

Transfer Pricing Perspectives/October 2013: A series of articles taking a broad look at the different transfer pricing requirements and unique challenges companies are facing all over the world.

Managing multiple stakeholders in the new economy



Foreword



Garry Stone

In the current economic environment, the continuing priority for governments worldwide – and Western governments in particular – is for their tax systems to generate the level of revenues they expect. Against this background, the media, politicians and NGOs worldwide have engaged in a sometimes heated debate about the ethics and legality of various multinationals' tax policies, often with significant impacts on the reputations of the companies concerned. Our client conversations and **16th Annual Global CEO Survey** both confirm that tax has moved up the agenda of business leaders around the world.

Undoubtedly, the tax world will continue to see a lot of change in the next year – and for years after that. And as transfer pricing tops more and more media headlines – and internationally coordinated efforts to aggressively collect taxes escalate even further –

the number of interested stakeholders is expanding. We now have to be prepared to manage multiple stakeholders in this new economy.

Add to this the impact on transfer pricing of OECD's recently released Coordinated Action Plan on Base Erosion and Profit Shifting (BEPS), and it's clear: The need for defensible transfer pricing policies is more important than ever. But it doesn't end there. Not only do we need to ensure we are legally compliant, it is critically necessary that we be perceived as doing the right thing. The recent "tax morality" debates taking place with respect to large US corporations brought before government bodies are prime examples. No doubt, all these factors combine to make one thing clear: There will be continuing changes in the transfer pricing world for a long time to come.

The articles in this October 2013 edition of *Transfer Pricing Perspectives* are designed to help you get the insights you need on transfer pricing issues to equip yourself for the changes we're sure to see.

Don't forget our app, **TP to Go** to keep you up to date with the latest transfer pricing developments. It's available to download on most devices. Search for it in your app store today. You can also sign up to our **PKN alerts** and receive emails on the latest transfer pricing news.

I hope you enjoy this edition of *Transfer Pricing Perspectives*.

A handwritten signature in black ink, appearing to read 'Garry Stone', written in a cursive style.

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Leading practices for managing double taxation risk in the oil and gas industry

Double jeopardy...



Double jeopardy...

Industry expansion leading to greater costs

The significant expansion of oil and gas (O&G) companies globally makes the need for industry players to align and coordinate local operations with corporate strategy greater than ever. As a result, the majority of multinational energy companies incur significant general and administrative expenses related to headquarters services rendered on behalf of foreign affiliates. In addition to general management and administrative activities including accounting, human resources (HR), and information technology (IT) services, O&G companies may also charge their related parties for centralised quality, health, safety, and environmental (QHSE) support services, engineering and technical services, and procurement and logistics services – among other functions – performed by corporate departments.

Global oil and gas expansion increases need for industry player alignment

The OECD Guidelines provide for – and many countries, including the United States, require under their local transfer pricing rules – charges for intercompany services that provide or are intended to provide a benefit to related parties. Although specific rules in a jurisdiction may allow for certain expenses to be allocated at cost, in some cases the services are required to be charged with a mark-up.

Tax authorities' response to OECD charges

Many tax authorities are sceptical of these charges – particularly those including a mark-up – and impose local requirements mandating documentation showing the

direct benefit received by the local affiliate or disallow the deduction of the service fee for tax purposes at the local level completely. In many cases, these decisions are made by the foreign tax authority unilaterally, not considering that there may be potential implications under an existing income tax treaty.

When this situation arises, a company potentially could be required to pay tax twice on the same income for the same period – in the local country which disallows the deduction and in the host country where the counterparty to the transaction must report the income on its tax return and pay tax on that income.

It is critical that corporate finance personnel recognise that a disallowance of an otherwise appropriate expense allocation or charge has potentially far-reaching tax consequences and take action to remedy the situation.

Double jeopardy...

Certain disallowances can have significant tax consequences



Many of the developing countries in which multinational O&G companies operate do not have extensive treaty networks. As such, remedies such as Competent Authority may not be available.

Intercompany headquarters services

To capitalise on economies of scale and remain cost competitive in the global marketplace, O&G companies generally centralise

administrative, management, and back office services. These shared services may be executed through the parent company's headquarters or in one or more regional service centres.

In addition to strategic management and corporate goal setting, the services provided at the head office level may include but are not limited to:

- Sales and marketing, including brand development and management
- Accounting, finance, and treasury administration, including global cash management
- Tax planning, reporting, compliance, and controversy support
- Legal and general counsel functions
- Management information systems and IT

Double jeopardy...

- HR, including expatriate personnel management, payroll, and benefits administration
- Engineering and technical support services
- QHSE programme development and management
- Corporate structuring and planning, including merger, divestiture and acquisition planning and execution
- Purchasing, logistics, and procurement, including asset and materials management
- Stakeholder relations, including investor, public and media relations
- Intellectual property administration, including patent and trademark registrations and defence

Broadly, headquarters activities can be bifurcated between those activities that provide a benefit to related parties and those that are performed on behalf of the company performing the

activity. As a threshold matter, headquarters services must not duplicate the activities performed at the local level and be seen as providing a recognisable benefit to the recipient in order for a charge to be made in most jurisdictions.

Services providing indirect benefits to more than one member often most contentious

Services providing indirect benefits to more than one member of a controlled group – such as QHSE programmes and company-wide asset management activities – are often the most contentious as local tax authorities are typically reluctant to accept charges for activities which do not appear to have a direct impact on the recipient.

Issues raised by foreign tax authorities

Due to their heightened visibility, O&G companies are on the radar of tax authorities around the world. Increasingly, multinational enterprises are facing tax authorities in many jurisdictions – including member states of the OECD – taking aggressive positions on audit to disallow the deduction of allocated headquarters services charges. In the case of more sophisticated tax authorities, the disallowance may be explained in a well-reasoned manner. Conversely, in less advanced economies, no justification may be offered at all.

Historically, foreign tax authorities have challenged headquarters services charges on the basis of lack of direct benefit received in the local country, misallocation of charges between affiliates, and inappropriate mark-up applied. Absent planning and proper documentation that meets local

Double jeopardy...

country requirements, these disputes can be difficult to address in the foreign jurisdiction. If these issues are raised in a treaty country, then relief may be available through Competent Authority under the Mutual Agreement Procedure (MAP) of the treaty.

Disallowance: Tax authorities see some troubling trends

However, a troubling trend has emerged over the last several years. Some tax authorities have asserted that the disallowance of the deductibility of headquarters services charges is a domestic issue – tied to local rules – and insist that Competent Authority has no right to negotiate the issues. For example, Mexico has been observed to deny inbound expense deductions claiming domestic substantiation and form requirements are not

met. Invoicing and cash settlement is another common reason given for disallowance of headquarters services charges, particularly in CIS countries. These jurisdictions do not accept offsetting journal entries or accounting cross charges, instead demanding that intercompany invoices be rendered and payments be made in cash.

Specific challenges for O&G companies

Due to the contractual nature of deals in the O&G space, there are particular issues industry participants face in determining and charging appropriately for headquarters and other management services.

Whether for commercial, liability, or other reasons – such as local content laws – O&G companies often will enter into a joint venture (JV) relationship with one company as the operator and others as investors who pay the costs of

the operation. While seemingly a third party relationship, a JV could face a near “perfect storm” where investors in the JV refuse to accept mark-ups on the operator’s service charges – seemingly an example of third party negotiations – while a tax authority asserts a mark-up on a perceived related party transaction.

Critical matter: Oil and gas companies need holistic approach to structuring joint venture activities

It is critical that O&G companies take a holistic approach to structuring their JV activities taking into account the tax implications of service activities performed by one or more members of the JV and prepare the appropriate analysis and documentation to support their positions.

Double jeopardy...

Leading practices

While the challenges related to foreign deductibility of headquarters services charges allocated by multinational enterprises will likely continue, corporate personnel can take proactive steps to better defend these deductions. Companies should consider taking the following actions:

What are the proactive steps corporations can take to defend deductions?

- **Put in place** comprehensive intercompany agreements and ensure that the duly executed agreements are registered with the appropriate local authority, where applicable.

- **Ensure** that intercompany charges are supported by specific invoices designed to meet local requirements for invoicing and payment.
- **Understand and follow** local transfer pricing documentation requirements.
- **Develop and maintain** specific evidence substantiating the benefits received by the local entities from the head office, where possible. This documentation could include executive travel logs, meeting notices, training or operating manuals, and the like, evidencing that important directions and guidance are communicated to the local entity from the corporate headquarters.
- **Identify and retain** local advisors to give timely direction on tangential sourcing issues for withholding purposes and indirect tax consequences.

When Competent Authority is not available, advisors with experience and a physical presence in the foreign jurisdiction are even more critical. This local presence is imperative as court actions, bond applications, and other necessary events and processes have deadlines and procedures unique to each country. The ability to navigate these local requirements is vital to achieving a successful outcome for the company.

Ultimately, advance planning and documentation prepared in accordance with the relevant jurisdictional requirements is essential to multinational O&G companies successfully defending headquarters services charges in both domestic and foreign environments.



Double jeopardy...

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David Swenson, global leader of PwC's tax controversy and dispute resolution network, predicts a second wave of tax audits and disputes is on the horizon around the world.

Global tax audits and disputes: New forces are converging to form second wave





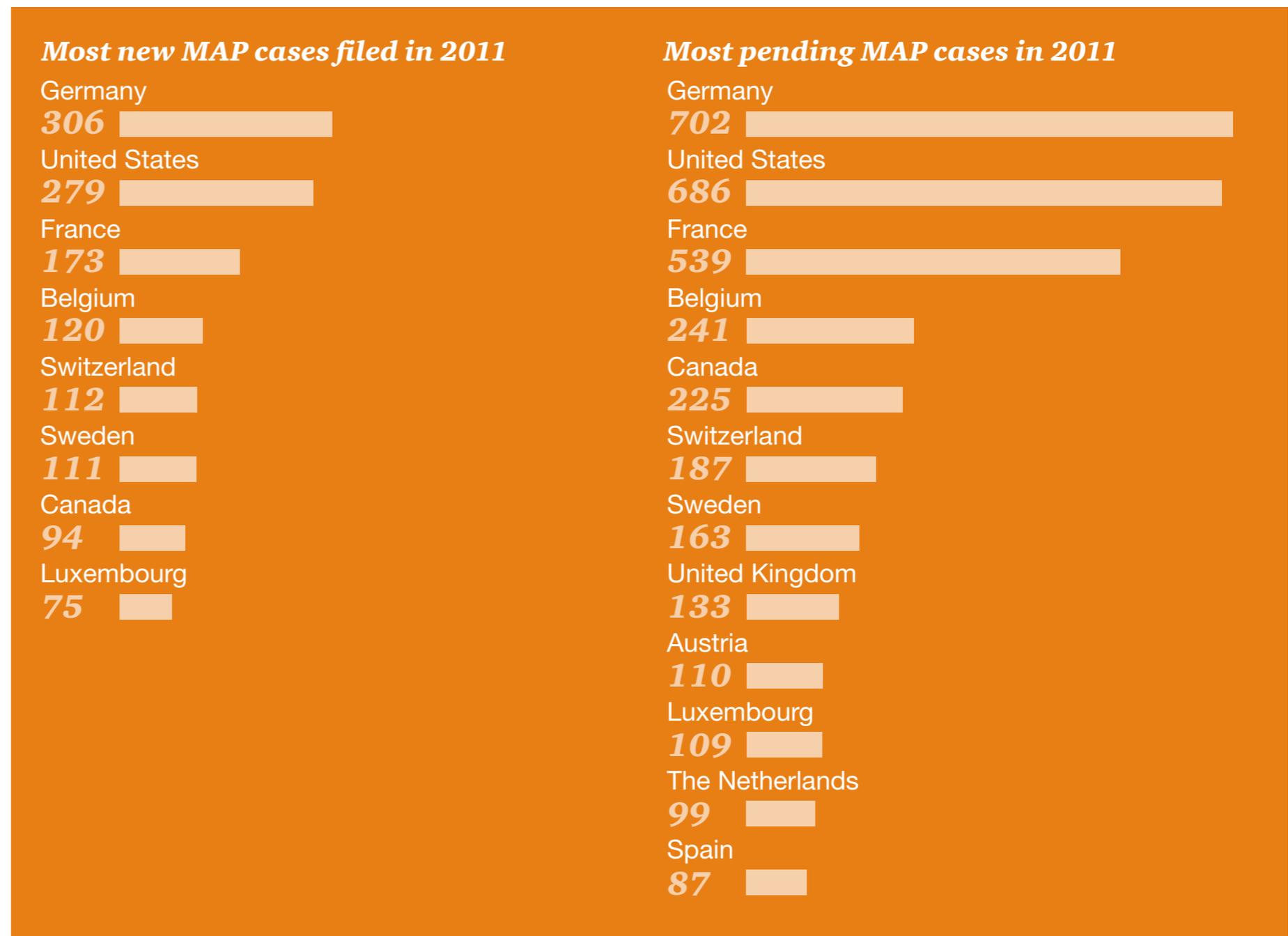
Global tax audits and disputes: New forces are converging to form second wave

The first wave of the storm

According to the most recent OECD statistics, 1,624 new MAP cases were initiated among OECD member countries during the 2011 reporting period, representing a 21% increase over 2010. The countries with the most new MAP cases filed in 2011 are shown opposite.

The total number of new cases filed in 2011 represents a substantial 57% increase over the new cases filed in the 2006 reporting period, and is the largest number of MAP cases ever filed in a single year.

The OECD statistics also show that the number of open (pending) MAP cases reported by OECD member countries at the end of 2011 totaled 3,838 – a 15% increase over 2010 – and the total caseload continues to grow each year. The countries with the highest total of pending MAP cases at the end of 2011 are shown opposite.



Global tax audits and disputes: New forces are converging to form second wave

Significantly, the existing overall inventory of open MAP cases represents a 63% increase compared with 2006, and is the largest number of pending MAP cases in history.

The average time for completion of MAP cases between two OECD member countries in 2011 was 25.6 months. Although this represents an approximately two-month reduction in the average completion time (from 27.3 months in 2010), it remains well above the recent four-year average of approximately 21.6 months.

These OECD statistics provide dramatic evidence of the surge in tax audits and disputes among OECD member countries over the last five years. New MAP cases are increasing at a significant rate and the total open inventory of cross-border disputes is on the rise each year. For example, statistics recently released by the US

competent authority office indicate that US- initiated MAP cases more than doubled in 2012 (over 2011).

How will increased tax audits/disputes and limited resources impact processes?

With limited tax administration resources in many jurisdictions, the total MAP caseload likely will continue to grow and the average completion time may lengthen in the near future. Although the concept of mandatory binding arbitration holds promise as a release valve in the storm, those provisions are included in a limited number of double tax treaties, and any widespread positive impact may be years away.

The second wave is rolling in

The first wave of the tax controversy perfect storm has already delivered record numbers of tax audits, disputes, and MAP

cases worldwide, and it has placed substantial strain on the existing framework for resolving cross-border tax disputes. Unfortunately, turbulent conditions are on the horizon and it appears that new forces will trigger a second wave of increased audits and examinations, presenting additional challenges for those facing the storm.

Driving factors

Nations throughout the world have an acute need to raise large amounts of revenue to fund a variety of short and long-term obligations, from infrastructure projects and defense initiatives to social programmes.

Governments must encourage voluntary taxpayer compliance and simultaneously develop tools to ensure compliance through cooperative engagements, documentation requirements, and enhanced enforcement initiatives. The primary enforcement actions

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include improved methods for reporting and sharing taxpayer information, robust risk assessment approaches, and aggressive audit and examination techniques. Governments are adding resources to audits and other enforcement initiatives and are supporting greater training and education of tax auditors and inspectors. These enforcement steps will inevitably lead to further audits and disputes in both developed and emerging countries worldwide.

Austerity measures implemented in many countries in response to the global financial crisis have placed a spotlight on tax obligations and enforcement. As deficit reduction measures are adopted and government services are decreased, stakeholders are focusing on obligations to pay tax and the enforcement of those obligations.

Unprecedented political pressure continues to escalate based on populist rhetoric. It has become politically acceptable to single out multinational corporations for intense scrutiny, even to the extent they have become targets of a crackdown on aggressive tax planning and perceived deficiencies in the historical architecture supporting the global tax system.

Non-governmental organizations (NGOs) have raised issues related to tax fairness and tax morality, and several governments have held public hearings on issues related to the tax planning debate, double non-taxation, and tax evasion. Some observers believe that concerted action on tax fraud and tax evasion is a necessary step to ensure that austerity and deficit reduction measures are fair and equitable, and attention on these topics has spread to the more traditional areas of



Intense scrutiny of multinational corporations now politically acceptable

international tax planning. In turn, these developments have led to a focus by the G-20 countries on preventing tax evasion and aggressive tax planning. In response, the OECD has initiated its well-publicised BEPS project.

With an eye on the second wave, the OECD has taken the lead in addressing base erosion and profit shifting in a systematic manner. Following up on its February 2013 BEPS Report, the OECD released in mid-July a Coordinated Action



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Plan (the Action Plan), which addresses perceived flaws in the international tax rules and sets forth precise action points and a suggested time line.

This highly anticipated Action Plan calls for fundamental changes - as opposed to wholesale amendment - to current mechanisms and the adoption of new consensus-based approaches designed to prevent and counter base erosion and profit shifting activities. Overall, the Action Plan reflects a balance in clearly identifying the gaps and a roadmap forward, while at the same time establishing a responsible tone by setting forth principles based on the need for clarity, predictability, and administrability for both governments and taxpayers. The Action Plan cautions, however, that inaction regarding base erosion and profit shifting may have more deleterious effects, likely including unilateral actions by individual

nations, a second wave of audits and disputes, resultant global chaos, and a potentially higher incidence of double taxation.

Will the BEPS initiative result in collective action by nations?

At present, it is unclear whether the BEPS initiative will result in collective (multilateral) action by nations, or whether unilateral measures will be adopted in certain areas. Many observers believe that it will be relatively easier for countries to agree on coordinated action in some administrative areas, such as transparency of information, reporting requirements, exchange of taxpayer data, joint audits, and revisions of procedural rules to make MAP cases more efficient.

There is also a view that it will be far more problematic to reach broad agreement on major changes to fundamental taxing rights that

have formed the foundation of the international tax system for many decades. As a result, because of the length of time necessary to achieve mutual understanding and consensus on changes to established technical rules, it may be extremely difficult to reach a holistic agreement on revised rules and common principles of taxing jurisdiction among developed and emerging nations on an expedited basis.

Some countries may believe that the historical international tax rules are no longer fit for purpose and need to be substantially rewritten, while others may believe that vigorous audits and aggressive enforcement of the existing rules, combined with allocation of additional resources to those efforts, will address the underlying issues raised in the OECD BEPS initiative.

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Conversely, some observers believe that tax competition among nations must be addressed as a first step, thereby leading to a lack of uniformity on the best path forward. Based on a number of competing considerations, it appears that a combination of collective and unilateral actions may be forthcoming, with some countries and regional organisations - such as the European Commission - adopting interim measures. Regardless of the approach ultimately adopted, there is little doubt that tax administrations will feel emboldened, and even compelled, in the current environment to escalate enforcement activities leading to a second wave of tax audits and examinations in the years ahead.

What to expect

As the global tax controversy area heats up and the second wave approaches, greater risk

and uncertainty will emerge, and there likely will be renewed interest in cooperative compliance programs among revenue authorities and taxpayers, such as the compliance assurance program (CAP) in the US, the real-time working procedures in the UK, and horizontal monitoring in the Netherlands.

Greater risk & uncertainty to accompany rising global tax controversy

There also may be increased demand for private rulings and pre-filing agreements to reduce risk and uncertainty regarding specific transactions and operations, such as advance pricing agreements (APAs) in the transfer pricing area.

With the anticipated surge in new audits and examinations, and as more cases are thrown into the tax

disputes hopper, an inevitable rise in the number of tax controversies will develop, as well as an increase in domestic alternative dispute resolution (ADR) options, including administrative appeals, mediation hearings, MAP cases, arbitration proceedings, and tax litigation. The existing system for resolving cross-border tax disputes will continue under growing pressure, and additional resources will be necessary in these areas to address the expanding caseload and to avoid delays and uncertainty in resolving these controversies.

Historically, there has been general agreement among OECD countries over the meaning of the arm's length standard and the definition of permanent establishments, creating taxing link between a taxpayer and the relevant jurisdiction.



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taxation. Others are of the view that although multilateral action on GAARs is preferable to separate country measures, the most appropriate response is through the proactive use of limitation on benefits provisions in double tax treaties. These differences of view will make finding common ground very challenging.

