

**Transfer Pricing Perspectives/October 2014:**  
*A series of articles based on our global transfer pricing  
conference in Switzerland*

# ***Transfer Pricing Perspectives:*** **Fit for the Future**



## Foreword



**Isabel Verlinden**  
Global Leader, Transfer Pricing  
PwC Belgium

+32 2 710 4422  
isabel.verlinden@be.pwc.com

Multinational organisations are operating in an environment of unprecedented change. There is a surge in volume and complexity of intercompany transactions. This is accompanied by increased enforcement of existing rules and lack of clarity around “what the new rules of the game” will ultimately look like. These developments have made transfer pricing a leading risk management issue for global businesses but probably equally a source of opportunities to “set things right”.

With “transparency” as a key theme marking the current evolution in transfer pricing and tax rules in general multinational enterprises encounter challenges in assessing what “good documentation” means.

In the past year there have continued to be significant changes in the area of transfer pricing with many new countries implementing either formal or informal transfer pricing documentation requirements. Needless to say, significant regulatory changes on disclosure are in the process of being designed and implemented under the OECD’s Coordinated Action Plan on Base Erosion and Profit Shifting (BEPS).

On top of all this, the subject of transfer pricing continues to be centre of a new public controversy on the issue of whether the current rules permit multinational entities to pay less than what is deemed to be a ‘fair share’ of the overall tax burden in some of the territories in which they operate.

In addition to compliance with a very technical and complex set of statutes, case law, regulations and guidelines, taxpayers may now need to evaluate the potential impact of decisions related to transfer pricing in more subjective areas such as corporate reputation and public perception.

We anticipate that this will be another eventful year. A combination of public debates on the ethics of tax planning, political and economic pressures, and well trained tax examiners will all contribute to a continuing increase in the number of transfer pricing disputes globally.

## Transfer Pricing Perspectives: *Fit for the Future*

The additional complexity means that making sure your transfer pricing strategy and execution are fit for purpose has become more important than ever before.

As every cloud has its silver lining, the current climate also offers opportunities. Indeed, companies will continuously streamline their businesses across borders. If tax authorities, politicians and business embrace the fast increase of new rules and concepts through a balanced and constructive dialogue the end result could be promising. Companies will be able to allocate means to transfer pricing compliance in a more effective way whereas tax authorities can focus on where “true risk” lies rather than spending long audit cycles less efficiently.

The articles in this October 2014 edition of *Transfer Pricing Perspectives* are based on a number of sessions from our Global Annual Conference, and are designed to help you getting equipped for the changes we’re sure to see and help you be fit for the future.

Last but not least, I would like to thank Garry Stone for his continued devotion to our PwC Global Transfer Pricing Network over so many years. I take pride in assuming this role as Global Transfer Pricing Leader.



