen are shown in the figure below. However, these are more commonly seen within the banking and capital markets and Insurance businesses.

Figure 13
Examples of sales credits by business

<table>
<thead>
<tr>
<th>Banking and capital markets</th>
<th>Insurance</th>
<th>Commodities</th>
<th>Traditional funds</th>
<th>Alternative funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed income</td>
<td>Sales commissions</td>
<td>Brokerage fees</td>
<td>Independent financial advisors</td>
<td>Distribution and capital raising fees</td>
</tr>
<tr>
<td>Equities</td>
<td>Fronting</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Derivatives</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private banking</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

14.1.2.1 Banking and capital markets:
- **Fixed income** – Hard and soft credits are both seen within fixed income sales activities (see following definitions). The value of the sales credit is generally based upon the bid/ask spread with the use of added value. There is no uniform approach to the percentage of the spread awarded as a sales credit. The spread itself may be based on the prevailing spread or the trend; it may also depend on the risk of the trade, the type of product, and the trader’s view of the market.
- **Equities** – In equity trading activities, the trading function may be more comparable to a pure execution function, but might also be more complex. In addition, the sales function may include an aspect of price setting.
- **Derivative products** – The approach to pricing sales credits within the sale of derivative products may be similar to that of equity and fixed income (non-derivative) products at the vanilla end of the spectrum. However, for more exotic derivative products, the approach is often ad hoc, with a sales credit agreed
Chapter 14 – Sales credits

Part IV: Banking and capital markets

on a case-by-case basis. The starting point for the calculation of the sales credit is more often the estimated value in the case of derivative products (see below); the sales function may receive a share of Day One P&L, but may also receive additional compensation, depending on business strategies.

- **Private banking** – Sales commissions within private banking are generally expressed as a percentage of a gross margin or net revenue. Depending on the type of product sold, trail fees may also be payable to the sales team.

### 14.1.2.2 Insurance

- **Sales commissions and fronting** – Sales commissions are often dependent on the type of insurance sold, with profit profiles generally different for each type of product. The basic sales commission tends to be agreed as a percentage of the annual premium. In most cases, trail fees or a lower commission for successive renewals are also payable.

Where fronting activities are concerned, profit commissions are generally paid on top of sales commissions to incentivise the sale of profitable policies.

### 14.1.3 Definitions

One of the main reasons that the pricing of sales credits presents such an issue from a transfer pricing perspective is that they originated as an internal management tool. As such, their use is by no means uniform across sectors and they have been adapted by individual businesses to suit particular needs.

Specific terminology has arisen to describe the precise use of sales credits within a business:

- **Soft sales credits** – Used for performance evaluation purposes within the front office rather than as an accurate measure of the ‘true’ value added for tax purposes.
- **Hard sales credits** – ‘Payment’ for value added by sales for both finance and tax purposes, i.e. the actual reward provided to an entity for performing the sales function.
- **Estimated value method** (also known as the Day One P&L method) – The value of the sales credit awarded is based on the deal’s NPV at inception, net of relevant provisions (e.g. cost of capital, counterparty, risk, hedging). The estimated value may also be referred to as ‘economic value’.
- **Added value** – The difference between the price quoted by the trader and the actual sales price.

### 14.2 Transfer pricing implications

The pricing of sales credits is complicated by the differences in products, the differences between management and financial information, and the difficulty in benchmarking such activities. As a result, the pricing of credits has always been a contentious issue.

The level of contention increases in a recessionary environment where profits fall or become losses.

The key determinant behind the pricing policy will ultimately depend on the value contributed by the sales function.

### 14.2.1 Role of the sales function

The guidance provided in Section B-3 of the 2010 OECD PE Report – Part III suggests that there is a spectrum of functions that a sales team may perform, from a basic sale
introduction to a more sophisticated function that includes structuring a product and negotiating terms with a client. The nature of the sales team is likely to depend on the nature of the products sold and on the particular facts and circumstances. The following figure sets out the sales spectrum:

Traders are typically responsible for setting the parameters of the trade, with the sales team often being responsible for negotiating the price with the customer within these parameters. The role of the sales person is then to sell the product at the dealer price or better. This is generally the case when dealing with fixed income or equity products, which are generally sold in high volume by a generalist sales team. This places the sales function on the middle-left side of the sales spectrum.

Factors affecting the nature of the sales function are as follows:

- Industry.
- Nature of products – Generally, the more complex the product sold, the more likely that the sales function performed will be located on the right side of the sales spectrum.
- Specialists versus generalists – Generalist sales teams tend to perform fairly routine sales activities, while specialist sales forces tend to perform more complex sales activities that could involve structuring, price setting, or product development.
- Risk assumption at point of sale.
- Level of relationship developed between the sales team and the clients.
- Level of product structuring.
- Internal team structures (e.g. interaction of sales, structuring, trading).
- Level of integration with other teams/jurisdictions.
- Business strategy.
- Trading model (e.g. separate enterprise, centralised, integrated).

14.2.2 Trading and structuring

The two main components of a trader’s role are the initial assumption of risk (sometimes called dealing or market-making function) and the subsequent management of risk (hedging or risk management function). The level to which these components are integrated is dependent on the business structure and the nature of the products traded.
The trading function is generally responsible for maximising the expected profit on the transaction for managing market risks. Traders manage the risks assumed in a given transaction by monitoring the risk and deciding either to take a risk position by leaving a position partially unhedged or, alternatively, locking in profits. Traders operate within the risk parameters of a given financial institution or a specific trading book.

As occurs with the sales function, there is also a trading/structuring spectrum.

Traders may provide their sales team with indicative and final prices at which transactions will be entered into with customers, and may additionally be responsible for the management of the market risk that arises from those transactions once they are entered on the institutions books.

The structuring function is often important in the context of the trading of structured derivatives, as it is responsible for both the creation and pricing of structured derivatives. A structuring group typically works closely with the sales and trading functions. This function is generally aligned to the sales or trading function within a global trading organisation.

When dealing with complex products, the trading function may also get involved in structuring and product development activities. At the other end of the spectrum, the trading function may consist only of a simple execution function, e.g. when dealing with equities.

14.3 TP methods

The guidance provided in Section C-2 of the 2010 OECD PE Report – Part III suggests that “the amount and type of reward would depend on the level of services provided, which may be particularly related to the type of product, the functions performed, the risks assumed and the intangibles involved.”

“In many global trading transactions between associated enterprises (controlled transactions) there may be little difficulty in using traditional transaction methods and in finding comparable transactions so that an arm’s length price or gross margin can be determined. This is because, where a business is organised on pure centralised product management model lines, many of the functions apart from marketing (i.e. trading and risk management functions) may all be centralised in one location.”

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69  Ibid. Part III, Paragraph 124.
70  Ibid. Part III, Paragraph 115.
“A component of the value added by marketing personnel may in certain circumstances be measured by reference to the difference between the price at which a trader would undertake a transaction with a customer and the price actually obtained by the marketer.”

“Some general sales personnel merely act as brokers in respect of standardised products and so do not assume any credit risk from the sales transaction. They are likely to be rewarded by a simple fee or commission that does not depend on the profitability of the particular deal.”

For a global trading business more akin to the integrated trading model, “some marketers are so highly specialised and closely involved in the process of developing and structuring products that they perform functions leading to the assumption of credit risk and carry out some aspects of the trading function leading to the assumption of market risk. They are likely to insist on a share of the trading profits and losses (although, in the former case, the parties might still call this a commission), which will reflect the amount of capital they require to support the risks they have taken on.”

Therefore, the three methods often considered when determining a return to a sales function in a global trading context are the following:

- **CUPs – internal or external** – “If the controlled transaction is in respect of general sales functions, market data are likely to be available so that the CUP Method, usually in the form of a commission, can easily be applied.” More complex sales and marketing functions raise “the issue whether reasonably accurate adjustments can be made to account for the extra functions performed and risks assumed.”

External or internal CUPs are mostly available through the use of brokerage commissions and general sales functions. These are often represented as a proportion of soft sales credits or a commission. The CUP Method is often applied when pricing the sale of commodities, equities, and fixed income products.

- **RPM/Cost Plus – gross profit margin level** – “A careful comparison of the risks assumed and borne in both the controlled and uncontrolled transaction will be necessary. A component of the value added by marketing personnel may be measured by reference to the difference between the price at which the trader would undertake a transaction with a customer and the price obtained by the marketer. However, care must be taken to ensure that the results attributable to the trader and marketer correctly reflect the functions performed by each, especially taking into account the risks assumed.”

The RPM or Cost Plus Method are often used to remunerate routine sales activities, where an appropriate margin is added to the costs incurred by the sales team. These methods are often applied when pricing the sale of commodities, equities, and fixed income products and could potentially also be used for derivatives.
• **PSM** – “It is only likely to be those marketers who are involved in the structuring or dealing aspects that need to be rewarded by a share of the profits from global trading.”

“The question arises as to how the share of the profit should be determined. Often the profits will be limited to the initial profits (dealer spread) on the customer transaction rather than the subsequent trading profit.” However, this approach may not be appropriate if the functions performed by the sales personnel involved the assumption of market risk (e.g. structuring), when trading profits/losses arising from the realisation of market risk should be considered.

The level of integration or cooperation between the sales personnel and traders may be evidenced by the bonus structure for rewarding such personnel and in their working relationships and procedures.

The PSM is generally used for pricing highly integrated sales and trading activities, such as derivatives. A Day One P&L split between sales and trading functions is often calculated using an appropriate allocation key.

The following table summarises the use of the TP methods in sales trading activities.

<table>
<thead>
<tr>
<th>TP methods</th>
<th>CUP</th>
<th>RPM/Cost Plus</th>
<th>PSM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>When to use it</strong></td>
<td>External CUPs mostly available through the use of brokerage commissions and general sales functions</td>
<td>Generally used to remunerate routine sales activities</td>
<td>Generally used for highly integrated sales and trading functions, e.g. highly structured derivatives</td>
</tr>
<tr>
<td><strong>Calculation</strong></td>
<td>Represented as a proportion of soft sales credits or a commission</td>
<td>An appropriate margin is added to the costs incurred by the sales team</td>
<td>Day One P&amp;L split between sales and trading through the use of an appropriate allocation key (e.g. total compensation)</td>
</tr>
<tr>
<td><strong>Considerations</strong></td>
<td>Can reliable adjustments be made?</td>
<td>Can use margin differentials for structured transactions?</td>
<td>Correct identification of functions performed and risks assumed by the sales personnel and traders is required; Identification of the revenue stream to be split; Definition of Day One P&amp;L.</td>
</tr>
</tbody>
</table>

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76 Ibid. Part III, Paragraph 178.
77 Ibid. Part III, Paragraph 130.
The following diagram illustrates the use of TP methods and their interaction with the sales and trading spectrums.

Key messages from this analysis are as follows:

- The nature of the sales and trading functions need to be considered in conjunction when considering the use of pricing methods for sales activities.
- Where the characterisation of one of these activities is that of a routine nature, it is often possible to apply a Cost Plus or Gross Profit Margin analysis.
- Where the sales and trading activities fall in the middle of the spectrum, these will be highly integrated and therefore it will be difficult to apply a method other than the PSM.
- Due to the difficulty in applying one reliable TP method, it is important to back-test the results of the policy implemented with the use of a secondary method.

14.3.1 Other considerations

Other important factors to consider when setting up a transfer pricing policy to remunerate sales activities in a global trading context are the following:

- Availability of information and tracking systems – It is important to consider how the organisation tracks sales credits to determine what they are for (e.g. are there any incentivisation structures?), how they are computed, and whether the Day One P&L revenue can be calculated.
- Difference between management and financial information – Consider whether it is possible to reconcile this information.
- Economic circumstances of the market that could affect the pricing.
- Local regulation that could constrain the use of certain methods.
14.3.1.1 Implementation and testing
When pricing sales trading activities, there is no set model or method that has to be used and the selection of the method and nature of the sales and trading activities will be dependent on various factors. Therefore, it is important for each organisation to develop its own pricing model. This will mostly depend on the nature of the data and information available. As there is no right answer, each organisation has to manage the risk surrounding the selection of their policy by selecting the answer that is most likely correct. It is therefore important to back-test the results obtained with the chosen methodology.

14.3.1.2 Losses and sales credits
When dealing with losses in global trading activities, it is important to consider whether any of such losses should be attributed to the sales function and to consider the assumption of credit and/or market risk by the sales function.

In addition, it is important to distinguish whether the losses materialise at a transactional or operational level. It is more common for a sale function to assume losses when it is of an operational nature and this can be managed by the sales location earning a proportion of the AV or EV.

In the case of a negative dealer spread “the sales function would expect to be rewarded for the broking function being performed and would not expect to bear any of the loss arising from the negative dealer spread.”

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78 Ibid. Part III, Paragraph 131.
Part V: Financial transactions
Chapter 15 – Loans

15.1 Introduction
The transfer pricing of inter-company financial transactions has received considerably more attention in recent years both from tax authorities and taxpayers. In particular, the impact that the global financial crisis had on credit markets and General Electric Capital Canada Inc.’s decisions, later introduced in this chapter, have dramatically increased the profile of the transfer pricing issues associated with such transactions.