There are also differing views on other important concepts such as the need to respect the existence of separate legal entities, the validity of binding legal agreements, and the allocation of risks among related parties. Further, there are divergent opinions concerning the need to respect transactions as structured by taxpayers and the limits on the ability of tax authorities to re-characterise bona fide existing arrangements. Expansion of the tax administration rights to re-characterise transactions and the ability to substitute government opinion for a taxpayer's

business judgment undoubtedly will trigger more difficult and complex tax controversies.

The business world must be able to rely on the rule of law, and it needs legal certainty in these areas. A uniform set of principles is critical to managing global business operations. Indeed, the OECD Action Plan acknowledges that more clarity is required around identifying which types of transactions can be re-characterised. In the interim, however, the current global tax environment is creating less certainty and greater tax risks and exposures.

Proactive approaches to anticipated surge in tax audits and disputes

With the second wave of the perfect storm on the horizon, taxpayers should adopt proactive steps to prepare for the anticipated surge in tax audits and disputes.

Strategic risk assessments (SRAs) are important tools to identify, evaluate, and manage tax risks and exposures around the globe. Proactive use of SRAs involving priority countries, operations, and transactions may identify material tax risks and exposures before an audit even commences. Implementation of SRA recommendations may also strengthen reporting positions, reduce uncertainty, and develop responses to anticipated tax authority positions.

In the current environment, many multinational corporations have 100 or more active tax audits and disputes underway around the globe. It is critical to proactively coordinate and manage those examinations, monitor statutes of limitations and treaty requirements, adopt consistent positions regarding facts and issues, and develop holistic approaches to resolving the

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controversies, taking into account local as well as multi-country tax attributes. Implementation of global coordination hubs and dispute resolution centers is useful to achieve these objectives.

It is also important to build defence into entity structures and transactional documents from the initial steps of establishing an organisational structure and throughout the operational

lifecycle. Proactive strategies to craft contracts, agreements, and other documents with a defensive mind-set will not only strengthen the taxpayer's position on audit, but also may lead to a more timely and favourable resolution of the tax dispute.

A pressing juncture arises when a tax audit commences. The taxpayer should develop an overall strategic plan for managing the

audit and, if possible, resolve all issues at the audit level. Early development of the taxpayer's affirmative theory of the case is critical to a favourable resolution of the audit or dispute. Informed strategies for responding to information document requests, employee interviews, and facility tours are also key to successfully resolving the issues at an early stage in the controversy process.



Strategic plan for managing the audit and respective issues is key



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An effective administrative appeals process should reduce the number of disputes that reach the MAP level, arbitration, and tax litigation. Improvements to existing administrative appeals programs are needed in many countries. Governments should consider the use of additional ADR approaches, such as domestic mediation and domestic arbitration as alternative methods to deal with the anticipated increase in tax disputes. Equally important, tax administrations should ensure that increased resources are devoted to APA and MAP programs in response to the rising inventory in these critical areas.

Finally, in the context of MAP cases, mandatory binding arbitration may offer a reasonable alternative for resolving complex or difficult cases. The use of specified time limitations, independent arbitrators, and a 'baseball arbitration' approach

(winner takes all) may serve as forceful incentives to resolve cases early in the MAP process (actually, even before arbitration begins). For those cases not resolved before arbitration, these factors may also lead to an objective means of resolving the underlying differences between the two governments.

Which forces could drive second wave in perfect storm of cross-border disputes?

The bottom line

New forces are gathering on the horizon of the global tax controversy environment. If nations deviate from historical international tax principles, substantial additional resources will be necessary to address the flood of new audits and disputes. Ultimately, double taxation may become more widespread as

fewer disputes are successfully resolved. Divergent positions by nations worldwide and pressure on existing dispute resolution options will lead to greater uncertainty and more controversy, and an unwelcome haze may be cast over the environment for years to come. These forces will drive a second wave in the perfect storm of cross-border disputes. Carefully coordinated actions and informed strategies are needed now before the next wave rolls in.



Global tax audits and disputes: New forces are converging to form second wave

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Industrial products companies have witnessed a significant shift in production to emerging markets, including most notably China, Brazil, and India.

Industrial products



Industrial products

Globalisation

Industrial products companies have witnessed a significant shift in production to emerging markets, including most notably China, Brazil, and India. Today, multinational enterprises in the sector continue to extend the breadth of their existing international operations while expanding into new markets to be closer to their customers. These companies are looking to emerging markets as sources of not only low-cost labour for manufacturing, but also highly skilled labour that will help drive development activities. In addition, emerging markets also are expected to propel future growth through lucrative new sales channels.

The chemical and industrial manufacturing sectors are good illustrations of the impact of globalisation. Many US-based chemical companies are building production facilities in emerging

markets to meet overseas demand growth. There has been a large increase in investment in China, with two chemical companies recently announcing plans to increase their research and development (R&D) capabilities in Shanghai. In industrial manufacturing, foreign trade and investment is becoming increasingly important as demand from emerging markets is growing faster than in the United States and Europe as a result of higher birth rates, improving living standards, and increasing industrialisation of their economies.

The impact of globalisation on transfer pricing

As a result of globalisation, transfer pricing is becoming a more important as well as a more complex issue for industrial products and services companies. As these companies expand their global operations, they must develop robust and defensible

transfer pricing structures and policies. They must deal with the growing number of jurisdictions that have adopted rigorous transfer pricing policies that, at times, rely upon inconsistent intercompany transfer pricing laws and standards. Multinationals also must respond to more aggressive enforcement by tax authorities – a consequence of the attempt by many countries to prevent perceived abuses by taxpayers and a desire for increased revenues to reduce deficits.

These developments are taking place both in developed and emerging countries. Indeed, the transfer pricing landscape throughout the world is constantly evolving, as evidenced by the recent focus on base erosion and profit shifting (BEPS) by the Organisation for Economic Cooperation and Development (OECD).

Industrial products

Multinationals must comply with material differences in transfer pricing rules across multiple jurisdictions. In certain countries, such as Brazil (a major market for industrial products), companies must comply with transfer pricing rules that do not adhere to the arm's-length principle.

The Brazilian transfer pricing regime is a formulary-based system that defines maximum price ceilings for deductible expenses on intercompany import transactions and minimum gross income floors for intercompany export transactions. This regime creates a unique challenge for multinationals operating in Brazil, since transfer pricing requires analysis under two distinct models that cannot necessarily be reconciled. In such instances, double taxation may be inevitable. This expansion of businesses across national borders, and the proliferation and

inconsistency of transfer pricing rules worldwide, will likely lead to a dramatic increase in transfer pricing controversies.

Due in large part to the global economic downturn, transfer pricing in recent years has been an exercise in the allocation of losses, rather than income, among related entities. Meanwhile, the governments auditing these companies are looking for tax revenues to help offset the cost

of deficit spending during the downturn. These factors have created an environment that is ripe for tax controversy. Indeed, multinationals have been confronted by enhanced tax compliance enforcement activity throughout the world, including intense attacks on their in-country "loss operations." As a result, transfer pricing presents unique challenges to companies seeking to manage multiple stakeholders in the new economy.



These factors have created an environment that is ripe for tax controversy

Industrial products

The risk of double taxation

Many multinationals are looking for ways to protect themselves from the risk of double taxation that could arise in a transfer pricing controversy. Traditionally, companies relied on preparing robust transfer pricing documentation to support their tax return filing positions. However, in today's more contentious transfer pricing environment, many companies are exploring Advance Pricing Agreements (APAs) and other forms of dispute resolution, such as joint audit examinations or the competent authority process, to avoid or resolve transfer pricing controversies.

The APA – an agreement between the taxpayer and tax authority that sets out the method for determining the transfer pricing for the subject transactions over an agreed time period – can be used to help gain a level of certainty on existing structures for future

years as well as to implement new transfer pricing policies coinciding with a business restructuring. Despite the benefits of achieving certainty, some multinationals have been reluctant to enter into the APA program, believing that APAs can be invasive, costly, and time consuming.

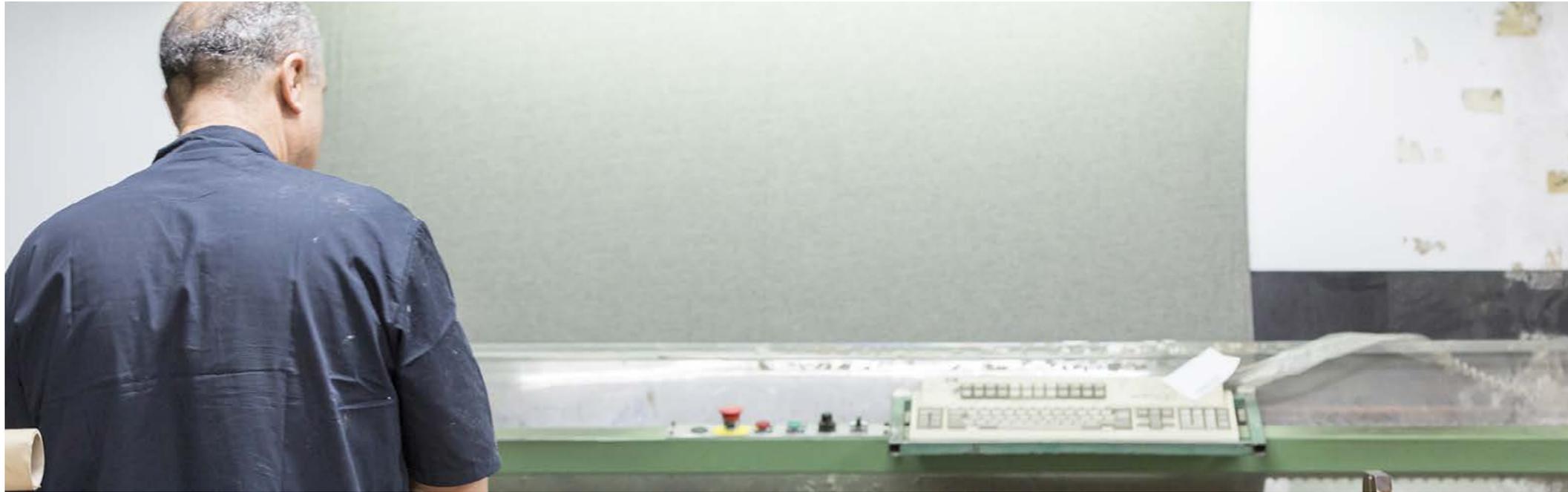
In response to concerns from multinationals for consistency and efficiency in audit processes in different countries and minimising the risk of double taxation, there appears to be a gradual shift from adversarial to collaborative approaches to resolving tax disputes. Indeed, collaboration is also increasing between tax authorities, including an increased willingness on the part of tax authorities to share information in order to reach mutually agreed upon outcomes with taxpayers. Some countries are beginning to offer joint audit examinations – a coordinated

single audit using a single team comprising representatives from two or more jurisdictions – although these joint audits have not yet gained widespread traction. In cases involving tax disputes between treaty partners, the competent authorities of the relevant countries may be engaged to resolve the dispute under the mutual agreement procedures embodied in the relevant income tax treaty.

Intangibles in a global economy

Globalisation also has resulted in a wide array of issues involving the ownership and use of intangible property. As companies expand internationally, they often seek to align the ownership and use of intangible property in a regional headquarters through cost sharing, licensing, or contract service arrangements.

Industrial products



Recent US regulations regarding cost sharing arrangements have made these structures administratively burdensome

Under a cost sharing arrangement, each participant in the arrangement is a co-owner of intangibles with certain rights to their use. However, recent US regulations regarding cost sharing arrangements have made these structures administratively burdensome. In addition, for many companies in the industrial products sector with valuable, self-developed intangibles, the buy-in payment by a new participant

upon the formation of a cost sharing arrangement potentially could give rise to a significant tax expense.

As an alternative to cost sharing, many industrial products companies have adopted licensing models, under which ownership of the group's intangibles are retained by the owner and licensed to affiliates within the group. Licensing models also

can prove challenging in certain jurisdictions, where foreign currency exchange or other limitations hamper the ability to make royalty payments or subject such payments to significant withholding taxes.

Supply chain management

Many US-based customers of industrial products companies are moving their operations to regions with faster growth or lower costs,

Industrial products

forcing suppliers to move with them. To meet these global shifts, industrial products companies are re-examining their supply chain management strategies.

Lean manufacturing, which revolves around concepts of continuous improvement and innovation, waste elimination, and the reduction of total costs, continues to gain traction as companies struggle to maintain margins in a highly competitive

business environment. Companies are standardizing and simplifying their product mixes and aligning their products and services with global macroeconomic trends, such as increasing needs for global infrastructure, clean and renewable energy and energy efficiency, and a more mobile, networked society. Manufacturing companies also are developing a regional approach to manufacturing, product

development, and sourcing, which makes them more responsive to local demands and less of an outsider to their customers.

Global placement of R&D and human resources

As demand for products increases in emerging markets, the need for local distribution channels to satisfy local demand is also increasing. Meeting local demand often requires knowledge of local consumer preferences, which, in turn, may necessitate a build-up of local R&D capabilities to ensure that product innovations are aligned with consumer preferences. This change in R&D investment brings with it the need to consider carefully how to structure the ownership of any intangible property, especially since some countries have weak laws in regard to intangible property protection.

Another important element in managing a global supply chain is the workforce, including the recruitment of skilled employees in multiple locations. The industrial products

sector as a whole faces a growing shortage of talent in many disciplines, including design engineers, project managers, superintendents, and middle and senior management, leading to intense competition among companies to hire qualified people. While this trend has been somewhat offset recently by lower demand due to the recession, it remains relevant for the longer term as knowledge and age gaps within the workforce continue to grow. To be successful in tight labour markets, all global companies have to provide additional incentives to potential employees by offering global training, rapid promotions, and attractive remuneration packages.

Industrial products

Increased controversy around restructured supply chains

In reaction to supply chain reorganisations by multinationals in pursuit of growth opportunities in emerging markets, some tax authorities in developed countries have sought to protect their tax base by challenging the movement of operations to emerging markets that offer more attractive growth opportunities. These tax authorities argue that reorganization constitutes a “transfer” that should give rise to an exit charge. It is important, therefore, for companies to consider the operational changes that must accompany a business restructuring.

More specifically, the restructured supply chain must carefully reflect the intended shift in functions, assets, and risks among the parties. The significance of this tax issue is highlighted by the release of Chapter IX on Business Restructurings in the

Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines). While the OECD Transfer Pricing Guidelines suggest that such restructurings will be disregarded or re-characterized only in exceptional circumstances, companies should expect challenges relating to the economic substance and business purpose of such restructurings. Accordingly, when considering an internal business restructuring, multinationals are advised to clearly demonstrate the business purposes and economic advantages relating to the restructuring.

Mergers and acquisitions (M&A)

Due to recent challenges in creating organic growth, industrial products companies with strong balance sheets have taken the opportunity to acquire the

The restructured supply chain must carefully reflect the intended shift in functions, assets, and risks among the parties

stock or business assets of other companies at competitive prices. For some companies seeking to streamline operations and remove non-core assets, divestment has been an attractive option. During the economic recession, deal volume and value declined in most industrial products sectors, including chemicals, metals, industrial manufacturing, transportation and logistics, and engineering and construction. As the economy continues to recover, with improved balance sheets indicating more internal financing capability, and healthier capital markets providing more external financing, there is an expectation that M&A activity will continue to increase.

Industrial products

Some of the largest business focused transfer pricing opportunities that arise in connection with M&A deals occur during the post-acquisition phase.

More robust M&A activity brings with it several pre- and post-acquisition transfer pricing considerations. Prior to an acquisition, a detailed due diligence review is needed to ensure the target company does not have any material transfer pricing exposures that could have a significant negative impact on the acquiring company going forward. In particular, during the due diligence phase, the acquiring company should look for exposures arising from non arm's-length pricing, lack of transfer pricing documentation, inconsistent transfer pricing policies or application of policies,

as well as the status of any rulings or APAs that may remain in effect subsequent to the acquisition. The acquiring company also has to consider how the transfer pricing policies of both companies can be unified going forward.

Some of the largest business focused transfer pricing opportunities that arise in connection with M&A deals occur during the post-acquisition phase. During this time, companies evaluate the transfer pricing policies of both the target company and the acquiring company and look for ways to harmonise the structures. When determining the optimal transfer pricing structure going forward, companies should consider any historical audit exposures, existing APAs, cost sharing arrangements, and tax authority rulings. The post-acquisition phase also may be an appropriate time to consider operational changes

for the acquiring company, such as centralising operations or intangible property, as well as evaluating the current supply chain structure. The post-acquisition period presents an excellent opportunity for a company to structure its intercompany pricing for the future in a way that is consistent with its operational and financial objectives.





Industrial products

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As the severity of the global financial crisis fades and the Euro zone shows signs of stabilising, governments continue to seek a cure for the economic stimulus hangover.

Progress, but no guarantees for the consistent treatment of intercompany financing transactions





Progress, but no guarantees for the consistent treatment of intercompany financing transactions

Current tax regimes in a post-crisis world

As the severity of the global financial crisis fades and the Euro zone shows signs of stabilising, governments continue to seek a cure for the economic stimulus hangover. Naturally, this remedy consists of a cocktail made of politically sensitive spending cuts mixed with the comparatively sweeter taste of changes in tax regulations and treaties. Consistent with this theme, the OECD, in its review of base erosion and profit shifting (BEPS), has been proactive in recognising the pressures that the new economy has imposed on the wealth of nations. In short, the review aims to determine whether current tax regimes allow for the allocation of taxable profits to locations other than where the actual business activity occurs, and to provide strategies for those countries concerned about BEPS.

Not surprisingly, intercompany financing transactions are highlighted both in the BEPS initiative and in three documents published by the OECD in July 2013, namely, the *Action Plan on Base Erosion and Profit Shifting*, the *White Paper on Transfer Pricing Documentation*, and the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*.

Collectively, these documents recognise the transfer pricing and tax treatment of intercompany financing transactions in a level of detail not seen before. This is not to say they provide guidance to the transfer pricing community on how to price these transactions (this guidance is anticipated with the release of the revised transfer pricing guidelines in December 2015); rather, they provide a clear indication that we can expect more attention paid to the arm's

Post-crisis: Expect more focus on arm's length pricing & tax treatment

length pricing and tax treatment of these transactions from both tax authorities and financial statement auditors.

This guidance should be welcomed because it attempts to establish at least some consistency among global members of multinationals. For example, in the *White Paper on Transfer Pricing Documentation*, the OECD proposes a masterfile portion to documentation that gives information on a multinational's intercompany financial activities accompanied by a local country file demonstrating that the MNE has complied with the arm's length principle in that country. Clearly the objective is

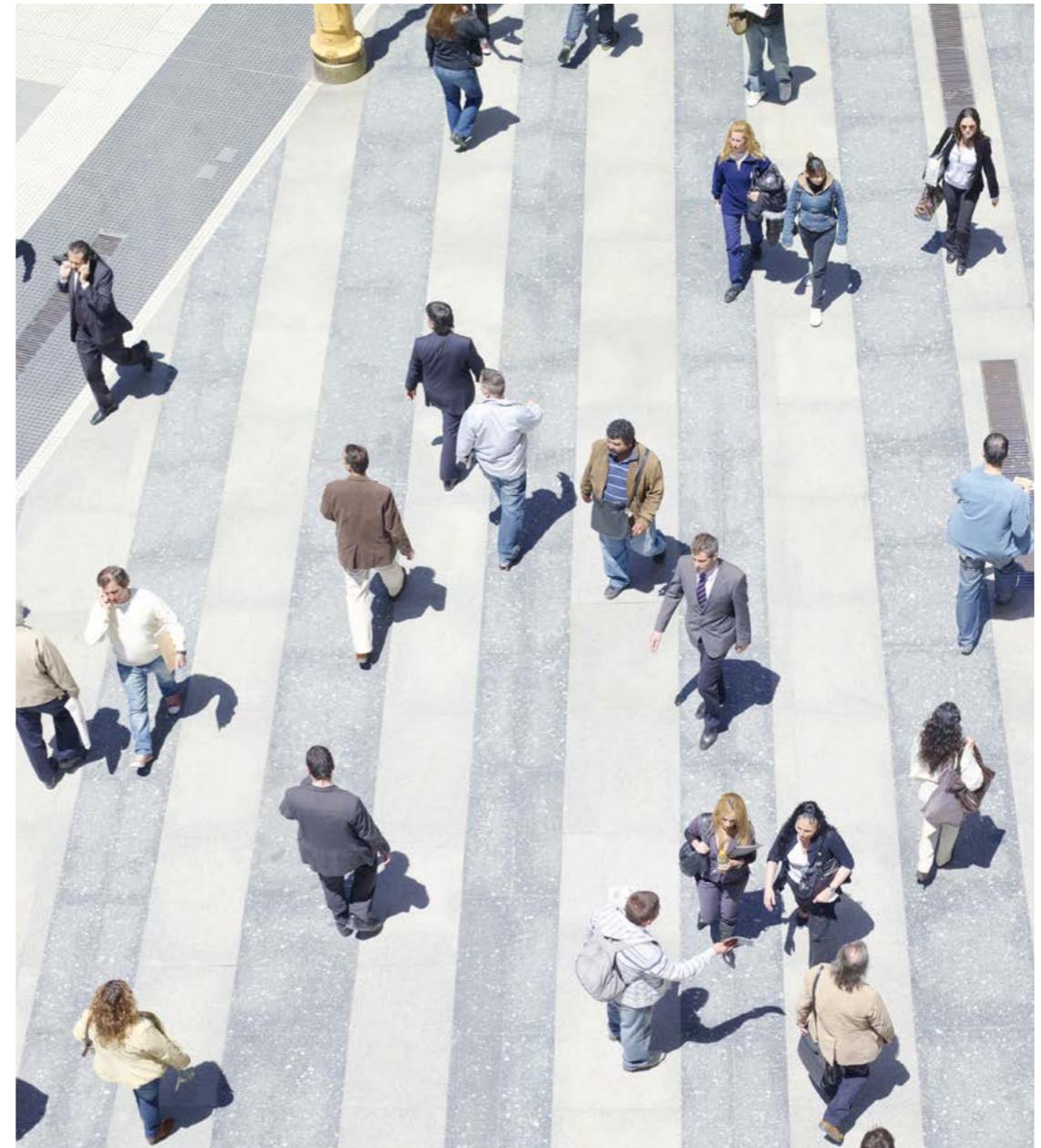
¹ At stake for Tyco is \$883.3 million in additional taxes plus penalties of \$154 million related to an IRS challenge of intercompany financing with certain international subsidiaries related to acquisitions and restructurings in the late 1990s. At stake for Ingersoll-Rand is a potential levy of \$400 million and \$700 million of additional withholding and income taxes with respect to a portion of the interest payments on intercompany debt to a Bermudan affiliate.