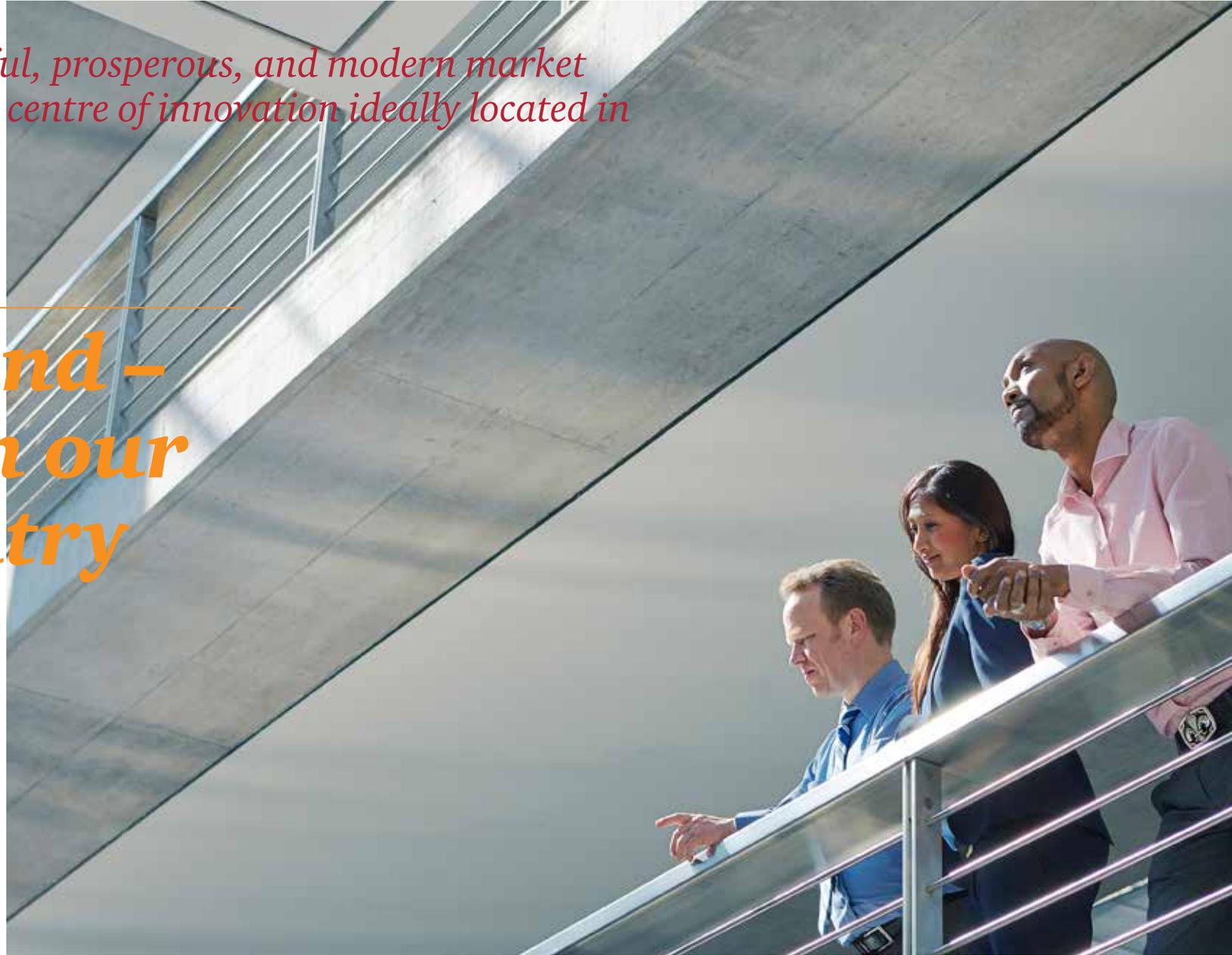
**Isabel Verlinden**

# Contents

Switzerland – A focus on our host country .....	1
Much ado about something: Country-by- country reporting and transfer pricing documentation .....	4
Technology – past, present, and future.....	9
Juggling several balls at once: Handling multiple APAs and MAPs .....	18
Transfer pricing implications around providing consumers the ‘total’ retail and consumer experience demanded – ‘anytime/anywhere’ .....	24
Managing transfer pricing risks in India’s evolving tax and regulatory environment .....	28
Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic .....	34
Permanent establishments and BEPS: The end of the beginning or the beginning of the end? .....	40
Transfer pricing for an industry in transition – Oil and gas .....	45
Financial services tax transparency – aligning processes, policies and messaging .....	53

*Switzerland is a peaceful, prosperous, and modern market economy and a leading centre of innovation ideally located in the heart of Europe.*

## ***Switzerland – A focus on our host country***



## Switzerland – A focus on our host country

Switzerland is a peaceful, prosperous, and modern market economy and a leading centre of innovation ideally located in the heart of Europe.

The Swiss marketplace is famous for a low unemployment rate, a highly skilled labour force, competitive tax conditions, and a per capita gross domestic product that is among the highest in the world. Switzerland's liberal economic system, political stability, and its close integration with the economies of other countries make it an attractive business location. Switzerland's economy is characterised by a highly developed service sector, led by financial services; a strong manufacturing industry that specialises in high-technology, knowledge-based production; and a well-established pharmaceutical and chemical industry.

Besides these hard economic factors, Switzerland's unique attractive total package is complemented by a very high quality of life, an excellent infrastructure, secure legal frameworks and a healthy national budget.

Furthermore, Switzerland has been a member of the European Free Trade Association since 1960; however, it's actually not a member of the European Union and hence was able to maintain its full political independence.

In the aftermath of the recent economic and financial crisis, financial deficits and correspondingly financial needs of many countries worldwide have grown tremendously.

As a result, those countries are in desperate search for additional (tax) income. This leads to a variety of political initiatives and regulatory developments at a national as well as supranational level, which looks at maximising its own tax base.

The international community of countries and in particular all advanced economies are equally impacted by the changing political landscape (i.e., it's a 'level playing field'). So, not only Switzerland has to face the challenges of the changing 'rules of the game'.

In the light of the increasing wave of new regulatory challenges, Switzerland has the ideal prerequisites to take a leading role in the future, among key business locations and remain uniquely attractive for multinational corporations (MNCs). This is reinforced by the declared political objective of the Swiss Federal Council and the cantons<sup>1</sup> to secure the international long-term competitiveness of Switzerland.