While credit markets have started to function again after the 2008 credit crisis, the terms and conditions that third-party providers of credit are willing to accept are, in many cases, still substantially more conservative than those that were prevalent in the years leading up to 2007. To cope with the aftermath of the crisis and alleviate the funding pressures that have been ensuing, multinational enterprises have devoted significant resources to developing treasury business models that promote a higher degree of self-funding using tools such as cash pooling. Upward pressures on funding costs have also generated an interest in the BCM marketplace for the development of guarantees.

The most obvious example of a transfer pricing issue involving financial transactions that is covered in this chapter is determining an arm’s length interest rate on inter-company lending. Following chapters in this section cover the broader transfer pricing issues associated with the treasury functions of a multinational enterprise as well as other types of financial transactions such as guarantee fee arrangements.

Many of the general principles and issues covered in this chapter are applicable to related-party financial transactions in all industries. However, in keeping with the target audience of this chapter, there is a focus on the unique issues that arise in respect of inter-company financial transactions within financial services groups. This chapter focuses on the intricacies of the pricing of inter-company loans.

15.2 Loans
Whenever possible, multinational enterprises have typically considered financing their operations using inter-company loans, as these have been perceived as efficient and cost-effective tools. Although the use of such tools is frequent and pervades all industries, there are considerations that, from a transfer pricing perspective, need to be carefully evaluated when pricing such transactions (e.g. establishing arm’s length of interest rates). This section details such considerations.

15.2.1 Guidance and OECD commentary
The arm’s length principle requires that inter-company financial transactions be undertaken on terms similar to those that would have been entered into by independent enterprises.

The OECD Guidelines touch upon the application of the transfer pricing methods in determining an arm’s length fee for inter-company financing activities, such as establishing interest rates on loans provided to group companies. This means that for the determination of interest rates on inter-company loans, one has to focus primarily on specific local transfer pricing rules (if any), which increases the risk of disputes on the interest rates applied (as the local rules may vary country by country).
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Part V: Financial transactions

15.2.2 Overview
A number of factors require consideration when determining arm’s length prices for an inter-company loan. In particular, if the underlying terms of a transaction are not consistent with those that would have been entered into by independent third parties, then, by definition, it is not possible to determine an arm's length price for that transaction.

Indeed, the OECD Guidelines mention financial transactions as a special case where it may be appropriate and legitimate for a tax authority to disregard a taxpayer’s characterisation of a transaction and re-characterise it in accordance with its substance.

The example cited in the OECD Guidelines is that of “an investment in an associated enterprise in the form of interest-bearing debt when, at arm’s length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way. In this case it might be appropriate for a tax administration to characterise the investment in accordance with its economic substance with the result that the loan may be treated as a subscription of capital.”

With this in mind, taking the example of an inter-company loan, before it is possible to begin any analysis to determine an arm’s length interest rate for a transaction, careful consideration should be given to the characterisation of the financial transaction to be priced. Such a step would typically be performed by answering questions such as the following:

1. Does the transaction meet the definition of debt under the relevant local tax rules/case law? Local laws should also be considered. For example, under US law, the ability to finance the required payments (i.e. interest rate and principal amounts) is considered.
2. Will the interest deduction be restricted due to local thin capitalisation rules in the country of the borrower?
3. Are the terms of the transaction consistent with terms that would have been agreed between two independent third parties?

It is only when those questions have been answered that one can consider, based on the terms of the transaction, what an appropriate arm’s length interest rate should be. Given that this chapter focuses on transfer pricing issues related to inter-company financial transactions, we will now turn our attention to the determination of the appropriate arm’s length interest rates.

15.2.3 Basic principle and method
Three key factors that determine interest rates in third-party scenarios are as follows:

- **The likelihood of borrower default** – e.g. how creditworthy is the borrower and how able is it to meet its liabilities?
- **The expected loss in the case of default** – e.g. how senior is the debt? Is there any security provided?

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79 The OECD Guidelines, Chapter I, Part I, Section D-2, Paragraph 1.65.
80 Each of these questions requires a significant amount of scrutiny. A large body of case law will typically be available to provide guidance regarding how one should approach the characterisation of the transaction exercise (e.g. what are the key financial ratios to be considered for a thin capitalisation analysis, what precedents have been set).
• **The opportunity cost of making the loan for the lender** – e.g. what is the term of the loan? Is it repayable on demand? What is the currency of the loan and current market interest rates for that currency? In the case of a fixed interest loan, what are the expectations of future interest rate changes over the term of the loan?

Interest rates do not cover the quantum of debt that is acceptable, because this varies significantly by country.

### 15.2.4 Setting interest rates

Although most countries agree that interest rates between related parties have to be set according to the arm's length principle, there is little guidance provided by the OECD or local country regulations on how to establish or determine an arm's length rate of interest. The lack of specified methods has resulted in tax controversies. In an attempt to comply with this requirement, taxpayers have tried to replicate what unrelated parties do to determine arm's length rates of interest in order to obtain a similar result. Most books and papers regarding technical analysis of interest rates and public information of transactions involve transactions entered into by banks. When banks determine the interest rate at which they will lend to their clients, they typically account for (i) the terms and conditions of the loans (e.g. the loan tenure, its seniority and collaterals), (ii) the credit or default risk of the borrower (measured through a credit rating process), and (iii) the interest rates offered by other lenders in comparable circumstances. Hence, when determining a range of arm's length interest rates for an inter-company loan, the above three items affecting the interest rate agreed between unrelated parties should be considered. Each of these items is discussed below.

### 15.2.5 Loan terms

When lending to unrelated parties, a lender starts the process by evaluating the financial standing of the borrower to determine if it is willing to even lend to such a borrower, then continues with agreeing on the terms and conditions of the loan, and concludes with determining the pricing for the loan (i.e. the appropriate interest rate). After this is done, the parties execute an agreement specifying the characteristics of the loan, including principal amount, interest rate, frequency of payments, and tenure of the loan. This process serves as a basis for a loan benchmarking analysis. All else being equal, under normal credit market conditions, longer tenured loans carry higher interest rates that increase further with their degree of subordination. Other features that affect the arm’s length range of interest rates on a loan include embedded options (e.g. convertible to equity, prepayment), seniority of the loan, collaterals, and guarantees, among others. Accounting for these features and how they compare with those of the inter-company transactions is the subject of the transfer pricing analysis to be conducted.

One item to note is the ability to obtain similar amounts from outside lenders. Having a bankability letter typically represents good corroborative evidence, even though it does not constitute a comparable for transfer pricing purposes because it does not represent an actual transaction. Other sources to support this point would include references to third-party loans with similar characteristics at the time of the inter-company transaction.

### 15.2.6 Credit rating process

As mentioned above, the credit rating of the borrower is a key determinant of the interest rate to be charged on a lending transaction. As such, a crucial step in the benchmarking analysis revolves around the determination of the credit rating of the
This section highlights the key transfer pricing concepts to consider when assigning such credit rating.

15.2.6.1 The arm’s length principle: competing definitions
This section examines the two competing approaches used in the transfer pricing of financial transactions, i.e. credit rating an entity on a ‘standalone basis’ versus considering its credit rating as ‘member-of-a-group’.

The objective of either approach is ultimately to demonstrate that transactions between related entities have met the arm’s length principle. Before delving into the details in regard to these approaches, it is useful to briefly survey the basics of credit ratings and their wider use.

15.2.6.1.1 What is a rating?
Simply put, a credit rating estimates the ability of a borrower to repay debt. Consequently, it is also a fundamental driver of the decision to lend money by a lender to any borrower. In fact, the estimation of the credit rating of a potential borrower is one of the key considerations in any commercial transaction involving the issue of debt between independent parties. Before any debt transaction is consummated, the borrower’s credit rating, along with debt-specific characteristics, such as currency of issue and term/duration, are typically used to determine the interest rates charged on the debt, as well as the amount of debt that can be extended.

In the financial markets, a credit rating is also interpreted as the likelihood that the potential borrower will default on its financial obligation. Given that the determination of the likelihood of default of any company is a rather complex exercise, an entire industry devoted to evaluating the credit ratings of publicly listed companies, banks, and countries has evolved over the last few decades.

15.2.6.1.2 OECD and US guidance
The OECD Guidelines provide extensive guidance in applying the arm’s length principle for a variety of inter-company transactions, including a detailed explanation of the methodologies available for testing each transaction. However, the guidance on inter-company financing transactions is more limited. While the OECD Guidelines do not provide explicit recommendations in determining credit ratings per se, the arm’s length principle implies that a credit rating of a related party should be consistent with one that would have been determined between parties acting at arm’s length.

In terms of the determination of the credit rating for an arm’s length analysis, the US regulations also provide limited guidance in line with the OECD Guidelines. The US has adopted the arm’s length standard for the purposes of applying Section 482, and the regulation promulgated thereunder establish procedural and substantive rules to determine whether the pricing of a taxpayer’s inter-company transactions meets the arm’s length standard. Pursuant to Treas. Reg. Section 1.482-2(a)(2)(i), in determining the arm’s length interest rate, the credit rating of the borrower is one of the factors that should be considered.

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81 The biggest credit rating agencies are S&P, Moody’s, and Fitch. There are also some smaller agencies such as Dominion. In general, the approach of most credit rating agencies is to use the rating methodology that best suits the borrower’s industry and offers the best possible relative ranking of the credit worthiness of a borrower vis-à-vis similar companies in the same industry. Given that credit ratings are relative, they are generally expressed using a letter designation such as A (excellent), B (moderate), C (poor), and D (already in default). In addition, credit rating agencies also use a second and third digit to provide a more gradual/precise result such as BBB (S&P) or Ba2 (Moody’s).
Unfortunately, both the OECD Guidelines and the US regulations do not provide specific guidance on how exactly to determine the credit rating of a borrower, leaving the door open for different interpretations and competing approaches. In the next section, we will discuss one of the most important and fundamental implications of this lack of clarity for taxpayers.

### 15.2.6.1.3 Credit ratings within the transfer pricing context

In a transfer pricing context, credit ratings play an essential role in determining whether a specific transaction between related parties is structured at arm’s length. Indeed, the first step of a transfer pricing analysis involving debt transactions is the determination of the credit rating of the borrower.

Under normal market conditions, an excellent credit rating will most likely mean that the costs (e.g. the interest rate) to obtain a certain financial instrument will be lower, while a poor credit rating will probably mean that the lender will want a higher interest rate to compensate for the higher risk of lending to a poorly rated borrower. Therefore, in a transfer pricing context, the determination of the credit rating of a borrower within a multinational group is of great interest to tax authorities since this is one of the clearest signals that the inter-company debt transaction has been structured at arm’s length.

It is important to understand that credit ratings are, at best, opinions on the likelihood of default of a company or an individual debt issue based on a set of quantitative and qualitative factors affecting the industry of the borrower. At worst, as has been experienced in the recent financial crisis, credit ratings can be problematic signals that potentially mislead investors about an entire class of financial products. Either way, it is hard to discount their importance since they are critical indicators of financial strength that allow companies to access funds in the financial markets.

In a transfer pricing context, where the focus is primarily on inter-company debt transactions, estimating the credit rating of a potential borrower is one of the best signals to tax authorities that taxpayers have followed standard industry practice and, as a consequence, made reasonable efforts to act as if independent parties would have done, i.e. at arm’s length. That said, the competing approaches to credit rating borrowers within a transfer pricing context and recent case law commentary that is best described as ambiguous does little to alleviate the uncertainty as to whether tax authorities will accept either approach as being at arm’s length.

Still, there is little doubt that estimating a credit rating of a potential borrower is a critical first step towards structuring/documenting an inter-company debt transaction following which other characteristics of the inter-company loan have to be taken into account to set an arm’s length interest rate. This aspect of a transfer pricing analysis will be addressed in the next section.

### 15.2.6.1.4 Standalone versus group rating

Given the lack of clarity in guidance from both the OECD and US perspectives on how to determine the credit rating of a borrower, taxpayers are left to decide between two competing approaches to determine credit ratings in a transfer pricing context: the ‘standalone’ approach and the ‘member-of-a-group’ approach.
In the standalone approach, a borrower within a multinational group is treated as an independent entity and credit-rated based on its own financial standing. This approach, while seeming to emulate the arm’s length principle, ignores the influence of the parent company and other members of the multinational group, which does not reflect reality in many multinational corporations. Rarely does a subsidiary of a major multinational make decisions on its own and is completely shielded from the influence of its related parties. In addition, it may be that the financial results and the capital structure of the subsidiary itself are influenced by decisions made by the parent company that directly and unequivocally influence the credit rating of the subsidiary. Therefore, while the standalone approach might appear to be at arm’s length, it requires taxpayers to suspend or at least ignore the reality of day-to-day operational activities of the entity being credit rated.

On the other hand, in a member-of-a-group approach, the subsidiary is given the same credit rating as the entire multinational group. This approach implicitly assumes that the parent company/multinational group will not let the subsidiary fail in the event that it runs into financial difficulty. In addition, there is also the additional implication that the subsidiary’s financial standing matches the financial standing of the group, which of course is unlikely in most instances. Nonetheless, there is an argument to be made that as part of the group, the subsidiary has the implicit support of the parent company. However, the question of how far one can practically take this argument is unclear. Therefore, in the case of the member-of-a-group approach, although there is some justification to assign subsidiaries the same credit rating as the multinational group, it is not entirely clear if this approach can always be defended as being at arm’s length.

