A series of articles based on our Global Transfer Pricing Conference in Toronto, Canada – October 2016

Transfer Pricing Perspectives:

The new normal: full TransParency

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Foreword

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Almost 700 enthusiast transfer pricing practitioners from both outside and within PwC gathered in Toronto at our annual Global Transfer Pricing Conference. No doubt it is again one of the most successful events we have ever hosted in our network.

When asked what drives our clients to work so close with us in navigating today's complexities of the quickly evolving international tax landscape, TransParency stands out. (Public) country-by-country reporting, ideally as part of an end-to-end compliance strategy from robust contracts till implementation of pricing policies is a good example. There are also novel best practices approaches such as our PwC Value Chain Analysis that require an objective approach to demonstrate our clients' efforts to come to a fair intercompany pricing with a business hat on.

One also needs to grapple with the European Commission's agenda on combatting so-called "illegal state aid". If transfer pricing deserves one trophy in "Brussels", it would definitely be the one for "Soft Target of the Year". Finally we are all anxious to see the United Nations' long awaited update of its transfer pricing manual very soon.

The articles in this October 2016 edition of *Transfer Pricing Perspectives* are based on our sessions in Toronto, and we hope they will help you be even better equipped for the changes we're expecting to see in the coming months. For this year's edition, we would like to highlight new and refined service offerings that are best suited to tackle the new challenges: with business operating models, we take a holistic approach and link tax expertise with deep business understanding. Global Coordinated Documentation with the Master File and Local File, as well as country-by-country reporting have changed the perception and added to the complexity of TP compliance in a significant way. Finally, we continue to "bridge the gap" between tax and industry expertise, which is why we are happy to share several excerpts on industry developments as well.

We hope you enjoy the read. Your PwC contact(s) can't wait to engage further in a dialogue with you to jointly roll-up their sleeves.

Isabel Verlinden

Contents

Greetings from Canada

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Canada has a thriving free-market economy, with businesses ranging from small owner-managed enterprises to multinational corporations.

Canada is the largest country in the western hemisphere and one of the largest in the world. It has a stable government, a highly skilled workforce, and its residents enjoy a high standard of living. The country has a well-developed transportation system and is rich in natural resources. Canada's official languages are English and French, and its federal capital is Ottawa. It is a parliamentary democracy and is divided into 10 provinces and three territories.

Canada has a thriving free-market economy, with businesses ranging from small owner-managed enterprises to multinational corporations. While its economic development was historically based on the export of agricultural staples and the production and export of natural resource products like minerals, oil and gas, and forest products, Canada now ranks as one of the top manufacturing nations of the world and boasts a rapidly expanding service industry.

While Canada has abundant natural resources and a strong banking system, the recent drop in crude oil prices is taking a toll on both the oil and gas sector and the overall economy. On the bright side, lower energy costs are helping consumers and non-resource based sectors, and the lower Canadian dollar and improved US economy are increasing Canada's manufacturing sector's exports to the US. Consumers are enjoying low gas prices and, combined with continued low interest rates, are able to spend more, though as consumer debt increases they may begin to exercise fiscal restraint. Likewise, most provincial governments are generally continuing to rein in spending to balance their books and will likely make only minimal contributions to overall economic growth in 2016 and 2017. In contrast, the federal government

Greetings from Canada

plans to incur large deficits in the next few years to improve Canada's infrastructure and stimulate the economy. The 2016 federal budget states that over CA$120 billion will be spent on infrastructure over the next 10 years and that this, along with other budgetary measures, will "raise the level of real gross domestic product by 0.5% in the first year and by 1% by the second year".

In terms of transfer pricing developments, the 2016 federal budget also includes a number of base erosion and profit shifting (BEPS)-related proposals as Canada continues to be a leading participant in the global movement toward tax transparency and accountability. These proposals include draft amendments to the Income Tax Act adopting country by country reporting (CbCR), effective for the 2016 taxation year, and penalties for failing to meet the Organisation for Economic Co-operation and Development's (OECD's) common reporting standard, under which Canada is to make its first information exchanges in 2018 on financial accounts held in Canada by foreign residents.

Canada's longstanding support of the OECD's global tax initiatives was confirmed at a recent transfer pricing conference, where the assistant commissioner (International) with the Large Business and Investigation Branch of the Canada Revenue Agency (CRA) stated that the new BEPS guidance merely reinforces Canada's current approach to international tax. As such, though the new CbCR legislation will likely have a significant effect on taxpayers, the Canadian transfer pricing rules are expected to essentially remain unchanged.

The CRA also acknowledged increasing concern among the general population about individuals and companies that don't pay their fair share of tax. It emphasised the importance of responsible enforcement and declared Canada's intention to share knowledge with developing nations to help them acquire the technical tools necessary to apply BEPS fairly and efficiently. Canada is also in favour of more arbitration and proactive approaches such as advance pricing agreements.

Last, a shout out to our global TP conference host city, Toronto, which was ranked third, behind London and Singapore, as one of the best cities to live and work in (see PwC's latest *Cities of Opportunity 7*[1] report, a biennial global study that benchmarks 30 cities against an extensive set of indicators and underlying variables to examine the social and economic qualities that make cities thrive).

Congratulations, Toronto!

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[1] www.pwc.com/us/en/cities-of-opportunity

Greetings from Canada

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Final BEPS guidance places renewed emphasis on intercompany agreements

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Summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on transfer pricing documentation and country by country (CbC) reporting, an outcome of the OCED's Base Erosion and Profit Shifting (BEPS) Action Plan. Developed as a replacement for the existing Chapter V (Documentation) of the Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and tax administrations (OECD Guidelines), last revised in 1995, the new guidance prescribes specific documentation to be compiled by multinational enterprises to support their structuring and pricing of intercompany transactions. Specifically, among other things, the final guidance calls for taxpayers to include a list of "important agreements" pertaining to intangibles in the Master File and copies of all "material intercompany agreements" in the local transfer pricing documentation files of their worldwide affiliates.

As multinational entities focus on their intercompany agreements in light of these new disclosure requirements, careful attention should be paid to the guidance provided by the OECD with respect to contractual terms between related parties. Specifically, the OECD has stated that written contracts alone should not drive the economic outcome. If the actual characteristics of a transaction between related parties are inconsistent with the legal written agreements, then the actual functions undertaken, risks borne, and assets employed by the parties ultimately should determine the factual substance that will affect the determination of the arm's-length conditions.

Final BEPS guidance places renewed emphasis on intercompany agreements

Historically, rules regarding intercompany agreements have varied widely from country to country. For example, US transfer pricing rules generally do not require intercompany agreements to be in place in order for related-party transactions to be respected by the Internal Revenue Service (IRS). On the other hand, without intercompany agreements, some countries, such as Nigeria, may disallow tax deductions for expenses resulting from intercompany charges. In a number of countries, including Argentina and South Africa, agreements are needed to facilitate the remittance of cash out of the country.

In 2013, well before the OECD issued its final BEPS guidance, Australia enacted substantive changes to its transfer pricing laws, specifically requiring that the legal form of intercompany transactions be reviewed against their substance. To the extent the two do not align, the law directs that the actual conduct of the parties overrides the legal agreement in determining an arm's-length result. Moreover, the Australian law also requires that, where the intercompany transactions are inconsistent with 'commercial' independent arrangements, taxpayers must disregard the intercompany transactions and replace them with an alternate hypothesis. Given the current focus on substance among tax authorities worldwide, other jurisdictions may introduce similar requirements.

As more and more countries around the world adopt the OECD's new documentation guidance, now is the time for MNEs to assess the level of intercompany agreement coverage for their material transactions globally and take action to remedy any identified gaps. Such an analysis is critical for many multinational companies that, historically, may not have prepared and executed intercompany agreements as a matter of course.

Moreover, as part of this intercompany agreement coverage analysis, MNEs should also reconcile the presentation of the functions performed, assets employed, and risks borne by the related parties to the intercompany agreements with the analyses presented in the transfer pricing documentation, particularly in the Master File.

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Final BEPS guidance places renewed emphasis on intercompany agreements

Final BEPS guidance

In 2013, the OECD and G20 countries adopted the 15-point BEPS Action Plan. The stated objective of the BEPS initiative was to develop a global framework to address perceived flaws in international tax rules that were seen by revenue authorities to result in the misallocation of income and expense among jurisdictions. Essentially, the OECD's focus was on coordinating and harmonising international tax rules to eliminate mismatches and incongruities between the laws of different jurisdictions that result in double non-taxation (i.e., income, that is not taxed in any country) as well as instances where profits are perceived as geographically divorced from the activities that gave rise to that income. With respect to Action 13, the OECD's stated goal was to increase transparency for tax administrations along with promoting certainty and predictability for taxpayers through improved transfer pricing documentation and a template for CbC reporting.

In the final Action 13 deliverable, the new Chapter V of the OECD Guidelines, MNEs are directed to prepare transfer pricing documentation consisting of a Master File and Local Files for each jurisdiction. As well they should complete three templates intended to capture specific data points and functional and other relevant information on a CbC basis. With respect to the Local Files, under the heading "Controlled Transactions," the final guidance specifically calls for "copies of all material intercompany agreements concluded by the local entity" to be included in the Local File. In this context, materiality is considered from the perspective of the local country, as opposed to the consolidated group. In relation to the Master File, a list of 'important' related party agreements related to intangibles (including cost contribution arrangements), principal services agreements and license agreements is required. Corporate tax professionals should note that the term 'important' is subjective and undefined.

Final BEPS guidance places renewed emphasis on intercompany agreements

In Chapter I, contractual terms are addressed in the context of the factors for determining comparability between a controlled transaction (or taxpayer) and uncontrolled comparables. The OECD Guidelines consider that an analysis of contractual terms should be part of the functional analysis, which looks to identify and consider the functions performed, assets employed, and risks borne by the relevant entities to the controlled transactions under review.

In addition to formal, written contracts, the OECD Guidelines highlight that contractual terms may also be found in correspondence between the parties – a reminder to taxpayers to always to be conscious of the content of their internal communications including written memoranda, email, text messages, and instant messages.

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As countries around the world implement guidance from Action 13 and other BEPS actions, MNEs proactively should identify any gaps between their current transfer pricing documentation components and the new Chapter V of the OECD Guidelines, particularly with respect to intercompany agreements.

Final BEPS guidance places renewed emphasis on intercompany agreements

Leading practices

MNEs are best advised to memorialise the actual conduct of their related parties in line with the substance of the intercompany activities through written agreements executed in advance of the transactions commencing, considering leading practices to mitigate potential risk.

Commerciality

Under the arm's-length principle, related entities are required to realise outcomes consistent with those that would be achieved between independent parties. In this context, particular attention should be paid to the precise explanation provided for each party's assumption of risk.

Under the arm's-length principle, related entities are required to realise outcomes consistent with those that would be achieved between independent parties.

For example, if one party bears foreign exchange risk in a particular transaction, this risk should be documented in the agreement (e.g., by denominating the currency of an intercompany payment).

Further, any relevant terms that may affect the price of the intercompany transaction should be documented. For example, in intercompany funding arrangements, taxpayers should include all relevant terms that typically would be present in third-party funding arrangements that would influence the interest rate applied – not only should the currency, term, and amount be included, but also subordination, guarantees, covenants, and security.

Final BEPS guidance places renewed emphasis on intercompany agreements

Contemporaneous

Intercompany agreements should be drafted and executed prior to a transaction being effected. Contracts made effective prior to the date of execution are unacceptable in many jurisdictions and the practice may increase risk. Ensuring coverage of material intercompany transactions in real time is also key to risk mitigation, and corporate tax personnel are well advised to collaborate with in-house counsel to develop, maintain, and monitor a catalogue of intercompany agreements, including a summary matrix setting out the parties to the contract, execution date, expiration date, and type of transaction covered. If this centralised catalogue is missing, there is a risk that the listing of intercompany agreements in the Master File could be incomplete.

Consistency

Consistency of contractual terms and standardisation of definitions across agreements can be beneficial for corporate tax and legal professionals with a large inventory of intercompany agreements to manage. Drafting a model agreement for use in memorialising intercompany transactions may aid in efficiency and cost control. Specifically, a model agreement may help ensure that defined terms are clear and consistent across the organisation, that contracts reflect the appropriate allocation of risk and warranty language, and that standard terms are included in the contract (e.g., choice of law, arbitration or mediation clauses, indemnity provisions).

Although a model agreement may help to reduce compliance costs and reduce administrative burden, every intercompany contract must still be tailored to the type of transaction and, most importantly, reflect the rules of the local jurisdiction. Local counsel should review all intercompany agreements prior to execution to ensure compliance with applicable rules.

In addition, when drafting intercompany agreements, corporate tax professionals and in-house counsel should pay close attention to the way in which the contractual terms reflect the functional profile of the parties to the agreement. Specifically, in the case of service agreements,

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Final BEPS guidance places renewed emphasis on intercompany agreements

care should be taken to enumerate the explicit functions that will be performed by the service provider. The explicit functions described and documented in the legal agreements must then be consistent with the description of the benefits the service recipient receives in its local transfer pricing documentation. To the extent that agreements relate to tangible or intangible assets, clear and specific descriptions of the assets in question are also important.

When drafting agreements applicable in jurisdictions that respect the arm's-length standard, the foundational principle of most transfer pricing regimes, taxpayers may want to consider including language stating that the consideration paid will be arm's length rather than giving a specific percentage or figure. This phrasing can help avoid a common pitfall where an intercompany agreement specifies payment of a certain dollar amount or a fixed mark-up that over the course of a multiple-year agreement could yield a non-arm's-length result. This approach may also contribute to cost savings because it will not be necessary to update the agreement every time the comparables on which the remuneration is based fluctuate.

In instances where the consideration for the transaction is based on a cost-plus mark-up or expressed as a percentage of a given amount (e.g., revenue, operating profit), corporate tax personnel should ensure that the cost or income base to which the rate will be applied is specified. Frequently, companies will focus on the percentage and leave the pool of costs or revenue to which the rate will be applied undefined. This mistake can be costly in practice as minor changes to the cost or revenue included in the base can create significant fluctuations in taxable income even when modest rates are applied.

A careful balance is required in drafting agreements to ensure there is enough explicit information for the agreements to be meaningful, consistent with substance, and easily reconciled to transfer pricing documentation prepared on the one hand, but also flexible enough to continue to apply as the business evolves over time.

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Final BEPS guidance places renewed emphasis on intercompany agreements

Confidentiality

Many taxpayers have expressed concern about maintaining confidential information in the face of seemingly extensive information sharing among tax authorities. With the OECD calling for all material intercompany agreements to be included in the Local Files MNEs prepare for the jurisdictions in which they operate, there is the potential for exposure of confidential information, particularly in the context of intercompany technology and intellectual property license agreements. Taxpayers must use discretion when including proprietary information in their intercompany agreements, balancing the need for completeness with respect to the detail contained in their contracts with the need to protect proprietary information. Taxpayers may want to consider drafting confidentiality clauses and survival clauses to ensure that sensitive information is not misappropriated.