*The Swiss marketplace is famous for a low unemployment rate, a highly skilled labour force, competitive tax conditions, and a per capita gross domestic product that is among the highest in the world.*

## Switzerland – A focus on our host country

In this context, Switzerland has some internationally unique trump cards to play. In the framework of the on-going Swiss Corporate Tax Reform III (CTR III), Switzerland strengthens its traditional long-term stability and offers MNCs planning certainty for the future. Due to the CTR III developments, the former EU-Swiss tax dispute could be resolved resulting in a respective Memorandum of Understanding between Switzerland and the EU-Commission.

Besides any (ceasing) privileged cantonal tax regimes, Switzerland offers internationally competitive ordinary corporate income tax rates (e.g., Lucerne: 12.20%). Furthermore, various cantons have announced a further decrease in corporate income tax rates over the coming years (Zug, Vaud, Geneva, etc.). On top of the very favourable ordinary income tax rates, Switzerland, as a result of its currently debated CTR III, will offer from 2019, internationally accepted tax measures such as a Swiss intellectual property (IP) box regime<sup>2</sup> and a Notional Interest Deduction on qualifying equity.<sup>3</sup>

As if that were not enough, further tax measures to improve Switzerland's attractiveness are under evaluation, e.g., abolition of stamp tax on equity, adaptation of the withholding tax system, improvement of lump-sum tax credit, adaption of cantonal capital tax, etc.

This not just sounds great – it actually is. In contrast to many countries' pipe-dreams and empty promises, Switzerland has a solid, healthy national budget which actually allows it to implement the discussed measures.

### Authors

 **Benjamin Koch**

 PwC Switzerland

 +41 (0)58 792 4334

 benjamin.koch@ch.pwc.com

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<sup>1</sup>Switzerland is composed of 26 Cantons

<sup>2</sup>Cf. Benjamin Koch, To Box or not to Box?, International Tax Review, 6 March 2014, <http://www.internationaltaxreview.com/Article/3316461/To-Box-or-not-to-Box.html>.

<sup>3</sup>Andreas Staubli/Remo Küttel, Swiss Corporate Tax Reform III – notional interest deduction, International Tax Review, 6 March 2014, <http://www.internationaltaxreview.com/Article/3316476/Swiss-Corporate-Tax-Reform-III-notional-interest-deduction.html>.

*The revised Chapter V of the OECD Transfer Pricing Guidelines has been released. As a consequence the traditional approach to transfer pricing documentation will shortly become a thing of the past.*

## ***Much ado about something: Country-by-country reporting and transfer pricing documentation***



## Much ado about something: Country-by-country reporting and transfer pricing documentation

### **The new transfer pricing documentation world**

The revised [Chapter V](#) of the OECD Transfer Pricing Guidelines has been released. As a consequence the traditional approach to transfer pricing documentation (TPD) will shortly become a thing of the past.

The revised guidance provides for three tiers of documentation (a master file, a local file and a country-by-country report (CbCR)).

As part of the OECD's Base Erosion and Profit Shifting (BEPS) project, the revised TPD rules are designed to provide greater disclosure and transparency of a multinational enterprises (MNE's) transfer pricing affairs to the tax authorities, primarily by requiring MNEs to provide lengthy and specific lists of information in both their transfer pricing files and CbCR.

The traditional approach adopted by many MNEs in preparing their TPD has been designed to:

- a. Ensure compliance with local documentation requirements.
- b. Provide penalty protection; and at the same time.
- c. Minimise the effort required.

We will go on to explain why we believe that MNEs now need to approach the preparation of their TPD with additional objectives in mind.

### **What is changing?**

To date MNEs have generally adopted a 'wait and see' approach to the proposed changes to the TPD rules. The original draft attracted extensive comments and there was significant uncertainty over its final content. However, the revised Chapter V is now agreed and to a greater or lesser degree, every MNE will be affected.

For example, the introduction of the CbCR template will make it easy for tax authorities to identify MNEs with entities in low-tax jurisdictions with significant income but limited substance.

What this means in practice is that there will be increased pressure on MNEs to ensure that their TP policy (and associated profit allocation) is defensible in light of this increased disclosure.

***The revised guidance provides for three tiers of documentation (a master file, a local file and a country-by-country report (CbCR)).***



## Much ado about something: Country-by-country reporting and transfer pricing documentation

MNEs will need to adapt to the changing environment by establishing a strategy which addresses the:

- **Heightened transparency** requirements on existing and new matters – the new requirements shine the spotlight on matters such as substance, intellectual property, and business restructurings. Being able to articulate your story has therefore never been more important.
- Increased pressure and scrutiny on **commercially sensitive information** – the new requirements are more prescriptive, focus on complex judgmental areas, and require disclosure of commercially sensitive information (such as the value chain and details of certain Advance Pricing Agreements).
- Increased need for **coordinated and consistent documentation** – until now there have been no uniform TPD requirements around the world. The new guidance changes this.