Progress, but no guarantees for the consistent treatment of intercompany financing transactions

to improve the ability of a tax authority to evaluate transfer pricing risk specific to individual financial transactions and verify the consistent application of a transfer pricing policy to these transactions.

For financial transactions, the proposed approach to documentation is superficially simple and yet fundamentally complex, as evidenced by our PwC survey of 40 countries that addresses these issues. The survey focuses on country-specific legislative requirements for pricing of intercompany loans as well as staff's experience with tax authorities' positions on various aspects of the transfer pricing of financial transactions.¹

Based on the responses, it is clear that transfer pricing legislation and general practice with respect to these issues is inconsistent across territories and, in many cases, still evolving. Nevertheless, some key themes have emerged from the survey in relation to (i) whether transfer pricing and thin capitalisation rules are embedded in tax law; (ii) generally accepted methods to evaluate arm's length interest rates on intercompany loans; (iii) the preferred method to evaluate the arm's length nature of guarantee fees; and (iv) whether passive association (i.e. where the creditworthiness of the subsidiary is evaluated based on its membership in a multinational group and assumes that the parent will intervene if the subsidiary encounters financial difficulty) should be accounted for in analysing arm's length interest rates and guarantee fees.



¹ <http://www.pwc.com/managingthecomplexity>

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Transfer pricing and thin capitalisation rules

While transfer pricing rules and thin capitalisation rules are embedded in the tax law of most responding countries, the transfer pricing rules are often not specific to financial transactions (such rules that explicitly address financial transactions primarily address intercompany loans, in particular in terms of volume and interest rate, with only limited rules addressing intercompany guarantees and cash pooling). To the extent that a country lacks specific guidelines for evaluating transfer pricing applied to intercompany financial transactions, the broader guidance provided in the OECD Transfer Pricing Guidelines is typically referred to.

The most commonly accepted method to evaluate arm's length interest rates on intercompany loans is the internal or external

comparable uncontrolled price (CUP) method; over 80% of respondents indicated that the CUP method is accepted, with the remaining respondents reporting no clear guidelines on accepted methods or very specific rules in the transfer pricing regulations.

Application of the external CUP method should typically

take into account the terms and conditions of the loan and the creditworthiness of the related party debtor based on a credit scoring analysis as a distinct and separate enterprise. Bank quotes are accepted in approximately one-third of the responding countries, but typically only as secondary evidence of the arm's length nature of the interest rate applied.

Generally accepted methods to evaluate arm's length interest rates on intercompany loans



Survey: CUP method most commonly used for evaluating arm's length interest rates

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The CUP method and the benefit method are the most commonly accepted methods to evaluate arm's length guarantee fees for intercompany guarantees. The benefit approach analyses the interest rate benefit obtained as a result of the guarantee and splits this between the guarantor and the guaranteed.

Other methods often accepted are the cost of capital approach, where the guarantee fee is determined based on the cost of the guarantee to the guarantor (typically determined by analysing expected loss on the guarantee and the cost of capital to be maintained in relation to the guarantee), and analysing the fees paid on credit default swaps on bonds with characteristics comparable to the guaranteed transaction (i.e. primarily the credit rating of the guaranteed). Other approaches include calculating the guarantee fee as (i) the value of a put option;

and (ii) the multiplication of the expected default frequency, the underlying asset valuation, and the loss given default of the guaranteed asset.

As the results show, there is no common approach for accounting for passive association in substantiating the arm's length nature of interest rates and guarantee fees. Nonetheless, the OECD embraces the concept of implicit support in the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, which includes an example that recognises that implicit support is a synergistic benefit and not a compensable benefit.

Generally accepted methods to evaluate the arm's length nature of guarantee fees



Passive association/implicit support



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Conclusion: Challenges presented by inconsistency and unclear guidance

The PwC survey highlights the current inconsistency and lack of clear guidance in global transfer pricing rules and in the planning and management of intercompany financial transactions from a transfer pricing perspective. This collectively presents challenges in the global context, and the 2015 guidance anticipated from the

OECD should be welcomed from a compliance perspective. In the interim, common practices can be identified to help ease some of the compliance burden. These practices can also be used as a basis for the master file and local country documentation discussed in the White Paper for Transfer Pricing Documentation when addressing an organisation's main financial transactions.



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The authors urge financial institutions to integrate their transfer pricing execution and reporting with the implementation of modified financial reporting processes arising from recent regulatory changes, noting the greater need for regulated entities to prove out and consider inter-company transactions from all angles and provide arm's length support for each participant's results.

Regulatory reform in the financial industry and end-to-end transfer pricing execution





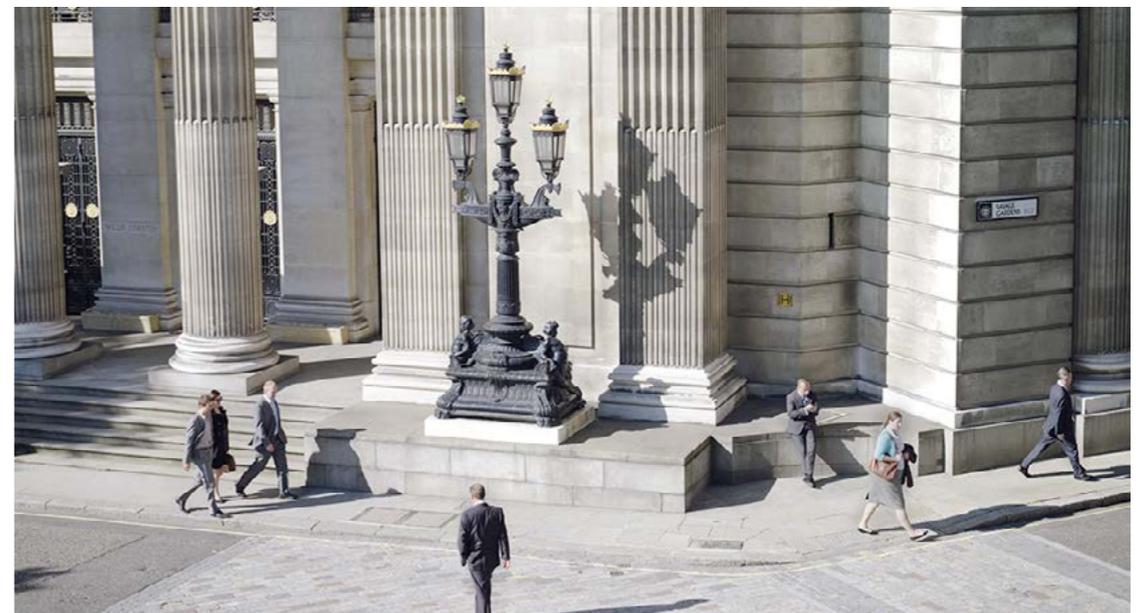
Regulatory reform in the financial industry and end-to-end transfer pricing execution

The recent financial crisis made clear to the world that the current operative regulatory rules and oversight were ill-suited to the way financial markets have evolved. And that reform was long overdue. Undoubtedly regulatory reform is a global agenda addressing multiple fronts. Countries active in the global financial markets have been taking measures to improve the controls governing the capital markets, with the immediate objective of protecting their own economy and fiscal health. These measures include improving transparency in securities trading among market participants and individual investors as well as tightening legal entity accounting and valuation protocols within a global institution. The U.S. has certainly been the most assertive and prescriptive in pushing legislation around these measures.

How will regulations affect banks' global capital usage and other operations?

When the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in 2010, banks as well as non-bank financial institutions braced themselves and started to devote significant resources to preparing for the significant fundamental changes to their compliance, reporting and operational structures. The U.S. was the first to adopt such broad regulatory reform into law, but other countries are fast on its heels, with provisions regarding capital requirements, ring-fencing and other measures. Whether these separate country initiatives will converge into a consistent and common regulatory landscape in application is undetermined. Regulatory capital requirements

will be uniformly increasing under Basel III and some countries will be going beyond Basel III requirements.¹ However, local regulatory definitions of types of capital that meet the various tiers or the risk-weighting of assets are still in flux with potential inconsistencies that banks now need to consider in optimising their global capital usage.



¹ In addition to risk-based capital requirements, U.S. regulators are proposing a higher leverage ratio for the eight largest U.S. bank holding companies that have been identified as global systemically important banks and their FDIC-insured bank subsidiaries at 5 percent and 6 percent, respectively. See Crittendon, Michael, "Plan Reins In Biggest Banks: Proposal Requiring Extra Capital Would Force Firms to Be More Conservative or Shrink," Wall Street Journal, July 9, 2013.



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One thing that is evident is that institutions need to tighten up on controls, process and execution of their governance policies, not least of which relates to their intercompany arrangements and dealings.

Ability to generate standalone legal entity financial statements key to compliance, but challenges are plenty

One of the chief impacts of these measures in the emerging regulatory environment is the requirement of institutions to reliably and accurately produce separate legal entity reporting of their financial positions on an ongoing basis. The ability to generate stand-alone legal entity financial statements is the cornerstone of an institution's ability to comply with the various regulatory changes around the

world. But this is an area in which many financial institutions have considerable process and system challenges. Many have seen acquisitions as a means to achieve their growth strategies, which have led to managing different types of legacy systems – whether at source data level or reporting platforms – without having properly and fundamentally reconciled these disparate systems. Global financial institutions have highly integrated operational structures heavily reliant on shared technology, operations, management and other critical infrastructure across multiple legal entities. Historically, they have not always applied the same level of diligence in accurately processing their intercompany arrangements as they do for third-party transactions, despite the fact that for many overseas subsidiaries of U.S. financial institutions intercompany transactions represent the greater part of their income.

Regulatory reform's impact on intercompany arrangements

The clearest manifestation of regulatory reform's impact on intercompany arrangements originated in the U.S. through specific provisions of Dodd-Frank. The U.K. has also recently enacted a rule requiring a nominated "senior accounting officer" to verify that financial statements reflect appropriate tax accounting arrangements. As other countries continue their own local agendas, a closer examination of these recent laws is mandatory in evaluating whether an institution is capable of reporting under these new standards.

This analysis begins with a review of the specific key provisions under Dodd-Frank for which successful compliance with the new regulatory requirements is acutely affected by the institution's operational execution



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of intercompany and affiliate transaction pricing policies. Often transfer pricing policies have been viewed in isolation as a cross-border tax matter with an occasional nod to its U.S. regulatory equivalent – the Federal Reserve’s Regulation W implementing Sections

23A and 23B of the Federal Reserve Act.² However, there is now wider recognition that the tax and regulatory governance of intercompany arrangements needs to be reconciled, both from a policy as well as an execution perspective.

Impact of Dodd-Frank

At the heart of Dodd-Frank is the need to ensure that a regulated institution is adequately capitalised and that it is sufficiently protected from risk that is created or borne by affiliates. All roads therefore lead to the following fundamental question regarding separate-entity reporting of the affected regulated entities and the operational framework: Are the assets, liabilities, revenues and expenses reported by the regulated entity complete, appropriately valued and appropriately classified?

For third-party dealings, the general accounting rules and regulations tend to ensure appropriately transparent accounting and operational processes as a general matter. However, the strict processes, procedures and discipline around external market transaction accounting and disclosures have often not been carried through to intercompany and affiliate dealings. An extreme scenario, which is not uncommon among some of the largest and most complex institutions, is one in which all

² These provisions govern transactions by a U.S. bank with its affiliates.



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intercompany transactions are captured and accounted for on a net basis through a single below-the-line intercompany settlement account irrespective of the nature of the intercompany arrangement – often with poor audit trails back to the source. Not least of the distortions created by this simplified accounting is that on a gross basis, a firm's assets, liabilities, revenues or costs are understated. This has immediate implications on the same inputs that drive capital requirement calculations.

A few factors have created the more lax operational environment around intercompany transactions as compared to external transactions:

- The increasing centralisation of operations within most multinationals has created a less direct accounting link

Strict discipline around external market transaction accounting and disclosures has often not been carried through to intercompany and affiliate dealings

between the costs incurred by the firm and the ultimate end-user business unit or legal entity that might rely either directly or indirectly on these centralised resources. In turn, there has been a vast increase in cost centers that require active mapping and profit or revenue center allocations. Further, various entities might serve as this operational or management hub, and therefore an end-user of one service is a provider of another.

- Many firms are measured more on management reporting

that is legal-entity neutral (that is, based on a region or a business segment) than on separate legal entity results. This has deemphasised the need to understand legal entity relationships and to ensure that transactions are fully recognised and recorded at the local statutory levels.

- To date, statutory audit and accounting governance has focused on controversial accounting methods such as Repo 105³ rather than on intercompany transactions with the proviso that they should completely eliminate at top-level consolidations, notwithstanding that local statutory financial statements would reflect their side of the offsetting accounts.

As a result, as firms try to align their operational, governance and control infrastructure to comply

³ Under Repo 105, a short-term deposit is classified as a sale, and the resulting cash is used to pay down debt. This allows the company to appear to reduce its leverage for purposes balance sheet reporting. After the reports are published, the company borrows cash and repurchases its original assets.



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with Dodd-Frank and other regulatory requirements, the status of an institution's intercompany and transfer pricing policy execution framework has become one of the primary areas of focus.

There are a few key initiatives and provisions within Dodd-Frank in particular for which the level of intercompany and transfer pricing operational framework is most visible. The initiatives to be discussed in this article are:

- capital requirements,
- resolution and recovery plans and
- swaps and derivatives push-out rules.

Bank capital requirements

Adequate capitalisation of a legal entity is based on the riskiness of the assets and liabilities on – and in some cases, off – its balance sheet and the stability of the revenues it derives and costs it bears to drive its profitability.

For a regulated entity that relies significantly on its affiliates for revenue, services and balance sheet usage, the accurate execution of the intercompany dealings is essential to the question of the required level of capital for that entity if valued on a pure, stand-alone arm's-length basis in which all the support provided by its affiliates (or that it is providing to other affiliates) are appropriately measured and reported on the balance sheet and income statement.

Resolution and recovery planning

Resolution planning requires that large U.S. banking organisations and certain designated systemically important non-bank financial companies submit to the regulators on an annual basis a resolution plan for their market-facing regulated entities under a hypothetical failure scenario. Usually the plans include courses of action for recapitalisation,

disposals or bankruptcy. In any of these scenarios, being able to provide accurate separate-entity financial positions is critical to the efficacy of the plan. Given that most regulated entities generally rely heavily on resources not directly within the control or sponsorship of that entity, a significant element of their financial position is driven by its intercompany dealings – including the need to capture service fees and cost allocations due to services being provided by an affiliate. Therefore, it is essential that the intercompany policies in place are implemented and executed correctly.

The execution includes ensuring not only that the correct costs and revenues are included in the calculations, but that the legal agreements are explicit about the nature of the services or goods being made available along with the risks. The exercise of preparing a resolution plan starts



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with a hypothetical scenario of being cut off completely from the support of affiliates. What are the operational, financial and management support functions that must now be provided by an external party – and at what price would the regulated entity be charged? Once these dependencies are identified, the existing intercompany transactions

should naturally already be priced and settled at arm's length and properly reflected on a stand-alone basis today.

Swaps and derivatives push out rule

Under the swaps push-out rule of Dodd-Frank, U.S. banks are required to push out certain swaps and derivative activities

to non-bank affiliates subject to Regulation W requirements.

This raises two scenarios regarding intercompany arrangements:

- a one-time intercompany transfer of the associated business or assets and
- potentially new or revised intercompany arrangements.

The question of a one-time intercompany transfer of a business or assets requires appropriate valuation of the related business or assets. As most assets, especially financial instruments, are generally accounted for on a mark-to-market basis, this should not be a significant issue. However, if there is a transfer of a broader business, then one must consider a more holistic valuation of the business itself, which includes identifying



⁵ Net interest is calculated as interest expense to related parties less corresponding interest income. Adjusted income is defined as taxable income, adding back interest expense, depreciation expense and exempted dividend income, but excluding extraordinary income or loss.

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the projected cash flows that account for prospective inter-company services expected to be performed. Generally, projections rely on past and current actual levels of costs and revenues, and therefore it is important to ensure that current execution of transfer pricing policies have resulted in accurate charges and service fees so that the projections built on historic figures are reliable and not distortive to the overall valuation.

Similarly, when a segment or business is transferred from one legal entity to another, new intercompany arrangements may be created due to the fact that some of the activities in support of the swap business that formerly were carried out by the same legal entity will not or cannot migrate with the swap trading activities. Therefore, these new intercompany services will need to be identified, priced and ultimately executed appropriately



to ensure that the separate-entity reporting of the business is accurate and complies with regulatory requirements.

Arm's-Length Pricing: 'Reg W,' Section 482

There has always been a natural overlap between the regulatory oversight of bank transactions with affiliates and the rules governing related-party pricing for tax purposes. The tax world has regulations under Internal Revenue Code Section 482, while

the U.S. banking regulatory world has Regulation W implementing Sections 23A and 23B of the Federal Reserve Act. There are a few nominal but real differences between the two in their respective historic applications, the most notable being that the Section 482 regulations generally provide a multi-party evaluation of the arm's-length pricing from the perspective of all participants to the transaction, whereas Section 23B is usually one-sided, from the perspective of the regulated entity



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only. That is, the bank transaction is on pricing terms that are at market rates or better, irrespective of results to the non-bank affiliate.

A brief background and history of each would be helpful to understanding why this coincidence and overlap has evolved into an outright convergence of principles and governance across the two regimes since Dodd-Frank.

Sections 23A and 23B make clear that the primary concern of regulators is to ensure that an entity is not, by virtue of its dealings with its affiliates, inadvertently exposed to its affiliates' financial and operational risks. Section 23A has a long history and is basically intended to ensure that banks are not unduly exposed to credit risks arising from transactions with affiliates. Section 23B has a much shorter history and is intended to ensure that a bank's

service and other transactions with affiliates are on market terms and conditions. The purpose of Section 23B is to ensure a bank is not using service contracts as a way to unfairly shift costs of operations to the bank, which can be financially damaging to the bank and a means for non-bank affiliates to price more aggressively than their competitors. Much of Sections 23A and 23B focus on enumerating financial and securities dealings with affiliates as greater concerns of the regulators.

With Dodd-Frank as the catalyst, affiliate service transactions have become much more prominent as entities work on provisions such as resolution planning. Resolution planning forces regulated entities to imagine being completely cut off from affiliates. What management, operational, administrative, infrastructure and other types of support would they now need to contract with third parties under

third-party terms and conditions? In this context, it is then expected that market prices and terms should already be reflected in the prices and terms for all of the affiliated service transactions and relationships in place today. Further, as an entity regulated under the one regulatory body such as the Federal Reserve may be transacting with another entity that is regulated under another agency such as the Financial Industry Regulatory Authority or the Commodity Futures Trading Commission with similar expectations of market pricing in affiliate transactions, the axiom of "market price or better" is compressed into "market prices," with less bandwidth for a onesided evaluation. Similarly, other bank regulatory bodies such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have an expanded role under Dodd-Frank to interpret and apply Sections



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23A and 23B to arm's-length transactions between banks and non-bank affiliates.