On the side of the tax authorities, there is also considerable uncertainty as to which approach they might consider appropriate. One of the most high-profile cases that involved extensive discussions around these competing approaches was the General Electric Capital Canada case relating to the validity of the payment of a guarantee fee by a Canadian subsidiary to a US parent, where the Tax Court of Canada in effect decided to apply both the concept of a standalone approach as well as the concept of ‘implicit support’ by the parent company to arrive at an appropriate credit rating for the Canadian subsidiary of General Electric Capital.

However, the Tax Court also stated that the ‘implicit support’ has limited value and therefore not equivalent to an ‘explicit support’ that would be required for the subsidiary to be assigned the parent company rating, which was the original stance taken by the CRA.

This decision, which was appealed by the CRA, has muddied the waters even further and it is unclear what the final outcome might be in terms of the appropriate guidance from a tax authority perspective to determine a credit rating. With its view on the limited value of implicit support, one could argue that the Tax Court sided more with the standalone credit rating approach. However, since the General Electric Capital case was specific (relating to the validity of the payment of a guarantee fee by a Canadian subsidiary to a US parent), it is not clear whether the decision of the Tax Court can be used to support the appropriateness of the standalone approach.
15.2.7 Benchmarking interest rates agreed between unrelated parties

Once the terms and conditions of an inter-company loan and the credit rating of the borrower have been identified, the determination of an arm’s range length of interest rates is pursued. The following components directly affect the interest rate level on the transaction:

- **Type of financing transaction** – Examples include term loans, revolving loans, and stand-by letters of credit.
- **Industry of the borrower** – Riskier or more volatile industries would expect higher interest rates (e.g. retail or dot-coms vis-à-vis utilities companies).
- **Credit rating of the borrower** – The credit rating indicates the probability or risk that the borrower will default on covering the principal or interest of the loan. Entities with a lower credit rating should expect higher interest rates.
- **Tenure** – The time to maturity of the loan affects the expected return on investment by the borrower. This relationship between tenure and time premium is illustrated in market yield curves. Under normal market conditions, this premium increases with the tenure of the loan.
- **Fixed versus floating rate** – Floating rates established as a base rate plus a spread typically represent less risk to lenders because they automatically reflect changes in the market conditions.
- **Currency** – The currency in which the loan is negotiated carries certain risk resulting from foreign exchange markets. Currencies more prone to devaluations typically draw higher rates of interest.
- **Embedded options** – Certain loans include different types of options, for example, giving the borrower the ability to repay before maturity, allowing the lender to collect before maturity, or making the loan convertible to equity.
- **Subordinated/senior debt** – This refers to the priority in which claims are paid by a company. If a loan is considered subordinated, it is paid after senior debt has been paid.
- **Collaterals and guarantees** – When additional collaterals or guarantees form part of the financing transaction, it typically represents a reduction in the risk of default.

Information about financing transactions is not as readily accessible as that of stock markets, and often reference is made to the rates observed in market yield curves; however, these yield curves are the result of groups of transactions and represent a market indicator but not necessarily actual transactions between unrelated parties. Information services often apply statistical tools and adjustments to obtain this curve, which can result in over- or under-estimating what actual unrelated parties agreed to in comparable transactions. For these reasons, although yield curves are considered a good source of quick references or information to apply in potential adjustments, they do not necessarily constitute a comparable in a transfer pricing context.
Chapter 16 – Treasury activities

16.1 Introduction
Financial transactions are the lifeblood of most organisations. Debt is an integral part of how most organisations manage their daily operations and simply exist. As such, the concept of debt management has been and is increasingly becoming a key aspect of most treasury groups. To optimise their intra-group working capital management and to obtain certain group benefits, almost all companies that operate on a cross-border basis make use of cash pools.

A cash pool seeks to ensure that cash and other liquid assets that are available within a group are utilised first within the group before external financing is sought. In more technical terms, a cash pool is simply a financial tool that first pools all cash and other liquid assets available within the various subsidiaries of the company before obtaining external financing (if required), generally from the bank that is facilitating the cash pool. As such, a cash pool reduces the external financing costs of the multinational.

As a result of the recent financial and economic turmoil, the utilisation and incidence of cash pools has become more relevant. It is increasingly more difficult for companies to obtain external financing, and the current market credit spreads have made external financing increasingly more expensive. Not only has funding become more expensive, it has also become scarcer. This has coincided with companies increasingly in need of more liquidity as a result of lower-than-expected operational profits. Companies have also found that (historically) relatively cheap credit facilities are reaching their maturity and need to be replaced by alternative financing. Therefore, considering using all liquid assets available within the company has become even more important for many companies.

Although a cash pool generally is set up for operational purposes, rather than for tax purposes, and there are important tax aspects with respect to setting up and running a cash pool. Next, we will discuss the most important transfer pricing aspects of cash pooling, considering the OECD Model Tax Convention and the OECD Guidelines as our starting point.

16.2 Cash pool: Background and characteristics
16.2.1 Why cash pooling?
Essentially, companies use cash pools:

i. to reduce costs (e.g. transactions) of the participants in the cash pool when compared to the situation in which the participants maintain separate bank accounts locally;

ii. to obtain more favourable borrowing conditions from banks as a result of their increased bargaining power with the banks;

iii. to centralise the management of the decision-making on financing matters and;

iv. to take advantage of the so-called ‘cash pool benefit’ which is based on the principle that the interest that a debtor pays to the bank (debit interest) is higher than the interest a creditor receives from the bank (credit interest).

The cash pool benefit, which is obtained at group level, results from the fact that the debit and credit positions of all participants are first settled among each other before surplus cash is deposited with the bank or cash is borrowed from the bank. The cash
pool benefit therefore consists of interest savings on debit positions to the extent that there are equally high credit positions within the group.

16.2.2 Types of cash pooling
In principle, two main types of cash pools form the basis for all other cash pools: the target-balancing (also known as the zero-balancing) and the notional cash pool. We review the mechanics of these two main types of cash pooling in the following sections.

16.2.3 Target-balancing (zero-balancing) cash pool
The bank accounts of the participants in a target-balancing cash pool are levelled regularly (often daily) to a certain predetermined amount (often zero). When the balance on a participant’s bank account exceeds this amount, the excess amount is transferred to a central bank account (i.e. the bank account of the CPL. If the balance on a participant’s bank account runs short on this amount, funds are transferred from the CPL’s bank account to level the participant’s bank account to the targeted amount. A zero-balancing cash pool (i.e. the targeted balance on the bank accounts of the participants is set at zero) is the most commonly applied form of a target-balancing cash pool.

If the target-balancing cash pool is linked to a credit facility (between the bank and the CPL), the CPL can off-set a total debit position of the cash pool with funds withdrawn from that credit facility. In this event, the CPL needs to pay interest to the bank. On the other hand, if the cash pool is in a total credit position, the bank pays interest on this position to the CPL. Alternatively, excess cash in the cash pool can be invested, typically, in short-term limited risk securities. To what extent the participants in the target-balancing cash pool need to provide a guarantee to the bank depends, among other things, on the financial position of the CPL and of the participants. It is normally the case that a guarantee is required.

In summary, a target-balancing cash pool is an important cash management tool that concentrates cash at the level of the CPL. The CPL is responsible for managing the company’s overall working capital as efficiently as possible.

16.2.4 Notional cash pool
A notional cash pool does not involve an actual transfer of cash from one bank account to another. Instead, the bank calculates the credit – and debit interest on each participant’s individual bank account and subsequently calculates (notionally) the total balance of all individual bank accounts combined. Based on this notional balance, the cash pool benefit is calculated. Depending on the underlying agreements, the cash pool benefit is (i) paid by the bank to the CPL or (ii) paid by the bank to the participants by means of adjusting the debit and credit interest accordingly. In practice, this type of cash pool is therefore also called an ‘interest compensation’ cash pool.

Similar to the target-balancing cash pool, in principle the combined total balance of the notional cash pool cannot be less than zero. Furthermore, the cash pool participants may have to provide cross-guarantees to the bank in order to prevent the bank from incurring the debtor’s risk on the notional cash pool. If the participants want to have the option to be in a debit position with the bank, the participants need to enter into a credit facility with a bank, which may need to be cross-guaranteed by the participants and/or by the parent company.
The CPL’s role with respect to notional cash pools consists mainly of contacting the bank on matters such as interest payments and cash pool benefit payments. A notional cash pool thus arguably serves fewer purposes than a target-balancing cash pool; its main purpose is to obtain an interest benefit for the group.

### 16.2.5 What type of cash pool to implement: notional versus target-balancing

An important difference (also for tax purposes) between target-balancing cash pools and notional cash pool is that inter-company payables and receivables are created in the former type, whereas this is in principle not the case in the latter type. Since the participants in a notional pool maintain their bank accounts with the bank individually, the debit and credit positions are maintained with the bank and not intra-group, i.e. there are no transactions between the participants and the CPL. Because a notional cash pool limits the number of transactions to be performed by the bank (and as such the transaction fees) and limits the number of inter-company payables and receivables, many companies prefer to implement a notional cash pool over implementing a target-balancing cash pool. Banks also often prefer notional cash pools because no credit positions are created with the cash pool participants (unless a credit facility is agreed upon) and, as such, the banks do not need to include the cash pool in their balance sheets. Therefore, banks do not need to maintain additional capital on their balance sheets with respect to a notional cash pool.

Another important element for companies in determining the type of cash pool that suits the company best is whether the company has a centralised management structure (target-balancing cash pooling centralises cash in one entity, often the company’s headquarters, resulting in more centralised control and management of cash) or a decentralised management structure (local subsidiaries may not be willing to give up their autonomy in making financing decisions and therefore would prefer a notional cash pool).

Furthermore, a target-balancing cash pool requires more management and administration compared to a notional cash pool and is therefore more costly to maintain. In addition, legal and financial monitoring considerations as well as operational considerations (such as IT-infrastructure) influence the decision as to whether a company should implement a notional cash pool or a target-balancing cash pool. Finally, the extent to which the CPL also provides other treasury services to the participants, such as a ‘payment factory’ (i.e. central payment of third-party invoices) or ‘netting’ (i.e. to allow inter-company credit and debit positions to set-off and partially or entirely cancel each other out), further influences the decision for a company regarding the type of cash pool to implement.

### 16.3 Cash pooling in practice

Irrespective of the type of cash pooling, all participants need to maintain a current account with, preferably, one bank (or local offices of that bank). Furthermore, one entity needs to be appointed as the CPL and, in this role, (i) manages the cash pool; (ii) for target-balancing cash pools, centralises all cash positions of the participants and the bank; and (iii) manages interest payments.

The bank generally offers the IT-platform on which the cash pool operates (e.g. all periodical payments, transfers).
A cash pool typically is not covered by just one legal agreement, but is covered by a number of legal agreements between all participating parties. A cash pool always relates to short-term financing of working capital. As such, a cash-pool is not intended to fund long-term financing. However, in practice it is not uncommon that some participants have long-term debit positions with the CPL, whereas other participants have long-term credit positions with the CPL. This arrangement may have consequences for the long-term legal relationships between the various participants and also for their transfer pricing position.

16.4 Transfer pricing aspects of cash pooling

16.4.1 Introduction
Most jurisdictions follow the arm's length principle as defined in Article 9 of the OECD Model Tax Convention and the OECD Guidelines in determining the appropriateness of the remuneration for financial activities. The arm's length principle states that where:

“conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.

As such, the arm's length remuneration for financial activities needs to be analysed based on the functions performed, the risks assumed, and the assets used by the relevant parties. For cash pools this means that the credit and debit interest rates, as well as the remuneration the CPL receives for its activities, need to be at arm's length. There are also further issues that should be considered, such as the impact of any guarantees (be they cross-guarantees or parental or by the CPL) on the overall pricing as well as the capital structure of the CPL and how its activities may be characterised either as an entrepreneur or as a service provider. In the following section, we consider the main types of issues that need to be considered from a transfer pricing perspective when implementing a cash pool and setting the policy.

16.4.2 How to determine the arm’s length credit and debit interest rates?
One of the most tangible benefits for the cash pool participants include savings on banks’ transactions-related costs and more favourable credit and debit interest rates. On the other hand, in most cases the participants also incur a higher debtor’s risk in the cash pool compared to having direct deposits with a bank.

To determine the arm’s length credit and debit interest rate, it is therefore crucial to recognise that, with respect to a cash pool, in most cases the ultimate debtor is neither the bank nor the CPL, but rather the participants with a cash deficit, and that their creditworthiness is often much lower than the creditworthiness of a bank. Therefore, in determining the arm’s length credit and debit interest rates applied within a cash pool, the creditworthiness of the participants should be referred to.

In the alternative case of a target-balancing cash pool where there are no cross-guarantees provided by the participants, the creditworthiness of the CPL may also need to be considered since, in principle, it is the principal to the transactions with the participants. It is unlikely, however, that the participants and the CPL have
their own credit rating. Therefore, in principle, for each participant and the CPL (for target-balancing cash pools) a standalone credit rating needs to be established.