The road ahead

Given many tax authorities currently require contemporaneously executed intercompany agreements, in order to respect local deductions and that some tax authorities already mandate the local registration of executed agreements, the requirement that the Local File contain all material intercompany agreements is another factor contributing to the advisability of documenting intercompany arrangements. Further, it is anticipated that tax authorities will continue to focus on the conformity between a MNE's internal legal agreements and the outcomes of its intercompany transactions.

In this uncertain environment, taxpayers are best advised to assess their established intercompany agreements proactively and take steps to eliminate any gaps. Further, by adopting leading practices with respect to intercompany agreement drafting, MNEs can improve their documentation practices and potentially achieve efficiencies resulting in lower compliance costs. Given the speed with which countries around the world are adopting the final BEPS guidance, the time for action by taxpayers is now.

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Final BEPS guidance places renewed emphasis on intercompany agreements

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Rethinking value chain analysis

Rethinking value chain analysis

As controversial as transfer pricing can be in many regards, there is an established set of principles and methods generally agreed upon under the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by the Organisation for Economic Cooperation and Development (OECD Guidelines) and most local statutes and regulations. Most of the controversy is in interpreting the facts and applying the available methods based on evidence from third party transactions. Typically, only the simplest sides of transactions are looked at, while the entrepreneurial entities and the full value chain receive limited review. We refer to this as classical transfer pricing.

Classical transfer pricing approaches and techniques are under review as the members of the OECD (and G20) are debating and publishing action papers focused on the concept of base erosion and profit shifting (BEPS), urging the importance of applying what classical transfer pricing principles intended to achieve; ensuring the arm's length nature of intercompany transactions. Much of the BEPS discussion focuses on how to effectively and accurately interpret the functions, risks and assets (tangible and intangible) of a multinational enterprise (MNE). An understanding of the MNE's full value chain is at the heart of the newly developed BEPS framework such that the value chain of the consolidated taxpayer is considered in assignments of profitability (and associated transfer prices) to individual entities.

Many taxpayers these days are considering and often using this comprehensive approach to transfer pricing called value chain analysis (VCA). The approach involves an investigation into the functions, risks, and assets of the controlled group as a whole, and an evaluation of how they integrate with the group's key value drivers. The conclusions from these analyses are often used to attribute group profits to key functions, risks, assets, and value drivers of the business.

VCA is not an easy task, especially for an MNE with complex function and risk matrices spread across different entities. Transfer pricing practitioners have been debating the "right" way to conduct a VCA in such situations. This article explores the two leading approaches to the VCA; the Formulaic VCA and the Empirical VCA. We argue that in certain cases, Empirical VCA could be the more defensible approach as it attempts to align with the arm's length principle, which continues to be the one enduring principle in the ever changing world of transfer pricing.

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Rethinking value chain analysis

BEPS initiative and VCA

The OECD has finalised a number of BEPS action papers, many of which posit that classical transfer pricing must be interpreted and applied in the context of the entire value chain of the MNE, urging the need for proper application of classical transfer pricing.[1] The OECD is addressing demands from governments to be able to see the entire value chain of a business without being limited to the part that is residing in their country. Much of the discussion revolves around identifying the appropriate entrepreneurial principal entity or entities in the MNE group transfer pricing arrangements and verifying the profits assigned not only to the routine service providers in the controlled group, but to the entrepreneur(s) as well. As a result, an analysis of the MNE's key operational and management activities generating entrepreneurial profit may lead to the transfer pricing structure being recharacterised if the facts and economic substance of the arrangements differ from the transfer pricing arrangements in place.

There is a worry that such recharacterisations could be applied too often and too widely. To limit the potential for unsupportable recharacterisations, a transfer pricing structure should be based on sound findings of fact from a carefully executed and thorough functional analysis, and fully grounded in principles of finance and economics. As such, it is critical in the post-BEPS environment to enforce the classical transfer pricing framework with a VCA mindset.

[1] The OECD finalised Action Papers 8-10: Aligning Transfer Pricing Outcomes with Value Creation as well as Action Paper 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting. The OECD also released a discussion draft concerning the use of profit splits in a value chain context.

Rethinking value chain analysis

The arm's length principle should be respected at all times and performance of functions and entrepreneurial risks and ownership structures should be evaluated based on arm's length evidence.

BEPS Action Papers 8–10 require a review of the entire MNE and a supporting economic substance and risk analysis for allocations of entrepreneurial profit to principal entities. Master file, local file, and country-by-country reporting requirements under BEPS Action Paper 13 will require much more thorough documentation than has historically been required. This is the new environment of transfer pricing, with VCA at the forefront.

Classical transfer pricing and the arm's length standard are still the prevailing principles of transfer pricing; however, the requirements for supporting a company's transfer pricing system are rapidly evolving and are demanding a more complete review of the entire value chain. This trend should not be perceived as a deviation from classical transfer pricing since the value chain perspective is, in fact, engrained in what classical transfer pricing intended to achieve. Only by creating a carefully designed, thoroughly documented, and well-executed and maintained transfer pricing system looking at the entire value chain of a controlled taxpayer group can a taxpayer gain some relative comfort and protection from over-reach by tax authorities in the future.

Different approaches to VCA

The OECD refers to VCA but the construction of a proper value chain is still undefined. Two schools of thought have been leading the VCA debate. One approach, the formulaic approach to VCA (Formulaic VCA), has been in use by some practitioners for several

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Rethinking value chain analysis

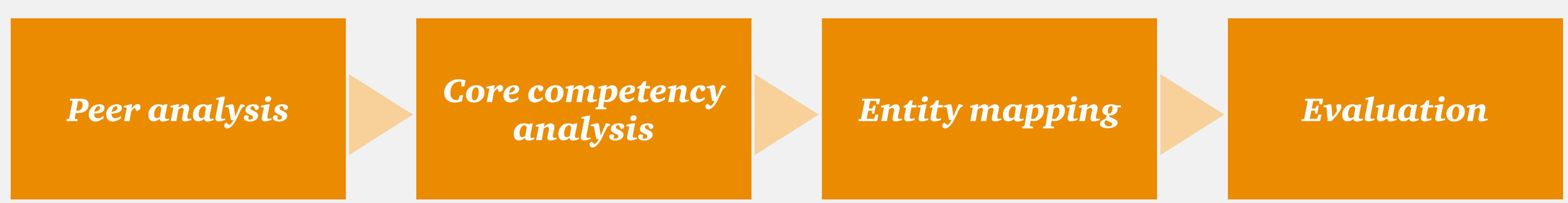
years. The formulaic approach is based more on creating minutely detailed weighting and scoring templates regarding key business activities and company business processes. These weights and scores are often developed through extensive company management workshops, and involve developing management's views into the detailed weighting and scoring templates that rank and score business processes and functions. The outcome of this approach is effectively a global profit split approach based on the identified value drivers. This approach is quite practical for taxpayers operating in industries where third party information about peers is limited or unavailable. In cases where third party data are widely available, however, the Formulaic VCA could be more susceptible to tax authority challenge as the tax authorities may try to replicate the findings of the Formulaic VCA using the third party evidence.

The second approach is based on the maximum use of arm's length information and applies classical transfer pricing tools to principal group peers to evaluate the entire value chain of the MNE. This is a relatively new approach, relying on classical transfer pricing skills to develop key insights into the value chain using objective third party evidence. The analysis is supplemented by insights and information supplied by management, and with maximum use of classical transfer pricing tools. We call this the empirical approach to VCA (Empirical VCA).

Empirical VCA

The structure-conduct-performance (SCP) paradigm and the core competency framework that is based on peer analysis are at the heart of Empirical VCA design, which provides powerful insights for the entire value chain of a business. The approach relies on third party evidence to formulate a structure that complies with the core intent of classical transfer pricing. Empirical VCA has four primary steps: peer analysis, core competencies analysis, entity mapping, and evaluation of results (see Figure 1).

Figure 1: Four phases of empirical VCA



Rethinking value chain analysis

Peer analysis phase

A peer analysis is conducted for the overall consolidated group and it is broader and applies to the entire value chain of the organisation. The peer analysis is intended to identify the sources of sustainable competitive advantages for the taxpayer relative to its peers. The peer analysis in this phase is different from the comparable company analysis employed in one-sided tests. Industry peers are selected for the consolidated group and represent comparability on a consolidated level. This analysis requires a thorough review of publicly available data for the MNE's primary competitors and peers in its industry. In certain cases, the peer analysis may focus on a specific function of the taxpayer, evaluating the functional competency of taxpayer vis-à-vis functionally comparable peers.

Core competencies analysis phase

The array of competencies of the MNE are identified and analysed under Empirical VCA. Here, the functions performed, risks assumed, and assets owned by the consolidated group are documented, and the profits or losses attributable to each competency are determined. This phase is conducted based on a thorough functional interview and a careful review of publicly available information and analyst reports about a taxpayer company group. The end product for this analysis will be a heat-map type illustration showing core competency areas of the taxpayer vis-à-vis its peers. Determining the core competencies of the taxpayer and comparing these with its peers is a crucial part of an Empirical VCA.

The core competencies phase of the analysis will allow practitioners to use arm's length data and publicly available information, along with information provided by the MNE's management, to identify layers of profitability that can be attributed to the primary functions and core competencies of the MNE. In this phase, practitioners should also identify the interaction of core competencies with risks and investments, managerial control of risks, and financial capacity to bear risks, which are the hallmarks of economic substance. Classical transfer pricing tools should be employed to determine arm's length profitability ranges for each routine function and core competency area. If necessary, functional and geographic segmentation of peer financials, where available, accounting adjustments, and other comparability adjustments should be employed to account for comparability differences between the taxpayer and the peers.

Rethinking value chain analysis

Entity mapping phase

Third, profits or losses attributable to core competencies and routine functions are mapped to each legal entity based on its specific facts and competencies, employing classical transfer pricing techniques to the extent possible. This phase identifies which functions, core competencies, and elements of economic substance can be attributed to each entity in the controlled taxpayer group. A focus on intercompany agreements and economic substance, with a maximum use of third party evidence, will indicate an allocation of profit within the MNE group that will be supportable by: i) the arm's length standard; ii) established principles of risk and investment; and iii) the BEPS Action Papers 8-10. Under this method, entities employing routine functions will be entitled to routine returns, whereas entities performing core competencies with economic substance will receive applicable entrepreneurial returns. When a split of entrepreneurial profit is required between entities performing core competencies, often approaches other than the classical approaches need to be employed. Further, in cases where intangibles are involved, appropriate allocations of profits to entities performing development, enhancement, maintenance, protection, and exploitation (DEMPE) functions, as described in the BEPS Action 8 report, should be considered.

The entity mapping phase is a profit-split exercise under Formulaic VCA, by design. Empirical VCA, on the other hand, provides the taxpayer with the ability to identify where in the value chain excess profits are earned and core competencies are employed, and it does not default to a profit-split-type apportionment. It provides enough insights about core competencies that it can effectively differentiate routine functions from core competencies and allocates profits accordingly via the profit-split approach or any other approach that may be suitable.

Evaluation phase

In the final phase, a variance analysis is performed between the taxpayer's existing transfer pricing policies and the conclusions of the Empirical VCA to identify any areas of risk and opportunities to bolster or improve existing transfer pricing policies. This phase involves a gap analysis between the conclusions of the entities analysis and the current allocation of profits within the controlled taxpayer group based on currently administered transfer pricing policies. If the MNE's current transfer pricing policies and the results of the Empirical VCA entity mapping are in alignment, then the Empirical

Rethinking value chain analysis

VCA approach will provide strong support for existing transfer pricing policies. If the review indicates a need for better alignment in certain areas, then the existing policies can be reviewed and potentially modified to bring them into alignment with the VCA conclusions, strengthening support for the taxpayer's transfer pricing arrangements going forward.

Conclusion

Overall, Empirical VCA makes maximum use of third party data through the application of classical transfer pricing techniques. Rather than looking only at the prices of individual transactions or at the profitability of the simplest side of intercompany transactions, the empirical approach to VCA looks at the consolidated totality of the MNE and its peers. This approach assigns arm's length returns to each entity in the consolidated MNE group based on the overall body of arm's length evidence for each participant in the value chain and provides direct support not only to the routine service providers in the MNE group but to the principal entities as well. We believe that, in certain cases, Empirical VCA is a powerful tool that can reasonably satisfy tax authorities' growing interest to evaluate taxpayers' total value chain before evaluating appropriate allocation of profits to specific transactions.

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Rethinking value chain analysis

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Audit readiness in transfer pricing

Audit readiness in transfer pricing

This article deals with some of the most common threats to taxpayers in transfer pricing audits.

Are you ready for an audit of your company in key jurisdictions? Will this result in double taxation, interest, and penalties? This article deals with some of the most common threats to taxpayers in transfer pricing audits.

International taxation issues have been a top priority in the political agenda in recent years. The integration of economies and national markets has increased substantially, threatening the tax systems of countries. Several governments have agreed to a comprehensive package of measures that require coordinated implementation through domestic legislation and international treaties, and these will be enhanced by selective monitoring and increased transparency. Many of the traditional strategies that enable double non-taxation will be restricted if widespread adoption of such measures is achieved, particularly the alignment of national standards with best practice guidelines.

In order to initiate a tax audit procedure, tax administrations are planning and programming their reviews by considering the types of transactions companies engage in, including intercompany transactions, level of revenues, treaty shopping indicators, restructurings, recurring losses, and types and quantity of assets, among others. During such reviews, tax administrations request information and documentation to support that income has been properly recognised and that deductions comply with the requirements established by the relevant provisions.

Audit readiness in transfer pricing

Frequent challenges by tax authorities

An important aspect to consider among multinational enterprises (MNEs) from a transfer pricing perspective is business reorganisations and restructurings within a corporate group. The reviews are based on different angles, including exit tax, existence of permanent establishments, and substance. From a tax administration perspective, the reallocation of significant risks of a business derived from a restructuring between associate enterprises without supported economic substance, will be challenged. Based on the above, taxpayers must consider that a restructuring cannot not be supported solely by contractual terms, but must also be consistent with the conduct of such enterprises as concerns the allocations of risks, which must comply with the arm's length principle. In that sense, a company's business restructuring must be planned and monitored not only from an economic and accounting approach, but also from a legal, tax, and transfer pricing perspective.

In addition, certain payments among related parties such as interest and royalties, back-to-back loans and expense allocations, including for research and development (R&D), will be closely scrutinised. For such activities, MNEs must consider not only the generation of a possible source of wealth and withholding tax rules in a specific country, but also the specific rules and requirements of each tax jurisdiction that allow the deduction of the expense. If these rules are not considered, such disallowance could result in economic double taxation, interest and penalties.