A bank's transfer pricing compliance process on its cross-border related-party transactions is the obvious and ready platform for regulatory compliance on affiliate transactions. For starters, the Section 482 regulations are vastly more rigorous than Reg W, Section 23B in the requirements to substantiate the arm's-length nature of related-party transactions. The Section 482 regulations provide for specific methods that can be applied in evaluating these transactions and require that the taxpayer consider the appropriateness of each method before selecting the best method to apply.

Section 23B does not elaborate further than the requirement that affiliate pricing should be comparable to market prices.

How exactly a bank can go about substantiating the market value of its affiliate pricing arrangements is not addressed. As a result, banks' historic experiences with regulators on this issue, according to anecdotal evidence, have been inconsistent and unpredictable. Banks' more recent experience speaks to more proactive scrutiny of affiliate service transactions with a dramatic uptick in requests for supporting documentation and analyses. No longer are regulators satisfied that some charge has been made and that the results are not unfavorable to the bank. They want the assertive analysis that the value of the charge is comparable to what would occur in a third-party arrangement and have started to more fully align, intentionally or unintentionally, with the provisions and standards of the Section 482 regulations.

Therefore, a bank's existing transfer pricing policies and

governance process to address cross-border transactions is the natural starting point to see how these can be extended and applied to affiliate transactions involving regulated entities, whether domestic or crossborder. And even more critical to regulatory compliance is the execution framework once transfer pricing policies have been established.

U.K. senior accounting officer provisions

In 2009, the U.K. introduced senior accounting officer (SAO) rules that require qualifying companies to nominate an SAO that is personally responsible for taking "reasonable steps to ensure the qualifying company establishes and maintains appropriate tax accounting arrangements." Within the rules, tax accounting arrangements are described as the end-to-end process "from the



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initial data input into accounting systems to arriving at the numbers which form the basis for completion of the tax return.”

In 2012, following revisions to the original rules, banks were brought within scope of the SAO rules such that today, banks with sizable U.K. operations are likely to qualify and be required to certify compliance with the SAO rules each year.

Many banking institutions will have transfer pricing policies that cover material cross-border transaction flows. The implementation of these transactions may involve tax accounting arrangements that span multiple jurisdictions and require data from several information sources. The complexity of these arrangements mean transfer pricing execution is becoming increasingly important for banks operating in the U.K. that are required to comply with

SAO rules.

Transfer pricing execution framework

It is therefore growing increasingly important for financial institutions to be able to “prove out” the implementation or execution of the policy in their books and records. This step is an integral part of the end-to-end processes and data flows that take a transfer pricing strategy all the way through to local financial statements and tax returns. This end-to-end execution is even more important for regulated entities in their reporting for intercompany transactions.

The increasing importance of legal entity governance continues to put transfer pricing execution higher on the agenda of executives and controllers. Where a unilateral focus was historically allowed, institutions are now faced with the requirement to look at transactions from all angles and provide

arm’s-length support for each participant. Add to this the lack of underlying execution groundwork and systems support, and financial institutions are faced with an extremely challenging time with significant constraints.

In some instances the issue may be even more acute – for example, in locations where the majority of the activity is intercompany, with little third-party activity. This results in jurisdictions where the impact of inaccuracies in transfer pricing execution for one transaction may result in material errors and restatements. The difficulty in managing this level of vulnerability can affect a company’s effective tax rate.

Execution risks

Large financial institutions in particular have built up constraints and obstacles over time due to the highly complex nature of their operations. These transfer



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Symptoms of transfer pricing execution challenges

Transfer pricing execution difficulties stem from a number of sources. When multiple difficulties are present in one instance, the uphill battle to execute transfer pricing policies can be exhausting and frustrating. As outlined earlier in this article, the picture is similar for large financial institutions trying to ensure their intercompany and affiliate pricing is executed accurately.

Some typical symptoms of intercompany execution challenges include:

- “hero dependency” – the overreliance on key individuals – in tax and accounting or controllership;
- a patchwork of data sources and Excel spreadsheets, and concern that enterprise and resource planning system do not provide sufficient functionality to

adequately maintain and monitor the transfer pricing results;

- undocumented interpretations of ambiguous terms in intercompany agreements;
- informal process hand-offs relying on goodwill and personal relationships, which create multiple manual processes;
- quarterly or annual close processes creating frustrations for tax, controllership and information technology;
- transfer pricing results themselves that are not consistent from period to period and cannot be easily explained, which mean that effective tax rate forecasts are hampered by lack of information at the entity or country level; and
- “near misses” and concern about the SarbanesOxley controls position.

Where to begin

Companies can establish a more strategic approach to managing intercompany processes that moves beyond typical ad hoc activities and manual data collection and also aligns all relevant control groups to more effectively monitor and implement intercompany policies and procedures. Successful companies focus on the people, process, and technology aspects to bring their organisations into alignment around the relevant transactions and processes.

For banks and other regulated institutions, this means a renewed focus on developing a transparent and collaborative team that works towards the same goal while achieving personal goals along the way.

The value to be realised

The more efficient and aligned the functions involved in executing intercompany pricing that feed

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into local statutory accounting, the more value can be realised. Examples of value typically observed include:

- statutory and regulatory requirements that are met in a more timely and efficient manner,
- reduced audit risks,
- better internal tax controls,
- a faster close process,
- automated and standardised data collection processes and transfer pricing calculations,
- rationalised IT and systems investment,
- decreased costs of audit defense,
- improved cash tax management,
- a completed transfer pricing scenario analysis, and
- reduced indirect tax compliance costs.

Conclusion

Today's financial institutions operate in a highly integrated manner across multiple regions

and functional groups, and ultimately across the branches and legal entity subsidiaries in which they operate. This has resulted in greater reliance on one another among branches and separate legal entity subsidiaries for capital, infrastructure and operational support. Not least of the affects of banking reform is the heightened need for end-to-end processes that are complete, reliable and sustainable to ensure accurate and complete execution of intercompany pricing policies. Therefore, as a financial institution navigates through the ongoing changes in the regulatory landscape, in developing strategy and planning for regulatory compliance and optimising capital usage across the globe, all control groups within the institution – legal, regulatory, treasury, finance and controllership as well as tax – require an active seat at the table.

Get more out of what you are already doing

So what does this mean for the financial institutions' current efforts?

One immediate opportunity is to get more out of what you are already doing. For starters, financial institutions have already been doing a lot since the early winds of regulatory reforms were felt post-2008. These efforts have included, among others:

- legal entity rationalisations,
- business unit realignments and migration,
- diagnostics of systems capabilities and constraints and
- modification or new builds of financial systems including revised or new reporting hierarchies and improved integrity of source data flows.



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Given how highly dependent regulatory compliance might rest on accurate and efficient execution and reporting of intercompany transactions, proactively considering and implementing intercompany as well as third-party transactions in the existing work streams is both necessary and highly beneficial. In addition, such activity might involve only incremental supplementing of the existing resources and expenses relative to the size of the overall investments.

Below are just a few examples of how including transfer pricing as an important stakeholder and sponsor in aspects of regulatory reform initiatives can optimise the results from the large investments currently being made in the way of internal resources, costs in-

curred for infrastructure changes and use of external advisers:

- Identifying opportunities to improve accuracy and efficiency in intercompany pricing data sourcing, calculations and reporting. This may include transfer pricing input into the definition of profit and cost center attributes, mapping or hierarchies by legal entities at the source data level.
- Expanding, modifying or designing reporting capabilities to improve transparency of intercompany transactions. This may include trying to automate as much as possible the aggregation of certain data, calculations processed directly in the system and providing analytics for more efficient and flexible sensitivity analyses to monitor intercompany transactions and impacts on each legal entity.
- Expanding, modifying or designing the overall policies and processes governing intercompany pricing calculations, journal postings and reporting. These should include unambiguous sets of policies, roles and responsibilities across all the relevant control groups such as tax, business unit and legal entity controllerships, regulatory, treasury and legal departments. Continued governance in the development of segmented legal entity reporting and implementing appropriate procedures around this process ensures that the value of the initial investment and control level are realised and optimised over the long run.

In this regard, the authors suggest that the institution formally include transfer pricing policy execution and accounting as an



Regulatory reform in the financial industry and end-to-end transfer pricing execution

objective of regulatory reform project plans due to the natural synergies mentioned above. Tax, transfer pricing and intercompany accounting control teams should be involved at the appropriate stages throughout the life cycle of these projects to assist in defining data and reporting requirements, and ongoing process and governance procedures.

The authors have assisted with and witnessed the short-term and long-term benefits of strategic alignment of resources, budgets and objectives on infrastructure to meet multiple objectives. As advisers actively working with institutions in their respective response to regulatory reform and compliance efforts, the authors view the work currently being undertaken on financial reporting institution reporting as a natural and critical opportunity to embed the data, reporting and control requirements around intercompany transactions.



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Regulatory reform in the financial industry and end-to-end transfer pricing execution

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The new Russian transfer pricing rules came into effect on 1 January 2012.

Russia's new rules: Overview and practical aspects





Russia's new rules: Overview and practical aspects

The new Russian TP rules came into effect on 1 January 2012. In comparison with the old rules, which were outlined in Article 40 of the Russian Tax Code (the Code), the new rules are largely based on TP Guidelines of the Organisation for Economic Co-operation and Development (OECD), but also contain certain peculiarities that can trigger TP issues for both related and unrelated companies transacting with domestic and cross border counterparties. A number of amendments regarding the deadlines for submission of the 2012 TP notification on controllable transactions and TP documentation were recently introduced into the rules. Due to the fact that the deadlines have been moved, companies now have more time for 2012 TP compliance. However, taxpayers should start planning the TP documentation process for 2013 beforehand.

Starting from 2013, the financial thresholds for controllable transactions will decrease and more transactions will potentially fall under control from the Russian TP perspective, thus increasing the volume and the complexity of the analysis.

The main changes in the Code in relation to TP include, among others, introduction of the arm's length principle as a fundamental principle of the Russian TP rules, setting the ownership ratio at which companies are considered related at 25 percent, etc.

This article focuses on:

- changes in the Russian tax authorities' structure aimed at TP matters and introduction of special TP audits to be conducted by the Federal Tax Service (FTS);
- introduction of reporting and TP documentation requirements

and penalties for non-compliance;¹

- introduction of APA procedures;
- practical hints and recommendations for Russian taxpayers.

Overview of tax authorities' structure

Prior to discussing the substance of the main changes to the TP rules and relative practical recommendations, we provide a brief overview of the structure established to oversee TP matters by the Russian tax authorities. In order to monitor compliance with the newly established rules and to perform tax control, the Ministry of Finance of the Russian Federation established a new department dedicated to TP issues (Department of International Relations and Transfer Pricing of the FTS). The main functions of this department include performance

¹ No penalties can be assessed for 2012-2013 transitional years in case of TP adjustments

Russia's new rules: Overview and practical aspects

of TP audits, conclusion of APAs, analytical and tax control procedures.

In addition to that, the FTS and the Federal Anti-monopoly Service set up a dedicated workgroup dealing with TP matters. Its main objective is to propose improvements to tax and antitrust legislation in the area of identifying arm's length prices. This work- group is expected to focus on common approaches to law enforcement practices.

Further, the Specialised Inter-regional Inspectorate for TP was created in April 2012 and currently employs approximately 200 specialists. Its main functions include collecting, processing and analysing information on intercompany transactions, analysing and evaluating market prices, identifying mechanisms for tax underpayment, responding to TP inquiries from central and local government authorities as well as

supporting the automatic selection of taxpayers for TP audits.

The above changes imply that the Russian tax authorities intend to pay close attention to TP matters. Their knowledge of basic principles will gradually grow and they will increasingly apply international practice in Russia.

Russian taxpayers could be facing audits from the Department of International Relations and Transfer Pricing in connection with controlled transactions and the arm's length nature of the pricing, as well as audits from the regular federal tax inspector on general tax matters. These audits could happen at different times and will be independent of each other.

TP compliance

Taxpayers are obliged under the Russian TP rules to prepare and submit notifications on controlled transactions and TP



Russian taxpayers could be facing audits from the Department of International Relations and Transfer Pricing in connection with controlled transactions and the arm's length nature of the pricing, as well as audits from the regular federal tax inspector on general tax matters.



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documentation which may be requested by the Russian tax authorities. The list of transactions subject to TP control specified by the Code includes cross border and domestic transactions between related parties, as well as a number of other transactions which may be considered as controllable (such as foreign trade transactions with exchange traded commodities, etc.).

A. Controlled transaction notification

Corporate taxpayers conducting business in Russia need to prepare and file the notification on transactions subject to TP control annually in order to comply with the reporting requirements. The notification form should contain information on the following:

- controlled transactions, including the amount of income derived and expenses incurred;

- the subject of the controlled transaction, including the relevant contract number, the amount, delivery terms and the price;
- the legal entity/ individual which is party to the controlled transaction.

The Russian tax authorities indicate that the notification should be prepared for each controlled transaction, therefore filing of notifications may prove to be quite a cost- and time-consuming process. Although the penalty for non-submission of the TP notification is not high,² the risks for taxpayers could be quite significant. As the notifications will be used by the tax authorities for conducting a pre-audit review and selecting entities to undergo tax control measures, non-submission of this form or submission of an improperly completed form may serve as a “red flag” and

trigger more questions. In order to maintain good relationships with local tax authorities, Russian taxpayers should strive to be fully compliant with the new TP requirements.

B. Documentation

In the autumn of 2012 the Russian tax authorities issued a Letter³ providing detailed guidance and practical recommendations on preparing and filing TP documentation, as prescribed by the Code. Although the Letter is non-binding, the guidance it provides is useful and it will likely be applied by the tax authorities during their reviews of taxpayers' documentation.

In addition to the Code, this Letter explained how to classify parties to a transaction, which transactions require documentation and how to select a pricing methodology, the content of the documentation,

² RUR 5,000, approx. US\$150.

³ Letter of the Federal Tax Service dated 30.08.2012 No. OA-4-13/14433 “On the preparation and submission of documentation for the purposes of tax control”

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the level of detail required in the documentation, the filing deadline and the archiving period.

The Letter indicates that taxpayers must file documentation at the request of the FTS.⁴ The FTS reckons that the taxpayer's document filings will be used for conducting a pre-audit review and selecting an entity to be subject to a TP audit, as stipulated in Chapter 14.5 of the Code. There are situations in which the Russian

tax authorities may request TP documentation, namely during a TP audit or at any time after June 1⁵ of the year following the year in which the controlled transaction took place, irrespective of whether a TP audit has been commenced.

When preparing the documentation, taxpayers should consider that Russian tax authorities prefer the transactional approach. Thus all transactions should be analysed

separately and taxpayers should consider the specific features and economic circumstances of each controlled transaction (a group of homogeneous transactions).

For 2012 – 2017, the Russian tax authorities have set a transitional period during which the financial threshold for controlled transactions will gradually decrease. The summary of documentation requirements is presented in Table 1.

Table 1: Documentation requirements

Period of audit	Requirements on preparation of TP documentation		
	Penalty for non- submission	Cross-border transactions	Domestic transactions
2012	n/a	if > 100 mln RUR (appr. US\$ 3,5 mln)	if > 3 bln RUR (appr. US\$ 107 mln)
2013	n/a	if > 80 mln RUR (appr. US\$ 2,8 mln)	if > 2 bln RUR (appr. US\$ 71,4 mln)
2014-2016	20%	all transactions	if > 1 bln RUR (appr. US\$ 35,7 mln)
2017	40%	all transactions	if > 1 bln RUR (appr. US\$ 35,7 mln)

⁴ Art. 105.15.1 Code

⁵ For year 2012 this date has been moved to December 1.

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C. Filing deadlines

As the rules are fairly new, the authorities continuously develop them and introduce necessary changes. One of the most important changes has been recently introduced, including the new deadlines for submission of TP notifications.

Federal Law No.39-FZ of April 5, 2013, introduced amendments regarding deadlines for submission of the 2012 notification on controlled transactions and preparation of 2012 TP documentation reports. The new dead- lines for submission

of notification, request of documentation by tax authorities and TP audit are summarised in Table 2.

The deferral of deadlines is an opportunity for taxpayers to increase the quality of their TP documentation –the tax authorities will widen their expertise and be much more prepared by 30 June 2014.

D. Intercompany financing

The new TP rules did not provide clear guidance on TP control for intercompany financial arrangements, as prior

to Federal Law No.39-FZ, the Russian tax authorities provided recommendations in relation to loans only in unofficial discussions and Q&A sessions. The Law put an end to this ambiguity and gave more clarity on financial transactions.

According to the recent clarification, the TP rules will not apply to transactions concluded before 1 January 2012 which relate to bank loans, loans granted by non-banking organisations (including commodity and commercial loans/deferrals of payments), guarantees, except for

Table 2: Deadlines

Document	Earlier established deadline	New deadline
Submission by taxpayers of the notifications on controllable transactions	20 May 2013	20 November 2013
TP documentation may not be requested by the tax authorities earlier than	1 June 2013	1 December 2013
The deadline for the issuance of the decision on the initiation of the 2012 TP audit not later than	31 December 2013	30 June 2014



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transactions for which the terms were changed after 1 January 2012. Therefore, if a taxpayer needs to change the terms of the loan due to certain business reasons, it is recommended that those changes are done under the frame of a new contract.

APA programme availability

The new TP rules introduced APA procedures for the “largest” taxpayers. The main aim in concluding an APA is to facilitate negotiations between the taxpayer and the tax authorities in order to avoid disputes regarding TP issues. It is worth noting that unilateral or bilateral APA procedures are available and could be concluded only for one specific type of transaction (group of homogeneous transactions). Therefore the conclusion of APAs could be rather time-consuming and costly for the taxpayer if it has

a number of different groups of controlled transactions.

Further to the introduction of actual TP rules, the Russian tax authorities issued a Letter⁶ providing more specific guidance on how the new rules will be implemented. Among other practical recommendations, the Letter introduces a pre-filing stage when taxpayers could evaluate the cost effectiveness of conducting an APA. According to the Code the APA period cannot exceed three years and can be renewed for no more than two years. Breaching the APA's provisions entails a penalty of RUR 1,500,000.⁷

By mid-2013 the Russian tax authorities had concluded three APAs with large Russian companies from the energy sector (Rosneft, Gazprom and Lukoil) and one with the largest Russian

Russian taxpayers should prepare TP documentation and submit TP notifications for controllable transactions

airline company, Aeroflot. In addition to that, up to 70 more companies have applied for APAs and are in negotiations with the Russian tax authorities (pre-filing and filing stages).

All four APAs with so far concluded have been unilateral. While there is a possibility to conclude bilateral APAs, we anticipate that it will take some time them to be implemented in practice.

Practical hints and recommendations

As outlined above, Russian taxpayers should prepare TP

⁶Federal Tax Service Letter OA-4-13/85 of 12 January 2012, “On Concluding Advanced Pricing Agreements for Tax Purposes”.

⁷Approx. US\$45,500.

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documentation and submit TP notifications for controllable transactions. When considering the potential impact of TP rules on their business activities (including the obligation to prepare the appropriate documentation) companies should perform the inventory of transactions and the functional analysis, analyse the pricing methodology applied, consider changing it (if necessary) and, finally, prepare TP documentation for controlled transactions.

There are some peculiarities specific only to Russian TP requirements, the most significant of those include:

- **True-up/true-down adjustments:** The mechanism for TP adjustments is not provided by the Code, therefore taxpayers should constantly monitor the profitability. Only upward adjustments (available



There are some peculiarities specific only to Russian TP requirements

- through bonuses or credit-notes) are allowed at the year-end. Moreover, certain risks may exist due to non-refundable extra customs duties and uncertain tax and foreign currency treatment.
- **Treatment of IP:** Unlike OECD countries, certain intangible assets (such as a customer list) are not recognised as IP objects under the Russian Civil Code. Therefore, the TP methodology related to these intangible assets and applied under the OECD principles requires tailoring for Russian TP purposes.
- **Cost allocation:** The Code does not formally recognise cost allocation arrangements which can be viewed as a cost recharge, rather than provision of the service. Therefore such arrangements, without proper support evidencing the services provided, are likely to be challenged by the Russian tax authorities.
- **Obligatory selection criteria for comparability analysis:** Russian tax authorities have expressed their strong preference for local comparables.