Subsequently, based on the standalone credit ratings and the terms and conditions of the cash pool, CUP analyses need to be performed based on relevant market information. These CUP analyses result in (inter-quartile) ranges of credit spreads which, together with the underlying base interest rate (i.e. the interest rate for risk free funding), can be used as the arm’s length credit and debit interest rates within the cash pool. These interest rates need to be verified regularly, and adjusted when appropriate, based on actual market interest rates.

Depending on the underlying guarantee structure, it may be required to remunerate those subsidiaries that provided a guarantee for the benefit of the cash pool but that do not belong to the cash pool themselves with a guarantee fee. Whether a guarantee fee is appropriate depends on the type of cash pool, the creditworthiness of the participants and that of the guarantors, and whether credit facilities are attached to the cash pool (among other things). To determine the level of the guarantee fees, reference can be made to the interest benefit realised by the participants with a cash deficit as a result of the provided guarantees. In practice, guarantee fees are an additional complexity in setting up and maintaining a cash pool.

16.4.3 Remuneration for the CPL
The remuneration for the CPL’s functions performed, risks incurred, and assets used has to be at arm’s length. Taking into account the different position of the CPL with respect to a notional cash pool compared to a target-balancing cash pool, the approach to determine the appropriate remuneration for the CPL may differ.

Within a target-balancing cash pool, transactions take place between the participants and the CPL on which an arm’s length interest rate needs to be applied. The CPL may effectively operate as an internal bank. If its role is not to act as simply a service provider (i.e. to take no principal risk on any of the transactions but simply to administer the scheme) but more as the entrepreneur (as the effective bank being the counterparty to the transactions), then its remuneration consists of the difference between the debit interest rates and the credit interest rates (and potential guarantee fees). In this respect, it is important to note that the higher the amount of equity (capital) of the CPL, the larger the interest rate spread. That is because with a high level of equity (capital), the creditworthiness of the CPL is better, which results in a lower credit interest rate. The CPL does not receive a separate remuneration for its functions performed; the CPL needs to recover its expenses and make a profit from the interest rate spread it realises.

Alternatively, within a notional cash pool, there are no transactions between the participants and the CPL (although potentially interest payments are routed via a so-called ‘master-account’ in the name of the CPL). Its function and risk profile depends mainly on the way in which the notional cash pool is set up. In the simplest of forms, the CPL instructs the banks on the credit and debit interest rates to be applied to the various participants. The CPL does not provide any guarantees and, as such, does not incur any debtor’s risk. In this situation, the CPL operates as a service provider. The Cost Plus Method or a (limited) basis point spread may therefore be appropriate methods to remunerate the CPL (the remuneration can be settled by means of a separate fee or by means of credit and debit interest rate adjustments).
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In all scenarios, it is required to analyse the exact role and position of the CPL before further analysing its arm’s length remuneration and reward system.

16.4.4 Allocation of the cash pool benefit
As a consequence of application of a method to determine the arm’s length credit and debit interest rates, the cash pool benefit may not necessarily reside with the CPL. Instead, the cash pool benefit may need to end up with those participants (and potentially the CPL) that (economically) incur the debtor’s risk with respect to the cash pool.

There is, however, a complicating factor stemming from the more favourable interest rate conditions that are a result of economies of scale. These should benefit all participants, not only those participants that incur the debtor’s risk with respect to the cash pool. That is because the more favourable interest rate conditions are a result of the total volume and the number of transactions of the cash pool, to which all participants contribute.

16.4.5 Practical considerations
Cash pools are regularly considered as a planning tool to obtain fiscal benefits, i.e. by establishing the CPL in a country with a favourable tax regime and allocating the entire cash pool benefit to the CPL. Putting aside the benefit generated from economies of scale, which should be shared across all participants, the entire cash pool benefit can be allocated to the CPL only if it both legally and economically (the CPL should have sufficient equity [capital] at risk with respect to the cash pool) incurs the debtor’s risk with respect to the cash pool.

Furthermore, in practice a participant may have a long-term credit position in the cash pool. The credit and debit interest rates of a cash pool, however, are determined on a short-term basis since the purpose of a cash pool is to facilitate short-term financing of working capital. Many discussions with local tax authorities have been taking place on this issue since tax authorities, with the benefit of hindsight, can establish if and when cash has been deposited in the cash pool for a long period. These discussions in particular relate to the interest rate that the participant depositing the cash has received on its deposit. The argument of the tax authorities is that the participant has been paid an interest rate that is too low due to its short-term nature.

16.4.6 Preparing a cash pool policy paper
In most European countries, but also in the US and most Asian countries, the arm’s length nature of the terms and conditions of a cash pool, the remuneration for the CPL, and the applied credit and debit interest rates need to be substantiated and documented. Taking into account that a cash pool is often implemented on a regional or even worldwide scale, it is important to comply with these transfer pricing requirements.

However, with often dozens of participants and a capital market that is constantly fluctuating, it is almost impossible for companies to apply real-time credit ratings and market interest rates for setting arm’s length credit and debit interest rates. The OECD Guidelines do seem to recognise that there may be a difference between theory and practice in applying transfer pricing, and therefore seem to accept that a somewhat practical approach can be taken.
16.5 Conclusion
Cash pooling is a specific financial tool and each cash pool should be analysed based on its own merits and operations. Furthermore, the current environment for cash pooling is dynamic: the financial markets are fluctuating as never before and the economic turmoil has put more pressure on companies to effectively manage their cash. These factors influence the transfer pricing for cash pools and as such need to be accounted for when setting up transfer pricing guidelines for cash pools.
Chapter 17 – Guarantees

17.1 Introduction
This section addresses the key transfer pricing considerations with respect to guarantees provided by one group company in relation to a (financial) transaction entered into by another group company, typically with a third party (internal guarantees). It shows that, despite the theoretical complexities, best practice approaches can be developed to comply with local transfer pricing requirements and, at the same time, to seize opportunities that internal guarantees may offer to multinationals.

First, we set out the background of internal guarantees and their increased use by multinationals. We then describe the relevance of the arm's length principle and the types of guarantees observed in practice. Last, we conclude with an overview of the elements that a best practice approach needs to address for dealing with the transfer pricing aspects of internal guarantees.

17.2 Setting the scene
The credit crunch and economic slowdown have put pressure on the funding sources on which multinationals rely. Banks and other financial institutions have become more risk averse, which has resulted in increased costs of borrowing or, even worse, dried up credit lines. To lower their reliance on external (bank) debt, multinationals have sought means to optimise their internal use of cash, e.g. through setting up cash pools, using inter-company loans to relocate idle cash, and centralising the collection of trade receivables (factoring).

Multinationals reliant on external debt often face increased demand for (additional) securities or for strict covenants. Although risk awareness may have eased since the credit crunch peaked in the first quarter of 2009, the focus on risks and the pricing of the cost of borrowing have not returned to their pre-crisis levels. Thus, both with internal cash optimisation and with external debt funding, multinationals often use credit guarantees.

The increased use of internal guarantees has also caught the attention of tax authorities around the world, because internal guarantees often benefit one group company at the expense of another. To ensure their 'fair' share of the multinational's profit, local tax authorities ascertain whether the internal guarantees are established and priced in accordance with the arm's length principle. Transfer pricing may also offer tax authorities a means to counter the potential tax consequences of internal guarantees in case they are invoked.

The following sections further detail the arm's length principle and the risks to which multinationals are exposed in the event that internal guarantees are not established and priced on an arm's length basis.

17.3 The arm’s length principle and guarantees
Internal guarantees used by multinationals are often governed by domestic transfer pricing rules and bi-lateral tax treaties, which many countries have concluded and which almost always include an article containing the arm’s length principle in
accordance with Article 9 of the OECD Model Tax Convention. If a transaction between
group companies is not at arm’s length, a tax authority may disregard the transaction as
structured by those companies, ‘impose’ arm’s length conditions, and tax accordingly.

Besides tax adjustments (i.e. to include retroactively deemed guarantee fees, rejected
 guarantee fees, or non-deductibility of claims made under an internal guarantee),
other typical risks include tax penalties and, ultimately, double taxation. Moreover,
multinationals can incur significant opportunity costs as tax audits tend to be
time-consuming and costly. Finally, given the typically long-term nature of a guarantee,
a tax audit may span multiple financial years as a result of which the impact of an
adjustment can be considerable.

That the transfer pricing aspects of internal guarantees may, indeed, have a significant
impact for multinationals is further underlined by the GE Capital case. In that case, the
CRA issued reassessments for several taxation years, totalling CAD 136 million, thereby
denying deductions for guarantee fees claimed by General Electric Capital Canada Inc.
in those years with respect to a guarantee provided by its US-based parent company,
General Electric Capital Corporation. On 4 December 2009, the Tax Court of Canada
allowed General Electric Capital Canada Inc.’s appeal and ordered that the Minister’s
reassessments be vacated, finding that the 1% guarantee fee paid was equal to or below
an arm’s length price. On 15 December 2010, the Federal Court of Appeal dismissed the
Crown’s appeal of a 2009 Tax Court of Canada decision that favoured the taxpayer.\(^4\)

In view of the above, it seems imperative to ensure that internal guarantees used
by multinationals are established and priced at arm’s length. Additional reasons to
closely consider internal guarantees include performance measurement and financial
reporting; for example, multinationals reporting under International Financial
Reporting Standards need to account for uncertain income tax positions on the basis
of IAS 12 (Income Taxes), whereas under US generally accepted accounting principles,
this may be particularly relevant under FIN 48.

17.4 Types of guarantees

Many multinationals are now confronted with an increased demand to secure their
external debt funding. At the same time, internal guarantees are still also being used
to obtain better conditions (notably interest rates) on external financial transactions,
hence creating a benefit on a group basis. Without the intention of being complete,
the following gives an overview of various types of internal credit guarantees that
are typically observed in practice and that may need to be accounted under the arm’s
length principle:

- **Comfort letters/letters of intent** – A promise (rather than a legally binding
  commitment), whereby a (parent) company declares it will refrain from taking
  actions that would jeopardise its subsidiary’s financial stability.

- **Keep well agreement** – A declaration by the parent company that it will provide its
  subsidiary with additional capital to prevent it from defaulting.

- **Explicit credit guarantee** – A legally binding commitment of a party (the
  guarantor) to pay an amount to another party (the creditor) in case a group
  company (the debtor) defaults under its obligations to the creditor.

As comfort letters/letters of intent, keep-well agreements, and other, more ‘soft’
commitments generally lack legal enforceability, most countries do not recognise

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these forms of internal guarantees as an inter-company transaction for transfer pricing purposes. As such, for the remainder of this chapter, only explicit credit guarantees are further considered because this type of internal guarantee is often observed in practice and creates a legally enforceable commitment for the guarantor. From a transfer pricing perspective, the question of whether this type of internal guarantee indeed constitutes a 'service being rendered' is more apparent in most countries.

Explicit credit guarantees may, depending on how they are used in a financing structure, be referred to as:

- **Upstream guarantee** – Issued by a group company to creditors for the benefit of its (ultimate) parent company for the purpose of the latter entering into an external agreement, normally to obtain external debt funding. This situation typically occurs when external debt financing is obtained at a group or top holding level (and where the central treasury function is performed by the parent company).
- **Downstream guarantee** – Issued by a parent company to creditors for the benefit of a subsidiary for the purpose of the latter entering into an external agreement, normally to obtain external debt funding. This situation typically occurs where business models are decentralised or where the (offshore) location of the subsidiary is more attractive to obtain external funding.
- **Cross-guarantees** – Issued by multiple group companies in respect of a creditor, whereby all the group companies can effectively be regarded as one legal obligor to the creditor. This situation typically occurs when multinationals set up cash pooling structures with independent banks.

### 17.5 The OECD Guidelines on credit guarantees

Further detail on the application of the arm’s length principle to internal guarantees is provided by the OECD Guidelines. Under the OECD Guidelines, a multinational should establish whether an internal guarantee qualifies as a ‘service being rendered’ between group companies and, if so, what the appropriate level of the arm’s length guarantee fee should be. The OECD Guidelines also provide further guidance for the application of Article 9 of the OECD Model Tax Convention.

#### 17.5.1 Internal guarantees: Service being provided or a shareholder transaction?

According to the OECD Guidelines:

“...the question whether an intra-group service has been rendered ... should depend on whether the [guarantee] provides a group [company] with economic or commercial value ... This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the [guarantee]...”

85 OECD Guidelines, Chapter IX, Paragraph 9.96.

This means that for each internal guarantee, (i) it should be established what the underlying reason is for the guarantee being provided and (ii) whether the guarantee creates a benefit for the guaranteed group company for which it should pay a fee. As further explained in the OECD Guidelines, such a guarantee fee should be established by taking into account the perspective from the guaranteed group company as well as from the guarantor (i.e. the group company issuing the guarantee). Thus, the underlying reason for the guarantee should take both these perspectives into account.
In the event that a third party (the creditor) would not under any circumstances have been willing to enter into the transaction with the guaranteed company (the debtor) had the guarantee not been issued, then this may indicate that the guaranteed company would not have been able to enter into that transaction with the creditor on a ‘standalone basis’. In other words, the guaranteed group company is not considered to be strong enough financially by the third party to enter into this transaction on a standalone basis. In such a situation, it is likely that the guarantee issued by the guarantor can be regarded to be provided by it in its capacity as a shareholder, as no third party would appear willing to accept the risk associated with the transaction. Hence, the internal guarantee does not qualify as a service being rendered and a guarantee fee is not appropriate. As a further consequence, in many countries any loss resulting from such a guarantee being invoked may not be deductible. Similarly, in a situation where the parent borrows as a means to capitalise its subsidiary, the parent may not be able to qualify this as a debt transaction.