Some of the issues observed by tax administrations regarding passive income include the thin capitalisation rules, back-to-back loans, and interest rates that comply with the arm's length principle, along with maintaining documentation that proves a loan is necessary for the business and that the entity can obtain the necessary cash flow to pay the loan balance in accordance with its contractual obligations. Similarly, purported ownership or migration of intangibles to low tax jurisdictions involving ongoing local expenses to advertise and promote brands and trademarks are closely reviewed, as well as allocated expenses (including R&D), payments for technical assistance versus know-how, and royalty-free agreements, among others.

Audit readiness in transfer pricing

Another aspect to be considered by MNEs involves intercompany management fees, which are challenged by tax administration on the basis that the taxpayer has not demonstrated in supporting documentation (contracts, deliverables, and appropriate allocation of expenses in the case of allocation agreements, among others) that such services have been effectively rendered and a benefit obtained. Further, in some countries, including Mexico, allocated expenses are routinely disallowed.

Finally, the process of assessing the consistency of a taxpayer's risk allocation with the arm's length principle can be burdensome and costly. However, it is a good practice for taxpayers to implement a process to establish, monitor, and review their transfer prices, taking into account the size and complexity of their transactions, the level of risk involved, and whether they are performed in a stable or changing environment. Where an MNE detects a possible risk through a review of its transfer prices, it is preferable that a voluntary self-correction be made by the enterprise before a tax audit is initiated.

Preventive measures – defence files

Many times, audits are conducted long after transactions take place, and several factors can affect the availability and reliability of information, as well as the defence of tax positions, when evidence is not prepared prior to or contemporaneous with the transactions. The main objectives of a defence file should be to reduce the risk of disputes and defence costs and to strengthen tax positions, considering that in almost all cases tax authorities challenge the tax treatment of a specific item derived from a transaction based on the following: lack of supporting documentation and information; absence of economic substance of the transaction; failure to comply with the formal requirements stated in the tax provisions; and lack of compliance with the arm's length principle for related parties transactions.

Finally, the process of assessing the consistency of a taxpayer's risk allocation with the arm's length principle can be burdensome and costly.

Audit readiness in transfer pricing

As mentioned, among different tax jurisdictions, one issue to consider from a taxpayer perspective is supporting documentation and evidence for each transaction carried out by the MNEs.
For transfer pricing purposes, a solid functional analysis is fundamental because it provides the basis for performing transfer pricing analyses of comparability with transactions with or among independent parties, and must consider the economically significant activities and responsibilities undertaken, assets used, and risks assumed by the parties to the transactions.

A complete functional analysis should identify key value drivers, the appropriate transfer pricing method, as well as other opportunities that may be relevant for the company. For example, it may be necessary in an audit defence to give special attention to preparing an analysis from the perspectives of different tax jurisdictions and being responsive to examiner requests, or strategic positioning and communication. Nearly all subsequent components of a transfer pricing study depend heavily on the reliability and thoroughness of the functional analysis.

A crucial point to consider is that a transfer pricing analysis requires the collection of reliable information not only to complete the study, but also to have the most suitable picture of the economic substance of each transaction and compliance with each country's transfer pricing guidelines and rules. Furthermore, the more complete and reliable the information, the more prepared it will be upon audit.

It is also worth noting that various documentation (such as invoices, contracts, deliverables of services rendered, policies,

invoices, accounting records, and certificates of residence for the fiscal year that a treaty benefit has been applied, among others) should be kept by the taxpayer considering the statute of limitations in each jurisdiction involved in the transaction, as well as local requirements (e.g. formal agreements, translation to local languages, apostils and notarisations), to be valid and

Audit readiness in transfer pricing

suitable as evidence of the tax treatment given to each item. For example, if services were rendered to a Mexican entity (five-year statute of limitations) by a foreign related party in the United States (three-year statute of limitations), the Mexican tax administration could request the deliverables issued by the US entity five years later in order to evidence the services carried out.

On the other hand, private letter rulings, legal and tax opinions by an expert, no-name basis approaches with tax authorities, as well as advance pricing agreements from the transfer pricing unit of each tax administration are resources that are worth considering in order to have a stronger position in case of a tax audit.

Procedural aspects to consider on multijurisdictional audits

Considering that nowadays the exchange of information between tax administrations of different jurisdictions is a fact, and countries have been engaging in joint tax audits in order to review a taxpayer simultaneously, each in its own territory, MNEs must carry out the necessary actions that allow them to deal with these types of procedures.

One of the most important aspects that the taxpayer must contemplate is the management of information in case of an exchange. The parties involved in the review process must be prepared with consistent information and documentation in case each tax jurisdiction requests evidence locally pursuant to an exchange of information procedure.

Also, an important resource to consider on international issues, is the advisability of filing a protective claim when a right to initiate a mutual agreement procedures or a bilateral advance pricing agreement is contingent on future events and may not be determinable until after the statute of limitations expires.

Finally, MNEs must define transfer pricing global policies regarding their intercompany transactions, assets, risks, and quality of the information kept and provided to transfer pricing specialists and tax authorities. These policies must not only be defined at a worldwide level, but must also be as flexible as possible so that they may be adjusted to comply with the regulations of each jurisdiction.

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Audit readiness in transfer pricing

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BEPS Action Plans 8-10 and the oil and gas industry

BEPS Action Plans 8-10 and the oil and gas industry

A goal of the BEPS Report was to clarify guidance on and strengthen the arm's length principle, and where TP risks remained, to depart from the arm's length principle via "special measures."

The base erosion and profit shifting (BEPS) Actions 8-10 final report (the BEPS Report), published by The Organisation for Economic Cooperation and Development (OECD) in October 2015 aims to align transfer pricing (TP) outcomes with value creation.[1] A goal of the BEPS Report was to clarify guidance on and strengthen the arm's length principle, and where TP risks remained, to depart from the arm's length principle via "special measures." Specifically, the BEPS Report looks to end "misapplication" of the arm's length principle in the areas of intangibles, risk and capital, and other high risk transactions. This creates new challenges for exploration and production (E&P), oilfield service (OFS), and offshore oil & gas (O&G) companies in their treatment of capital, risk, and people functions, some of which we outline below.[2]

Risk, capital, and value creation in the context of BEPS

A key theme in the BEPS Report is the interplay between contractual allocations of risk, financial capacity to bear risk, and exercise of control over such risk (i.e., related substance of the associated enterprise). In examining contracts, the BEPS Report emphasises the risk bearing entity's capacity to perform risk management decision-making functions as well as actual performance of those functions. This is a consistent theme in the BEPS Report, which generally covers the importance of capital, risk, people functions, and intangibles, but tends to focus more on people functions.

[1] On 5 October 2015, the OECD published a package of 13 final reports covering the 15 Actions of the OECD/G20 BEPS Project with a goal of promoting comprehensive, coherent, and coordinated reform of international tax rules.

[2] Offshore support vessels (OSVs), floating production storage and offloading vessels (FPSOs), seismic companies, jack-ups, semisubmersibles, ROV assets, drillships, and others. E&P can mean independent E&P companies, or fully integrated E&P companies including National Oil Companies (NOCs) and International Oil Companies (IOCs). In some cases, we also only describe the downstream side of a fully-integrated E&P company, i.e., lubricant or petrochemical production and distribution.

BEPS Action Plans 8-10 and the oil and gas industry

Together with other BEPS initiatives that focus on overall headcount rather than relative contributions of those people to business success or failure, there is increased risk that tax authorities may misunderstand capital intensive industries like O&G, conflate bodies on the ground with relative contributions to the group as a whole, and attempt to implement something that looks more like formulary apportionment than the arm's length principle.

In a post-BEPS world, E&P, OFS, and offshore O&G companies should look to review their structures paying specific attention to the location of decision-making activities, the location of financial capacity to bear risks, the multinational company's (MNC) position on its intangibles (if any), and how such factors map to the allocation of revenue, costs, and/or profits. This is particularly relevant as the BEPS Report emphasises substance over (legal or contractual) form and provides several specific examples where a tax authority's re-characterisation of a given transaction may be warranted. Whereas the pre-BEPS world placed more of an emphasis on limiting tax-related distortions on business operations, the post-BEPS changes may actually warrant that MNCs re-examine their operations to see whether and how changes in taxation may warrant real operational change.

General challenges for O&G

BEPS and capital-rich, low function entities

Historically, ownership of MNC assets has been typically viewed to accrue to those capital-rich entities which have provided the funding under an implicit "if you pay for it, you own it" doctrine. The BEPS Report challenges this historic view and places more emphasis on "the level of activity undertaken by the funding company." Particularly, where a tax authority should view a capital-rich entity as not exercising sufficient control or capacity to assume contractually assumed risks, the BEPS Report recommends that such returns associated with the risks be re-allocated elsewhere and the entities providing the funding be provided *no more than a risk-free return* on the funding provided.

The examples in the BEPS Report of the capital-rich, low function entities focus on intercompany financing, and place a specific emphasis on headcount and people functions. Nonetheless, MNCs in asset heavy industries (financial assets, physical assets, or otherwise) like O&G may expect to see tax authorities place more emphasis on people functions in

The examples in the BEPS Report of the capital-rich, low function entities focus on intercompany financing, and place a specific emphasis on headcount and people functions.

BEPS Action Plans 8-10 and the oil and gas industry

spite of the economic reality that capital and returns to capital often play a more critical role in business success or failure.

Operational asymmetries in the post-BEPS world

The BEPS Report emphasises a holistic approach to understanding TP and together with the group-wide reporting requirements of BEPS Action 13 could be interpreted to imply that differences in cross-country profitability of MNC group members with similar functional profiles relates purely to the shifting of profits. This can be particularly challenging for O&G/E&P companies where differences in production sharing agreement (PSA) regimes may place restrictions on the eventual pricing of production and will often cap (or disallow) deductions for interest, technical services (i.e., centralised/shared geoscientists

or geophysicists), or procurement (capital expenditure, CAPEX) charges, thereby creating large differences in profitability among otherwise equal companies. Fully integrated E&P companies also often rely on index-based pricing (MOPS, ICIS, etc.) for transfer pricing in their downstream businesses which can lead to large differences in profitability across countries or time periods for similar activities. Although these types of differences are often a normal part of operations for O&G/E&P companies, tax authorities may fail to consider all of the facts and circumstances and incorrectly conclude that any inconsistencies in financial performance are the result of profit shifting. Overall, these BEPS-related changes and the associated risks may lead O&G/E&P companies to re-examine their TP transactional models and structures or to reconsider their TP documentation and supporting defence files.

BEPS Action Plans 8-10 and the oil and gas industry

Technology intangibles in addition to tangible sets can play a large role in operations of OFS companies. The BEPS Report places particular emphasis on profit shifting via the use of intangibles and is critical of relying on legal ownership as a means to allocate profits.

Timing mismatches in the exploration, development and production cycle

There can be considerable time between exploration (pre-capture) and actual production and many such exploration costs are often incurred prior to a legal entity being established. During the 90 percent plus of the time when exploration is unsuccessful, the parent or affiliated entity cannot recover those pre-work costs. Going forward, E&P companies may want to consider whether and how to allocate such costs throughout the broader group, including what portion of such costs should be considered "shareholder" versus rechargeable costs and where not deemed as shareholder costs, establishing group-wide protocols to capture and bear such costs as well as the upside of successful production.[3] The decision to allocate or not allocate these costs throughout the wider group is particularly sensitive given the BEPS Report's emphasis on corporate services as a "tool to shift profits."

Headcount and people functions in the post-BEPS world

Technology intangibles in addition to tangible sets can play a large role in operations of OFS companies. The BEPS Report places particular emphasis on profit shifting via the use of intangibles and is critical of relying on legal ownership as a means to allocate profits. The BEPS Report instead indicates that intangible-related profits should accrue to those entities that development, enhancement, maintenance, protection, and exploitation of intangibles (i.e., entities performing (DEMPE) functions). As a result, companies having centralised intangible owning entities or making use of

[3] All of which can be further complicated by PSA regimes.

BEPS Action Plans 8-10 and the oil and gas industry

royalties may want to re-examine their group's operations, paying special attention to DEMPE-related economic substance considerations and ensuring key decision making functions are aligned with intangible asset owners.

As another example, commodity trading can play a significant role in a fully-integrated E&P company's business model with respect to its ability to hedge risk and manage group capacity related issues. Due to the scale and frequency of these transactions, even small margins can generate substantial profits for a full-risk commodity trading company with limited personnel. Given the BEPS Report's perceived emphasis on people functions, companies with significant commodity trading operations may anticipate additional challenges. These challenges can either be in the jurisdiction itself or in other jurisdictions with relatively more headcount and lower profit margins due to tax authorities' misunderstanding of the business model.

The role of scale and people functions can have an impact on tax risk for petrochemical companies, as well. Dealing in commodity chemicals, regional sales and marketing entities within lean organisations like petrochemical MNCs may generate sales in very large quantities with just a few sales people, either based directly in the country or based at regional hubs. The BEPS Report, taken together with BEPS Actions 7 and 13, can lead tax authorities to challenge this particular model, particularly when seeing very high top-line revenues, very low people count, and relatively modest in-country profit margins. As a result, in the post-BEPS world, petrochemical companies may want to pay special attention to their TP transactional models to thoroughly document where key decisions take place and any intangible assets within their group so as to reduce future TP and permanent establishment challenges from tax authorities.

Challenges for offshore O&G companies

Key contractual arrangements such as bareboat charter arrangements (BBC), wherein a capital intensive, asset owner leases the asset to a contracting party that provides services to a third-party, can be expected to face additional scrutiny due to several items addressed in the BEPS Report.

De-emphasising the importance of contracts

A general theme repeated throughout the BEPS Report is that the arm's length principle has been interpreted to over emphasise contractual allocations

BEPS Action Plans 8-10 and the oil and gas industry

of functions, assets, and risks and that over emphasis on contractual terms has led to manipulation and profit shifting. As a result, contractual relationships like BBCs can be expected to face a new level of scrutiny. Tax authorities may increasingly use their own views on functions, assets, and risks to challenge specific provisions in intercompany agreements or to re-characterise the transaction entirely. Specifically, the BEPS Report recommends re-characterising the terms of the transaction with respect to allocations of risk "which may not correspond with the activities actually carried out" in favour of entities exercising control or having capacity to bear those risks.

As a result, contractual relationships like BBCs can be expected to face a new level of scrutiny.

Requirement to understand the conduct of all parties to the transaction and potential comparable transactions within the MNC

The BEPS Report places a requirement on tax authorities to carefully delineate the actual transaction through understanding both contractual terms and conduct of all parties contributing value to the transaction. Specifically, tax authorities that have historically been content to understand only what is happening (functions performed, risks assumed, assets employed) within their specific jurisdiction are beginning to look outside their borders with more detailed information requests and full functional analyses on all direct and indirect parties to the transaction. Moreover, tax authorities which may not have made comparisons across similar transactions within the group are beginning to look at a particular transaction within the context of the MNC group as a whole.