- **Greater amount of qualitative and quantitative information** – whilst it is clear that more information will need to be disclosed, in particular in the CbCR and the master file, we believe that MNEs should be focusing their efforts on how best to present sensitive information, such as that on value creation and intellectual property arrangements.
- Increased need for **adequate IT systems** – we live in an IT enabled world. Compliance with the revised Chapter V will place a significant burden on IT systems to deliver on a timely and accurate basis, the data that has to be disclosed.

### **Keys to success in the changing environment**

Success in the changing TPD environment will involve reassessing your current TPD, adapting it to meet the additional quantitative and qualitative requirements of the revised Chapter V, and aligning it with your business operations.

We do not believe that there is a one-size-fits-all solution – MNEs will have some flexibility in how they structure their TPD whilst still complying with the new requirements.

To establish the best solution for your business, you should look to develop a strategy which:

- **Allows sufficient time** to prepare for meeting the new requirements. This means identifying not only how to collect the additional data required but also, and more importantly, how to disclose the key information in your TPD. This will fundamentally change how MNEs present their TP arrangements to the tax authorities and other stakeholders.
- **Anticipates** increased pressure from all tax authorities. The focus and objectives of the new requirements are clear. TPD is overtly intended to be a tool for tax authorities to use for risk assessment purposes.
- **Deals** with the shift in the focus of TPD from pure compliance to strategic risk – adopting a mechanical approach without considering whether it paints an appropriate picture of the MNE's value chain will be a risky approach.

- **Harmonises** and integrates the three-tier approach (Master File, Local File and CbCR) with existing information requirements (i.e., Transfer Pricing Information Return) in several countries. It is likely that some countries will keep existing requirements, converting the exercise into a four-tier approach.
- **Addresses** the importance of your IT systems in delivering the information that you are required to disclose.
- **Recognises** that documentation is a key element, but just one piece, of your wider BEPS response.

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*We do not believe that there is a one-size-fits-all solution – MNEs will have some flexibility in how they structure their TPD.*

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## Much ado about something: Country-by-country reporting and transfer pricing documentation

*Stay ahead of tax authorities' increased pressure, expectations and requirements.*



### **What do I need to do now?**

For the reasons set out earlier, it is likely to take time to prepare for the changing environment.

Therefore, MNEs should be taking action now to:

- **Monitor developments** on the implementation of the new rules in countries in which your group operates. Implementation will vary. Some countries are expected to formally adopt Chapter V earlier than others and some countries may look to extend the disclosures in CbCR. In any event, we are already seeing the behaviour of tax authorities around the world shift towards these new underlying principles.
- **Identify gaps** in your current TPD compared to the revised Chapter V and broader BEPS requirements.
- **Identify potential sources of the information** required to fill those gaps.
- **Assess which gaps are particularly sensitive** and develop a strategy as to what (and how) such information should be disclosed.
- **Evaluate IT systems' current potential limitations** and assess what changes can be made to provide the additional data required.

- **Monitor and re-assess your strategy** in light of the overall BEPS action items. Your TPD may need to be amended further in line with changes made in the business as a reaction to other BEPS actions.
- **Stay ahead of tax authorities' increased pressure, expectations and requirements.** Under the guise of BEPS we are expecting to see tax authorities taking an increasingly aggressive approach.
- **Use the opportunity to tell your story.** The CbCR will highlight countries in which you have a large number of employees but have reported only a relatively small amount of profit. MNEs should use the time available to ensure that they can explain their TP model to the tax authorities.

The new requirements may not be incorporated into national legislation yet but given the number of areas to be addressed, advance planning will be essential for MNEs to successfully support and substantiate their global TP policies.

## Much ado about something: Country-by-country reporting and transfer pricing documentation

### **The next steps**

The traditional approach to TPD is a thing of the past – the revised Chapter V profoundly changes the way MNEs should approach the preparation of TPD going forward.

The preparation of TPD should no longer be regarded as purely a compliance exercise but instead should be an inherent part of the group's strategic tax risk management. MNEs across the globe will be grappling with this, in particular how to balance the requirements to disclose more information with the increased risk of tax audits. This places greater importance than ever before on presenting the required information in a way that best enables the MNE to tell its story.

We are at the halfway stage of the BEPS project with further changes expected. Alignment of your future TPD with these wider BEPS themes is crucial in creating sustainable TPD and business structures. Implementation of Chapter V will vary by country, creating additional complexity for MNEs in meeting their compliance obligations globally. More immediately, we are seeing a behavioural shift in the tax authorities' approach to the areas targeted by the BEPS project.