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In addition to that, the rules specify certain obligatory criteria which should be used when performing a benchmarking study (e.g. independence and net assets screening, necessity to renew the benchmarking study on a yearly basis, etc.).

As preparation of TP documentation and alignment of the existing policies to the new TP requirements proves to be a time consuming process, it is recommended that taxpayers begin the process well in advance.

From our experience, good quality documentation would be the best defence in case of any challenges from the local tax authorities. The more details taxpayers provide to justify their approach to the aggregation of transactions and TP methodology, the less tax risk would exist. It is expected that the Russian tax authorities will most likely focus on large taxpayers with significant intercompany flows

and taxpayers who fail to submit properly completed notifications on controllable transactions during the first year of TP audits.

Based on the economic analysis of actual financial results, taxpayers may need to think about restructuring their operations and streamlining intercompany transactions for future periods. Therefore, tailoring TP documentation and revising TP policy for Russia should be considered as a priority for the next couple of years to ensure compliance with Russian TP rules from the outset.

Although the Russian TP rules are broadly consistent with OECD Guidelines, there are certain significant differences which make it difficult for multinational groups to tailor their TP documentation

Conclusion

In order to comply with the new TP rules, companies doing business in Russia (both Russian-based companies and MNEs with a presence in Russia) are required to analyse and tailor their existing TP policies taking into account the provisions of the Russian rules, tax authorities' clarifications and existing administrative court practices. Although the Russian TP rules are broadly consistent with OECD Guidelines, there are certain significant differences which make it difficult for multinational groups to tailor their TP documentation (e.g. requirement for local comparables, yearly renewal of benchmarking study, absence of true-down adjustments, etc.). Russian taxpayers who are deeply involved in preparation of local TP documentation have already experienced the significant work load associated with it, which resulted in reconsideration of the 2012 filing dead- lines by the Russian Ministry of Finance.

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The regulations in place in South America, as well as the approach adopted by the tax authorities in relation to intercompany transactions, create problems when applying certain OECD compliant structures in the region.

South America: Dealing with local complexity when applying global transfer pricing policies



South America: Dealing with local complexity when applying global transfer pricing policies

The regulations in place in South America, as well as the approach adopted by the tax authorities in relation to intercompany transactions, create problems when applying certain OECD compliant structures in the region. In particular, special care must be exercised when recurring to central marketing or sourcing entities, or when applying royalties or shared services agreements.

The growing relevance of intercompany transactions and the administrative approach in South America

Since the first tax laws including transfer pricing regulations were enacted in the region at the end of the 1990's, South America has experienced significant economic growth and has become increasingly integrated with the rest of the world. In 2012, South America's GDP was 60% greater than it was in the year 2000, while the international flow of goods

and services reached 36% of the regional GDP from 28% at the end of twentieth century.

With transfer pricing regulations now applicable in eight countries, whose economies jointly represent 99% of the regional GDP, and more demanding documentation requirements, transfer pricing is now a top priority not only for tax authorities, but also for multinational enterprises with operations in the region.

In this context, tax authorities have struggled to deal with the increasing quantity and complexity of intercompany transactions. To cope with this situation, they have adopted a Pareto Principle approach by focusing on certain types of transactions that represent a significant part of international commerce flows, such as commodity trade and intercompany service fees received from abroad. Furthermore,

the tax authorities' practical approach included the creation of special and easily auditable methods in the case of commodity transactions, which in some cases might be at odds with the arm's length principle, and greater focus on deductibility requirements rather than pricing in what relates to service and royalty fees.

As a result, multinational corporations have found it difficult to align some of their global transfer pricing policies with local regulations, many times resulting in cases of double taxation. Next we review the most common pitfalls encountered by corporations when applying global TP policies in South America.

Commodities – Ad hoc methods that focus on global sourcing or marketing agents

In 2003, Argentina established a special method for the analysis of the exports of goods

South America: Dealing with local complexity when applying global transfer pricing policies

with publicly quoted prices in transparent markets to a related company, where an international intermediary -- who is not the actual receiver of the goods and does not meet certain substance parameters contained in the law -- is involved. In such cases, the price for tax purposes must be the greater of (a) the price negotiated with the intermediary and (b) the publicly quoted price at the date of loading of the goods. This rule, initially intended to prevent base shifting through the manipulation of transaction dates with related entities, soon extended to non-related intermediaries for which compliance with the substance thresholds might not be easily documented (which happens, in fact, in most cases).

Thriving South American commodity trade gives rise to tax/pricing rules adoption in several countries

Given the importance of commodity trade for the economies in South America, which nowadays represents 67% of the total exports of goods, other countries such as Ecuador, Peru and Uruguay soon adopted similar rules targeting intermediaries as well as extended their scope to imports. In 2012, Brazil implemented a similar pricing method for commodity imports and exports with related parties –regardless of the participation of an intermediary - by which the publicly quoted price at the date of transaction – where such can be reliably determined - or at the date of loading of the goods is used for tax purposes.

As a result of the application of these methodologies – which consist in setting a price for tax purposes equal to a market quote at the date of the loading of the goods – two comparability issues arise: (i) the pricing date for tax



Can certain ad-hoc methods result in double taxation?

purposes generally differs from the actual transaction date that is recommended by OECD Guidelines to set the arm's length price; and, (ii) the publicly quoted price may not reflect the characteristics of the controlled transaction in terms of delivery, quality and quantity, among other comparability factors. Hence, the application of these ad-hoc methods to set the prices for these transactions could result in double taxation.

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Furthermore, many offshore marketing structures - in the case of exports (or central purchasing structures in the case of imports) - create significant tax risks, since their transfer pricing policies generally command a discount or premium, respectively, on the publicly quoted price to account for the differences in quality, opportunity and delivery terms, among others. This risk is particularly significant for companies sourcing minerals or agricultural products from South America, and for industrial groups providing raw materials for its local operations.

In short, many corporations have found that customising their global marketing or sourcing policies to align them with local rules is the best way to avoid or mitigate double taxation.

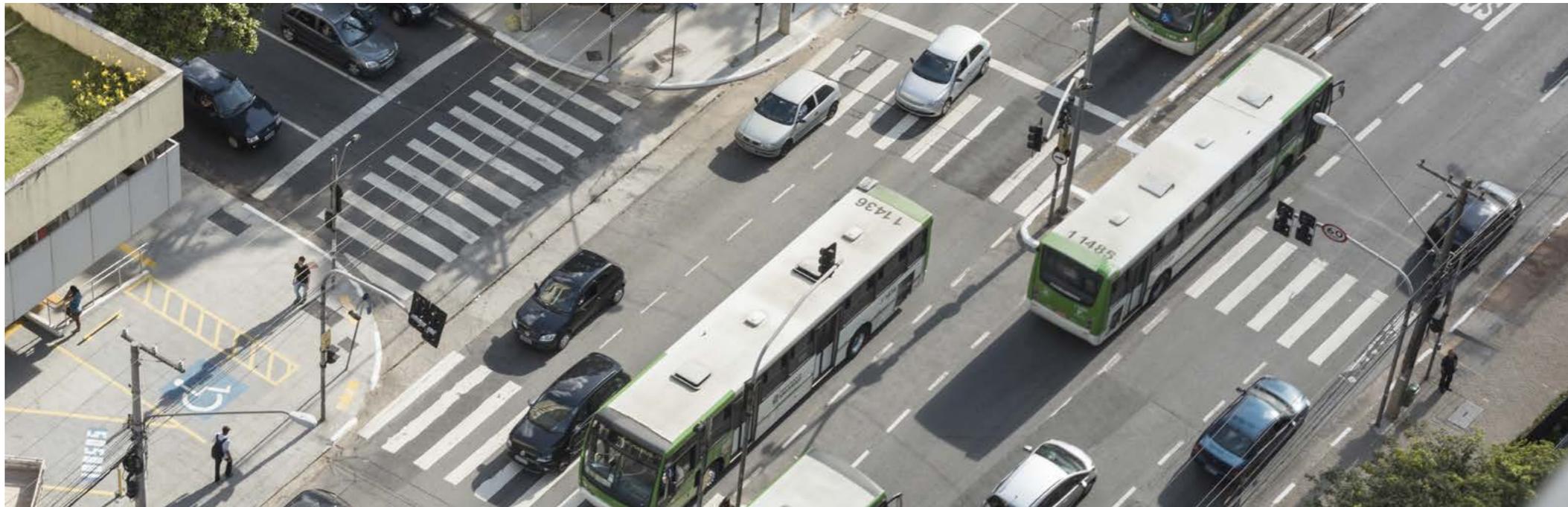
Services – Documenting the benefits for the local entity

Most multinational corporations rely on a series of centrally provided management, research, finance and IT services, among others. Accordingly, these corporations generally apply an OECD compliant cost sharing or cost plus policy to determine the transfer prices for such services, using allocation drivers selected to reflect usage intensity of each subsidiary.

In most OECD member nations, a great deal of effort is put into analysing the functions developed by the service providers and in determining an appropriate remuneration for them. But South American tax authorities have been focusing on the deductibility of the fees before reviewing the pricing policy itself. In this regard, most countries in the region have implemented some of the following deductibility requirements:

- The services must have been actually rendered;
- The services must be related to the activity performed by the company and necessary to generate taxable income in the country;
- The charges must be proportional to the activity performed by the subsidiary (i.e. reasonable amount of expenses correlated to the income or profit generated) and follow an arm's length compensation structure; and,
- In some cases, both the service fee and the withholding tax, where applicable, must have been paid prior to the income tax return due date (e.g. Argentina).

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Documenting benefits & relevance of services received from abroad is extremely difficult

Gathering information for deductibility requirements has its own challenges

Even though these requirements are also present in OECD documents and its discussion may seem trivial from the service provider's standpoint, actually gathering the information to prove the compliance with deductibility requirements can pose quite a challenge for South American subsidiaries. For example, the

Tax Authority may require the taxpayer to provide evidence such as flight tickets, correspondence and reports by headquarters' experts to demonstrate the provision of the services, as well as to show clear examples on how such advice generated profits for it. Since in many cases the assistance provided by the headquarters is of a fragmentary nature (e.g. a multiparty conference call with an expert in the legal department

or a four-hour assistance from engineers in the headquarters when selecting a new supplier), generating a file that extensively documents the benefits and relevance of the services received from abroad is extremely difficult, especially when such evidence is spread all over the organisation and is gathered extemporaneously during the course of an audit.

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In conclusion, when applying global transfer pricing policies for services in South America, documenting the benefits and nature of the services received from foreign related parties from the local perspective is a first threshold that must be passed prior to documenting the price itself.

Deductibility and currency flow restrictions – The trade off between global policies and double taxation

During the last few years, some countries like Argentina and Venezuela have implemented legal or factual restrictions to currency outflows and foreign trade, delaying or precluding the payments of goods, services, royalty fees and loans. In consequence, local subsidiaries' balance sheets show swelling intercompany payables and liabilities, giving rise to deductibility challenges. As it was mentioned before, some countries

require payments before allowing deduction, double taxation and thin capitalisation problems.

Under this scenario, many companies have evaluated different alternatives to pay off their liabilities with foreign related entities, such as writing-off debts, discontinuing the accrual of the fees, or paying off debts in local currency or in kind. Even when these alternatives may allow the deduction of the charges or prevent double taxation in the short term, they might have side effects that conceal tax risks for both the local and foreign entities. For example, if the billing of fees is suspended until payments are once again allowed, the local tax authority may question whether the services were actually needed by the subsidiary in the first place, while the foreign tax authority may question this exception to the global transfer pricing policy.

Hence, when dealing with customs or currency restrictions that impede the application of the regular policies, a comprehensive analysis of the pros and cons of each alternative must be carried out, so as to avoid collateral or unforeseen transfer pricing consequences.

In short – Certain approaches and ad hoc rules can pose troubles

Even though – with the exception of Brazil - transfer pricing policies in South America are generally consistent with the arm's length principle, the approach adopted by the tax authorities as well the existence of certain ad hoc rules – particularly in Brazil - pose troubles when implementing certain policies consistent with the OECD Guidelines. At the very least, evaluating timely customisations to global policies may reduce the likelihood that the company suffers double taxation.

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Highlighting some recent developments concerning the financing of real estate through mezzanine loans

The impact of transfer pricing on real estate funding – Mezzanine financing





The impact of transfer pricing on real estate funding – Mezzanine financing

Introduction

In this article, we highlight some recent developments concerning the financing of real estate through mezzanine loans. With those developments in mind, we then describe the relevant transfer pricing landscape in three representative jurisdictions: Japan, the UK and the US. We conclude with some suggestions on how to increase the robustness of transfer pricing policies for real estate financing.

Current environment changing traditional lending dynamics

The weak economic climate, the sluggish tenant market and increasing regulatory requirements have changed the dynamics of traditional lending facilities within the real estate sector. The terms and conditions that third party providers of credit are willing to accept are, in many cases,

substantially more conservative than those which were prevalent in prior years. As such, making optimal use of the funds already available within real estate groups is becoming ever more important.

This higher degree of self-funding, together with budget pressures experienced by governments, has resulted in an increased focus by tax authorities across the world on the transfer pricing of debt. For example, as of the writing of this article, two high profile audits involving intercompany debt have been taking place in the US.¹ As a result, the correct application of transfer pricing legislation has become a higher priority as the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation, has increased. Ensuring that a robust transfer pricing policy

Rising threat of double taxation makes correct transfer pricing of debt funding a higher priority

is in place is becoming a key management focus.

Recent developments Real estate investment financing trends

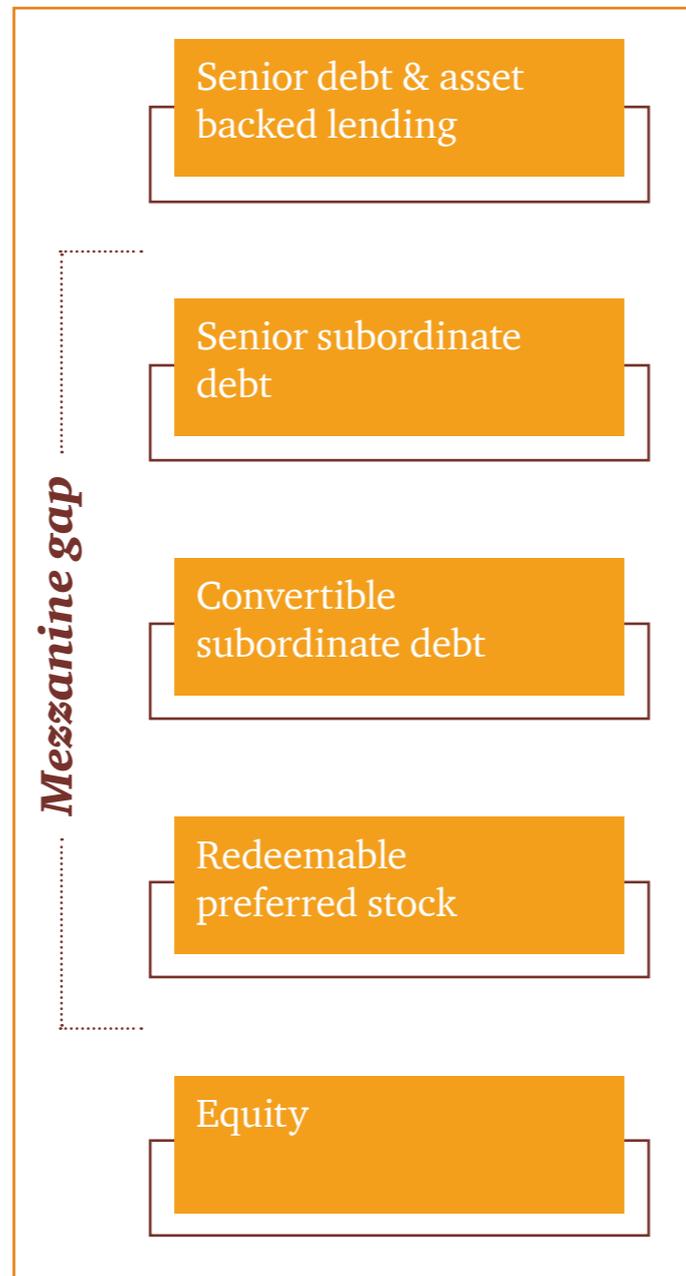
Foreign investors, from high net worth individuals to sovereign wealth funds, are faced with certain challenges should they wish to fund their acquisitions with debt. European real estate investors are faced not only with the paralysing effect of the European sovereign debt crisis, but also the impact of unprecedented regulatory changes, resulting in banks facing a stark choice of raising new capital or disposing of

¹ At stake for Tyco is \$883.3 million in additional taxes plus penalties of \$154 million related to an IRS challenge of intercompany financing with certain international subsidiaries related to acquisitions and restructurings in the late 1990s. At stake for Ingersoll-Rand is a potential levy of \$400 million and \$700 million of additional withholding and income taxes with respect to a portion of the interest payments on intercompany debt to a Bermudan affiliate.

The impact of transfer pricing on real estate funding – Mezzanine financing

>60%

Risk aversion and regulation are pushing senior lenders down to LTVs of 60% or lower, which creates an opening for mezzanine debt providers.



funds that have managed to raise capital and are now starting to lend.

The mezzanine gap

The most immediate opportunity in real estate investment appears to be the provision of mezzanine debt since the retreat of senior lenders is opening a gap in the capital structure. When senior lenders, generally banks, were providing debt at 80% or even higher LTV ratios, few borrowers needed mezzanine debt. Risk aversion and regulation are pushing senior lenders down to LTVs of 60% or lower, which creates an opening for mezzanine debt providers.

However, two major concerns have been identified in *Emerging Trends in Real Estate in Europe 2012*³. First, mezzanine lenders need active senior lenders behind whom

to provide the mezzanine product; i.e. the retreat of the banks could leave mezzanine lenders in an exposed position rather than tucked into a well protected gap in the capital structure. The other concern is pricing.

If return expectations for equity are falling, then the population of potential mezzanine borrowers will also decline unless mezzanine expectations are reduced correspondingly. If not, the main role of mezzanine and preferred equity will be in restructuring situations where the borrower has little alternative.

Real estate financing structures

Overview

There are various options to structure the financing of real estate: debt, equity or a combination of both. In terms of

³The 2012 report is the 9th edition of the report published by PwC and the Urban Land Institute. It is a survey of sentiment based on 310 face-to-face interviews and 386 online survey responses of representatives of the Real Estate sector consisting of senior executives from across Europe from a broad cross-section of the industry, including institutional investors, fund managers, listed and unlisted property companies, lenders and service providers. <http://www.pwc.com/gx/en/asset-management/emerging-trends-real-estate/emerging-trends-in-real-estate-europe-2012.jhtml>

The impact of transfer pricing on real estate funding – Mezzanine financing

debt, various types of financing are available with a broad range of criteria including different priority levels of repayment in case of liquidation; i.e. ranging from senior debt which must be repaid first to junior and mezzanine debt, the latter being structured either as debt (typically an unsecured and subordinated note) or preferred stock.

As the main focus of this article is the transfer pricing of mezzanine debt in real estate financing structures, the following sections first define mezzanine financing from both a tax and a commercial perspective before going into more detail on the tax aspects associated with mezzanine financing.

Mezzanine financing

Moody's⁴ defines mezzanine financing as: "lending to a borrowing entity or group of entities that directly or indirectly

own a property-owning entity, which debt is secured by a first security interest in the borrower's pledged ownership interests in the property owner". Mezzanine finance is typically used by companies that are already highly leveraged but still have positive cash flow to support additional debt payments. Mezzanine finance is often used to support growth through expansion projects; acquisitions; recapitalisations, and leveraged buyouts.

Tax authorities may use a broader definition than Moody's. For example, Her Majesty's Revenue and Customs (HMRC), describes mezzanine debt in their International Tax Manual (INTM) as follows: "Mezzanine debt sits between senior debt and equity in the capital structure of a business. Often a high-risk form of finance, it is subordinated to the senior debt, so that if the borrower gets into

financial difficulties, the mezzanine debt is unlikely to be recovered. It has the characteristics of debt but it may carry a right to shares as a way of providing some form of recompense to the holder in the event of default. The term originally referred to debt financing which gave the lender an equity stake, or had the possibility of conversion into equity. It has more recently been used to describe any middle layer of debt in leveraged buyouts, "below" the senior debt and "above" the equity, whether or not any equity rights are attached to the debt. Such debt may be fixed rate or floating, secured or unsecured and it is common that the loan is bullet repayment rather than amortising".

In contrast, the tax authorities of other countries, such as Japan and the US, may refrain from formally defining mezzanine financing in legislation.

⁴ In its paper "US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans", March 2007.