Going forward, this may put stress on one-sided tests such as the comparable profits method/ transactional net margin method. This is particularly pertinent with respect to BBCs where the BEPS Report may recommend looking to people functions as being responsible for residual profits/ losses with less importance on the asset (i.e., capital and risk) to explain those same residual profits/losses. A future outcome may be a residual profit split (value chain analysis) between lessor entities and other key entities within the group responsible for commercial and decision-making functions (CAPEX decisions, fleet location, etc.).

BEPS Action Plans 8-10 and the oil and gas industry

Transfer pricing in a downturn

In the current economic downturn impacting the O&G industry, there is a likelihood of creating "phantom income," that is, limited risk operating companies receiving income in various jurisdictions while the overall group experiences a system loss. This imposes a tax burden on the limited risk operating companies in MNC groups that is not borne by similar independent companies that are free to make losses and create tax assets during an industry-wide recession. During a short-lived downturn, this implied restriction on limited risk operating companies within MNC groups to be profitable may even be consistent with their risk profile.

In periods of prolonged downturn, however, it may be appropriate to recognise that independent third-parties, operating at arm's length, will consider their available alternatives and elect to renegotiate contracts when the contract terms are no longer consistent with economic and operational reality. In the same way that an independent entrepreneur or asset owner would not be perpetually bound to fulfil a contract resulting in continuous losses, and an independent operating company would not insist on enforcing contract terms that drive a valuable business partner into bankruptcy, it may be reasonable for O&G companies to re-examine their own TP policies and intercompany agreements in light of economic reality.

Conclusion

The OECD's BEPS Report aims to align TP outcomes with value creation through a focus on capital, risk, people functions, and intangibles, but arguably puts more weight on people functions. Although the BEPS Report aims to strengthen the arm's length principle and better match taxable income with economic reality, this apparent over emphasis on people functions and de-emphasis of contractual allocations of risk may produce challenges for industries where capital and risk play a larger role than headcount in creating value. In this post-BEPS world, O&G companies may want to consider re-examining their TP transactional models and operations to see if a re-aligned TP model is necessary.

BEPS Action Plans 8-10 and the oil and gas industry

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TP Lab – PwC's virtual think tank to generate transfer pricing thought leadership

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We are convinced that deep technical expertise is key in delivering value-adding services to our clients. In this context, TP Lab continuously acts as one of our key thought leadership initiatives for transfer pricing.

What is TP lab?

Kicked off in January 2011, TP Lab is a virtual research laboratory made up of nominated members of the global PwC transfer pricing network (the Network). TP Lab generates solutions, approaches, and tools to address technical issues and needs identified by the Network. Solutions are designed to reflect the coordinated wisdom, skills, and depth of the Network and aim to benefit clients around the globe.

We are convinced that deep technical expertise is key in delivering value-adding services to our clients. In this context, TP Lab continuously acts as one of our key thought leadership initiatives for transfer pricing. TP Lab serves as a resource to the Network by providing globally consistent solutions that are based on worldwide transfer pricing expertise and insights.

How does TP Lab operate?

TP Lab's goal is to conclude between six and eight research projects per year. Each project is staffed by experienced members of the Network with an additional sponsoring partner per research project. Members are newly assigned per project, i.e. Typically, TP Lab assignees work on one project and then cycle back out of TP Lab.

TP Lab – PwC's virtual think tank to generate transfer pricing thought leadership

General scope of research

The scope of TP Lab research assignments covers all aspects of transfer pricing, including the following:

- Specific technical issues within a certain transfer pricing sub-domain (e.g. determining appropriate discount rates for intangible property valuation).
- General survey-type intelligence on topics of particular interest (e.g. known best practices regarding the interaction of transfer prices and customs).
- Industry-specific analyses of particular questions of interest in transfer pricing (e.g. analysis of contractual agreements in pharma in terms of impact of contractual details on pricing).

The number and variety of research covered by TP Lab since 2011 is remarkable. In addition to the earlier examples, previous research topics include location savings analysis best practices, analytical approaches to making risk adjustments, reviews of best practices in determining the useful life of intangibles, and many others.

Current research assignments

Current research assignments relate to value chain analysis, risk and recharacterisation, and the digital economy, as follows:

- In their research on value chain analysis (VCA), Adam J. Cooper (CA), Emre Furtun (US), Hannes Kammerer (DE) and John Burgess (US) have developed a framework to perform the core competency analysis and entity mapping steps of a VCA. Their research contributes to PwC's VCA service offering, which is a novel top-down approach to analyse a company's value chain that makes use of objective data from comparable third party multinationals. Recently, VCA has become an important tool under the base erosion and profit shifting (BEPS) initiative of the Organisation for Economic Co-operation and Development (OECD), and TP lab successfully proved to be the right place to develop and define the components of a VCA.
- In a complex effort, Alejandro Lozano (MX), Jim Matthews (US), Kenny Sun (CH), Marco Fiaccadori (US), Michael S. Mills (US), Pavel Sarghi (LV), Regina Martinez (US) and Ryan M. Decker (US) are surveying current trends and perceptions on risk and recharacterisation and designing (building on, among others, work by Kartikeya Singh and W. Joe Murphy) an analytical framework to address risk in transfer pricing analyses.

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- Himanshu Bhandari (IN), Francisco Garcia Valdivia (MX), Marion David (FR) and Sina Litterscheid (DE) are working on a paper that summarises the potential implications of OECD thinking on digital business models from a transfer pricing perspective. Their research is designed to identify solutions for digital economy topics in transfer pricing, which will certainly be a hot topic in transfer pricing over the next decade.

Summary

As a virtual research laboratory, TP lab brings together joint expertise of the entire Network in order to further PwC's thought leadership in transfer pricing. TP Lab delivers solutions for important transfer pricing topics and thereby contributes to PwC's proposition to offer innovative and value-adding transfer pricing services for our clients.

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New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

The pharmaceutical and life sciences (PLS) industry is a priority industry for China's State Administration of Taxation, and as such is subject to close scrutiny with PLS multinationals facing sweeping transfer pricing audits across the country.

In June 2016, China introduced new transfer pricing compliance rules around the same time the Organisation for Economic Co-Operation and Development (OECD) released its *Guidance on Implementation of Country by Country Reporting* (Action 13 guidance). Reflecting China's support of Action 13, the new rules overhaul the related party transaction disclosure forms and introduce country by country reporting (CbCR), as well as Master File and Local File transfer pricing documentation requirements.

Current regulatory and tax environment in China

Although China has become one of the world's largest and fastest growing pharmaceutical and life sciences (PLS) markets, growth has slowed in recent years. General economic headwinds have undoubtedly played an important part, and pressure from recently introduced government cost containment measures and investigations into anti-competitive practices also factor into the equation. PLS is one of the most heavily regulated sectors in China, and new regulatory initiatives such as the "two invoices" system and the introduction of government-negotiated drug prices into medical insurance are expected to put downward pressure on multinationals' drug prices in China. Chinese regulators such

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

as the National Development and Reform Commission are also closely examining the pricing methods of local and foreign PLS companies for potential anti-trust violations, looking for price manipulation among competitors or through the distribution chain.

PLS multinationals operating in China also face a difficult and uncertain Chinese tax and transfer pricing environment. Unfortunately, China's new transfer pricing requirements may only serve to further increase the compliance and administrative burden. The PLS industry is a priority industry for China's State Administration of Taxation (SAT), and as such is subject to close scrutiny, with PLS multinationals facing sweeping transfer pricing audits across the country. This is particularly the case for PLS multinationals with more than one Chinese subsidiary undertaking different types of activities (e.g., manufacturing, distribution, research and development), which may face simultaneous centrally coordinated national and local audits. Securing tax certainty in China is difficult, with limited opportunity to pursue unilateral or bilateral advance pricing agreements (APAs) given the long and congested queue of outstanding cases and the low number of PLS APAs successfully concluded to date. To further add to the uncertainty, depending on the location of your Chinese operations, an APA application may invite a transfer pricing audit for historical years. The rigidity of the Chinese customs regime restricts the ability of multinationals to adjust their transfer prices into and out of China for fear of customs authority challenge, and the existence of foreign exchange controls further limits the options for multinationals to make year-end price adjustments.

These challenges are significant enough to have caused some PLS multinationals to seek alternative methods to achieve arm's length transfer pricing results – for example, with service fee arrangements. This creates additional complexity and challenge for multinationals trying to maintain a globally consistent and cohesive transfer pricing model.

The new Chinese requirements

The new rules introduce a range of additional transfer pricing filing and disclosure requirements covering potentially sensitive and subjective data and analysis. The CbCR requirement will typically be addressed through tax authority exchange of information provided the general conditions described in the Action 13 guidance are met. The Master File documentation also generally follows the Action 13 guidance, with a few additional

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New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

China-specific disclosures covering items such as changes in operational structure and the functions, assets, risks, and personnel of the group's research and development (R&D) facilities. The Local File, on the other hand, replaces the old Chinese contemporaneous documentation rules and contains potentially significant new disclosure requirements, including the following:

- **Value chain analysis**, which is generally described in the new rules to include group transaction flows, latest financial statements, measurement, and attribution of "location specific factors" contributing to value creation and the allocation of group profit across the global value chain (including the allocation basis).
- **Key factors affecting pricing of transactions**, including intangibles, and an analysis of location specific factors such as local China cost savings and China market premium (described below). The Chinese authorities typically consider aspects such as labour costs, environmental costs, market size, market competition, consumer purchasing power, substitutability of goods or services, and regulatory controls in analysing these topics.

The Local File replaces the old Chinese contemporaneous documentation rules and contains potentially significant new disclosure requirements.

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

As is commonly the case in China, the new rules are light on detail and are therefore open to interpretation. In particular, the value chain analysis requirement remains somewhat ambiguous. Regardless of this uncertainty, with the first China local file due for all taxpayers by 30 June 2017, PLS multinationals must immediately study these new rules, evaluate the potential implications for your business, and develop a strategy to comply.

Chinese tax authority views on value chain analysis

The new Chinese disclosure requirements differ from the Action 13 guidance in certain key respects, reflecting the Chinese tax authorities' unique and results-oriented views on value chain analysis and location specific factors in particular. They are specifically designed to enable the Chinese authorities to obtain additional information on multinationals' global and commercial value chains to support these types of analyses and ultimately support proposed tax adjustments.

Most multinational tax departments will already be familiar with the Action 13 guidance on the importance of identifying value drivers and analysing intangible property (IP) development, maintenance, protection, and exploitation activities (the so-called DEMPE functions) across the value chain. This forms the cornerstone of understanding intangibles in a multinational organisation and is a key part of the value chain analysis required to be included in the Master File. Aligned with this, the new Chinese rules require

The new Chinese disclosure requirements differ from the Action 13 guidance in certain key respects, reflecting the Chinese tax authorities' unique and results-oriented views on value chain analysis and location specific factors in particular.

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

a description of value drivers and the locations where DEMPE functions are performed across the worldwide value chain. This differs from the approach typically adopted up to now, which has relied on one-sided tests to support the returns of the Chinese operations on the basis that they are generally characterised as less complex than their foreign counterparts.

With the new Chinese rules, it appears the SAT is focused on trying to identify value created and contributed by local Chinese entities through local enhancement, exploitation, and promotional activities (e.g. R&D, marketing, and sales) with a view to justifying higher local returns or profit allocations. Although it is not clear that PLS multinationals necessarily or generally perform high value-adding activities in China, you should anticipate these types of China tax authority positions and be prepared to defend against them. The Chinese authorities emphasise the importance of location specific factors, suggesting additional returns should be allocated to China – the two most common being local cost savings as compared with other countries and higher prices of foreign goods and services in China (China market premium) as compared with other markets. Interestingly, the fact that labour is not typically a highly significant cost for PLS multinationals may weigh against the local cost savings argument, and Chinese price regulations and anti-trust investigations may serve to limit the potential to attribute additional profits to China. The fact that new PLS products are usually launched with premium prices in more developed markets before they are introduced in China with lower prices may also serve as a counterargument against the existence of a China market premium. Nevertheless, the burden of proof rests with the taxpayer in an audit situation, and the authorities are likely to ask the taxpayer to provide more than one-sided tests to defend its transfer pricing, including, potentially, an analysis of system profit allocation.

Additionally, Chinese tax authorities may attempt to use a holistic analysis approach to argue the existence of synergies among multiple functions being performed in China (e.g., manufacturing, distribution, and R&D), whether in one or more entities. Their hypothesis is that analysing the returns of these transactions separately using one-sided tests would result in under-recognition of China's contribution to the global value creation and hence in an under-allocation of profit to China. As a PLS multinational with operations in China, you should be prepared to address this through your value chain analysis.

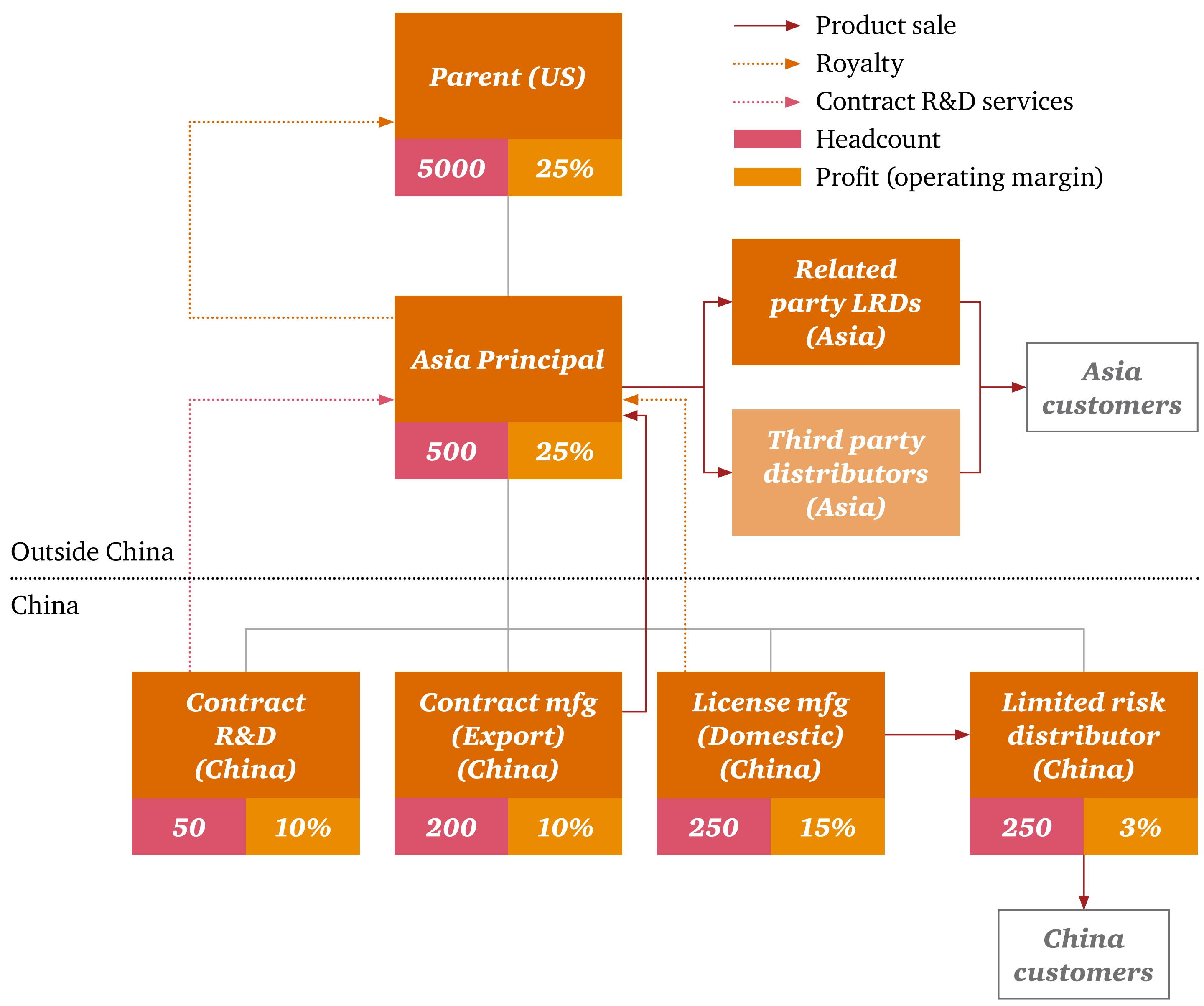
Authorities are likely to ask the taxpayer to provide more than one-sided tests to defend its transfer pricing, including, potentially, an analysis of system profit allocation.