There is no one-size-fits-all solution for all MNEs but as the detailed requirements are known, the time to review your existing documentation and plan your future strategy is now.

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*Under the guise of BEPS we are expecting to see tax authorities taking an increasingly aggressive approach.*



### **Authors**

 **Matias Pedevilla**

 PwC US

 +1 305 347 3544

 [matias.l.pedevilla@us.pwc.com](mailto:matias.l.pedevilla@us.pwc.com)

 **Kati Fiehler**

 PwC Germany

 +49 40 6378 1304

 [kati.fiehler@de.pwc.com](mailto:kati.fiehler@de.pwc.com)

 **Kevin Jenkinson**

 PwC UK

 +44 (0) 1223 552225

 [kevin.j.jenkinson@uk.pwc.com](mailto:kevin.j.jenkinson@uk.pwc.com)

 **Martin Kennedy**

 PwC UK

 +44 (0) 1293 594646

 [martin.s.kennedy@uk.pwc.com](mailto:martin.s.kennedy@uk.pwc.com)

*It should come as no surprise that the technology industry is thriving right now. Four out of the top five most known companies in the world are technology companies, with Google and Apple taking the top two spots<sup>1</sup>.*

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## ***Technology – past, present, and future***



## Technology – past, present, and future



It should come as no surprise that the technology industry is thriving right now. Four out of the top five most known companies in the world are technology companies, with Google and Apple taking the top two spots<sup>1</sup>. This industry has created evolutionary and disruptive innovation that has driven changes in business and revenue generation models. While this progression of the digital economy represents an opportunity for growth, it also presents new challenges for business leaders, governments and tax authorities around the globe to keep up with the speed of business.

These disruptive innovations<sup>2</sup> have uprooted industries. Consider the impact iTunes has had on the music industry. When the internet changed the medium of content distribution from physical to digital, the iTunes platform provided a successful revenue generating alternative to piracy, and made the idea of digital music ubiquitous<sup>3</sup>.

Currently, the technology buzzword of choice is the “Internet of Things” (IoT). The IoT is the network of physical objects accessed through the Internet. These objects contain embedded technology to interact with internal states or the external environment, resulting in the collection of enormous volumes of data<sup>4</sup>. Google’s recent \$3.2 billion acquisition of Nest Labs represents a play in home automation, a consumer-facing segment of IoT<sup>5</sup>.

More data, gathered from more places, means more ways to increase efficiency and improve safety and security<sup>6</sup>.

### ***Business models in the digital economy***

The fundamental shift to mobile devices from personal computers, accelerated by faster broadband on 3G and 4G mobile telecommunications networks, has resulted in traditional business models being adapted to the digital age, as well as the establishment of entirely new business models.

<sup>1</sup>Source: <http://www.businessinsider.com/the-20-most-valuable-brands-in-the-world-2014-5?op=1>.

<sup>2</sup>In this context, disruptive innovation refers to a term coined by Clayton Christenson in the *Innovator’s Dilemma*, published by Harvard Business Press in 1997. It describes an innovation that creates a new market by applying a different set of values which ultimately and unexpectedly overtakes an existing market.

<sup>3</sup>Source: <http://www.billboard.com/biz/articles/news/1559622/seven-ways-itunes-changed-the-music-industry>.

<sup>4</sup>Source: <http://www.cisco.com/web/solutions/trends/iot/overview.html>.

<sup>5</sup>Source: <http://www.forbes.com/sites/drewhendricks/2014/01/20/what-does-googles-purchase-of-nest-mean-for-the-internet-of-things/>

<sup>6</sup>Id.

## Technology – past, present, and future

E-tailers, app development and app stores, social networks and content platforms, and cloud computing are a few notable models used successfully by businesses.

### **E-tailers**

The internet has knocked down the walls formerly encasing traditional brick and mortar retail, allowing access to a larger audience of customers. This platform offers convenience, selection, information, and value, compared to off-line models. E-sales play a major role in the revenue mix for many traditionally brick and mortar retail giants. S&P Capital IQ expects that e-commerce sales will continue to outpace growth in overall retail sales for the foreseeable future<sup>7</sup>.