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Mezzanine financing may be short term or long term, amortising or interest only, floating or fixed rate, though the current market sees most mezzanine loans as relatively short-term, interest-only, floating rate transactions. In contrast to some preferred equity deals that have debt characteristics, few, if any, mezzanine loans destined for the capital markets have cumulative returns or equity “kickers”; they are straight debt notes, for the most part, albeit at higher spreads to reflect the risk of being in the transition zone between debt and equity.

Most mezzanine loans are targeted to be at the bottom of the debt stack and are expected to receive below investment-grade shadow ratings. Isolated mezzanine transactions, however, may reach low-to-mid investment-grade levels, often when the real estate is located in jurisdictions with hefty mortgage recording taxes. The

common features of all mezzanine instruments are that they offer a risk/return profile that lies between debt and equity.

Intercompany mezzanine financing

As a result of the recent financial and economic turmoil, the utilisation and incidence of intercompany mezzanine financing in the real estate sector has become more prevalent. It is increasingly difficult for companies to obtain external third party financing and higher current market credit spreads have made external financing less attractive. Therefore, considering using funds available within the company, rather than attracting funds externally, has become even more important for many companies.

There are some important tax aspects to consider when choosing to use mezzanine financing. For example, returns on equity and

returns on debt capital are treated differently for tax purposes and so thin capitalisation poses an issue for tax authorities as further elaborated below. The returns to shareholders on equity investment are not tax deductible for the paying company, being distributions of profit rather than expenses of earning profits. Alternatively, the returns to lenders of debt (typically in the form of interest) are normally deductible in arriving at profits assessable to corporation tax. Therefore, there is an incentive to present what is in substance an equity investment in the form of debt to obtain the favourable tax treatment.

Having said that, many countries, such as the UK, the US and Japan, place other restrictions on the use of debt funding, such as thin capitalisation rules or earnings stripping rules (which limit the deductibility of interest

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expenses on related party debt). Nevertheless, debt funding for real estate investment may still provide a more attractive alternative than equity funding for many real estate groups.

Transfer pricing of debt

Governments have imposed various regulations to curb the misuse of intercompany finance arrangements. Perhaps the most common regulations across various taxing jurisdictions would be the imposition of the arm's length standard, which states that the price of a related party debt arrangement should be consistent with the price of comparable third party debt arrangement. Below, we first set out the tax regulations on interest deduction in Japan, the UK and US relevant for the purpose of this article before describing the basic principles of transfer pricing of debt.

Relevant Japanese regulations

Broadly, Japan limits the use of related party debt through its thin capitalisation and earnings stripping rules.

In general, the thin capitalisation rules provide a 3:1 debt-to-equity safe harbour. Article 66-5 (1) of the Act on Special Measures Concerning Taxation (ASMT) sets out that if the annual average balance of interest-bearing debt owed to a foreign controlling shareholder exceeds the capital contributed by that foreign controlling shareholder by a ratio in excess of a 3:1 safe harbour, the excess interest expense paid or payable to the foreign controlling shareholder is not tax deductible. In addition, interest paid to a third party may also be subject to Japanese thin capitalisation rules if the loans are guaranteed or bonds are provided as collateral by the foreign controlling shareholder.

CUP method preferred for pricing of intercompany debt in Japan

In addition to the above, from the tax years beginning on or after April 1, 2013, an earnings stripping rule has been introduced. Under this rule, the deductible portion of a corporation's net interest expense to a related party will be restricted to 50% of adjusted income.⁵ Where interest expense is not deductible, it may be carried forward for seven years and deducted in a fiscal year up to the 50% threshold in that fiscal year.

Given these domestic law limitations on deductibility of related party interest expense, the volume of debt has not been a major issue in Japan.

⁵ Net interest is calculated as interest expense to related parties less corresponding interest income. Adjusted income is defined as taxable income, adding back interest expense, depreciation expense and exempted dividend income, but excluding extraordinary income or loss.

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Finally, in terms of the arm's length nature of intercompany debt pricing, the comparable uncontrolled price method (CUP method) is the preferred methodology. According to ASMT Directives 66-4, (7)-4, and 68-88, (7)-4, where the same method as the CUP method is to be applied, the following factors should be taken into account: The currency of the loan; the timing and term of the loan; the manner of setting the interest rate (i.e. setting of fixed or variable rate, or simple or compound rate); the method of interest payment (i.e. method of advanced or deferred payment and so on); the credibility of the debtor; and the conditions of collaterals and guarantees as well as other factors affecting the arm's length rate.

Relevant UK regulations

The UK transfer pricing legislation is contained in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). S147



sets out the basic pre-conditions for transfer pricing legislation to apply: When a provision is made or imposed between any two persons by means of a controlled transaction that differs from the provision which would have been made in an uncontrolled transaction (the arm's length provision") and, as a result, a UK tax advantage is conferred on one or both persons, then the profits or losses of the advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead.

For intercompany financing, specific rules around thin capitalisation are included in Part 4 TIOPA 2010. Following S152, a person is said to be thinly capitalised when it has excessive debt in relation to its arm's length borrowing capacity, which then leads to the possibility of excessive interest deductions. In addition to considering the level of debt, it is also important to consider whether the rate of interest applied is consistent with arm's length prices.

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HMRC takes a broader view than just the amount of debt and the interest rate when looking at thin capitalisation. One of the key considerations is whether indeed the borrower would have chosen to take on a loan, even if the lending were available. HMRC describes this approach as looking at the “could” and “would” arguments:

- The “could” argument – what a lender would have lent and therefore what a borrower could have borrowed; and
- The “would” argument – what a borrower acting in the best interest of their own business would have borrowed.

For mezzanine financing with a very high interest rate, it may be the case that it could be made available to a company; however, whether the company in reality would choose to take on that

additional debt from a third party given the interest rate and terms of the available finance is a different question. In looking at the transaction from both sides (which is consistent with the OECD Guidelines and from a UK thin capitalisation perspective) it is necessary to apply basic transfer pricing of debt principles; on what terms a third party would be willing to lend, and on what terms would a third party be willing to borrow.

Relevant US regulations

In general, Treas. Reg. §1.482-2(a), describes the transfer pricing rules applicable to intercompany loans in the US. These regulations provide three general approaches to establishing an intercompany interest rate: i) safe harbour approach under Treas. Reg. §1.482-2(a)(2)(iii); ii) situs of the borrower approach under Treas. Reg. §1.482-2(a)(2)(ii); or iii) an approach

that is based on comparable uncontrolled transactions under Treas. Reg. §1.482-2(a)(2)(i). However, it should be noted that the ability of a taxpayer to deduct interest on debt from a related party is contingent on whether the indebtedness is considered bona fide.⁶ The issue of whether an intercompany debt obligation is bona fide debt is not described in Treas. Reg. §1.482-2(a) but rather, is described in Section 385 of the Internal Revenue Code. As part of US tax law, the generality of IRC §385 serves as guidance for defining bona fide debt for tax purposes, but the resolution of whether an intercompany debt obligation is bona fide debt has generally been considered in the context of US Tax Court decisions as a result of the lack of statutory or regulatory guidance. The approach taken by the US Tax Court can be best described as a facts and circumstances

⁶Treas. Reg. §1.482-2(a)(1)



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approach that considers the nature of the financial contribution to the recipient of the funds and the circumstances under which the contribution has been made. Ultimately, the economic substance of the transaction governs the tax treatment of the transaction.⁷

Other tax rules should also be considered in establishing an intercompany debt arrangement in the US. Section 163(j) of the US Internal Revenue Code limits interest deductions where the corporation's debt to equity ratio exceeds 1.5 to 1 or when the corporation has excess interest expense for the tax year. Additionally, Real Estate Investment Trusts are subject to a 100 percent excise tax to re-determined interest deductions for their Taxable REIT Subsidiaries under Section 857(d)(7)(A) of the US Internal Revenue Code.

Basic principles for transfer pricing of debt

There are three key factors that determine interest expenses in third party scenarios. The first is the likelihood of borrower default; e.g. how creditworthy is the borrower and how able is it to meet its liabilities? Another factor is the expected loss in the case of default; e.g. how senior is the debt relative to the borrower's assets; is there any collateral pledged to protect the creditor from realizing a loss? Finally, what is the opportunity cost of making the loan for the lender; e.g. what is the lender's cost of capital and/or next best investment alternative?

Taking the above into account, in an attempt to comply with the various transfer pricing regulations, taxpayers have tried to replicate what unrelated parties do when entering into

debt transactions in an attempt to establish debt on an arm's length basis in an intercompany situation by analysing:

- the terms and conditions of the debt (e.g. the loan tenure, its seniority and collateral);
- the volume of the debt (i.e. by analysing borrowing capacity through free cash flow analyses and comparing to financial ratios of comparable independent companies);
- the credit or default risk of the borrower (measured through a credit rating process); and
- the interest rates offered by other lenders in comparable circumstances.

⁷Treas. Reg. §1.482-1(f)(2)(ii)(A)

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banks reducing their lending to the real estate sector, it may prove difficult to obtain such a letter for mezzanine financing to fund the acquisition of real estate.

As such, other sources of data to support related party transactions become even more important, including referring to third party loans (preferably third party mezzanine loans) with similar characteristics at the time of the intercompany transaction.

Arm's length borrowing capacity should be determined based on independent comparables

Volume of the debt

As described above in the case of Japan, some jurisdictions use safeguards other than transfer pricing rules to indirectly limit the volume of debt that may be borrowed from related parties.

In contrast, the volume of related party debt will be a critical issue in countries where there are less restrictive requirements outside of transfer pricing.

The arm's length volume of any mezzanine financing is a determinant of the total borrowing capacity of the debtor. The arm's length borrowing capacity should ideally be determined based on independent comparables; key financial ratios should be used to assess the arm's length nature of the transaction (e.g. interest cover and gearing/leverage ratios/LTV).

Several factors relevant to the real estate industry may impact the borrowing capacity of an entity, for example, in relation to property backed lending: third party lenders are more prepared to grant a loan if land or buildings are available to put forward as security. They will still, however, look closely at the borrower's

capacity to service debt, and are likely to want financial conditions in the loan agreement (such as the ratios described above) to ensure that this capability continues.

In terms of quantifying the borrowing capacity of the debtor, market practice is to look at LTV ratios; which consist of the debt expressed as a proportion of the value of a property that a lender is prepared to lend (most often expressed as a percentage). However, it should be noted that mezzanine debt is often issued in situations where bank debt is not available. As such, careful thought should be made with respect to the use of LTV ratios in a mezzanine debt capacity analysis, particularly when such LTV ratios are derived purely from bank loans. Because publically available information on non-bank LTVs is scarce, it is recommended to substantiate the arm's length volume of the debt by additional analyses such as free

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cash flow analyses (i.e. will the property generate sufficient cash for the debtor to repay the debt and make the required interest payments).

Credit risk in relation to the mezzanine debt

In a transfer pricing context, typically one of the most important steps in analysing debt transactions is estimating the credit rating of the borrower adjusted for the transaction under review.

Under normal market conditions, the higher the credit rating of the debt issue, the lower the associated interest expenses (and vice versa). As such, in a transfer pricing context, the estimate of the credit rating of a borrower is of great interest to tax authorities since this is one of the clearest signals that the intercompany debt transaction has been structured at arm's length.

In terms of estimating a (shadow) credit rating of the debtor in relation to the mezzanine financing issued, a potential approach could be to use a credit scoring tool or to map the borrowing entity's financial ratios against S&P/Moody's financial ratios (e.g. Moody's Approach for REITs and Other Commercial Property Firms, 30 July 2010) to estimate the corporate credit rating of the debtor.

Subsequently, the corporate credit rating of the debtor may be adjusted to take into account the specific characteristics of the mezzanine financing (e.g. its junior characteristics).

Interest rates offered by other lenders in comparable circumstances

When looking for third party comparables, tax authorities typically focus their attention

on executed transactions and evidence of actual market activity, and tend to be less willing to accept notional offers of finance, which have neither had to be issued or accepted in reality, without any additional supporting market evidence.

Higher values of ratios such as DEBT / EBITDA (Earnings Before Interest Tax, Depreciation and Amortization) and debt: equity are tolerated by lenders for a period of time following an acquisition, as long as the projections clearly show that the debt payments can be met and that the level of gearing is going to be reduced over time.⁸ Typically, this means that the focus is on the intercompany financing arrangements that are in place at a point in the future that can be considered to represent a steady state (usually three to five years).

⁸ <http://www.hmrc.gov.uk/manuals/intmanual/INTM578090.htm>

⁹ <http://www.hmrc.gov.uk/manuals/intmanual/INTM579030.htm>

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Publically available information for companies with similar size and character in a particular industry is typically preferred for suitable comparables. For example, the De Montfort report which is published annually, along with a half yearly update, can be applied.⁹ The report includes information covering major lenders within the UK, US, Germany and outside, as well as the majority of the smaller lenders. The information published includes a range of statistics, charts, and analyses covering comparisons of loan terms, interest rates, types and locations of lenders relating to the commercial property market.

Other sources of potentially comparable data include publically available databases such as Reuter's LoanConnector DealScan and Bloomberg Professional Database that contain information

on debt issued (such as loans and bonds) by companies active in the real estate industry and can be searched based on a wide range of debt terms such as mezzanine financing. Furthermore, information contained in publications such as Property Finance 2013 can be used as corroborative evidence of the information obtained from the De Montfort report and the databases mentioned above.¹⁰

Conclusion

There is general pessimism regarding the availability of senior debt funding in the market. As the retreat of the traditional senior lenders is opening a gap in the capital structure, the most immediate opportunity in real estate investment appears to be the provision of mezzanine debt, which is typically the most junior debt with equity-type

characteristics and interest rates that are commensurate with such risks. As a result of the high interest rates, and given that mezzanine debt is most prevalent in the real estate sector, many tax authorities have increased their scrutiny on the levels of and interest rates on mezzanine debt.

As the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation, has increased, it is critical for real estate investors that a robust transfer pricing policy is in place which assesses and documents (i) the terms and conditions of the mezzanine debt, (ii) the volume of the mezzanine debt, (iii) the credit risk in relation to the mezzanine debt and (iv) the interest rates offered by other lenders in comparable circumstances.

¹⁰ For example, PwC UK has prepared their own in-house database of real estate financing deals based on publically information for the purpose of corroborating information from the De Montfort report. In the U.S., the PwC Real Estate Survey provides detailed information on the real estate market in the U.S. which can be used to inform and anecdotally corroborate the debt capacity analysis described above.



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Leading practices for integrating tax and transfer pricing requirements with enterprise resource planning (ERP) for multinational enterprises

The intersection of ERP systems and transfer pricing



The intersection of ERP systems and transfer pricing

Rapid expansion creates challenges in tax and transfer pricing integration of ERP systems

As multinational enterprises continue to expand through acquisition and organic growth, the need for accurate and timely reporting of operational and financial data has never been more critical. Companies rely on their management information systems to deliver reports that enable corporate executives to make informed decisions in real time. However, rapid expansion – particularly through acquisition – can result in companies having an excess of accounting, supply chain, human resources, and other systems and software platforms that often cannot be integrated easily.

These systems gaps result in poor management reporting and are of even greater concern for multinational enterprises with

a high volume of intercompany transactions. The ability to accurately price, record, and report transfers of tangible goods, licenses or sales of intellectual property, and the provision of services and financing between related parties - or transfer pricing - is critical to correct and timely tax reporting domestically and abroad. Poor tracking of transfer prices translates to increased enterprise risk and a possible impact to the bottom line.

Corporate executives within multinational businesses must work cross-functionally – bridging operational, financial, and information management systems – to integrate tax and transfer pricing requirements into their enterprise resource planning systems.

Leading practices for integrating tax and transfer pricing requirements

Although there are complexities in integrating tax and transfer pricing requirements into an existing ERP system, companies can take certain practical steps to close gaps and improve data collection and reporting. As a threshold matter, generally companies are most successful when they leverage core ERP functionality rather than trying to fit the ERP into what may be a jumble of existing manual processes and incompatible software.

Alignment of policy and execution. To the extent that companies can employ their ERP system to execute the transfer pricing policy, gaps between policy and execution are narrowed.

Early communication on integration efforts can save costs in the long run

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Leading practices direct that tax departments communicate their user requirements to the ERP system team early in the implementation process and work closely with their management information systems colleagues to achieve appropriate integration. Many companies have rejected this approach because the upfront set up costs can be high. However, when compared to the cost of remediating these disparities on an annual basis, the initial expense is often significantly less in the long term.

Moreover, ERP system upgrades do not always keep pace with growing geographic footprints or operational expansion, particularly in newer companies. Often the frugal and entrepreneurial mindset of an emerging multinational enterprise translates into systems that lag behind the needs of the business over time. Commonly, new businesses start out with several desktop-based tools to manage

transfer pricing. These systems tend to be harder to scale and less robust than enterprise systems which aim to synthesise and integrate virtually all functional areas across a business.

Issues with desktop-based tools appear when companies try to generate segmented profit and loss statements by legal entity that incorporate tax and transfer pricing adjustments. Leading practices dictate that companies prepare these financials by leveraging an ERP or business intelligence (BI) system to ensure accuracy and completeness. Similarly, many companies rely on spreadsheet models to determine overhead and headquarters cost allocations. These documents are often used year after year without considering structural changes internally, such as the addition of new cost centers, and externally, including modification of local tax rules.

Corporate information management executives and their advisors are well advised to consider user requirements carefully and to select scalable, enterprise-wide systems that have the capabilities to meet the changing needs of the business.

Taking the time to understand & leverage available information is key for choosing best transfer pricing policies

Know your data. Often, the ERP system is perceived as a so-called “black box” as opposed to a key tool that gives tax departments visibility into critical financial detail. This distinction is important because, from a price-setting perspective, companies need to identify all cost elements – including cost of goods and inventory variance and customs

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duties. Specifically, tax departments can leverage the detailed cost data buried within ERP systems to make better decisions, set appropriate policies, and enhance the quality of their transfer pricing documentation. It is a leading practice for corporate tax personnel to invest the time and effort to understand what information is available and leverage that knowledge to select the best transfer pricing policy for each transaction based on the granularity of data available and the ability of the system to accurately calculate and record the transfer price.

Management does not typically prepare forecasts on a legal entity or product segmentation basis. This data is important though for setting and managing transfer pricing targets. It is recommended that finance and transfer pricing personnel work as a team to monitor planning systems. Invoice generation is another key concern.

The proper level of detail must be included in the invoice for both income and indirect tax purposes. Single, lump sum invoices may be rejected by tax authorities who want visibility into cost of goods versus other operating expenses.

Appropriate configuration.

Closely related to the integrity of the data contained within an ERP system is the quality of the outputs it generates. As tax and transfer pricing compliance is not limited to tax returns and written reports, supporting documentation is a key part of substantiating and, when necessary, defending tax positions. This additional support may include invoices, expense reports, and executed agreements with both related and third parties, among other things. Configuring the data warehouse, general ledger, and other information caches to generate useful outputs is a leading practice for multinational enterprises.

Specifically, companies should consider how their ERP system manages trading parties to track intercompany sales, which can be challenging if the appropriate modules are not in place to monitor related customer or vendor lists. Incorporating terms, such as INCOTERMS, is also a key consideration. Instead of manually capturing the movement of goods, companies should leverage the ability of ERP systems to configure flash title transfers for drop shipments and other transactions. ERP systems are also able, through customisable modules, to manage parallel valuation of goods dynamically, allowing for the tracking of cost in both management and tax accounting instances.

Cross-functional collaboration.

Implementing and maintaining an efficient ERP system requires coordination and communication across corporate departments

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Successful ERP systems require a team effort – and good communication

and operational business units. Understanding the user requirements of groups ranging from design and engineering to marketing, legal, tax, accounting, regulatory compliance, information technology, and treasury helps to develop a system that truly integrates the business and allows for real-time strategic and tactical decision-making. Especially important for multinational enterprises is the involvement of the tax department

to understand additional reporting or data capture that may be necessary as the business evolves, the company enters new markets, or tax laws change.

Depending on the intercompany pricing policy, transfer prices may need to be submitted to finance as absolute prices, a mark-up on standard cost, a discount from a list price, or another mechanism. Proper communication between departments and propagation

within the ERP system is paramount. For example, the controller group should be made aware of interest payments, unrealised inventory profit, and year-end true up adjustments.

More is not necessarily better. Although an excess of add-on modules is available for most ERP systems, multinationals are well advised to use moderation and restraint when it comes to adding supplemental systems

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to their existing ERP. Carefully evaluating the cost and the benefits of additional modules is necessary to avoid creating a system that is unwieldy and disjointed. At the same time, businesses should also be vigilant in creating exit strategies for legacy systems. Particularly a concern for highly acquisitive companies, often there are significant intervals between the time a new company is purchased and the sunset of its previous systems. With older software, compatibility issues frequently arise that result in the need for manual actions to translate data from one system to another. These added steps create opportunities for potentially costly errors.