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

Specific PLS value chain challenges

PLS multinationals operating in China face a particular set of challenges due to the regional principal company models they commonly adopt, where strategic business management activities and value creation are concentrated in centralised locations. These types of principal models will be the subject of particular scrutiny by the Chinese tax authorities going forward. Given the 30 June 2017 China local file deadline for FY2016 documentation, PLS multinationals need to begin preparing for potential challenges immediately.

Take the following simplified example — a US PLS multinational with an Asia regional principal located outside China and four Chinese subsidiaries performing contract R&D, contract manufacturing, licensee manufacturing and limited risk distribution. Group operating margin is 25% and the Chinese entities earn margins of 3–15% depending on their activities.



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As a PLS multinational under audit, you should expect the Chinese tax authorities to focus on the following types of questions and analysis:

- Compare the Chinese returns (3% – 15%) with global and regional returns (25%). How do you explain and support the lower profits of the Chinese affiliates?
- Investigate the nature and cost base of China R&D and manufacturing activities. Are there any local IP or process enhancement, exploitation or promotional activities, or cost savings due to the location of these activities?
- Analyse sales and marketing activities and expense levels of the limited risk distributor. Are there any unique China market development activities that might create marketing intangibles? Do your products command a price premium in China?
- Are there any synergies for your organisation associated with having a range of activities (e.g., R&D, manufacturing and distribution) in China?

These are the types of arguments the Chinese authorities typically pursue to support their position and propose tax adjustments. Anticipating these questions and developing a strategy to address them will be crucial for PLS multinationals in supporting their tax and transfer pricing positions in China.

PwC's value chain analysis approach – VCA

There are two main schools of thought on how best to conduct value chain analysis – the traditional "formulaic" approach and the empirical approach. The formulaic approach is essentially a global profit split using weighting and scoring techniques to allocate system profit based on value drivers. This approach is quite practical for taxpayers, but may be susceptible to tax authority challenge given its inward focus and reliance on internal management reporting data. In contrast, the empirical approach is based primarily on third party data. PwC has developed our own empirical value chain analysis approach, which we call VCA, to assist multinationals meet

Are there any synergies for your organisation associated with having a range of activities (e.g., R&D, manufacturing and distribution) in China?

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the standards of the Action 13 guidance and ensure they are prepared to address potential tax authority questions or challenges such as those described above for China. In light of all of the BEPS developments and the new environment of tax transparency, multinationals will be best served with a single value chain analysis providing a globally consistent story that can be provided to any tax authority around the world, rather than attempting to develop different analyses or arguments to serve different purposes or for different jurisdictions. The key to our empirical VCA approach is maximising the use of arm's length industry and third party publicly available information, applying traditional transfer pricing analysis to industries and peers, and supplementing this with appropriate internal management information where necessary. This approach seeks to minimise inward-looking subjectivity and risk of successful tax authority challenge by tying as much as possible back to industry and third party data and analysis.

Our VCA comprises four steps: peer group analysis, core competencies, entity mapping and evaluation. The objective of the peer group analysis is to identify competencies or attributes that are a source of sustainable competitive advantage for a multinational. The core competencies analysis involves analysing the associated functions, assets, and risks to identify appropriate profit or loss outcomes for each competency. To address China-specific considerations, a PLS industry analysis may cover, for example, public labour cost data and the findings of Chinese government anti-trust investigations to help shed light on true value drivers and defend against Chinese tax authority arguments on location specific factors. Entity mapping explains how profits or losses map to types of entities based on factors such as functions, risks, investments, assets, and contractual relationships. Evaluation essentially compares the multinational-specific VCA findings back to the industry and peers, identifying any gaps and opportunities for alignment where appropriate. The resulting output is a strategic and thoughtful empirical VCA supporting the multinational's allocation of profits across the global value chain. An executive summary describing the VCA findings would be included in the master file and this could also be used to also support local country compliance requirements (e.g., China local file) where required. Elements of the more detailed VCA report may also be extracted and used as part of local country audit defence where appropriate.

New rules for transfer pricing transparency in China – challenges and change for pharma and life sciences companies

Next steps – navigating the compliance and audit cycle

As a PLS multinational with operations in China, your next steps are critical and your strategic assessment of the impact of the new Chinese rules on your positions should start immediately. Given the 30 June 2017 China local file deadline, you should move quickly to develop your value chain analysis, ensuring you fully understand and can support the allocation of profit across your global value chain, taking remediation steps to address any gaps if necessary. You should begin to consider whether you have any particular challenges in China as well as how these might be addressed and incorporated into your global value chain analysis using industry and third party empirical data and analysis to the extent possible. The road ahead remains complex and challenging, but an early start on your value chain analysis should help to ensure you enter the new China compliance and audit cycle with your best foot forward.

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Implications of the new permanent establishment definition on retail and consumer multinationals

Implications of the new permanent establishment (PE) definition on retail and consumer multinationals

One of the most far-reaching outcomes of the Organisation of Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project is the modification of the definition of a PE.

In Action 7 of the BEPS project, the OECD tries to tackle common tax avoidance strategies used to prevent the existence of a PE, including through agency or commissionaire arrangements instead of establishing related distributors. Action 7 also aims to prevent the misuse of specific exceptions to the PE definition, which relate to activities of a preparatory and auxiliary character. The changes in the mPE definition have significant consequences for international groups. Some sectors, especially the retail and consumer (R&C) industry, seem to be even more exposed than others to the changes.

Effecting the changes to the PE definition will require amendments to bilateral tax treaties. To facilitate this process, the OECD is working on a multilateral instrument that will implement the results of tax treaty-related BEPS measures in existing bilateral tax treaties. The instrument should be ready for signature by the end of 2016. It is expected that the changes proposed by the OECD may be effective from 2017.

The key changes to the definition of a PE can be summarised as follows:

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- *Dependent agent PE.* Currently a PE arises when an agent acting on behalf of a foreign enterprise habitually exercises authority to conclude contracts in the name of the enterprise, unless

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the agent is an independent agent (legally and economically independent from its principal) acting in the ordinary course of its business. Since the current definition is limited to the formal conclusion of contracts, the OECD widened it to also include situations in which an agent habitually plays the principal role leading to the conclusion of contracts that are then routinely concluded without material modification by the enterprise.

- *Specific activity exemptions and anti-fragmentation rules*. Under the current regulations, a PE is deemed not to exist when a place of business is engaged solely in certain activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing of goods or merchandise, collection of information). With the revised regulations, the exclusion will apply only when these activities are preparatory or auxiliary in relation to the business as a whole. Anti-fragmentation rules have also been introduced to prevent the breakup of an operating business into several small business units in order to benefit from the preparatory or auxiliary exemption. As a result of the new provisions, the activities performed by different related parties are to be combined (analysed on an aggregated basis) when assessing whether they can be regarded as of a preparatory or auxiliary nature.

- *Splitting up of contracts*. According to the existing provisions, a PE arises when work on a construction site lasts at least 12 months. In order to prevent splitting up contracts artificially into shorter periods, the OECD advocates for a principal purposes test,[1] or a specific provision that allows for combining the activities of the related enterprises carried out at one construction site during different periods of time, each exceeding 30 days, when determining the duration of work.

[1] This rule is one of the outcomes of Action 6 of the BEPS project on the prevention of treaty abuse. According to this rule, if one of the principal purposes of a transaction or arrangements is to obtain treaty benefits, these benefits will be denied unless granting them would be in line with the object and purpose of the provisions of the treaty.

Implications of the new permanent establishment (PE) definition on retail and consumer multinationals

What are the main concerns of these changes for R&C multinationals?

The most significant impact on mR&C multinationals will likely result from the changes to the specific activity exemptions.

According to the OECD, the decisive factor used to assess mwhether a given activity can be regarded as preparatory or auxiliary involves determining whether the activity carried out by the place of business in itself forms an essential and significant part of the overall activity of the enterprise. In particular, the activity cannot be regarded as of a preparatory or auxiliary nature when the general purpose of the activity performed by the place of business is the same as the general purpose of the whole enterprise. For companies operating in the R&C industry, activities such as purchasing or warehousing typically correspond to a company's core business activities and thus these companies may no longer benefit from the existing activity exemptions. Further considerations on the potential influence of the new PE regulations on purchasing and warehousing functions are presented below.

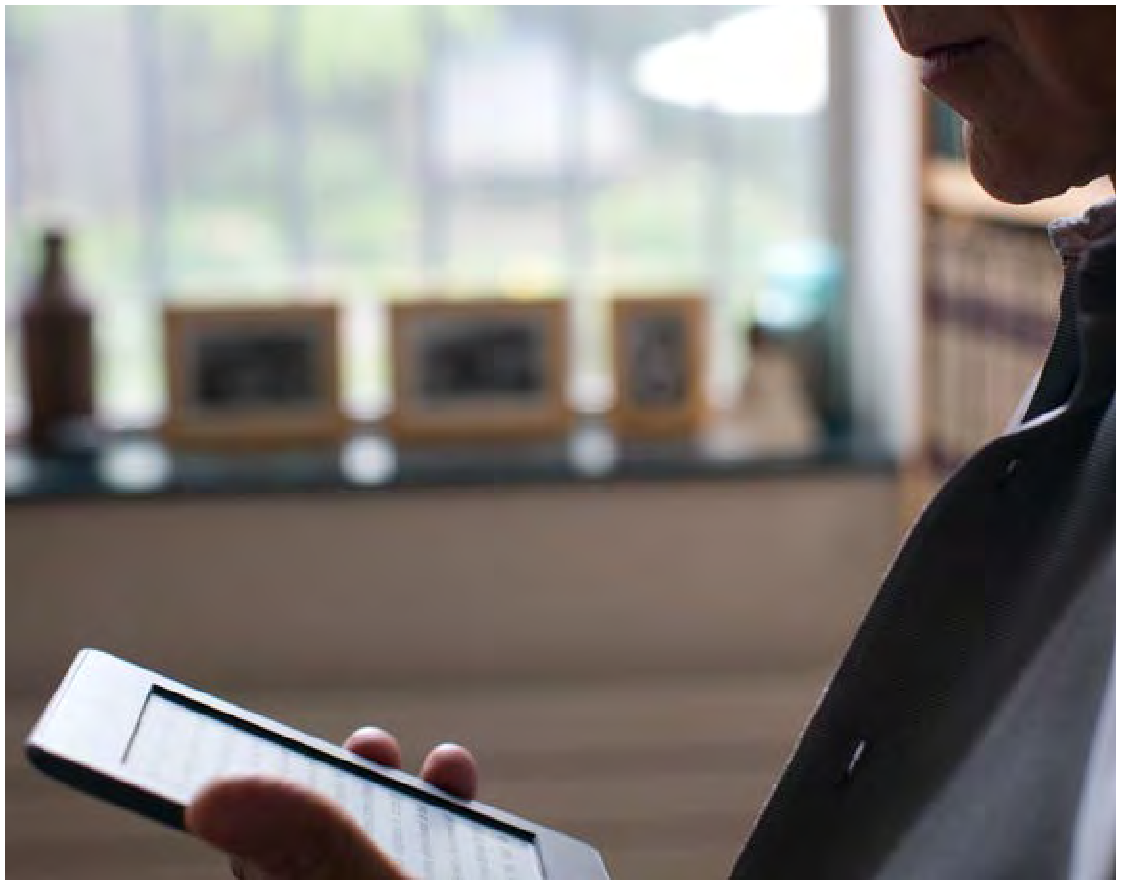
Purchasing

R&C multinationals often use central buying entities to streamline purchases. These entities are typically represented in local markets by related party service providers or purchasing offices. In principle, responsibilities of such local units include searching, auditing, and selecting suppliers as well as negotiating with suppliers with regard to products and the commercial terms of cooperation. Under the new PE definition, such local places of business will constitute a PE, as the purchasing function is an essential and significant part of the enterprise's overall activity (consisting of selling these goods).

The other model used by multinationals involves a central purchasing department that provides support services for the operating companies that purchase goods directly from suppliers. Such support usually includes selecting and recommending suppliers, negotiating global purchase agreements with suppliers, and supporting negotiations with local suppliers. So far, such activity has not been sufficient to create a PE.

Under the new regulations, one may argue on the one hand that in this scenario the dependency condition is not met, as the central department does not follow the instructions of the operating companies but rather instructs them on how to execute the purchasing process. Thus, the central purchasing department should be perceived as an

Implications of the new permanent establishment (PE) definition on retail and consumer multinationals



independent agent. However, because in principle such services are provided for the benefit of group entities only, tax authorities might claim that the central purchasing department does not in fact meet the independent agent condition, which would result in the creation of a PE (provided that all other conditions are met). This example shows that the inherent subjectivity of the new provisions triggers a risk of creating a PE even when tax is not the key driver behind the arrangement.

Currently, most R&C multinationals are involved in online sales, with some international sellers engaged solely in digital sales.

Warehousing

Currently, most R&C multinationals are involved in online sales, with some international sellers engaged solely in digital sales. Online sales usually require that an enterprise maintain a warehouse abroad (with an adequate number of employees) where goods owned by the enterprise are stored and delivered to local customers (once sold by the enterprise). It seems indisputable that storage and delivery activities to fulfil online sales constitute an essential part of an enterprise's distribution business and therefore do not have a preparatory or auxiliary character. As a result, under the new PE definition, these local places of business are likely to constitute a PE of the enterprise.