### **App development and app stores**

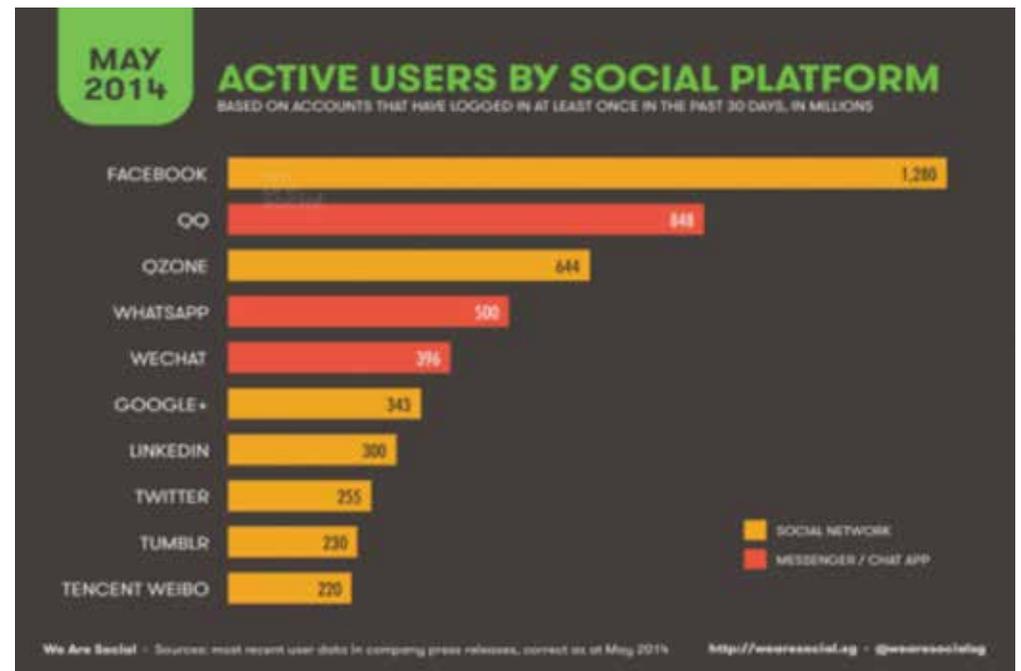
Application development is a force of creative destruction. Apps are software programmes that may be installed on mobile devices. Mobile app stores are retail platforms for the sale of mobile apps. Gartner has estimated that mobile app stores, such as Apple's App Store and Google Play, which account for up to 90% of total app store downloads, saw upwards of \$100 billion annual app downloads in 2013, up from \$64 billion in 2012<sup>8</sup>. Total revenue for

app store purchases exceeded \$26 billion in 2013. Nearly 91% of all downloads are free downloads, using a business model that leverages in-app purchases and in-app advertising to generate revenue<sup>9</sup>. Gartner expects that in-app purchases will account for almost half of app store revenue by 2017, up from only 17% in 2013.

### **Social networks and content platforms**

Business models are emerging where companies create a platform and then rely on user-generated content to drive value and create social impact (by going viral). The broadest and most obvious application of this model is social networks. As of May 2014, four social networks have more than 500 million active users, with Facebook approaching a massive global user base of 1.3 billion<sup>10</sup>. User bases are constantly being mined for valuable user data and typically monetised through increasingly sophisticated targeted advertising.

While many social networks and content platforms focus primarily on creating an environment for user-generated content, news websites, online blogs and magazines, and streaming companies rely on business-generated content.



Examples include Netflix and Pandora.

Their revenue model also involves advertising, but may additionally employ subscription based services for access to content. Another common revenue generation model used by social networks and content platforms is the “freemium” model.

This is where businesses offer a basic streamlined service for free in order to attract a user base, with the intention of upselling the premium version of the service, either for a subscription fee or as a one-time payment.

<sup>7</sup>Source: Standard and Poor (S&P) Capital IQ; Computers: Consumer Services & the Internet; May 2014.

<sup>8</sup>Source: <http://www.gartner.com/newsroom/id/2592315>.

<sup>9</sup>Source: <http://techcrunch.com/2013/09/19/gartner-102b-app-store-downloads-globally-in-2013-26b-in-sales-17-from-in-app-purchases/>.

<sup>10</sup>Source: <http://wearesocial.sg/tag/qzone/>.

## Technology – past, present, and future

### Cloud computing<sup>11</sup>

Cloud computing offers customers a cost effective alternative to purchasing and maintaining their own IT infrastructure. The Cloud computing environment presents economies of scale since the cost of the consumer resources is generally shared among a broad user base. Cloud computing companies perform services over the internet most often broken down into infrastructure as a service (IaaS), platform as a service (PaaS) and software as a service (SaaS).

A few business models have arisen in response to cloud computing. The subscription model - or “pay as you go” model which results in recurring revenues - dominates the enterprise markets. In the consumer markets, many cloud services (e.g., email, photo storage, and social networks) are provided free of charge, with revenue generated through advertising or the sale of user data.

Worldwide revenues from public cloud services were approximately \$37.3 billion in 2012, and are expected to reach \$107.2 billion by 2017<sup>12</sup>.

The growth rate for cloud services is expected to outpace worldwide IT spending over the same period five times over<sup>13</sup>.