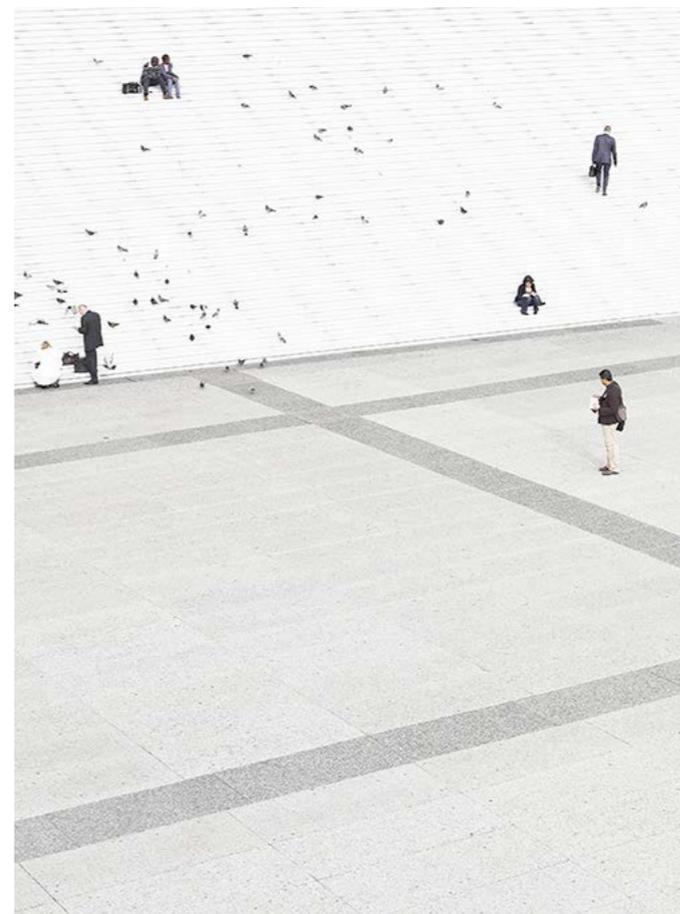
Generally, companies that seize upon corporate lifecycle events – mergers, divestitures, acquisitions, and reorganisations - as a springboard to enhance and realign ERP systems with the business

are better positioned to mitigate enterprise risk.

Return on investment. When tax and transfer pricing integration with ERP systems becomes a business imperative, companies are better able to leverage their systems to monitor profit level in local jurisdictions - enabling business results that are consistent with the economic realities and the functions performed, assets employed, and risks borne - and closely track the enterprise's effective tax rate (ETR). Understanding the drivers of ETR in real time can help corporate tax and finance professionals quickly to identify unutilised deductions and non-beneficial transactions that do not support the business and take action to remedy the situation.

It is vital that corporate management information systems professionals work together within their organisation - especially

with their tax, treasury, and finance colleagues - to guide the development, implementation, and on-going maintenance of the ERP system. Ultimately, the ability to report and analyse operational financial data in real-time typically turns to increased profitability and the easing of enterprise risk.



Making tax & transfer pricing integration with ERP systems a priority benefits the business

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“The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.”¹

The politics of taxation



¹ Jean Baptiste Colbert, French Economist and Minister of Finance under King Louis XIV of France 1619-1683



The politics of taxation

Criticisms, perceived shortcomings, and responses to today's changing environment

It is an understatement to say that the last year has been an interesting one for transfer pricing practitioners. When asked what we do, for a lot of us, it's no longer a case of blank looks, but rather suspicion and an attempt to explain the arm's length principle in layman terms (the authors wish the reader good luck in that endeavour).

Since our global transfer pricing conference in New York last year, we have witnessed unprecedented criticism of some of the largest and best known multinational groups for their apparent ability to avoid paying their 'fair' share of tax. We have also seen senior executives of multinationals called before parliamentary committees in the UK to explain their tax affairs; a UK prime minister call

on international groups to 'wake up and smell the coffee' when it comes to paying tax; US Senate public hearings into the failings of the US system of corporation tax and perceived abuses by US groups; and the leaders of the G20 group of countries come out in favour of real reform of the current system of business taxation.

This article takes a look at the criticism and perceived shortcomings of the current system. It also looks at the potential alternative and policy developments to date because of public and political pressure. We also look at how companies might react to the changing environment. With the (social) media attention unlikely to fade any time soon, a 'wait and see' approach to the OECD's Base Erosion and Profit Shifting (BEPS) project is unlikely to be enough. However, the OECD's suggested remedies to address system

shortcomings is still at a fairly embryonic stage – and far reaching change will require plenty of (political) courage to implement. These factors complicate further companies' decision making on a robust course of action.

Critics feel multinationals are abusing a tax system designed for another era

So why the criticism?

Undoubtedly business tax has been caught in the headwinds of austerity, with companies under pressure to not only pay their share but be seen as paying their share.

One of the leading criticisms of the current system is that multinationals are able to abuse a system of taxation designed for a different era. Indeed to some extent that is a fair assessment. The present system is set out in

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double tax treaties, many of which were put in place decades ago based on an era where capital was less mobile.

Critics argue that the system allows multinationals to set up their operations in a way that separates value creation and profits (the latter often located in low tax jurisdictions). Multinational groups also have the ability to achieve double non-taxation through mismatches within the international tax system.

Others, and particularly non-governmental organisations (NGOs), have chosen to highlight the impact of what is now commonly referred to as transfer 'mispricing' on developing countries, depriving them of corporate tax receipts which would allow local governments to improve the lives of their citizens. The ongoing 'IF' campaign²,

promoted by over 100 NGOs, is a leading example of this line of argument.

Is there an alternative?

But if the current system of corporation tax (based on the arm's length principle) is no longer fit for purpose, what other option exists?

Is formulary apportionment a solution to current system of corporate taxation... or will it lead to more (but different) problems?

The most common suggestion is formulary apportionment (also known as unitary taxation). This system would be based on certain factors, by which profits would be allocated and taxes then levied. The most common methods suggested for allocating

profits (and therefore taxes) are sales, fixed assets and headcount.

However these allocation keys may well lead to greater (and not less) inequity in the system. Because developed countries are wealthier than developing ones, assets values are likely to be higher. A system that allocates profit based on assets risks pushing more (not less) profit to developed countries – which goes against the very arguments NGOs use to criticise the current system. Moreover, shifting from residence to source based taxation (eg using sales as one of the allocation factors for profits) will create winners and losers among countries and so international consensus is unlikely to prove possible.

Not only this, these factors themselves may not reflect where value (and profit) is created. Most systems that use some form of

² <http://enoughfoodif.org/issues/tax>

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apportionment (eg US sales tax or the EU's proposed common consolidated corporate tax base) ignore intangibles. Yet these are increasingly driving profit. Other factors that are commonly considered may not actually have a significant link to profit generation.³

The OECD's Base Erosion and Profit Shifting project

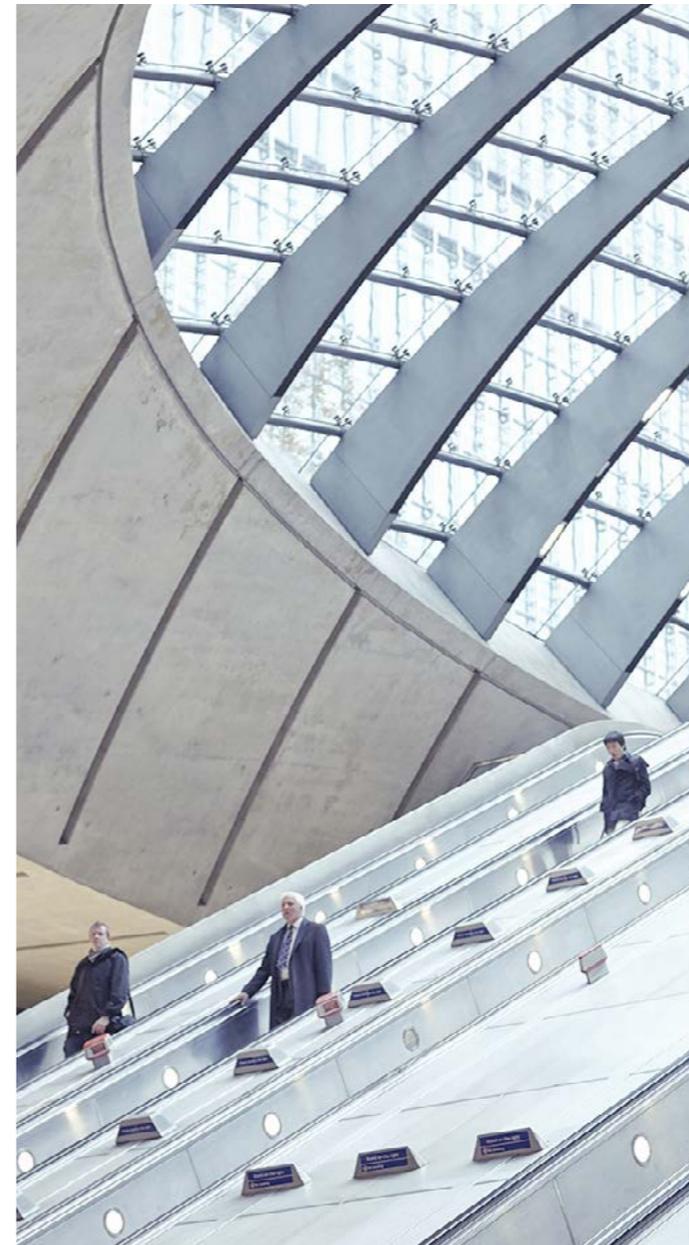
Nevertheless, with very significant political momentum behind the case for reform, the OECD has been tasked with updating the system of taxation, under the auspices of its Base Erosion and Profit Shifting (BEPS) project.

As most of you know, the latest stage of the BEPS project was the release of a 15 point action plan in July 2013 to modernise and tackle the failings of the current system of corporation tax.

In so doing, the OECD came out firmly against systems such as formulary apportionment and re-stated its view that the arm's length principle remained the fundamentally sound method by which company tax will be determined between countries. Only in those cases where a comparability analysis is impossible to perform would it be possible to introduce "special measures" that go beyond the arm's length principle. An example would be the measure similar to the US "commensurate with income standard" recently mentioned by Marlies de Ruiters of the OECD at the IFA Conference in Copenhagen.

Where should key areas of action be centred?

Volumes have been (and continue to be) written about the OECD's BEPS work. It's not our intention



OECD upholds arm's length principle as fundamentally sound

³ For example, headcount has been shown not to be a significant driver of profit generation yet is included in most examples of apportionment. See <http://www.nber.org/papers/w15185.pdf> for further details.

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to replicate that knowledge here, other than to highlight the insightful material available on the PwC website <http://www.pwc.com/gx/en/tax/tax-policy-administration/policy-trends.jhtml>. Suffice to say, the key areas of action are centred on countering base erosion and double non-taxation, aligning taxation and substance, and transfer pricing and the arm's length principle.

So with all this change, how should companies react?

While we authors are not known for our clairvoyance (and do not count a crystal ball among our possessions), it is possible to identify certain outcomes from the BEPS project that will have direct relevance to transfer pricing (there are many changes that are not directly related to transfer pricing so are not dealt with here).

- It will be necessary for groups to understand and justify their global value chain. It remains an open question as to what level of disclosure will be necessary, but it is clear that more transparency will be required. Indeed the requirement to show 'big picture' information on the global value chain is mentioned in the OECD's white paper on documentation⁴ as a risk assessment tool rather than an adjustment tool for tax inspectors. This being said, companies should be able to explain consistently (ie same story across multiple territories) where the value in their business is generated.
- Companies also need to consider how their tax strategies might be viewed with greater disclosure. Preferential rulings will need to be made public; the significance of intra-group transactions to overall company profitability

is likely to become readily identifiable to tax authorities; and business structures designed to avoid tax (particularly those without sufficient commercial substance) will become more obvious to tax authorities. This will heighten the risk of tax authority challenge to these structures and, perhaps more importantly in the long term, could do serious reputational damage.

- The era of generic and superficial local country functional analysis is likely to come to an end as is widespread use of one-sided transfer pricing analyses. There was much debate on this same point in 2010 with the release of the revised OECD Guidelines (which abolished the hierarchy of methods) but tax authorities worldwide have not used the ammunition these changes provided to challenge the

⁴ <http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-documentation.htm>

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approach of many taxpayers. Nevertheless, with the current political backing and focus on the use of profit split as part of a value chain analysis, it is more than likely that over time tax administrations will demand a two-sided approach.

- The OECD is moving to accept the arguments of the BRIC economies in particular around higher returns for ‘routine’ functions performed in fast developing economies. This point rings true particularly in light of the recently issued OECD’s updated draft chapter on intangibles⁵ and its recognition of workforce in place, location savings, etc. Even though these factors appear to be seen as comparability factors affecting prices rather than intangibles, this will put pressure on the returns allocated to local operating companies

in developing economies and give levers to tax authorities (eg explicit support for local comparables in the latest draft Intangibles chapter) in those countries to argue for higher local returns.

- Functions are going to increasingly drive where profit is located. First we had key entrepreneurial risk takers (KERTs; for branch profit attribution in financial services), then came significant people functions (SPFs; for profit attribution in the widget world), and now we have important functions (in relation to intangibles). Indeed newer CFC regimes, such as the UK, also draw on these concepts and look at where functions are performed in calculating jurisdiction to tax. The good news though is that this does not mean a convergence between

the Model Tax Treaty provision of Article 7 (profit attribution using SPFs, which looks at what people do and where) and Article 9 (transfer pricing under the arm’s length principle where the starting point is the contractual arrangements). Less good news is that tax authorities will move quickly to look at what people do in cases where the actual conduct departs from what the contracts say.

- The issue of permanent establishments is coming back into fashion among tax authorities (leaving aside potential changes that may come in relation to PE definition). Outside of financial services the question of PEs had gone away in a large number of countries. This is partly because it is a difficult topic and tax authorities often did not have the experience. However with

⁵ <http://www.oecd.org/ctp/transfer-pricing/transferpricingaspectsofintangibles.htm>

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Can subject matter experts and PR specialists help the tax function counter (social) media challenges?

increased tax authority resources going into the area, eg the UK has set up a specialist PE unit, the risk of challenge is set to increase. This is particularly true for digital business which will continue to be a high profile area. Tax authorities can be expected to pay close attention to how business is conducted and whether local territory activities give rise to a PE of the offshore principal.

Conclusion

Undoubtedly these are challenging times for companies looking to deal with the changing tax environment. A number of changes are clearly signposted by the unilateral actions of governments as well as the OECD's direction of travel. As such, companies can act now with a significant degree of confidence to meet the new conditions and should not wait until specific actions are agreed multilaterally at the OECD level.

To wait will probably be too late, particularly as we see tax authority behaviour changing and becoming increasingly aggressive in light of favourable political headwinds to take on multinational groups and the amount of tax they pay.

On a final note, many companies are asking these days whether the tax functions should be staffed with subject matter experts or PR specialists who may proactively counter (social) media challenges. This is a difficult question to answer and a fair response is likely to be that one needs both. This will not go away soon.

It will be fascinating to take stock a year from now and consider where the debate stands over half way through the OECD's two year timetable for its action plan.

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Transfer pricing symptoms of chronic industry challenges

Some of the toughest challenges for you as a professional in a pharmaceutical and life sciences company come from rapidly changing market conditions and a complex global economy with multiple stakeholders. Pricing controls, the patent cliff, parallel trade, realised and unrealised firm synergies and the creation of local marketing intangibles are only some of the key areas of concern in the industry. You may deal with these issues day to day, but have you considered all their potential transfer pricing implications in today's evolving tax environment?

Some of the notable trends in the current landscape of the pharmaceutical industry also bring about complex transfer pricing (TP) dilemmas that require companies to tailor their TP strategy accordingly.

Pricing controls

Challenge: Soaring public healthcare costs

Tighter economic governance driven by a global fiscal crisis significantly reduced industry revenues over the last few years. Constraints on budgets and healthcare expenditures will likely continue. Healthcare reforms in countries such as Portugal, Greece, and Italy are expected to reduce costs and overall pharmaceutical spending.

Why are pricing controls becoming more prevalent nowadays?

To combat the unsustainable trend of soaring public healthcare costs, many governments have tightened pricing controls and have increased regulation of the pharmaceutical industry. These actions have contributed to an

increasingly tough market. Growth economies are joining mature economies in using direct and indirect pricing controls. Russia, India, and Turkey are a few of the countries that have recently introduced new or amended pricing controls.

Pricing controls can inevitably decrease your company revenues, which are expected to be reflected in local country income tax collections. For some countries, the decrease in public healthcare costs may be tempered by a loss of tax revenues from the pharmaceutical industry.

TP impact: Pressure on local margins

Government pricing controls generally impact the residual profit claimant or the local distribution entity. To insulate a local distribution entity from regulatory or pricing control risks, you may consider various alternatives,

Transfer pricing symptoms of chronic industry challenges

and gross margin restrictions and also limits marketing activities. Complying with the new requirements may lead to intercompany results below an arm's length level and it is unclear whether the law overrides existing TP rules.

As a pharmaceutical company you can address the challenges of pricing controls by establishing a flexible TP system and a robust end-to-end process that accommodates the challenges of multiple tax and regulatory requirements.

Patent cliff and post-patent life of drugs

Challenge: Survive the fall

As a pharmaceutical company, you may have tasted the bitterness of the so-called 'patent cliff' during 2012 – when the patents for a number of blockbuster drugs expired, and sales of generics eroded industry profits. A second wave of patent expirations in

2015 is expected to shrink sales nearly as much as in 2012. These developments put pressure on research and development (R&D) in a market where sales and new product launches are expected to be limited. The anticipated result is fewer blockbusters and more high-priced specialty and orphan drugs. Patent cliff concerns are less prevalent for biologics as these large molecule drugs are more difficult to replicate.

Also, the patent cliff and the inherent pressure on the R&D pipeline may generate more merger and acquisition activity in the industry. A recent example is Amgen's \$10 billion acquisition of Onyx. Companies with promising Phase II/III drugs in their portfolio make attractive acquisition targets. More companies may also consider spinning off an established cash-generating business from a more speculative drug development business as it happened for Abbott.

TP impact: Comprehensively redefine transfer pricing policy

The patent cliff may spur companies to take a closer look at the value drivers of their business. In the past, many companies ascribed value to product intellectual property and manufacturing-related functions, which is most likely no longer the case after patent expiry. Therefore, companies may need to carefully consider their post-patent commercial value drivers and, if appropriate, unbundle product intellectual property, manufacturing intangibles, other corporate functions and distribution intangibles.

How does the patent cliff impact your transfer pricing strategy?

The distribution TP policy might have received little attention during the patented life of

Transfer pricing symptoms of chronic industry challenges

blockbusters when the local market enjoyed high margins. As products come off patent and pressure on system profit increases, the local distributor should be properly compensated in line with its functional profile.

You may also want to reconsider your intellectual property licensing arrangements. Prior to patent expiration, these agreements often accounted for both product and marketing intangibles, and now their scope may need to be redefined or adjusted. Firstly you should analyse which products demand post-patent royalties and then reassess the royalty rate, which in some cases will be expected to be significantly lower.

Depending on factors such as the speed of introducing generics or certain manufacturing advantages, margins for generics can erode almost instantly or progressively over time. The resulting volatility

in local distribution returns also creates challenges for local TP compliance purposes.

When patents expire, local health authorities usually like to ensure drugs reach the market at the lowest possible price (particularly if included on reimbursement lists) and could impose pricing controls that put pressure on the local distribution margin. Transfer prices should be revised immediately after patent expiration as delayed action may also have indirect tax consequences.

Parallel trade

Challenge: Retain brand profit

Globalisation has increased the challenges of retaining brand profit. An increasingly complex supply chain involving multiple stakeholders across geographies makes preventing product diversion more difficult. Therefore, one real threat to a pharmaceutical

company these days is the parallel trade of drugs on the 'grey' market.

Parallel imports are pharmaceutical products produced under protection of a trademark or patent that are placed into circulation in one market and then imported by an unaffiliated intermediary into a second market without the authorisation of the local owner of the intellectual property right. Parallel trade occurs when one takes advantage of the price differential between two countries. For example, parallel trade tends to prevail in certain countries of the European Union (EU) where drug prices are considerably higher than in other EU member countries.