Implications of the new permanent establishment (PE) definition on retail and consumer multinationals

Overall impact of the changes

The existence of a PE does not automatically mean a material increase in tax exposure (although it is likely to trigger additional compliance costs and administrative burden for businesses), especially where the local place of business already receives arm's length remuneration. In most cases, remuneration based on costs incurred by the PE should be appropriate, though there may be situations in which remuneration mbased on commission would be more suitable. This might apply in particular when a local unit either concludes contracts with suppliers or plays the principal role leading to the conclusion of contracts that are then routinely concluded without material modification by the enterprise. Selection of the appropriate method of profit attribution to the PE, as well as determining whether or not a given place of business constitutes a PE, are the areas where there is heightened risk of a dispute with tax authorities. This translates into uncertainty and increased compliance costs, and may also result in double taxation.

In order to prepare for the new regulations, multinationals should review their existing structures or planned arrangements. In particular, they should analyse the activities performed by their entities/places of business from the perspective of the value chain of the whole enterprise in order to identify activities that could give rise to a PE, and measure the impact of any potential PE on the business. Depending on the outcomes of this analysis, taxpayers might need to revise their business models or gather and document arguments supporting their position.

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Implications of the new permanent establishment (PE) definition on retail and consumer multinationals

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Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

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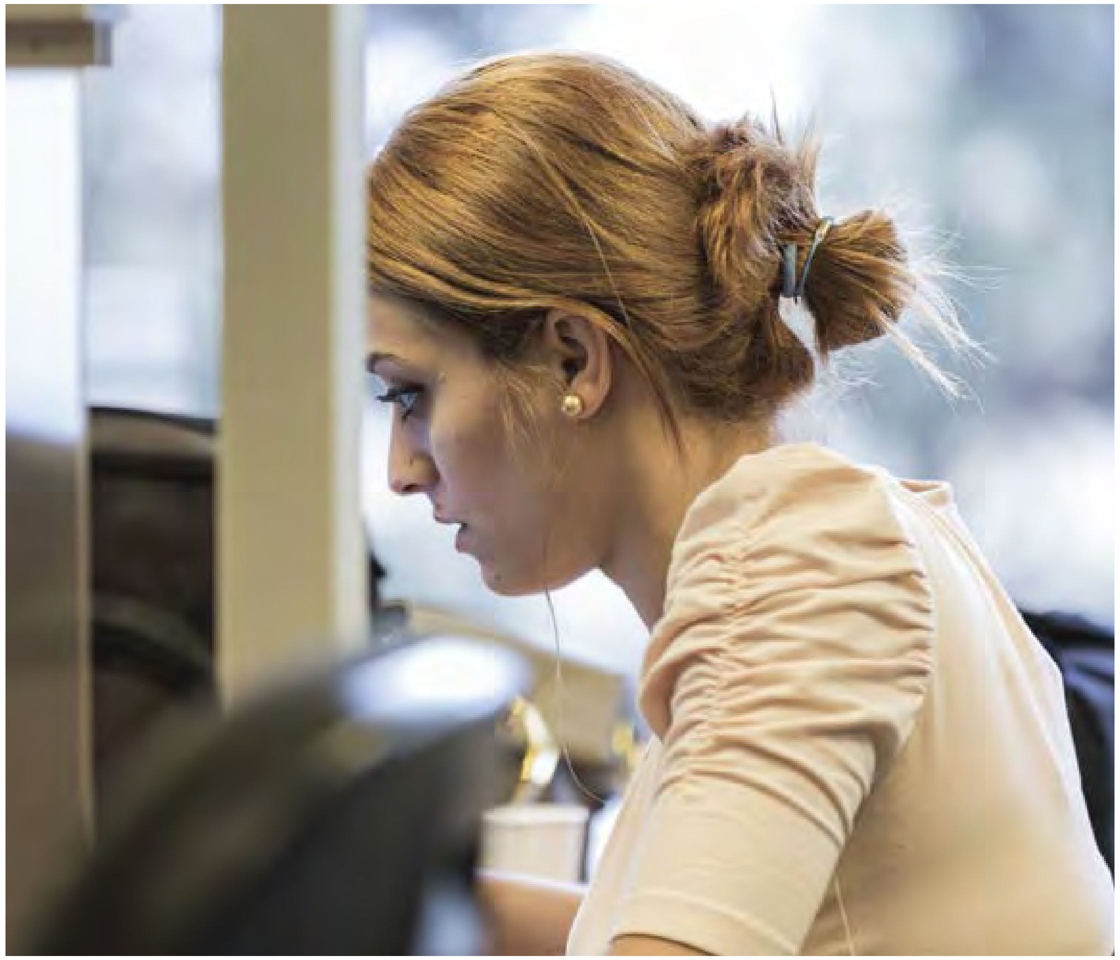
Though it may sound like a cliché, most of us have heard various business leaders talk about data as the "new oil," the "new currency," and make similar statements about the overall impact of data and analytics. We live in a world that is increasingly impacted by data. Every aspect of our lives – from the sports we watch to the way we shop to the daily advertisements we see – is impacted by enhanced computing power and improved analytical tools. These technological advances have given us the ability to quickly analyse data sets that were previously too large or complex to handle without the use of a supercomputer and many hundreds of man hours. The emergence of Big Data is disrupting our current way of thinking, causing us to re-examine everything we thought we knew. Transfer pricing is no different than any other business process; however, it is in a better position to leverage rich and unique data sets to provide business insights.

Our discipline is at the core of the information collection process, including transactional data, legal entity company information, benchmarking data, legal settlements and other sources of information impacting intercompany pricing. These data sets exist across a variety of sources and systems. The ability to capture and analyse data is transforming every aspect of the transfer pricing life cycle, from strategy and planning to price setting, maintenance, documentation, and even dispute resolution. In addition, new technologies that allow for data management, analysis, and visualization are being developed and released at a staggering pace. This rapid progression of technology is finally helping to move data analysis closer to the artificial intelligence objectives set by technologists thirty years ago.



The emergence of Big Data is disrupting our current way of thinking, causing us to re-examine everything we thought we knew.

Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

Data analytics is a very broad concept that includes various angles and objectives that can be achieved in the world of transfer pricing. The first and most common application of Big Data can be labelled as **descriptive analytics**. It consists of analysing large data sets to derive trends and patterns from a descriptive standpoint. In the transfer pricing world, this may serve multiple purposes and provide a large variety of insights to the tax payer, including but not limited to:

1. providing a clear and compelling overview of financial results across regions, jurisdictions, legal entities, business units, or stock keeping units (SKUs);
2. facilitating the tracking of transfer pricing policy implementation results;
3. measuring the successful achievement of any potentially relevant metrics or KPIs; and
4. identifying, bucketing, and packaging information in a manner that improves and supports the decision-making process.

In sum, descriptive analytics allows for improving and deepening the understanding of certain information that is routinely gathered but usually buried into infinite amounts of quantitative data and sorted into large Excel files.

Although descriptive analytics has been around for decades, new technological solutions – centred around data visualisation tools such as Tableau, Qlickview, PowerBI (to name a few) as well as data computation tools and database management software – allow us to significantly expand the amount of data we analyse and efficiently grow data analytics to include a predictive and prescriptive angle.

Predictive analytics is the use of data and analytics to provide insights into the potential outcomes of various what-if scenarios and hypotheses. This analysis of historical trends and patterns to anticipate and predict the future allows for a more efficient and impactful decision-making process. Finally, prescriptive analytics utilises the power of data management, visualisation tools, and artificial intelligence solutions not only to analyse data at a deeper level but also to further assist the user (and, to some extent, replace it) in the articulation of approaches and policies designed to achieve a specific outcome.

Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

Descriptive analytics
to understand
what has happened
(reporting on key metrics)

Predictive analytics
to understand what is
likely to happen
(modelling and trend detection)

Prescriptive analytics
(use of predictive models
to determine the best
course of action)

Our Transfer Pricing Analytics practice understands the importance of data and analytics for solving traditional and emerging transfer pricing issues. Our practice has been developed on the premise that focusing on technical excellence is no longer enough to be a differentiated adviser. Our clients expect us to deliver end-to-end assistance, from strategy through to execution. By leveraging data analytics and visualisation tools we can provide clients with tailor-made solutions and transactional insights to secure the monitoring and implementation of transfer pricing policies. We can also generate valuable information that improves the strategic decision-making process and facilitates the reduction of risks going forward. These benefits may be achieved holistically or at a specific level of the transitional data life-cycle, defined as follows:

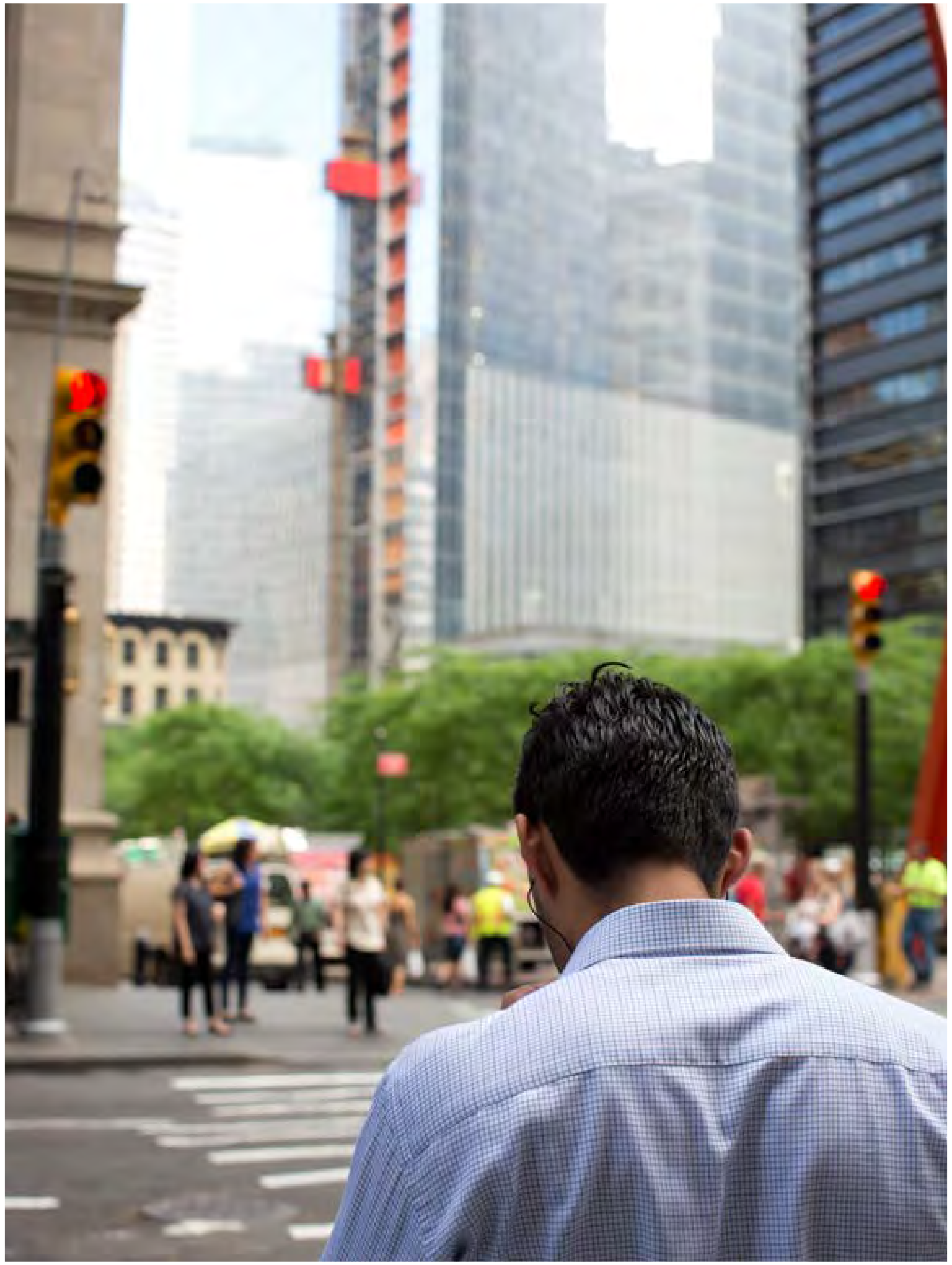
1. **Data extraction:** Within most organisations, data is manually gathered from disparate sources and cannot be analysed cohesively. Via Extract, Transform and Load (ETL) tools, data can be pulled automatically from source systems and stored centrally for efficient use.
2. **Data storage and basic manipulation:** Excel is the predominant tool leveraged for storing, calculating, and analysing tax data, which can be effective but is often time consuming to maintain and review. Adding data and analytics solutions (e.g., SQL, Alteryx, PowerPivot) to the current Excel environment can augment the potential for automation (and reduce time and level of effort).

Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

3. **Complex data computation:** Updating and reviewing calculations in complex Excel models can be time consuming and adds risk of error to the process. Data analytic tools (e.g., SQL, Alteryx, PowerPivot) can bolt onto existing Excel models, or replace the use of Excel all together, to increase the scalability of complex calculations (e.g., across legal entities, business units, consolidated groups) and mitigate overall risk via greater control.