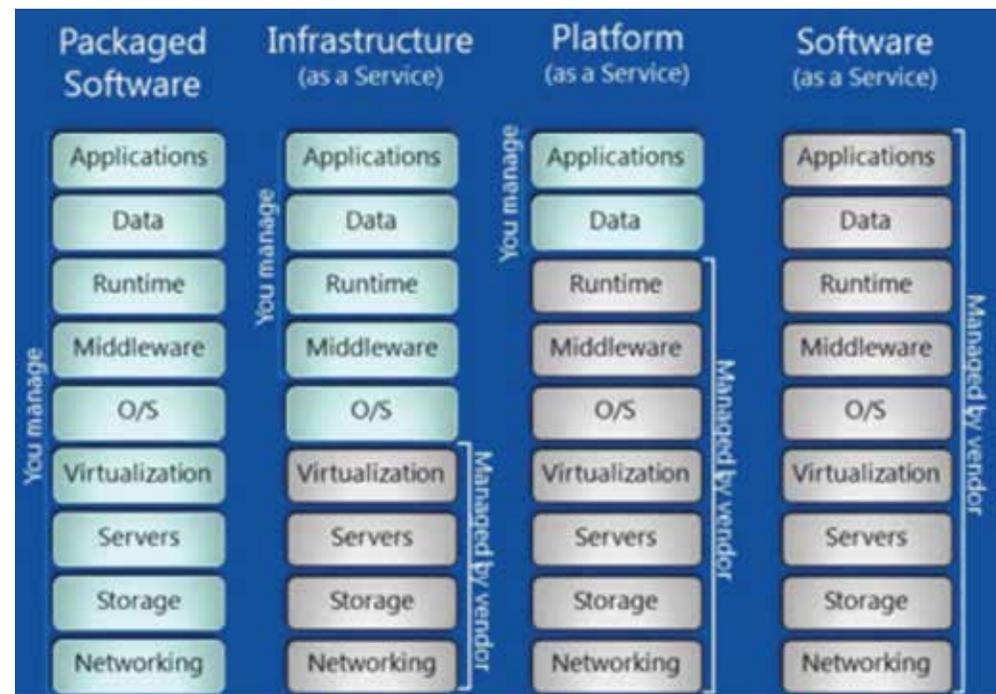
### The rise of complex business models

A complex business model allows for the operation of several applications providing complementary services which may be packaged into a form that is more attractive for users.

When a platform is made available to third parties to develop applications, the result can increase the value of the underlying platform. For example, many social networking services provide an application programming interface, which allows third-party developers to easily implement apps using the existing platform.

Many companies in the technology industry use multidimensional business models to open up multiple revenue streams. A company may offer some services for free under a “with advertisements” revenue model, while also offering the same services “without advertisements” for a subscription fee.

### Traditional software versus cloud-based services



*The growth rate for cloud services is expected to outpace worldwide IT spending over the same period five times over.*

<sup>11</sup>Source: <http://venturebeat.com/2011/11/14/cloud-iaas-paas-saas/>, unless otherwise noted.

<sup>12</sup>Source: S&P Capital IQ, Computers: Software, April 2014.

<sup>13</sup>Id.

## Technology – past, present, and future

The convergence of multiple business models presents unique challenges such as characterising the fundamental nature of revenue.

As companies innovate and business models evolve, the level of complexity increases. Take for example Amazon - an Amazon customer may choose to purchase an e-reader or tablet without advertisements for a higher price, or purchase that very same device for a lower price with advertisements. Further, Amazon customers may pay for shipping with each purchase, or for an annual membership fee receive free shipping, plus access to movies, music, e-books, Amazon created television shows, and other services like cloud storage.

### **Transfer pricing challenges in the digital economy**

The most significant transfer pricing challenges brought on by the digital economy are nexus, characterisation, data, and - an overarching issue of critical importance - the definition and tax treatment of intangibles.



### **Nexus**

Digital technologies have reduced the need for a significant physical presence to carry out business functions. Using the search engine business as an example - Google and Microsoft's Bing are able to serve advertisements, and thus generate company revenues, in countries where they have little to no physical presence.

Taxation rights were previously predicated on a physical presence - brick and mortar. Now the Organisation for Economic Co-operation and Development (OECD) is exploring alternative triggers to ground taxation rights, specifically examining the efficacy of a virtual permanent establishment (PE). Given the current state of the internet, particularly advances in cloud computing, the existence of an in-country server as a minimum threshold for taxation rights is no longer considered useful in the eyes of the tax authorities.

Even if international consensus could be reached to establish new nexus criteria, the question of profit/loss allocation to each country with sufficient nexus still remains.