TP impact: Manage TP audit risk

Parallel trade products may compete with and benefit from the marketing activities of the local distributor or licensee. Therefore, your local entity sales volume

Transfer pricing symptoms of chronic industry challenges



What is the potential TP exposure triggered by parallel trade?

may decrease in spite of the same level of marketing efforts, which proportionally benefit the parallel importer. Tax authorities in some countries, such as Germany, are considering the TP implications of parallel trade as if local promotional activities provide a service to affiliated entities whose products get parallel exported. Local tax authorities may adjust taxpayer income to accommodate parallel trade effects by the following potential approaches:

- Deeming the parallel trade sales to be sales of the local distribution entity;

- Requiring cost-plus compensation on (deemed) local marketing and promotional expenses incurred by the local distributor with respect to the parallel trade sales; or
- Denying deductibility for tax purposes of the local marketing and promotional expenses incurred by the local distributor with respect to the parallel trade sales.

A strong brand protection programme may help you identify and prevent parallel export. You should consider a

coordinated, consistent, and cross-functional approach to brand protection that reaches across the entire organisation. In assessing the related risks, you need to consider the possible impact on your TP strategy and the potential for adjustments by local taxing authorities. One option to address the parallel trade related exposures could be to have preventing compensating adjustments for the affected affiliates.

Transfer pricing symptoms of chronic industry challenges

Local marketing intangibles **Challenge: Keep up with the evolving international tax environment**

Tax authorities have recently looked to address the observational trend that profit resulting from locally-developed intangible property often goes untaxed in the local jurisdiction. Consequently, tax authorities are raising more and more challenges with respect to locally developed or locally funded marketing intangibles when discussing the appropriateness of characterising the local entity a routine entity.

To establish a more robust framework on the international treatment of intangible property, the Organisation for Economic Co-operation and Development (OECD) issued in July its long-awaited Action Plan regarding Base Erosion and Profit Shifting (BEPS). The Action Plan proposes

15 separate action points, including assuring that TP outcomes are in line with value creation (function) with regard to intangibles. Shortly after the Action Plan was published, the OECD released its Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles. The Revised Discussion Draft provides guidance on allocating intangible-related return and focuses on functional value creation.

TP impact: Manage scrutiny of local marketing intangibles

Intensely competitive market conditions and the strict regulatory environment in the pharmaceutical industry have increased the importance of local sales and detailing activities, as well as after sale complementary activities. As such, as a pharmaceutical company you will often come under scrutiny when it comes to the risk of creating local marketing

intangibles. To avoid the TP pitfalls associated with marketing intangibles, you should consider aspects of your operations that could impact this determination, such as relationships developed with local healthcare professionals and regulatory bodies, expertise of the local sales force, etc.

Local Phase IV clinical trials may also present an area of concern. Trials can be powerful tools in influencing prescribers of a product and could generate local marketing intangibles. In particular, you should consider the funding of local Phase IV clinical trials by a foreign related party to inoculate yourself of this risk.

Why local marketing intangibles are still an area of concern for pharmaceutical companies?

Transfer pricing symptoms of chronic industry challenges

All these industry developments should be high on your agenda when formulating your company's transfer pricing strategy. It is important to stay abreast of marketplace evolution and ask yourself, is my transfer pricing strategy:

1. Current?
2. Managing the needs of our various internal and external stakeholders?

3. Flexible in accommodating industry and regulatory developments?

4. Efficient and reliable?

As the industry transforms itself to adapt in a changing global economy, you are not alone in having second thoughts about some of the above questions. Crystallising your optimal transfer pricing strategy requires a clear understanding of your

new operating model, deliberate consideration of several factors, lessons learned from the industry's audit and controversy history, and a fresh perspective on the latest industry trends.

Is it time to think about revisiting your transfer pricing strategy?



As the industry transforms itself to adapt in a changing global economy, you are not alone in having second thoughts about some of the above questions.



Transfer pricing symptoms of chronic industry challenges

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Running and growing an international business continues to become ever more complicated in today's geopolitical and economic environment.

Value Chain Transformation Globalisation Maturity Framework





Value Chain Transformation Globalisation Maturity Framework

Overcoming complex challenges to achieve goals and realise benefits

Running and growing an international business continues to become ever more complicated in today's geopolitical and economic environment. From difficulties in attracting and retaining talent, managing supply chain operations through extreme market volatility, disruptive events and rapidly evolving sales channels, to managing financial and regulatory risk and reputation in the post-BEPS¹ environment, companies across all industries find themselves faced with increasingly complex and multi-dimensional challenges as they expand their businesses globally. PwC's recent research and discussions with executives provides a new framework – the

Value Chain Transformation (VCT) Globalisation Maturity Framework – to enable multinationals to assess how they are dealing with these challenges and what changes are required in various dimensions of their management (decision-making), operational (execution) and legal (control) structures to achieve their strategic goals and realise operational and financial benefits.

Understanding the multi-dimensional elements of globalisation models

Based on our research, including a fresh review through the lens of today's global business environment of Bartlett & Ghoshal's seminal 1998 work *Managing Across Borders: The Transnational Solution*², Cohen and Roussel's *Strategic Supply*

*Chain Management: The Five Disciplines for Top Performance*³ and PwC's PRTM Management Consultant's Insight article *Guiding Global Growth*⁴ and discussions with executives of multinational companies across various industries, we have concluded that the path to globalisation maturity in today's business environment typically leads through four phases with four different models - Domestic, Export, Regionalise and Originate. We have observed that the implications for international businesses of all sizes and in all industries of adopting these models may be analysed using a matrix of twelve dimensions covering three types of structure within the organisation – management, operational and legal.

¹ Organisation for Economic Co-Operation and Development (OECD): *Initial Report on Base Erosion and Profit Shifting (BEPS)*, February 12, 2013

² Christopher A. Bartlett and Sumantra Ghoshal: *Managing across Borders: The Transnational Solution – 2nd Edition*. Harvard Business School Press (1998)

³ Shoshanah Cohen, Joseph Roussel: *Strategic Supply Chain Management: The Five Disciplines for Top Performance – 2nd Edition*. McGraw Hill (2013)

⁴ Keith Robinson, David Van Oss, Shoshanah Cohen: *PRTM Insight: Guiding Global Growth Q2*, 2010.



Value Chain Transformation Globalisation Maturity Framework

Figure 1 opposite defines the twelve dimensions used in the VCT Globalisation Maturity Framework.

Companies typically start with *Domestic* model and grow into one of the other three business models to meet various objectives, strategies and requirements. Enabling strategy requires supporting a company’s key sources of competitive advantage, and a good strategy should be aligned, tailored, resilient, responsible and adaptable. New models may need to be implemented over time to align with changing circumstances. This may be for a range of reasons from something as commonplace as shifting market requirements to a single significant event – such as an industry player changing model and deriving an advantage as a result, forcing its competitors to follow or develop an alternative differentiating approach. Progression from one

model to another is often difficult and disruptive and companies may retain elements of more than one model as they move through transition periods.

This model generally applies to companies about to embark on international expansion. They may be leaders in their home territories or companies with rapidly growing businesses which may be looking to grow a global footprint initially through alliance with other companies or cross-border acquisitions.

Companies adopting the *Export* model typically have a centralised management, operational and legal structure, with development and ownership of core competencies concentrated and retained at the headquarter location. This model allows companies to scale up for international business with strong control from the headquarter location.

Figure 1: PwC’s VCT Global Maturity Framework dimension definitions

		Definition
Management structure	1. Talent	Ensure that critical skill sets are available where needed
	2. Governance	Define responsibility for setting strategy and meeting business objectives
Operational structure	3. Market reach	Define and penetrate target markets
	4. Market offering	Maintain a product portfolio suited to the needs of target markets
	5. Operations	Define an operating footprint that balances cost and customer service objectives
	6. Procurement	Ensure product quality, reliability, and timeliness through a network of trusted suppliers
	7. IP management	Develop strategic technologies while protecting access
Legal structure	8. Service	Ensure customers’ needs are met before, during and after delivery of products and services
	9. Partnerships	Define and manage internal and external partnerships and alliances to achieve the right operational strategy for each new market
	10. Capital	Ensure access to strategic capital and meet investor expectations for ROI
	11. Legal	Frame business structures, contractual relationships, corporate transactions and compliance
	12. Economics	Deploy functions, risks and assets across legal entities

Value Chain Transformation Globalisation Maturity Framework

Figure 2 below provides a summary overview of the matrix of models, structures and dimensions in our VCT Globalisation Maturity Framework.

Figure 2: PwC's VCT globalisation maturity framework matrix

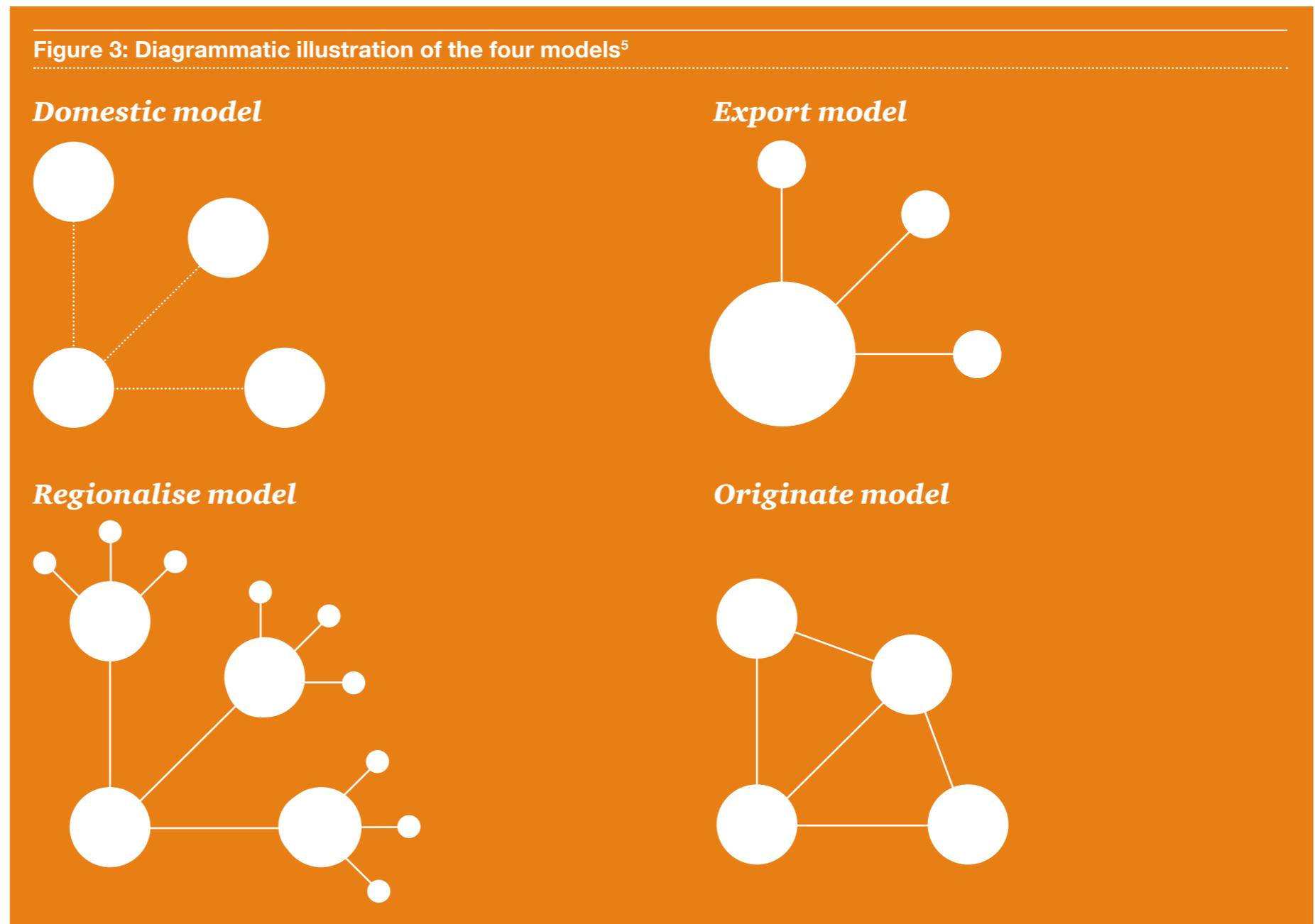
		Domestic model	Export model	Regionalise model	Originate model
Management structure	1. Talent	Leadership and talent focused in local country	Senior management from home country	Recruits locally including regional management	Senior leaders from various home regions
	2. Governance	Decentralized federation	Command and control approach	Increasing regional dimension and evolution	Integrated global / local governance
Operational structure	3. Market reach	Focused on local market	Overseas sales through rep offices / third parties	Increased overseas presence	Market approach adapted for each region
	4. Market offering	Local market	Virtually identical products cross-markets	Products adjusted for local markets	Products originate in and tailored to new regions
	5. Operations	Local country, plus potentially leverage low cost country	Strong home country supply chain with int'l distribution	Increasing localization of production and supply	Global footprint determined by total landed cost
	6. Procurement	Local country, plus potentially low cost country	Procurement for low-cost countries	Active sourcing in newly targeted regions	Company manages a global tiered partner network
	7. IP management	IP developed, managed, retained in local country	IP closely guarded in home market	R&D centers deployed in expansion regions	Global network to exploit wider R&D ecosystem
	8. Service	Predominantly local market	Home country resource support internationally	Regional service centers of excellence	Global best practice applied in each market
	9. Partnerships	Limited within local market	Focus on distribution & potentially service & sales	Broader use of partnerships across multiple dimensions	Global partnerships based on strategic core competencies
Legal structure	10. Capital	Local financing on strength of local balance sheet	Capital financing provided by home country	Increasing regional allocations of capital	Structuring to access new sources of capital
	11. Legal	Autonomous local entities	Contractual relationships controlled by center	Hub and spoke contractual relationships	Shared responsibility for contractual relationships
	12. Economics	Limited cross-border interaction	Key activity concentrated in center	Key activity split between center and regional hubs	Interdependencies between countries

Value Chain Transformation Globalisation Maturity Framework

Figure 3 provides a diagrammatic illustration of the models.

Implications and application

The implications of the framework are important and far-reaching for all companies operating or wishing to expand internationally. A move from one model to another forces companies to adopt new approaches for each dimension to support the new model. Different dimensions will carry different levels of importance for different companies, depending on their strategic and other priorities, but ultimately all dimensions need to adapt to the new model. The level of change required to ensure competitive advantage sources support the strategy under the new model is significant and requires a deep understanding of the issues as well as the drive and discipline to implement. However, the results of high-performing supply chains on business performance are



⁵The circles may represent countries, market or legal entities, with the circle size corresponding to importance or size. The lines between the circles represent their interrelationships, with solid lines denoting strong interrelationships and dotted lines representing weaker interactions.



Value Chain Transformation Globalisation Maturity Framework

compelling. Compared with their industry competitors, leaders see⁶:

- 50% higher average annual sales growth
- 20% higher profitability
- 50% higher net asset turns
- 15% lower supply chain management costs
- Less than half the inventory levels
- More than three times shorter cash-to-cash cycle times

Regardless of industry or size, it is vital for management to understand exactly where their organisation lies along the globalisation maturity spectrum, where their competitors are positioned, what they need to change to meet strategic objectives and how they achieve that change. Our VCT Globalisation Maturity Model provides a focused and objective way to

achieve this understanding and develop a strategy that is aligned, tailored, resilient, responsible and adaptable. Up to now, companies implementing new models have typically focused on changing one structure or a select few dimensions. However, invariably, the analysis of the change required is not comprehensive or holistic and without understanding all of the interdependencies between the full range of structures and dimensions, it is generally not possible to truly understand the overall implications of such change. Successful transformation starts with setting realistic goals. Changes can range from incremental improvements, such as making processes more consistent and predictable, to breakthrough innovations, like brand-new ways of competing in an industry.

Up to now, companies implementing new models have typically focused on changing one structure or a select few dimensions

PwC's approach leverages a closely integrated team of professionals with the range of experience and expertise across the full range of relevant disciplines to understand, analyse and evaluate the implications of changing the various dimensions and, most critically, the interdependencies between them. Our framework for analysis may be applied broadly for companies of all sizes in different industries and aims to align management, operational and legal structures to achieve strategic goals and realise financial and operational benefits.

⁶ Shoshanah Cohen, Joseph Roussel: *Strategic Supply Chain Management: The Five Disciplines for Top Performance – 2nd Edition*. McGraw Hill (2013).

⁷ PwC: 10 Minutes on Strategic Supply Chain Management. September 2013.

Value Chain Transformation Globalisation Maturity Framework

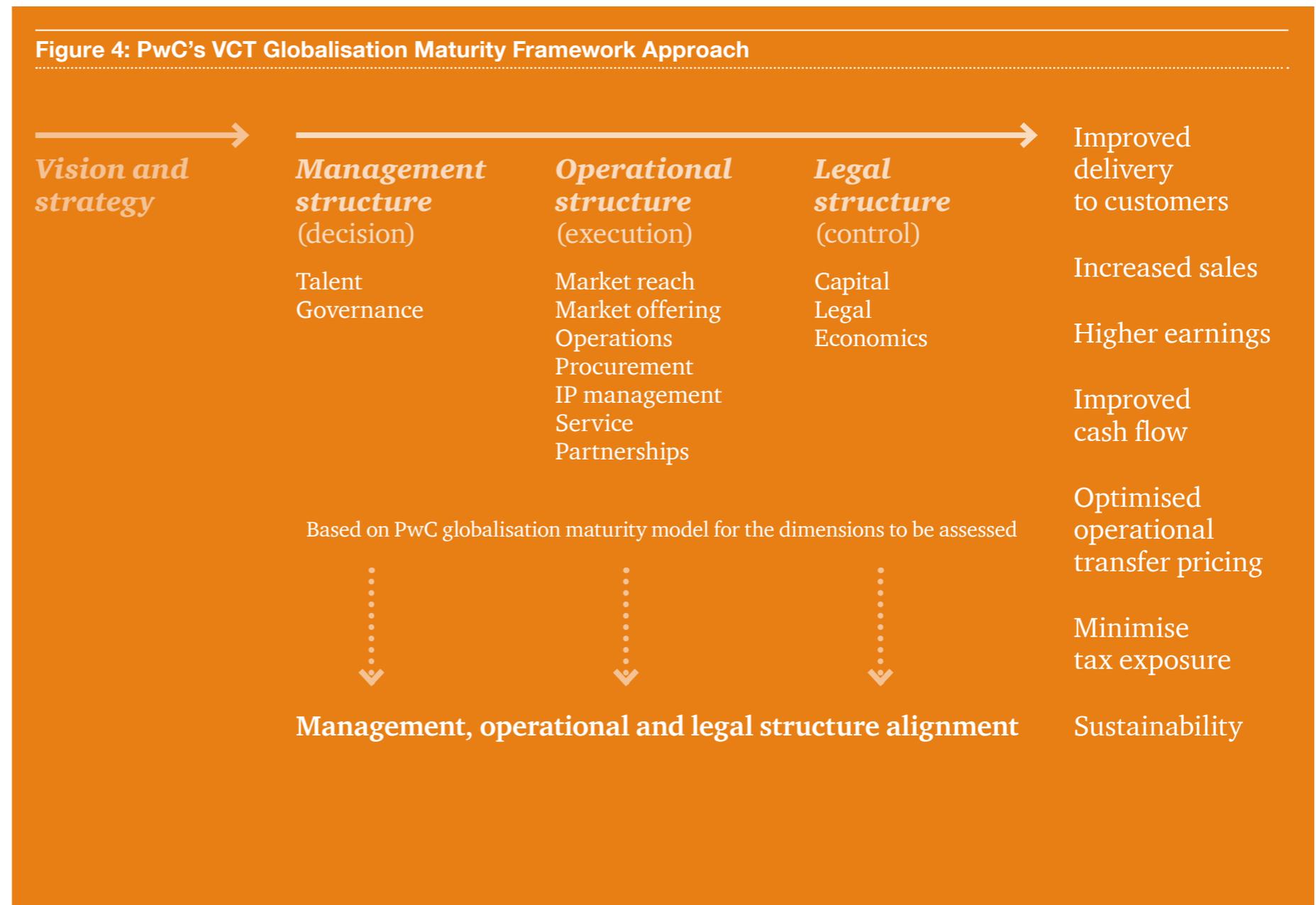
Figure 4 opposite summarises our approach in applying the VCT Globalisation Maturity Framework approach.

Using the framework to assist multinationals in analysing and evaluating some key questions.

For example:

- **How do we evaluate whether our current model will continue to help us achieve our vision and strategy going forward?**

Using the framework, we identify where multinationals currently lie on the VCT Globalisation Maturing Framework spectrum, analyse whether they are as evolved as they should be, evaluate how they compare to their peers and competitors and identify optimal target models.





Value Chain Transformation Globalisation Maturity Framework

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