17.5.2 Internal guarantees: Establishing the guarantee fee

In the event that the guaranteed group company is indeed able to obtain better conditions for external funding through an internal guarantee, a commercial rationale seems to exist for that group company as long as the benefits of the better conditions exceed the guarantee fee being charged for the internal guarantee. As such, the benefit of an internal guarantee to the guaranteed group company typically reflects the value of that internal guarantee for that company.

On the other hand, in principle the guarantor would need to at least cover the costs it incurs with respect to that guarantee. These costs may include administrative expenses as well as the costs of maintaining an appropriate level of cash (equivalents), capital – for instance for regulatory purposes (banks) – or standby credit lines. In addition, the guarantor would want to receive appropriate compensation for the risk it is incurring.

Following the above, although more complex approaches do exist, an arm’s length guarantee fee is in practice typically established in the range between the guarantee fee the guarantor would, at least, want to receive and the guarantee fee that the guaranteed group company would, at most, be willing to pay. In practice, this fee in many cases is an approximation of the interest rate benefit the guaranteed group company is able to make as a result of the guarantee.

One of the controversial issues relating to the calculation of guarantee fees under the interest saving approach is the role that the previously discussed ‘implicit parent guarantee’ plays. Following the GE Capital case, various positions could be argued in determining this saving, such as:

- No guarantee fee is payable because the borrower did not receive any economic benefit, as it would have been able to borrow at the same rate due to its mere affiliation with the Group.
- A guarantee fee can be calculated based on the credit spread resulting in the difference between the credit rating of the guarantor and the guarantee, with no adjustments made to reflect any implicit support.
- A guarantee fee can be calculated based on the credit spread resulting in the difference between the credit rating of the guarantor and the guarantee. However, in determining the credit rating of the guarantee, the implicit parent guarantee element, if applicable, needs to be appropriately considered.
This seems to be best practice from a transfer pricing perspective, albeit that determining the impact of the implicit parent guarantee, if any, is unfortunately highly subjective.

After having determined the interest saved following one of the approaches above, companies should determine if and to what extent it can be argued that the full benefit needs to be charged as a guarantee fee, or whether the benefit should be split between the guarantor and the guarantee.

17.6 Best practice approach
Charging a guarantee fee may be contentious in some countries, yet it may be expected elsewhere (particularly with outbound guarantees). Multinationals should therefore carefully review their internal guarantee structure and prepare appropriate documentation or policies to substantiate the arm’s length nature thereof. Typically, the transfer pricing of internal guarantees is still country specific, and it seems that there is no international consensus on how to determine the arm’s length nature of internal guarantees and the level of the arm’s length guarantee fee. Examples of the differences include:

- Most countries do not recognise comfort letters, letters of intent, or keep-well agreements as a service being rendered, whereas some do.
- Guarantee fee payments may be characterised differently, e.g. as a service payment or an interest payment, potentially triggering withholding tax or thin capitalisation issues.
- Different approaches are taken to establish the arm’s length guarantee fee, whereby some countries may account for ‘passive association’, whereas others would not.

Because of these differences and the complexities surrounding internal guarantees, it is important for multinationals to develop a consistent and robust approach towards the transfer pricing aspects of their internal guarantees. Such an approach can consist of a group policy that can be tailored towards the specific local country requirements.

17.7 Credit guarantees in the BCM industry
The BCM industry uses a wide variety of guarantees for capital requirement and commercial purposes. In dealing with these guarantees from a transfer pricing perspective, it is important to understand the characteristics and the background of the guarantees being dealt with. Broadly speaking, the following types of guarantees can be found in the BCM industry:

- **Regulatory capital guarantees** – Guarantees provided for the benefit of subsidiaries and branches in the place of shareholders’ equity, to respect regulatory capital requirements as established by regulatory authorities (hereafter ‘regulatory capital guarantees’).
- **Comfort letter/letters of intent** – Comfort letters/letters of intent generally do not constitute a genuine (i.e. legally enforceable) guarantee. They are typically provided for the benefit of subsidiaries and branches to regulatory bodies, unrelated counterparties, financial institutions, and investors.
- **Credit guarantees** – Credit guarantees are provided for the benefit of subsidiaries and branches to unrelated banks and financial institutions in relation to specific financial transactions (including letters of credit issues) and to investors in relation to financial instruments and issuances (for subsidiaries’ financing requirements).
Part V: Financial transactions

- **Performance guarantees** – A performance guarantee often takes one of two forms. It either guarantees the performance of the entity contracted by a third party or it guarantees that any penalty obligations will be met in the event the contracting entity (the guaranteed entity) is required to pay one or more penalties as a result of non-performance.

In pricing these guarantees, the general principles as set out in this chapter apply. However, consideration needs to be given to the specific regulatory environment and the rating of subsidiaries operating within the BCM industry, for which financial strength and reputation are crucial. In addition, in certain territories such as the European Union, the BCM industry often works with branches. For intra-branch transactions, the OECD has made an explicit reservation in its publications on the allocation of profit to permanent establishments, stating that the credit rating of a permanent establishment should be considered the same as that of the general enterprise.

**17.8 Conclusion**

Since the 2008 financial crisis, the essential role of financial services companies as capital allocation optimisers has regained its prevalence. From an intra-group perspective, this has spurred a rebound of inter-company loans as well as guarantee arrangements and cash pooling structuring. Due to the potential adverse tax consequences of such intra-group arrangements, the pricing of such transactions needs to embrace and follow the arm’s length principle enacted in the OECD Guidelines as well as the US Treasury Regulations.

This section has offered insights in the pricing of such transactions in light of the idiosyncrasies of the BCM industry. It is reasonable to expect enhanced scrutiny by tax authorities with respect to these types of transactions in the future and, as such, taxpayers should take great care to ensure they develop thorough pricing strategies.
Part VI: Plenary topics
Chapter 18 – Head office services

18.1 Introduction
As applicable to all parts of this publication, regardless of whether the parties are related, when a service is rendered, it is expected that the recipient will remunerate the service provider for the activities performed and will do so on an arm’s length basis. The arm’s length principle requirement is generally understood in the case of front-office or value-adding services; however, it is as well understood when applied to shared or centralised services (such as those provided by the back office or for administrative purposes). This chapter discusses the issues that arise (i) in determining, for transfer pricing purposes, whether such shared or centralised services have been provided by one member of a group to other members of that group; and, (ii) if so, in establishing arm’s length pricing for such services.

Shared services refers to the provision of a service by one part of an organisation or group where that service had previously been provided by more than one part of the organisation or group. The concept of shared services is to create convergence and streamline an organisation’s functions to ensure seamless delivery of services to the end customer in an effective and efficient manner. The process often involves the centralisation of certain back-office or administrative functions, such as HR and finance, but can also be applied to certain functions within middle or front offices. A key advantage of this convergence is that it enables organisations to take advantage of economies of scale and creation of synergies.

Shared services often include those that are typically available externally from independent enterprises and can include those that are ordinarily performed internally.

With the growing speed of global integration, many organisations within the financial services sector have already established shared service centres performing centralised services.

18.2 Categories of services
Services that are provided to related parties range from general management services, such as accounting, legal, or tax, to those specific to the industry or product in which the company operates. In the financial services world, the shared services can be broadly broken down into two types of services: management and product-related services.

18.2.1 Management services
Management services are typically associated with the back office or administrative support required to ensure the front office of the business operates in a seamless and efficient manner. Examples of these services include centralised executive administration (such as HR and legal), finance, audit, marketing, and IT.

Typical examples of those providing such services include senior management and the middle and back office. Middle- and back-office services most commonly include strategic direction (e.g. the CEO’s office, IT services,86 risk management, legal, treasury, HR, accounting, and finance). If the recipient(s) of these services were independent

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86 Transfer pricing issues specifically relating to IT services are separately addressed in Chapter 19.
companies, they would either perform these services in-house and bear the associated costs or acquire them from a service provider.

18.2.2 Product services
Product services vary depending on the specific financial sector in which the organisation is classified (i.e. banking, investment management, or insurance) and tend to support the actual nexus of the business. Within the banking industry, for example, functions such as loan processing, data validation, and treasury/capital management are often centralised in shared service locations. For insurance, support in relation to product offerings (e.g. bancassurance, annuities, and institutional sales) and risk management may be located in shared service centres. For investment managers, middle- and back-office support in relation to fund accounting and settlement is often harnessed in shared service centres.

18.3 Shared services
As discussed above, the rationale for shared services is changing dramatically. A growing number of financial institutions see these services not simply as a cost-cutting measure, but also as a means of obtaining strategic advantages by providing efficient delivery services to customers. However, for most tax authorities, these services are an easy and understandable target when analysing transfer pricing within a financial institution. While some exotic financial transactions remain shrouded in an air of mystery and intrigue, tax authorities have transported into the financial services sector the experience with intra-group service charges they gained and honed in the non-financial service sectors. As such, a shared service is often the first transaction that is queried during an investigation.

18.4 Transfer pricing for controlled services transactions
Per OECD Guidelines, two issues need to be considered in the analysis of transfer pricing for services:

• Whether services have in fact been rendered and a benefit has been conferred.
• What the intra-group charge for such services for tax purposes should be in accordance with the arm’s length principle.

The concept of the ‘evidence of benefit’ is fundamental to whether a service has been rendered. Within the OECD Guidelines, this concept states that a clear and definable benefit must be conferred to the recipient of the services.

The objective of providing services from a centralised location is to not only harness cost savings and enhance economies of scale, but to also efficiently manage operations to provide seamless service to customers. In addition, given the level of globalisation in the financial services sector, the centralisation of services enables the group to project connectivity and consistency in delivering best-in-class service through consolidation and leveraging of global scale.

The next key aspect to evaluate is whether an enterprise, in comparable circumstances, would have been willing to pay for the service if performed for it by another independent enterprise or would have performed the activity in house. If the activity is not one for which the independent enterprise would have been willing to pay or

87 The discussion is predominantly provided from the perspective of the OECD Guidelines. Where relevant, specific reference to applicable Section 482 Regulations are also provided.
Part VI: Plenary topics

perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle,\(^8^8\) and therefore the treatment does not apply.

In general, an activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may reasonably be anticipated to do so.\(^9^0\) On the other hand, for an indirect or remote benefit, the service is not considered to provide a benefit to the recipient.\(^9^0\)

The determination of whether the benefit from an activity is sustained would have to be established from the provider and the recipient of the activity. This involves detailed documentation setting out the following:

- The service provided creates economic and commercial value for the recipient.
- The service cannot be easily provided by engaging a third-party consultant at the same cost or efficiency.
- The service enhances operational efficiency of the recipient to facilitate delivery of the service to the end customer.

18.4.1.1 Shareholder activities
Examples of activities that may be considered non-beneficial to the recipient are shareholder activities, which are related to the group members but do not provide them with any benefits and hence cannot be charged out. In distinguishing shareholder activities from beneficial activities, consideration should be given to:

- The motivation of the service – Is the service motivated by the parent company’s ownership of its subsidiaries (i.e. is there protection of the renderer’s capital investment in the recipient)? Examples include the consolidation of group accounts, costs of raising funds for acquisition of affiliates, activities related to legal structure, regulatory control, corporate governance, and shareholder reporting.
- Independence test – Would an independent enterprise require these services?

Functions constituting multiple activities may be classified partly as beneficial and partly as shareholder activity. For example, the finance function provides a number of support services, some of which constitute beneficial services and others of which constitute shareholder activities. In these cases, allocations based on the services provided may be used to determine the bifurcation between beneficial and shareholder designations.

18.4.1.1 Duplication
Where the activity performed by the provider duplicates an activity performed by the recipient, the activity is generally not considered to provide a benefit to the recipient. For example, HR services can be provided both centrally and locally. Typically, the service provided centrally is akin to strategy and management of HR within the group (e.g. to ensure a consistent development/training programme for staff), while local services involve the implementation of the programme. In this situation, it is important to delineate and differentiate between the services provided locally and centrally to establish that no duplication is involved.

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\(^{88}\) OECD Guidelines, Chapter VII, B(ii), Paragraph 7.6.
\(^{89}\) Treas. Reg. Section 1.482-9(f)(3).
\(^{90}\) For example, procurement functions within financial service institutions have not been typically charged out as a service under these definitions.
In addition, certain services may appear to be duplicative but may in fact confer a benefit to the recipient. In the case of internal audit, for example, a parent company may be required to comply with certain regulatory requirements in relation to the review of control procedures for each affiliate within its group. On the other hand, the local entity may already perform its own review of certain internal procedures, simply as part of its local business functions. Nevertheless, although an internal audit provides an outside review of all control systems, even if the local entity reviews some of those systems, an internal audit may well confer a benefit by validating the accuracy of the local systems and review. In such cases, assuming such services are not stewardship, the services performed centrally may be legitimately charged out, even though to some extent they may be considered to duplicate services that the local affiliate already performs.