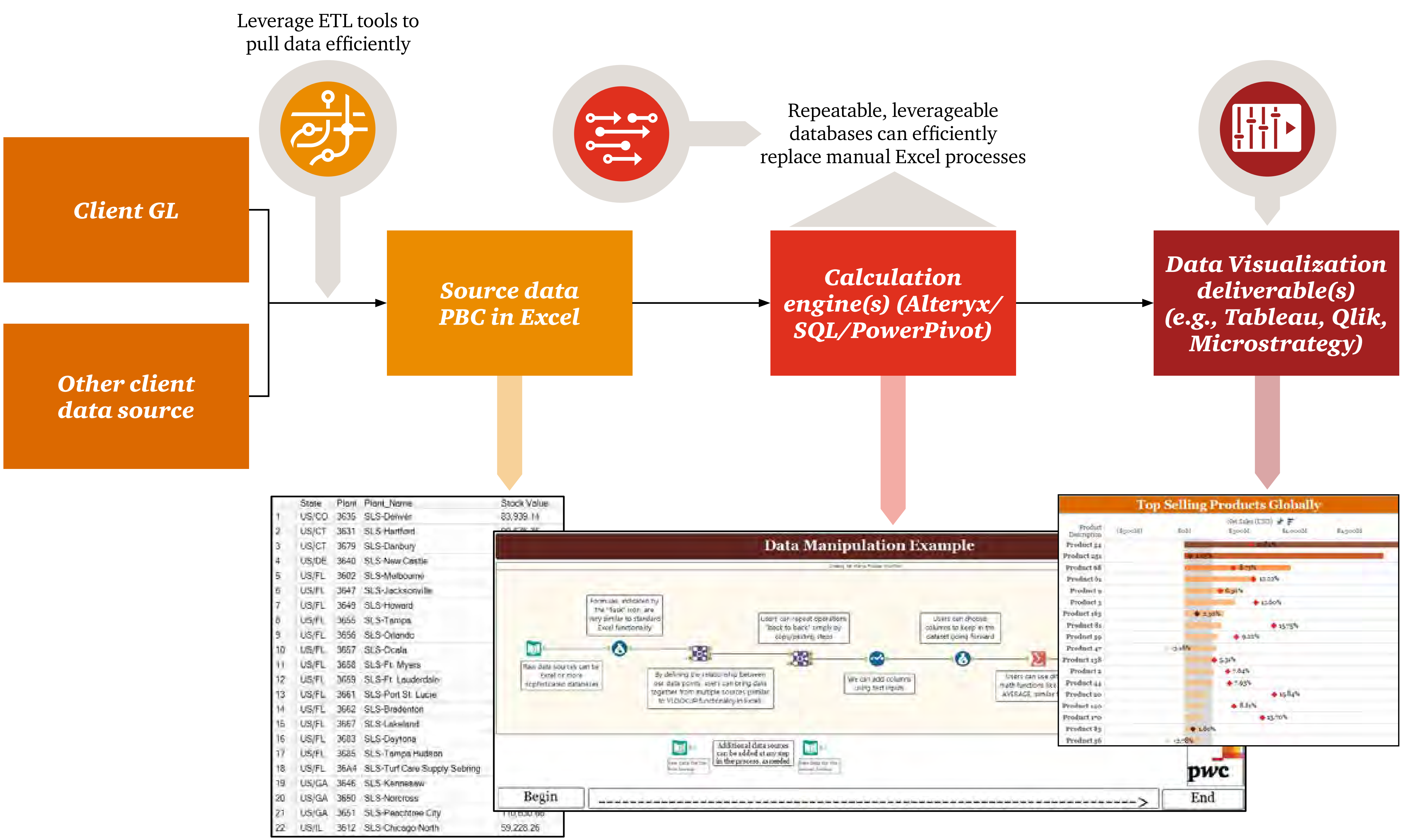
4. **Data visualisation and dynamic modelling:** Tax calculation results are highly aggregated and documented in static reports (e.g., PowerPoint, Word), requiring these deliverables to be manually updated each time data is refreshed and minimising end-user functionality to dynamically interact with reported data. Visualisation solutions (e.g., Tableau, MicroStrategy, Qlikview, etc.) are leveraged and tack directly onto the calculation engine(s) (e.g., SQL, Alteryx, Excel) to create web and mobile-enabled dynamic dashboards and to provide enhanced data insights, enabling end users to efficiently make strategic business decisions.

As shown in the table below, our solutions span over the entire data life-cycle. With capacity and technological solutions from data extraction to data visualisation, our approach allows for enhanced customisations of tailored-made solutions, based on the very specific needs of clients across industries. This is a clear competitive advantage in a space where solutions usually tend to focus on standardised output, and seldom sufficiently takes into consideration the client's capacity to maintain sustainable back-end solutions.



Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

Sample process flow leveraging data analytics and visualisation technologies



ETL = Extract, transform and load GL = General ledger PBC = Prepared by client

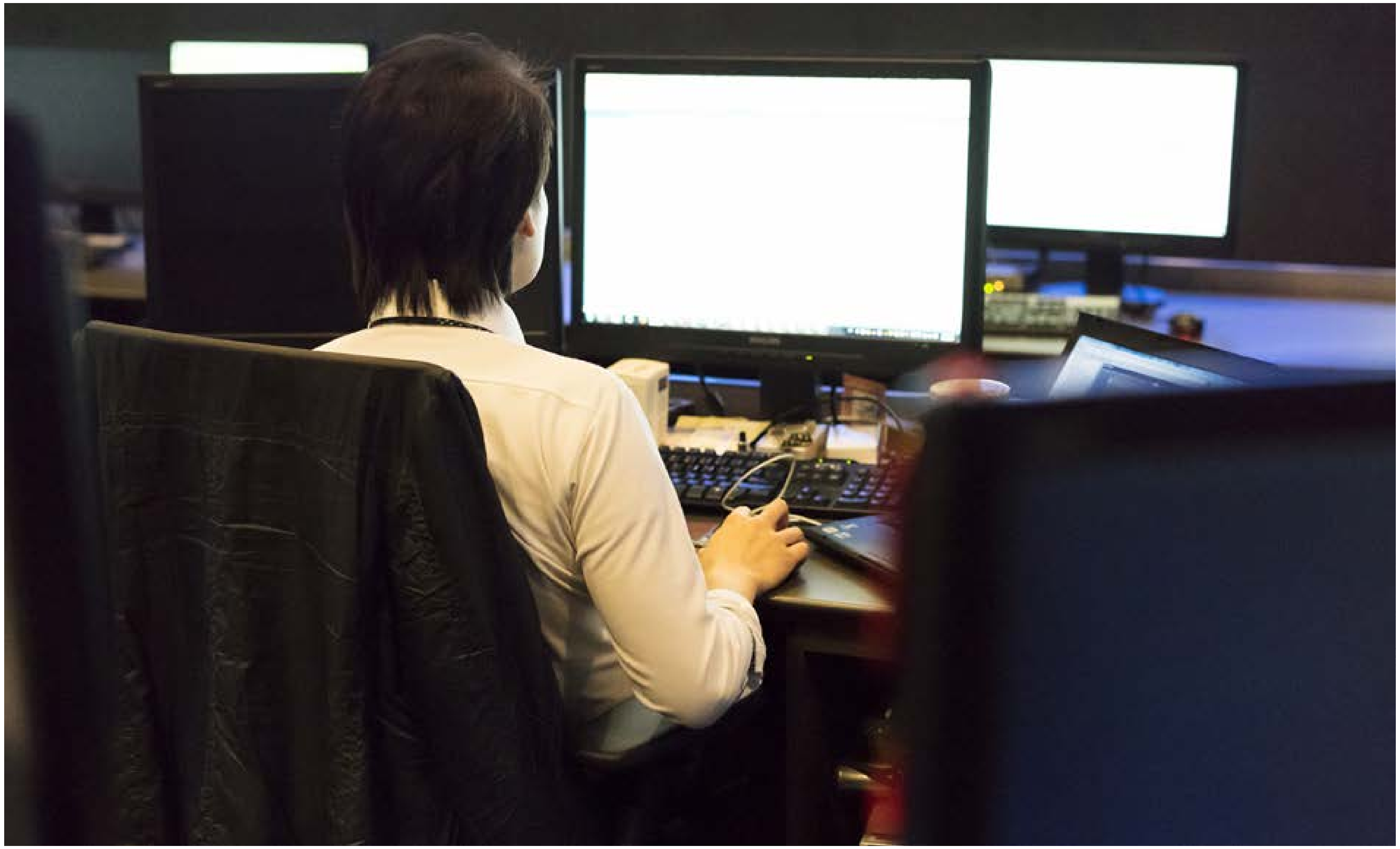
Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

The positioning of transfer pricing analytics within our global transfer pricing service offering and the larger cross-service environment is key in understanding the full potential of such an initiative. Composed of a cross-functional team of tax and advisory professionals, transfer pricing analytics is a unique approach currently unmatched in the market. It can be viewed as a stand-alone service offering, an ad-hoc value-add contribution, or as an innovative way of delivering work product, as well as a cross-functional discipline aimed at facilitating the collaboration between tax and business stakeholders to produce unique and valuable insights. Currently, every sub-specialty in our transfer pricing global service offering is impacted by transfer pricing analytics (i.e., the data gathering process can be expanded and analysed) and may benefit from transfer pricing analytics. For example, data can be properly mined and analysed to leverage predictive analytics in the context of a transfer pricing dispute resolution. Clearly, transfer pricing analytics is at the core of today's transfer pricing challenges and opportunities, and the variety of solutions delivered to clients to date further reinforces this statement. In fact, we have already developed highly performing tools in the following areas (and continues to create innovative tools for re-shaping the transfer pricing service offering):

- **Legal entity output:** end-to-end solution for the development of legal entity results based on aggregated general ledger for compliance, planning, and modelling purposes.
- **Country by country reporting (CbCR):** end-to-end solution to comply, analyse, and prescribe change in the CbCR environment, from data extraction to dynamic visualisation.
- **Margin analyser:** dynamic data visualisation solution to review, monitor, and correct operating margins for legal entity to SKU-related profitability levels based on third-party benchmarks.
- **Scenario analysis:** data computation engine and dynamic modelling output solution for realtime comparison of planning scenario.
- **Financial transaction / 385:** end-to-end solution for treasury departments with respect to intercompany financing transaction in the Prop. Regs. Section 385 context.

Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

Tax authorities in many jurisdictions are already beginning to use data analytics in their assessment of transfer pricing. The emergence of country by country reporting disclosures will only create more data to potentially be analysed.



Our global Transfer Pricing Analytics initiative comprises a core team of professionals in the United States and key regions around the world. In addition to transfer pricing experience, the team has expertise in statistics, data science, programming, and artificial intelligence. The exploitation of Big Data to enhance the depth of our transfer pricing services is anticipated to disrupt our traditional service offering for the benefit of our clients throughout the network. Tax authorities in many jurisdictions are already beginning to use data analytics in their assessment of transfer pricing. The emergence of country by country reporting disclosures will only create more data to potentially be analysed. Therefore, we will lead this trend by bringing innovative and client-customised solutions to the market in order to harness the computing power available to businesses.

Transfer pricing analytics: The exploitation of Big Data and emerging technologies in transfer pricing

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The post BEPS world in the automotive industry

The post BEPS world in the automotive industry

The automotive industry has followed a global footprint strategy since many years and it represents now the industry with the highest cross border intercompany transaction volume. In 2015 the seven largest original equipment manufacturers (OEMs) had turnovers of more than 1,000 billion Euro. The OEMs have factories around the world and suppliers have expanded their global presence to be close to these factories. Thus it is not a surprise that tax and customs authorities spend their utmost attention on arm's length transfer prices of OEMs and their suppliers.

1. Current tax audit environment

Given the high volume of intercompany transactions, tax audits are mostly focused on classical transfer pricing topics, i.e. the arm's length profit for distributors and for manufacturing operations. The suppliers often struggle in tax audits with the economic qualification of their plants, i.e. plants which contractually operate as license manufacturers are requalified to be contract manufacturers as the core intellectual property (IP), application engineering and sales functions are not controlled by the plant. The major challenges in tax audits are presented in the table below.

TP audit challenges in the automotive industry

Distribution	*Contract manufacturing*	*License manufacturing*	*Research and development*	*Services*
• Benchmarking challenges (retail vs. wholesale) • Profit level indicator (RoS vs. C+) • Aggregation vs. separation of financial services • Marketing intangibles • Location specific advantages	• Profit level indicator (C+, Berry Ratio, RoA, RoNA) • Location savings • Start-up / extension costs • Benchmarking challenges • Attribution of risks	• Substance of license manufacturer (vs. contract manufacturer) • Arm's length royalties for trademark and/ or technology • Limitations in royalty rates in BRIC countries and joint ventures	• Arm's length mark-up for contract R&D • Attribution of intangible related return to contract R&D	• Documentation of benefit • Duplicative services

The post BEPS world in the automotive industry

Substance requirements

A major challenge is the compensation of the intangibles and the question of "who should bear the major risk in a transaction?" In most cases the producing entity compensates the entity generating the core IP (product core design) through a royalty and through a separate compensation for application engineering (which is sometimes included in the license for core IP). As the royalty is often a fixed percentage of net sales, factories often bear contractually the major risk of the projects. This raises concerns of the tax authorities in the involved countries. If the factory is loss making, the tax authority in that country highlights that economically the factory has only limited control of volume and price risks and should be treated as a contract manufacturer. Thus, the factory should receive a stable C+ return. Vice versa, if the factory is making high profits the tax authority in the country of the IP owner has challenged the license fees and requires a higher royalty. The issue of lack of control and substance is now emphasised in note 1.48 of the OECD guidelines. The OECD describes a situation which has a certain similarity to the set up in the automotive supplier industry. In the example the parent company negotiates contracts on behalf of its subsidiary and provides technical support services which enables the subsidiary to fulfil its customer contracts. The parent company grants a royalty to its subsidiary and, according to the example, takes central control in project execution. The OECD concludes that a license agreement is not in line with the actual transaction. In an earlier version of the final OECD guidelines it indicates that the factory does in fact provide a service to the parent company,

The parent company grants a royalty to its subsidiary and, according to the example, takes central control in project execution.

The post BEPS world in the automotive industry

which would have meant that the factory would have been required to invoice the parent company instead of the customer. The OECD is now silent on the consequences if the factory continues to invoice the customer.

Location specific advantages

The countries of the emerging markets strongly encourage the concept of location specific advantages. China is now the most important automotive market and puts a high emphasis that location specific advantages must be considered when the arm's length principle is applied. The OECD is very unclear on the treatment of location specific advantages and provides little practical guidance. If the treatment of such advantages cannot be derived from third party data, the OECD suggests to share such advantages. However, the OECD is silent on the question "how a split should be performed." The industry countries view the established brands and technology as a core value driver, whereas countries like China claim their share for the local consumer preferences, their cheap and qualified labour on top of the functional return of the local operations. The issue becomes even more challenging as competent authority cases with China are complex – if successful at all.

Service transaction

A global supplier operates a network of factories and often provides comprehensive technical and managerial assistance, while the plant is focused on operational execution. From the perspective of the country of the plant, the taxpayers are burdened with high and complex charges which might be separate for core IP (i.e. license transactions), project specific application engineering, technical services, global and regional services etc. Tax authorities are inclined to challenge the benefit and require a high documentation to evidence the local benefit.

Quick savings

Another complex issue relates to quick savings. If the supplier is awarded with a new project the OEM sometimes requires that one time or ongoing price reductions are realised on ongoing projects. As the business is global, the OEM might receive a discount by a factory in a country whereas the benefit of a new project is awarded to a factory in a different country. Obviously this might artificially move income across border whereas the entity which grants a discount – if it were a third party – would ask for a compensation from the benefiting entity. Some suppliers have introduced balancing payments to neutralise the effects of a quick saving, thus the benefiting entity compensates the effected entity. Such balancing payments can

The post BEPS world in the automotive industry

It is yet not fully clear how the new OECD rules will be applied, but already there are many challenges for automotive companies.

then be easily challenged as often there is only very poor evidence available to substantiate the effects of quick savings, i.e. the nexus between the current project and the new awarded contract is not agreed in writing with the OEM but informally agreed.