The potential for duplication also often arises not only between the shared service centre and the local affiliate, but also between the regional shared service centre and the head office/global parent. For example, both the head office and regional shared service centre may provide finance services to a local entity. Nevertheless, there may be legitimate differences in the finance services provided by the two service providers. In such a circumstance, it is important to clearly document these differences. The global service may involve setting of financial policy, while the regional shared service centre’s responsibility may relate to oversight of accounting and reporting functions performed locally.

18.4.1.2 Determining an arm’s length charge
Once it is determined that an intra-group service has been rendered, it is necessary to determine the amount to be charged in accordance with the arm’s length principle. The arm’s length principle requires that the charge for intra-group services be that which would have been made and accepted between independent parties in comparable circumstances.\(^91\)

The OECD Guidelines identify two arrangements by which organisations seek to charge for intra-group services:\(^92\) the Direct Cost Method and the Indirect Cost Method.

18.4.1.3 Direct Cost Method
The Direct Cost Method analyses the cost of activities that are beneficial to the recipients. Costs that can be easily identified and linked to one recipient include travelling expenses and secondment staff salary. These costs should be recharged directly to the specific recipients on an item-by-item basis. Typically, this method is applied in respect of third-party costs that are directly attributable to specific affiliates.

18.4.1.4 Indirect Cost Method
The Indirect Cost Method analyses the costs of activities associated with the services rendered and apportions these costs to each of two classes of activity: beneficial and shareholder. In application of the indirect charge method, it becomes necessary to ascertain the chargeable cost base (i.e. all costs directly or indirectly related to the services performed). Typically, organisations first identify the services and costs associated with rendering their services by examining the allocations made for internal purposes (e.g. department cost budgets), which are then confirmed by key personnel responsible for providing the services. During this process, the delineation

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91 OECD Guidelines, Paragraph 7.19.
92 Ibid, Paragraphs 7.20 and 7.23.
of beneficial services versus shareholder services is determined based on the criteria discussed above.

After identification of the cost base, the next issue to be addressed is that of apportioning the beneficial services cost. There is no specific method or formula for allocating these costs. Typically, if the portion of the value of the service directly attributable to each of the service recipients cannot be determined, an appropriate allocation key is used to allocate the costs.

The basic premise of this exercise is that the recipients of services consume activities and that activities consume resources. The consumption of resources drives costs, which can be apportioned based on allocation keys approximating a given service recipient’s use of resources. As such, allocation keys:

• tend to be simple to measure and apply
• reflect metrics of the industry (i.e. consistent with what third parties would consider to be an acceptable basis), and
• reasonably reflect the substantive nature of the services provided.

For management-related services, allocation keys such as estimated time spent or number of accounts (finance), headcount (HR), or number of users (IT) are often used.

Product-related services involve the support of the front office of the recipient’s business. As such, the allocation keys tend to revolve around revenue. For example, in the insurance industry, the key may be premiums generated, and in the investment management industry, the key may be assets under management or management fees.

In these examples, the service is provided in relation to the product that directly correlates to generating revenue for the recipient. However, the service still needs to be evaluated from a business perspective. Where, for example, the recipient is in a developing market, the provider may spend more time to support and develop the recipient’s business than it would for a recipient in a mature market, where less support may be required. Therefore, using an allocation key akin to revenue in this case may not directly correlate with the level of support provided, as it is possible that revenues for the recipient in the developing market are lower than that of the recipient in the mature market. Thus, in this case, estimated time spent may be a more appropriate key. A similar situation may also arise for management services where revenue is used as an allocation key. That is, the mature entity is likely to have its own back-office and administrative teams, so it may need less of these services from the shared service centre.

In view of the above, it is useful to perform sensitivity checks on various allocation keys and conduct discussions with the provider to understand the objective of the service. In this way, an appropriate allocation key can be determined that reflects the commercial and substantive reason for providing the service. Such a systematic approach to identifying and documenting allocation keys indicates alignment with the business objectives.

Another key consideration in implementing any services recharge is the interaction of the recharge with other transfer pricing policies within the group. For example, a service that uses an allocation key that is sensitive to the revenues must be calculated after any revenue-sharing transfer pricing adjustments have been made in order to avoid the danger of overloading the booking locations, which may initially receive the majority of revenues with a disproportionate level of costs. Failure to consider
the interaction with other transfer pricing adjustments could result in a structural loss in certain locations. Thus, it is recommended to consider the overall profitability of the local affiliate, after payment of the shared service charges, to identify such structural issues.

### 18.4.1.5 Application of arm’s length mark-up

After services are identified and chargeable costs are allocated to the recipient entities, a mark-up is often applied. However, although service providers would typically expect to earn a profit on the services rendered, the OECD Guidelines describe several circumstances where the cost of a service would represent an arm’s length charge.

The decision on whether the cost of the service is a sufficient charge by itself depends on the economic alternatives available to the recipient of the service, the recipient’s willingness to pay above cost for the service, and the legislative requirements of the relevant jurisdictions. For example, the OECD Guidelines state that recipients of intra-group services may agree to centralise certain services only if it provides them with cost savings. Under these circumstances, cost might be an appropriate charge for the intra-group services.

With this background, the OECD Guidelines detail four factors that are useful in determining whether a mark-up should be charged:

1. The nature of the activity.
2. The significance of the activity to the group.
3. The relative efficiency of the service provider.
4. Any advantage that the activity creates for the group.

Recently, tax authorities in both the provider and recipient locations have begun to focus on collecting detailed analysis of the composition of the costs as well as the nature of services provided. In view of their focus, when evaluating whether to mark up the costs, the entity needs to consider the cost base in comparison to the quantum amount of the mark-up (which is likely to be significantly less).

### 18.5 The way forward

Given the subjective nature of the pricing process and the relative ease in understanding the underlying transactions (compared with other more complex financial services transactions), it can be expected that tax authorities will focus on, from both the recipient and provider perspectives, the issues of what constitutes a service and what is the proper arm’s length return for the provision of such a service.

From a provider perspective, it is key to establish an approach with clear audit trails on the composition and build-up of costs in line with commercial and economic benefit rendered to recipients. From a recipient viewpoint, ensuring deductibility requires analysing in detail the composition of the costs and establishing why the services are provided and the benefits of the services rendered.

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93 In the US, a specific election is available to taxpayers to apply the Services Cost Method under which cost is considered an acceptable arm’s length price for certain services if certain conditions are met. Section 1.482-9(b).

94 OECD Guidelines, Paragraph 1.33.

95 Ibid, Paragraph 2.52.
As a result, many organisations have employed systematic approaches to identify and document the nature of a service and the ultimate beneficiaries. The OECD Guidelines provide a framework to develop a policy; however, thought needs to be given to local rules in various jurisdictions to ensure compliance. Given this, the transfer pricing policy needs to be evaluated for implementation factors and establishment of a robust defence during a tax authority challenge. To achieve compliance and maintain consistency, some compromise is required between the recipient and provider in deriving a robust charging mechanism that is in line with the arm's length principle.
Chapter 19 – IT services

19.1 Introduction
Transfer pricing issues arising from the use of technology are common to all financial institutions. Technology often represents one of the more significant costs, if not the most significant, for financial institutions and has connection and usage in the front-, middle-, and back-office operations. Moreover, for MNEs, technology operates cross-border by definition. In general, transfer pricing policies for technology-related services differ based on a variety of relative factors, such as customisation of the technology and its purpose and use within the front-, middle- and back-office functions of the institution.

19.2 Categories of technology activities
Technology activities can generally be categorised as follows: technology infrastructure, applications, and other ancillary activities.

19.2.1 Infrastructure
Infrastructure and related network elements refer to the ‘pipes’ and hardware that transmit information within and between the financial institution, its various affiliates, and/or external sources. Any interruption in network performance results in disruption of the company operations. Activities that support the infrastructure may include network administration, operations, and maintenance.

19.2.2 Applications
A number of software applications are used within a financial institution’s front, middle, and back offices. Activities related to applications include in-house development of proprietary software and/or customisation of third-party-developed software, ongoing management and maintenance, and other related IT support.

19.2.3 Other ancillary services
Several ancillary activities that are technology related include:

- **Adaptation for ‘local’ use** – Configuration and customisation of off-the-shelf software to serve a specific business line or location. For example, for insurance companies, an insurance application should be customised for each insurance product and region. The customisation includes loading of local statistical, demographic, and regional data for insurance products such as car insurance to be priced, as well as interfaces in the local language.
- **Data entry (including data conversion)** – Entering external information into a business system that is required for supporting business lines of service. Examples include entry of macroeconomic indicators or interest rates into forecasting models or conversion of a postal code database or historical financial data into a format recognised by business support systems.
- **Installation services** – Installation of software developed internally or by third parties onto relevant hardware.
- **Training services** – Education of a company workforce on the efficient use of the company information resources, software, and applications.
Chapter 19 – IT services

The general purpose of all support services is to ensure seamless and uninterrupted technology operations, including fast troubleshooting of issues and their timely correction. However, as with infrastructure and applications, there are different levels of support services. Some of these may be clearly routine, such as data entry, while others may be more difficult to classify, such as adaptation or customisation for local use. Thus, even among support services, a number of transfer pricing policies may need to be considered.

### 19.3 Transfer pricing for technology activities

Different categories of technology, varying development models, and collateral services raise several interesting transfer pricing questions. The following subsections highlight some of the key questions to consider in determining an appropriate transfer pricing model around technology, although the list should not be considered definitive or exhaustive. Following that, salient features of the key alternative pricing approaches are discussed.

#### 19.3.1 Transfer pricing considerations

The discussion above highlights important distinctions in the nature, use, development, and linkage of technology for the business, all of which could have different transfer pricing implications within a multinational financial institution.

**19.3.1.1 Use – Front-, middle-, or back-office applications**

All else being equal, front-office technology is perceived by tax authorities to have higher relative value versus middle- or back-office technology. This is driven by the obvious and direct tie to revenue generation and the related importance of ensuring performance and controls. At the same time, recent market turmoil and the increased focus on risk assessment have raised the stature of middle-office applications, ranging from ‘fit for purpose’ to value preserving (or even value enhancing when used in conjunction with front-office technology).

**19.3.1.2 Spend – Magnitude and footprint**

Tax authorities also draw a direct connection between the technology spend within a financial institution (as a percentage of total costs or revenues) and its relative contribution to profit generation. As part of this discussion, it is also important to consider the dispersion or footprint of technology spend across an organisation (i.e. whether it is or should be spread across all affiliates/users or centralised within one or more hubs).

**19.3.1.3 Reach – Local, regional, or global**

From both a geographic and an operational perspective, the reach of technology is also considered a contributor to value. A technology that primarily serves a single business unit or location has less value to the institution as a whole than a technology that is used on a broader basis, across multiple regions or the entire organisation.

**19.3.1.4 Life – Defined or perpetual life**

A critical and often contentious point of discussion around the value of technology is its expected useful life. First, is the structure/architecture of the technology such that an element of the technology remains intact irrespective of modifications/customisation (i.e. perpetual life)? Or must the technology be entirely replaced on a periodic basis (i.e. defined life)? Second, is the nature of the technology such that it needs continuous updating to continue to generate revenue or cost savings, regardless of whether it has a defined or perpetual life?
19.3.1.5 Risk – Development model and risk of abandoned or failed projects
In conjunction with the above considerations, a central element to consider for transfer pricing purposes is the overall acquisition and/or development model under which the technology is created, modified, and utilised. For example, off-the-shelf technology is likely to be more routine than technology developed in house, the latter typically having a strong proprietary content. Further, the combination of the technology development model with the manner in which that technology is funded is a key risk determinant for technology transfer pricing policies.

It is also common to find that certain technology systems/projects are abandoned after several years of development. The transfer pricing policy will need to find an appropriate consideration for the risk and reward of such ‘dead’ projects.

19.3.2 Alternative pricing approaches
Within MNEs, including multinational financial institutions, the most typical transfer pricing policies observed that relate to the development and utilisation of technology are licensing, cost sharing, and contract R&D.

19.3.2.1 Licensing
A common approach related to the development and dissemination of technology within a multinational financial institution involves licensing. Under this model, a single entity incurs the initial funding costs of technology development, and thus bears the related risk of success or failure. Once fully developed, the technology is made available to affiliates via inter-company licensing arrangements in exchange for a royalty.

19.3.2.1.1 Arm’s length principle analysis
From an arm’s length perspective, when considering the position of a licensee, it is necessary to consider the benefit derived from the use of the technology and, specifically, whether that benefit is satisfactory relative to the licensee’s other options. In addition, it is important to ensure that the licensee has the potential to generate profits after paying the relevant royalty, either through generation of additional income or a reduction in internal costs.

Further, a common ‘smell test’ evaluated by a number of tax authorities when considering a licensee’s perspective is to determine whether the sum of any royalty payments is likely to exceed the cost of reproducing the development/creation of the technology on a standalone basis. This is especially important in the case of fit-for-purpose, back-office technology where substitutes may be available.

In addition to the benefit to the licensee, the calculation of the arm’s length royalty should take into account the attributes of the technology, such as geographic area, exclusivity, and whether there is a right to participate in further development of the technology by the licensor.96

In the context of front-office, proprietary technologies, strong arguments are available to disconnect initial costs of development from subsequent royalty payments because of the risk undertaken at the outset and the know-how contributions made by the licensor. Nevertheless, any arm’s length analysis of proprietary technology must still outline the ability for the licensor to recover its costs incurred and to earn a level of profit that compensates it for the risks undertaken.

96 Ibid. Paragraph 6.20.
In addition, it is important to consider if there is any distinction between legal and economic ownership. While licensing arrangements must compensate the legal owner of the intellectual property for the value provided, this compensation must consider any economic contributions made by parties other than the legal owner (such as a licensee that develops a niche application or value-added component to the licensor’s base technology).

19.3.2.1.2 Transfer pricing support
Evidence from the market for licensed technology demonstrates that independent parties typically consider three approaches to pricing:

1. Market rate.
2. Income method.
3. Cost method.

The typical method used to substantiate inter-company licensing arrangements is the CUT Method, equivalent to the market rate adopted by third parties. This approach uses evidence from third-party agreements, whether internal or external, and considers a number of relevant comparability factors to either determine or support the inter-company royalty rate. These factors include:

- Payment structure, including upfront payments and revenue thresholds.
- Terms/duration.
- Access to technology updates.
- Provision of technology upgrades.
- Inclusion of separate fees for support services and maintenance.
- Geographical use – global, regional, or local.

The analysis must consider the comparability of the underlying technology or software and the included services provided within the chosen, comparable third-party agreements. Given that the standards of comparability are necessarily high for this approach, it is widely acknowledged that it can be difficult to identify suitable evidence, especially when evaluating highly valuable technology. As such, where comparables are identified from publicly available sources for similar but not identical intellectual property such as technology, these are best used to corroborate the analysis arising from one of the other approaches.

In the absence of comparable third-party licensing agreements, an alternative approach can be to develop a customised pricing model that uses the key considerations listed in Section 2 above. In general terms, taxpayers can develop a pricing model that includes all of the following:

- Data on the costs incurred in the development of the relevant technology.
- Knowledge of the anticipated useful life of the technology.
- Potential revenue streams, marginal increases in revenue, or reductions in costs from the use of the technology.
- Appropriate expected rates of return based on the risk profile resulting from the above.

These parameters can provide an estimate of value that can be converted to a royalty stream over the relevant licensing period. To ensure deductibility of the royalty payments from the licensee’s point of view, as noted above, the royalty should also be
structured to help establish that it results in a net benefit and/or supportable level of profit from the licensee’s perspective.

More specifically, the income method determines royalties based on the profits of the licensee. The licensor contributes its technology, which the licensee then deploys in its business using its own efforts and often its own assets. The royalty is calculated as the amount of the profits the licensee would be prepared to surrender to the licensor, taking the relative contributions of the parties into account. This typically results in the majority of the profit being retained by the licensee.

In applying the income method, one of two measures can be used: the total profits of the licensee or the incremental income arising from the technology in question. Incremental income from an intangible may be identifiable where the intangible is being used in the business for the first time or where additional revenues or cost savings can be identified.

In contrast, the cost method examines the replacement cost of the technology or cost of developing an alternative technology to determine an arm’s length royalty amount. However, where this is impractical or unreliable, the ongoing costs of the licensor or investments required by the licensee may still be relevant.

19.3.2.2 Cost sharing
As the name implies, cost sharing involves the joint funding of technology development by multiple affiliates, in a manner consistent with anticipated benefits. This approach allows for a dispersion of risk related to technology development across all the participants in the arrangement. Affiliates can enter into cost sharing arrangements at the outset of a development programme or can ‘buy in’ to development efforts that may already be initiated by one or more members of the group.

19.3.2.2.1 Arm’s length analysis
The key analytical issues around cost sharing arrangements concern the initial establishment of the arrangement, including defining the relevant parties, the covered activities/costs, and other related specifics around the technology development programme.

In addition, it is also important to establish principles for dealing with the subsequent management and maintenance of the arrangement. Factors include computation of the buy-ins related to any existing technology or intellectual property brought to the table by the initial participants, computation of buy-ins for new joiners, and periodic determination of proportional cost share payments based on the established measures of benefit.

19.3.2.2.2 Transfer pricing support
Tax authorities pay particular attention to buy-in payments because these involve subjective valuation issues. To the extent that the covered development is for proprietary, front-office technology, the taxpayer can expect significant scrutiny around computations related to any existing technology contributed by participants, as well as the anticipated benefits.

97 OECD Guidelines, Paragraph 8.3 refers to these arrangements as CCAs.
98 Section 1.482-7 refers to such approach as QCSA.
As an example, although the OECD Guidelines discuss general considerations around the need for such payments,\textsuperscript{99} the recently issued final US regulations related to cost sharing contain detailed and prescriptive requirements for the valuation approaches to use and the resulting expectations for potential returns achievable by affiliates transferring intangibles.\textsuperscript{100} Further, proposals in various jurisdictions indicate a continued focus on this issue via contemplated changes to definitions of what constitutes an intangible and changes to the US tax treatment of non-US income generated from the use of intangibles above a certain threshold level.

With respect to subsequent/ongoing cost allocations, the cost base and allocation keys must be appropriately tied to the anticipated sharing of benefits. Thus, there is an ongoing monitoring and maintenance component to this analysis that needs to be reviewed periodically to ensure a continued connection to benefits. This component is also linked to local tax issues relating to the characterisation of such charges and the ability to claim deductions.

\textbf{19.3.2.3 Contract R&D}

Contract R&D involves the use of affiliated service providers to perform application development services activities on a fee basis, while maintaining/centralising the economic risk of success or failure at the headquarter location (or any other central intellectual property owner).

\textbf{19.3.2.3.1 Arm’s length analysis}

From an arm’s length perspective, contract R&D arrangements should compensate the relevant service providers with fees designed to earn a routine profit element over and above the costs incurred in providing the services. This form of inter-company payment structure ensures that the contract service provider is protected from any market risk associated with the development effort. Such arrangements should be codified through inter-company contracts that clearly outline the responsibilities of the parties and establish the ownership of any resulting intellectual property at the entity that is paying for the contract services.

The contract and behaviour of the parties should also be consistent with typical arm’s length contract R&D arrangements. In such a case, the efforts of the service provider are controlled and supervised appropriately by the entity paying for the services, and strategic direction and critical ‘go’ versus ‘no-go’ decisions require approval by the payer of the services.

\textbf{19.3.2.3.2 Transfer pricing support}

Inter-company contract R&D arrangements are typically supported via benchmarking analysis using third-party information on the returns earned by similar, standalone contract research organisations. For example, the results of such third-party comparables are evaluated with respect to their operating income as a percentage of total costs. This analysis is then used to establish the inter-company compensation, either as a cost plus mark-up or a conversion to an hourly billing rate (based on budgeted hours and costs).
Key factors to consider in the selection of comparable benchmarks include:

- The nature of activities performed by the third parties (study design, testing, evaluation of results, or some combination of the above) versus the inter-company arrangement.
- The sector in which the activities are performed (pharmaceutical versus technology outsourcing versus another sector).
- The region of operations (e.g. North America, Asia, Europe).
- The scale of operations (small or niche operations versus large research organisations having the advantage of volume/scale).

The arrangement should also be formalised on an ex ante basis via an inter-company contract with a clear description of the roles of the parties, risks, limitations, and ownership rights.

19.4 Conclusion
The increasing importance of technological differentiation within the financial sector, both as an avenue of gaining cost efficiencies and a source of generating premium returns, makes it a critical element of any transfer pricing review.

From a planning perspective, the diversity of models and the multiple activities involved provide useful opportunities to align tax objectives with the broader operational objectives of the technology function. From a compliance and support perspective, it is important for the tax department to consider the implications of the internally determined model of technology development and support in terms of the anticipated distribution of returns or costs among relevant affiliates.

Whatever the organisation’s objectives or goals, however, the investments in technology that multinational financial institutions routinely incur ensures that the transfer pricing issues around technology will only increase in importance.
Chapter 20 – Business restructuring

20.1 Introduction
The global financial crisis has generated significant business restructurings activity within and between financial institutions worldwide. Whether they opt for an acquisition, a disposition or a merger arising from adverse market conditions, or a reorganisation resulting from increased regulatory requirements, financial services organisations have experienced the full range of restructurings in the last few years.

Business restructurings and/or refinancing of financial institutions is also on the increase as stakeholders, including governments, seek improved performance and greater returns on investment following the global financial crisis.

Transfer pricing issues will clearly arise with an internal restructuring, given changes in the location of activities and/or the allocation of risks between locations/entities. However, even restructurings between independent financial institutions are likely to generate transfer pricing issues because further internal restructuring almost always follows an external acquisition, disposition, or merger (although such internal changes may occur over a longer time than the initial transaction).

First, the acquirer of a business generally tries to integrate or harmonise the new operations into its already existing portfolio of businesses. This may involve, for example, eliminating duplicative activities, consolidating functions of the acquired business with existing activities, and even legally reorganising ownership chains or legal entity forms. Second, even the seller of the business may need to restructure some of its remaining operations. For example, depending on its structure post-sale, the seller may need to provide continuing geographical coverage for customers if some of its existing operating entities formed part of the disposition.

In Chapter IX of the OECD Guidelines, business restructurings are defined as the “internal reallocation of functions, assets and risks within an MNE.” 101 When such restructurings are completed successfully, they can deliver significant benefits to a financial services organisation. However, as noted by the OECD, “business restructurings are typically accompanied by a reallocation of profits among the members of the MNE group, either immediately after the restructuring or over a few years.” 102 The question to be addressed, therefore, is how to apply the arm’s length principle in cases of business restructuring – both at the time of restructuring and to post-restructuring transactions.

As of this publication, there is an OECD project related to transfer pricing for intangibles to achieve certainty and to achieve a set of rules to help eliminate double taxation. OECD delegates met with business commentators in November 2011 to discuss relevant definitional and ownership issues. These include:

i. the definition of intangibles for purposes of Chapter VI of the OECD Guidelines;
ii. the definition and treatment of goodwill for transfer pricing purposes;
iii. the definition of the term ‘brand’ and the importance of brand in transfer pricing analyses;

iv. the appropriate approach for determining entitlement to intangible-related returns for transfer pricing purposes; and

v. the importance of corporate synergies in a transfer pricing analysis.103

20.2 Types of restructuring

20.2.1 Reallocation of functions

The reallocation of functions for an organisation in any industry is relatively commonplace. As markets or customers change or efficiencies are sought through centralisation, the business may need to move certain functions globally or regionally.

However, the global financial crisis – together with an increasing focus on emerging/new markets – has created even more activity in this area for financial services organisations. Such relocations may arise in a number of ways; however, the trend appears to be towards regionalisation of management. For example, more regional service centres are being established to provide support services to local entities within the same region, and some global investment banks are now centralising trading activities in a single regional trading hub, rather than through multiple local trading desks. Similarly, larger asset managers may now conduct all of their trades through a single execution/trading team located in a regional centre, rather than using locally based execution teams.

Typically, the relocations in such cases involve consideration of the following potential payments: an exit charge to be paid to the transferor for loss associated with the transfer of ‘something of value’104 (if any)105 and post-restructuring payments for ongoing inter-company transactions. The latter may include the arm’s length remuneration for any functions that are ‘left behind’ with the transferor or for functions that the transferee now performs.

The assessment of whether an exit charge is required in the case of a particular transfer of functions still carries much uncertainty. The OECD’s reference to ‘something of value’ would appear to be broader than simply a transfer of a property interest, yet it is still unclear exactly what types of transfers this might include. Workplace in force is one area of particular difficulty. Although the OECD suggests it is necessary to consider whether a third party would have received some type of compensation for such a transfer, this may not always be evident, particularly if the type of business restructuring is rarely (or never) seen in third-party cases.

Although the OECD acknowledges that it is not necessary to break down the transfer of functions into each of its component pieces,106 the amount of such a charge might take into account a number of financial costs to the transferor, such as restructuring costs, re-conversion costs, and loss of profit potential.107 While restructuring and re-conversion costs may be fixed and known, the estimation of lost profit potential arising from the transfer of ‘something of value’ (to use the OECD’s phrasing) seems deliberately vague and involves making a number of assumptions about the future performance of the functions transferred.

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103 Source: http://www.oecd.org/document/63/0,3746,en_2649_37427_49034751_1_1_1_37427,00.html, visited in December 2011.
104 Ibid. Paragraph 9.65.
105 Ibid. Paragraphs 9.100-9.103 (referred to as an ‘indemnification’).
106 Ibid. Paragraph 9.94.
107 Ibid. Paragraph 9.100.
Chapter 20 – Business restructuring

On this point, although the OECD explicitly denies the use of hindsight to analyse restructurings after the fact,\(^{108}\) it should be noted that at least two tax authorities have legislation that permits retroactive amendments to transfer prices in certain cases.\(^{109}\) Moreover, other tax authorities may well take the view that significant deviation in the underlying assumptions of a valuation over time demonstrates that those assumptions were in fact not reasonable at the date of the restructuring itself. Accordingly, despite the OECD’s statements to the contrary, a conservative approach to the process of transfer pricing in the case of a restructuring transaction involving a valuation may be to monitor the underlying assumptions upon which the transfer price is based over time (in the same way that transfer prices for ongoing post-restructuring transactions would be monitored on a regular basis in the ordinary course of good transfer pricing management).