2. What to do in the post-BEPS world?

It is yet not fully clear how the new OECD rules will be applied, but already there are many challenges for automotive companies:

- **Review of the business model:** As explained above, factories often operate as license manufacturers and bear significant risk. Companies must review the substance and ensure that either the substance is sufficient or business models might need to be redesigned. Some companies have introduced profit oriented license systems to ensure that the profit is in line with the limited functional and risk profile of factories.
- **IP landscape and research and development (R&D) functions:** The OECD now requires in the Masterfile to draw a clear landscape of the group's IP. Many automotive multinationals have followed a centralised IP strategy, however at the same time OEMs and suppliers follow a global footprint strategy for their R&D functions and outsourced R&D functions are compensated based on a C+ method. To maintain a centralised IP strategy it is a must to document and ensure control over outsourced R&D functions. It is easy to predict that tax authorities in the countries of the service provider will carefully scrutinise whether the R&D is controlled by the foreign principal or alternatively they will require to receive part of the intangible related return.

The post BEPS world in the automotive industry

- **Marketing intangibles:** The OEMs should carefully review their marketing strategy and review how far it is centrally controlled. The OECD has strengthened its concept of marketing intangibles and countries will carefully review how far local distribution companies or regional hubs take control in local marketing.

- **Service transactions:** These must be carefully considered and structured. It should become clear that there's no double charging and the compensation must observe local withholding taxes and VAT issues.

- **Permanent establishments:** OEMs and suppliers are faced with many potential permanent establishment (PE) risks. In many cases plants are supported by central engineering teams and provide on ground support. The OECD will lower the threshold for the duration to create a fixed place of business which will create more PE challenges. Moreover, agency PE issues are and will be a major issue for the suppliers as, by the nature of their business, customer contracts are negotiated by a legal entity in one country but executed by a legal entity in a different country.

- **Documentation:** In many cases OEMs and suppliers have very similar functional and risk profiles for certain activities such as distribution and manufacturing and should be able to leverage from a global documentation approach. It is now an imperative to review and fine-tune the existing documentation processes.

3. Outlook

The room for discussion within the concept of the arm's length principle becomes wider for tax authorities and the legal uncertainty for multinationals further increases. Given the high volume of intercompany transactions and the history of tax audits in the industry legal certainty will become a high value asset. Thus, automotive companies are well advised to establish a well-defined risk management process. Even if risks are closely monitored, substantial risk will remain as the views of tax authorities are yet not aligned in practice. Thus, utmost attention must be spend on emerging markets and the expansion of the use of advance pricing agreements (APAs) must be considered.

The post BEPS world in the automotive industry

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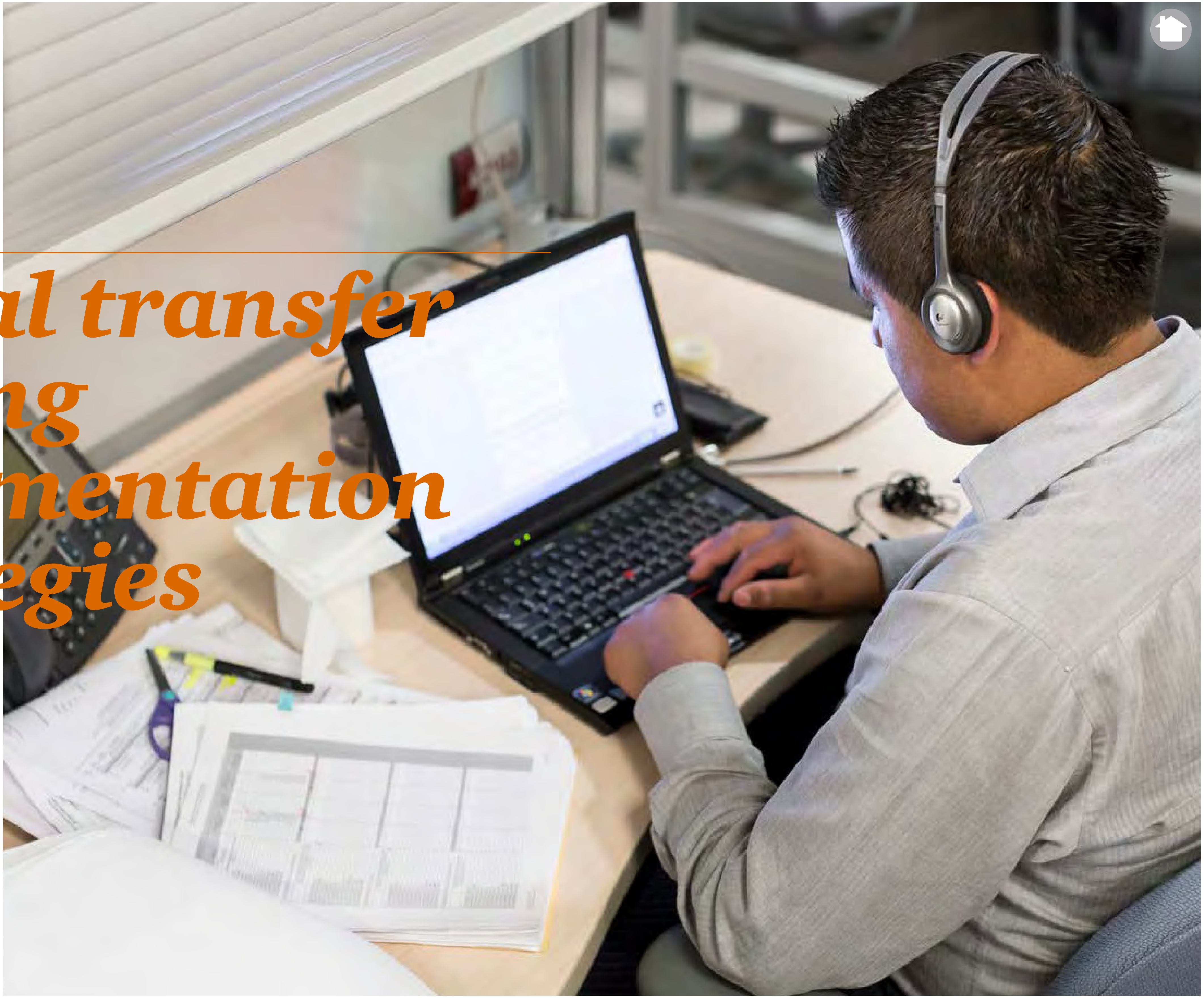


Global transfer pricing documentation strategies

Global transfer pricing documentation strategies

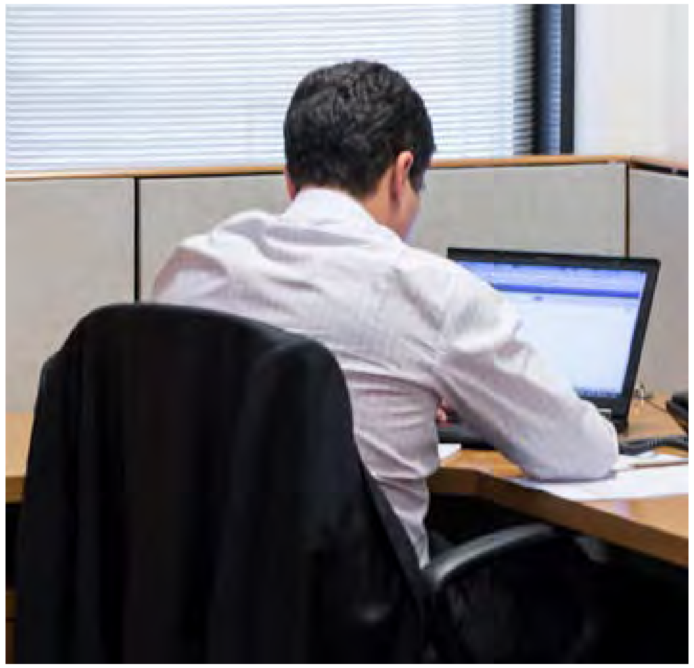
Where are we today?

The new Chapter V of the OECD's Transfer Pricing Guidelines covers three tiers of transfer pricing documentation: (1) the Master File (MF), which provides a detailed representation of the global operations of the multinational enterprise (MNE); (2) the Local File (LF), which contains detailed information on an MNE's intercompany transactions in a particular jurisdiction, and (3) the country-by-country (CbC) report.

Over the last year since the Chapter V final report was published in 2015, many local tax administrations have been taking steps towards introducing, to different extents, new transfer pricing requirements into their domestic legislation. For example, within the last 6 months:

- Canada has issued proposed legislation on CbC reporting.
- Uruguay has submitted a tax bill to Congress, which includes the adoption of the CbC report and the MF approach.
- Austria has introduced mandatory documentation requirements requiring companies to prepare a MF, LF and CbC report.
- Germany has published a draft bill intended to implement the three-tiered documentation approach recommended by the OECD.
- The US issued final regulations for filing the CbC report for US-parented MNE groups.
- The Australian Taxation Office finalised its design of the LF requirements under the Australian CbC reporting laws.
- Luxembourg has proposed CbC reporting obligations"

In addition to the three tiers mentioned above, over the last year, countries that have historically required the filing of local forms detailing various aspects of intercompany transactions (i.e., information returns), have confirmed that such requirements will continue, thereby creating a fourth tier to the transfer pricing documentation burden.



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Global transfer pricing documentation strategies

As more and more countries release or update their local documentation requirements, it is clear that while the OECD's aim was to introduce "coherence in the domestic rules that affect cross-border activities", the practical evidence shows that such coherence is not happening. For example, some countries, including the US, only introduced CbC report requirements, while not changing the local documentation requirements, whereas others countries, while introducing the MF/LF concept, did not align their requirements with the OECD Guidelines. Some examples include China where they introduced the MF/LF requirements, but also adding a special issues file that local taxpayers need to prepare; Japan introduced a group threshold for the MF and contemporaneous preparation of the LF and Australia introduced a form based approach for the LF. These nuances on a country by country basis are challenging MNEs to define a more comprehensive strategy for preparing transfer pricing documentation which meets all the relevant requirements around the world.

MNEs are realising that the approach taken for documentation going forward is likely to change significantly as compared to their historical approach, and the adaptation to this new environment needs to be made quickly to ensure the new compliance requirements in the post Base Erosion and Profit Shifting (BEPS) world are met.

New approach to documentation

In the past, as a result of the ad hoc development of transfer pricing documentation requirements globally, MNEs have faced a myriad of different regulations, formats, and levels of prescription.

The traditional approach adopted by many MNEs in preparing their transfer pricing documentation has typically been designed to ensure compliance with local documentation requirements and penalty protection, where feasible, while minimising the efforts required. This approach typically resulted in MNEs focusing on preparing transfer pricing documentation for higher risk affiliates located in key countries. Some of the most often used criteria included jurisdictions with prescriptive local requirements or aggressive tax authorities, affiliates where the most material transactions took place, or other similar factors.

The new Chapter V requires a much more global approach to documentation, which represents a significant change and will require MNEs to reassess how they approach transfer pricing compliance. In PwC's view,

Global transfer pricing documentation strategies

the traditional approach to documentation is a thing of the past, and the preparation of transfer pricing documentation will shift from a compliance to a more strategic exercise.

In this new environment of transparency, MNEs need to look at transfer pricing documentation differently and plan for a more comprehensive and deliberate review in order to determine the approach for compliance and obtain the information required, as well as ensure a smooth transition. It is key for MNEs to consider how the transfer pricing documentation presents their global business to the outside world, as well as which documents exist that impact their transfer pricing policies or practices (such as intercompany agreements, information on their company website, etc.). Furthermore, even if there are currently no requirements to publish any of the tiers of documentation, there is pressure, mostly in Europe, to make certain information (such as the CbC report) available to the public. As such, in planning the future approach to transfer pricing documentation, the nature and sensitivity of the business information to be disclosed needs to be carefully considered.

In terms of preparing the MF/LF, based on the Chapter V guidelines, there appears to be some flexibility in how to provide the mandated information. In this sense, when planning the documentation approach, MNEs could consider different approaches depending on the facts and strategy. For example, for certain businesses a modular approach may be considered appropriate, where the content of the MF is split between a main MF and separate business line MFs with only the relevant business line information, versus having all the different business lines' information in one MF. Under this approach, only the relevant modules can then be used as part of each local company's documentation set, jointly with a LF that is tailored to the local operations. However, when taking this approach the OECD clarifies that the entire MF consisting of all business lines should be available to each country. Another alternative could be summarising the business information in the MF, limiting the information included in this document, while providing more detailed information in the LFs to meet the information in the local documentation requirements.

Consistency is a critical area of focus. The written words in the MF/LF should provide the background to the data in the CbC report and should be consistent with other relevant documents, such as local information returns. This should be carefully considered throughout the

Global transfer pricing documentation strategies

planning process, as any changes in future documentation are likely to be scrutinised by tax authorities.

With this burden in mind, from gathering relevant information to producing the final documentation, it appears as though MNEs are taking a more holistic approach to collecting information and consolidating the process in order to have central visibility and control of the transfer pricing compliance process, although the involvement of the local affiliates is key to ensure that the local operations are accurately represented and the local requirements are met. Understandably, this approach requires expanding or reassigning transfer pricing resources to meet these new, more onerous documentation requirements, or alternatively looking to outsource some portion of the process, typically from assistance with the MF/LF strategy to preparation of the relevant documents.

Throughout these changes in landscape, we expect that technology will play a larger role for the coordination and preparation of transfer pricing documentation. From centrally gathering the data, to managing the timeline for compliance and documentation process, to issuing final reports, technological tools are likely to have a positive impact in the execution of the documentation strategy and the efforts and resources required to achieve it. With this factor in mind, we have developed various tools to assist our clients with the different elements of the transfer pricing compliance process under the new environment, including project management tools like Tax Engagement Center (TEC) and report writing tools like GCD Reporter.

We believe there is no one-size-fits-all solution when it comes to transfer pricing documentation strategy. There are numerous approaches and it is up to MNEs to take advantage of the flexibility and determine a game plan that fits their business facts, resources, and overall objectives.

Key takeaways

The last few years have seen a sustained increase in transfer pricing requirements around the world, a trend that is expected to continue based on the OECD's new Chapter V. This constantly changing environment, along with the increased transparency requirements have resulted in a heightened need for MNEs to disclose more information and rethink their transfer pricing documentation approach. In addition, MNEs not only need to closely monitor worldwide developments to ensure compliance with the evolving local obligations,

Global transfer pricing documentation strategies

but they need to act now as the rules apply to financial years which end in less than three months' time.

The new rules are currently in place in many countries, so now is time to formulate a plan. MNEs need a global strategy, along with underlying systems and processes to enable them to deliver consistent and robust transfer pricing documentation across all their affiliates in line with statutory deadlines. As the requirements continue to get more onerous it will become even more critical for MNEs to rely on technology to help gather the data, prepare the documentation and project manage the process on an annual basis.

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A truly global Transfer Pricing network

With over 3,000 dedicated professionals in over 110 countries, PwC's leading transfer pricing network is well positioned to advise you on a strategy that can help advance your goals within the ever-shifting compliance landscape.

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