Finally, post-restructuring transfer pricing following the reallocations of functions should also be considered in light of the price paid for the restructuring, if any (i.e. the exit charge). The OECD notes, for example, that the price for the restructuring may not necessarily be a one-off payment, but may in fact be incorporated into the ongoing transfer pricing post-restructuring.\(^{110}\)

### 20.2.2 Reallocation of assets

Arguably, one of the less complex cross-border restructuring opportunities is the transfer of an asset from one jurisdiction to another. Although this type of restructuring is common in manufacturing industries with the transfer of tangible assets (such as equipment) as well as intangible assets (such as manufacturing know-how), it may be less common in the financial services industry, where the most valuable asset for many businesses is experienced personnel.

Nevertheless, transfers of assets do occur in the financial services sector from time to time. Typically, these involve financial assets, such as the sale of a loan portfolio, or intangible assets – whether technological (e.g. trading algorithms, trading platforms) or customer related (e.g. marketing intangibles such as customer lists). In addition, given the consumer disillusionment with some areas of the financial services industry, there is an increasing focus on the management of a financial institution’s brand and associated intellectual property (e.g. trademarks, logos). Accordingly, asset transfers involving brand-related intangible property may well increase in the future as organisations seek to centralise such assets for better management and coordination.\(^{111}\)

The decision to restructure by transferring financial assets between one or more entities in a group raises a number of transfer pricing issues. These generally tend to be simple in concept but more difficult to apply in practise. The most obvious of these is developing the transfer price for the restructuring itself (i.e. valuing the financial asset at the date of transfer). As with all asset valuations, this requires a number of assumptions to be made, including future cash flows, discount rates, and market liquidity.

Likewise, the amount to be charged for ongoing management of the transferred financial assets would seem at first a relatively simple case of determining an arm’s length fee (e.g. a commission derived as a percentage [or basis points] of the assets being managed). However, in cases where the transfer involves a portfolio of bad

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\(^{108}\) Ibid. Paragraph 9.57.
\(^{109}\) Germany and the US.
\(^{110}\) OECD Guidelines, Paragraph 9.102.
\(^{111}\) See ibid. Part III, Chapter 4, Section 12.1 for a more detailed discussion on branding in the financial services industry.
debts, it may be far more difficult to determine an arm’s length price for the ongoing management. This is particularly the case if the current management team had no role in the original decision to enter into the loan, and instead is applying their expertise in such a manner that the potential loss going forward is reduced.

The transfer of intangible assets also requires a valuation of the assets as of the date of transfer. Again, the concept is simple, but in practise this could also involve an analysis of assumptions about the likely ‘profit potential’ for the transferee over the estimated useful life of the assets (e.g. revenue generated from transferred trading algorithms or platforms or from transferred customer lists). In the financial sector, this is made more complex due to the uniqueness of valuing financial instruments and potential liabilities, and also ‘marked-to-market’ issues under financial accounting and tax standards.

In addition, if the intangible assets are licensed back to the transferor for continued use (e.g. in a case where the business restructuring is designed to centralise management of certain intangible property rather than simply move it from a business in one jurisdiction to a business in another jurisdiction), then an arm’s length royalty for the use of the intangible assets going forward must be calculated. When considering the arm’s length nature of such transactions, the OECD notes that third parties would typically negotiate the future use of the assets together with the conditions of their initial transfer. Consequently, there is likely to be a relationship between the arm’s length valuation of the asset transfer and the arm’s length royalty rate for a license back.

20.2.3 Reallocation of risks

In the banking and capital markets industry, proposed regulation in almost every jurisdiction is focused on increased transparency and capital adequacy. This focus, in turn, is prompting consolidation of booking locations to improve risk and capital management. Similar tightening of capital adequacy ratios in the insurance industry, including the introduction of Solvency II, is pushing insurance companies to consider adopting a branch structure in Europe. Such structures allow companies/groups to take advantage of, among other things, lower capital requirements for single-entity structures, while re-evaluating organisational structures in Asia to address capital management requirements.

Within the financial services industry, business restructurings involving the reallocation of risks often arise where a multinational organisation wishes to consolidate such risks for more efficient management of its capital.

One example is the increasing use of internal insurance for consolidation or improved management of financial risks within a business. An increasing number of corporations (both inside and outside the financial services industry) are deciding to use a captive (i.e. internal) insurer for this purpose. The restructuring may involve the transfer of existing risks that the organisation wishes to place with the captive insurer or the ongoing transfer of new risks arising.

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112 Some jurisdictions, such as the US, carve out ‘foreign goodwill’ from a taxable transfer of property.
113 OECD Guidelines, Paragraph 9.86.
114 Note that the OECD is clear that the guidance on risk allocation in Chapter IX of the OECD Guidelines is not intended to cover the transfer of risks in the ordinary course of an insurance business; Response of the Committee on Fiscal Affairs to the Comments Received on the September 2008 Discussion Draft on the Transfer Pricing Aspects of Business Restructuring, Paragraph 25.
Another example of business restructurings involving reallocation of risks is the consolidation of booking locations in the banking and capital markets industry. Again, while the ability to book back-to-back transactions locally to a central booking location has long been a mechanism for capital management in this industry, with external pressures from regulators and the general lack of liquidity in the market, global banking and securities operations are starting to focus more closely on such opportunities. Such a restructuring typically involves the transfer of existing open positions to the central booking location or the transfer of risks assumed for new positions adopted in countries where local booking will continue to occur.\textsuperscript{115}

The OECD Guidelines clearly state that the starting point for considering risk in any transfer pricing context, including business restructurings, is an examination of the contractual terms between the parties. Given this, the OECD Guidelines strongly recommend that taxpayers document the basis for their decisions to allocate or transfer risks before such allocations or transfers occur.\textsuperscript{116} Although the OECD primarily refers to inter-company contracts, such documentation typically also includes an analysis of the business rationale for the transfer (including consideration of the profit potential of the transferor) and documentation outlining the price for the transfer of existing and future risks.\textsuperscript{117}

Moreover, as in many cases involving transfer pricing, regardless of documentation prepared, the tax authorities may look through the stated contractual terms between the related parties to the actual economic substance of the transaction between them. If the latter differs from the former, the tax authorities may adjust the transfer price to reflect such differences or, in the worst case, may re-characterise the transaction (see Section 3 below).

When assessing the arm’s length nature of any shifting of risks between two related parties, the tax authorities typically refer to comparable data. If comparable data is available, taxpayers should consider whether they need to apply adjustments to that data to account for the related parties to such a transaction possibly having greater information about the nature of the risks being transferred than would two third parties. Although it is important to consider the need for adjustments under any transfer pricing policy that relies on comparable data, the pricing of risks is particularly sensitive to the information known about those risks. Thus, the third-party price in such a case may reflect a premium to the risk taker for this lack of knowledge, which may not be required in the case of related parties.

Where no comparable data exists, the OECD is clear that this does not negate arm’s length status for the transaction. Instead, consideration should first be given to which party has most control over the risk, and second to which party has the financial capacity to assume such risk\textsuperscript{118} (although these factors are not determinative of a transaction being at arm’s length). Moreover, the transfer price for the transfer of existing risks (e.g. open trading positions) is likely to be based on a valuation of those risks (and assets associated with them). In this regard, the discussion at Section 2.1 above is also relevant.

\textsuperscript{115} The requirement to continue to book locally may arise due to regulatory considerations or commercial considerations (e.g. where counterparties prefer to enter into transactions with an entity based in their jurisdiction).
\textsuperscript{116} OECD Guidelines, Paragraph 9.11.
\textsuperscript{117} In addition, although not as clearly stated by the OECD as for transfers of risks, it is implicit that the same type of documentary support is also recommended in the case of transfers of assets or functions.
\textsuperscript{118} OECD Guidelines, Paragraph 9.20. In addition, Paragraphs 9.22-9.28 provide a detailed discussion of the notion “control” over risks with examples, while Paragraphs 9.29-9.32 provide the same for “financial capacity to assume risks.”
As control over risks assumed becomes an increasingly important part of the consideration of an appropriate transfer price for the reallocation of those risks, some organisations are beginning to physically locate their risk management teams in the jurisdiction where the entity assuming the risk is located. In the case of risk transfers relating to global banking or capital markets, this often involves establishing large risk management teams in the central booking location. Where the booking location is in a major banking hub, such as London, New York, or Hong Kong, ‘control over risk’ may be easier to substantiate and manage.

In the wake of the global financial crisis, another important consideration in the analysis of risk allocation is whether the risk taker had the financial capacity to accept the risk at the time it entered into the transaction. While the OECD Guidelines note that “a high level of capitalisation by itself does not mean that the highly capitalised party carries risk”, at least in the global banking and capital markets industry, the general regulatory trend has been towards increasing the capital requirements of entities that do assume market risk.

Transfer pricing policies for ongoing risk transfers typically vary between those that attempt to provide a return to the transferor of the risk (which usually assumes the risk for a short period only), using a form of commission or cost plus return, and those that attempt to remunerate the transferee’s at-risk capital. Because the transfer pricing analysis is somewhat simpler in the former case than in the latter, transfer pricing policies that reward the transferor, historically have been more widely applied in the financial services industry than those that reward the transferee.

### 20.3 Transfer pricing considerations

As discussed briefly above in relation to the reallocation of risks, the business rationale behind a restructuring is inevitably of critical interest to the tax authorities that may eventually review the transaction. This issue is fundamental – first to whether such a transaction would have happened at all between third parties, and second whether it would have happened on the terms adopted by the related parties.

To substantiate the business rationale for the transaction, the OECD suggests to document not only the anticipated synergies (whether cost savings or otherwise) from the restructuring, but also the assumptions upon which the estimate of any projected benefits was based. The OECD notes that this documentation is likely to be the same – and contain the same analysis – as the documentation used by group-level management when conducting its decision-making process for the restructuring. Moreover, although the OECD does not expect taxpayers to document all possible restructuring alternatives, Chapter IX does refer to the “options realistically available” when considering if a particular restructuring would have happened between third parties at all or would have happened on the terms adopted by the related parties. Thus, if there is an obvious restructuring alternative to that selected by the taxpayer (such as an alternative adopted by key competitors), the OECD’s language suggests that such alternatives should be identified, with an explanation as to why they are not appropriate in the taxpayer’s specific case.

Moreover, although the OECD explicitly states that analyses conducted after the fact and with the benefit of hindsight are not to be considered when determining the transfer pricing for a restructuring, the legislative position taken by some governments and the practical position taken by the field examiners in other countries from time
to time are, in fact, to look back with the benefit of hindsight. This suggests that if synergies are not delivered, the taxpayer may need to make adjustments to the (post-) restructuring pricing or to document the reasons for the change in underlying assumptions in preparation for defending the original pricing during an audit.

Finally, on the topic of business rationale, it is also important to note that the OECD specifically states that the fact that a restructuring makes good sense at the group level does not necessarily mean it makes good sense at the individual entity level. Thus, whatever documentation is prepared in support of the business rationale for the restructuring should focus on each local entity as well as the group as a whole – however difficult this may prove to be in some cases. In particular, the implication of Chapter IX that both the transferor and transferee should assess the restructuring options ‘realistically available’ to each of them may be particularly troublesome in many business restructurings situations.

Another area of concern for many taxpayers is the ability of tax authorities to re-characterise (or even disregard) a business restructurings transaction – as opposed to simply making adjustments to the terms of that transaction. Chapter IX of the OECD Guidelines makes it clear that such re-characterisations should be adopted only in exceptional (i.e. rare or unusual) cases. Factors that the OECD considers might be relevant in a re-characterisation consideration include whether the economic substance of the transaction differs from its form or whether third parties would not have restructured in the same manner as the related parties and an arm’s length price cannot be determined for the transaction.

20.4 Conclusion

For reasons not specific to the financial services industry, business restructurings have become a key area of focus for the OECD and tax authorities worldwide in recent years. Unfortunately, the global financial crisis has necessitated an increase in restructuring activity within the financial services industry in the middle of this spotlight.

Moreover, although the OECD has now published Chapter IX of the OECD Guidelines to specifically address the transfer pricing aspects of business restructurings and various governments are beginning to introduce tax legislation dealing with the same issue, the lack of historical practice and precedent in most countries makes it difficult for the tax director of a multinational financial institution to derive certainty over the tax treatment of any business restructuring their organisation may decide to undertake.

In these circumstances, therefore, business restructuring should be considered one area where it is incumbent on the tax director to continually monitor the changing laws and practises of the various jurisdictions in which their organisation operates – not only for future transactions that may be considered, but also in relation to past business restructurings.

121 Ibid. Paragraph 9.63.
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For some time now there has been growing recognition and concern among taxing authorities and taxpayers alike that the published transfer pricing legislation, regulations, and guidelines do not provide an adequate framework for analysing many of the inter-company transactions that arise as financial institutions go about their day-to-day business. Concerns have been raised about the lack of direction provided by these guidelines, especially following the global economic crisis.

Clarifying the rules: Sustainable transfer pricing in the financial services sector, provides an outline of the key considerations, observations and challenges arising from the transfer pricing issues pertinent to the financial services industry. Written by our Financial Services Transfer Pricing network experts worldwide, this publication serves as a unique and practical reference guide to help manage financial services transfer pricing issues at an operational level.