### **Characterisation**

Since the inception of the software industry, characterisation from a transfer pricing perspective has always posed a challenging dilemma. As the software industry has evolved and cloud computing has become the dominant business model, the conversation has become more convoluted. When software was delivered as physical media, there was a strong argument for characterisation of the transaction as a tangible property transfer transaction. Existing rules treat the transfer of software under the assumption that the medium for the transfer is that of tangible property. A cross-border transaction is characterised as tangible property if the only right conveyed is the right to use the software, similar to purchasing software on a disc. However, that very same transaction is characterised as intangible property if rights to reproduce or distribute are conveyed. Meanwhile, Treasury Regulation (Treas. Reg.) 1.861-18 makes a distinction between the transfer of "copyrighted articles" and "copy rights".

## Technology – past, present, and future

Unlike transfers of software on a disc, cloud-based services can be provided in one country from a server located in a different country - without the purchased software ever crossing a border. With the rise of SaaS and the liberation of software access from physical media, the argument for transaction characterisation has moved away from tangible property, with the stronger argument for characterisation as intellectual property (IP), or even as services under Treas. Reg. § 1.482-9. It is unclear whether the provision of software in a SaaS delivery model constitutes a license of intangible property developed by the software provider, or whether, as the nomenclature suggests, SaaS deserves a “services” characterisation.

Regardless of what position you adopt, understanding the specific fact pattern through documented functional interviews and analyses is necessary to support the appropriate stance.

### **Data**

According to a publication issued by the OECD in March 2014 (Discussion Draft), “the growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree”<sup>14</sup>. Data has become a key value driver for a number of digital economy business models, especially for social networks and content platforms looking to monetise through targeted advertisement, and e-tailers focused on understanding the purchasing habits of their customers. A challenge here is the attribution of value to this data.

Does raw, unrefined user data have intrinsic value? Or is the real value created through the process of refining, analysing, and finally drawing conclusions from that data? Furthermore, one must consider the ownership of personal data. In the Discussion Draft, the OECD acknowledges the fact that in a legal context, most data protection and privacy legislation has considered user data to be the property of the individual from whom it is derived, even if that information was voluntarily provided in exchange for a product or service<sup>15</sup>.

Yet, in the digital economy, this user data is increasingly being monetised and viewed as an asset by companies. The challenges posed in the characterisation and attribution of value to data will only become that much more complex and numerous, if, as predicted, we see an increase of IoT-related connectivity and data intensive companies.

### **Intangibles**

Intangibles and intellectual property are undoubtedly the lifeblood of most technology companies. An intangible is defined by the OECD as “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”<sup>16</sup>.

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*The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information to an unprecedented degree.*

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In the OECD Revised Discussion Draft on Intangibles (Revised Discussion Draft) released 30 July 2013, intangibles continue to be broadly split into two categories:

- (i) marketing (or consumer-facing) intangibles; and
- (ii) trade intangibles.

Further, in Action 8 of the BEPS Action Plan the OECD has highlighted intangibles as an area of focus when assuring that transfer pricing outcomes are in line with value creation.

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<sup>14</sup>Source: OECD Public Discussion Draft, Base Erosion and Profit Shifting (BEPS) Action 1: Address the Challenges of the Digital Economy.

<sup>15</sup>Id.

<sup>16</sup>Source: Revised Discussion Draft, Chapter VI, Section A.1., Paragraph 40.

## Technology – past, present, and future

If this is to be accomplished, the first step is adopting a broad and clear definition of what constitutes a non-routine intangible. The Revised Discussion Draft asserts that the definition of an intangible from a transfer pricing perspective does not necessarily need to coincide with other accounting, tax, or legal definitions.

Six examples of intangibles were explicitly provided in the Revised Discussion Draft, including:

- (i) patents;
- (ii) know-how and trade secrets;
- (iii) trademarks, trade names and brands;
- (iv) rights under contracts and government licenses;
- (v) licenses and similar limited right in intangibles; and
- (vi) goodwill and going concern value. Interestingly enough, there is no explicit reference to user-base and/or user-data constituting an intangible<sup>17</sup>.

*The technology industry is undergoing a renaissance - benefitting from sustained disruptive innovation and an active private equity environment.*

***Technical tax goes mainstream***

The technology industry is undergoing a renaissance - benefitting from sustained disruptive innovation and an active private equity environment. Not surprisingly, it is not just investors and venture capitalists looking to share in the incredible successes of technology companies, but also governments and tax authorities across the globe.

Technology companies now have a target on their backs, with international tax structures and transfer pricing policies being subject to higher scrutiny by governments and tax authorities.

Moreover, during the past year, transfer pricing has become a target of the press and other non-government organisations, with publications ranging from the Wall Street Journal to the Times of India running stories that have characterised transfer pricing policies of technology companies as a mechanism for international tax avoidance.

On 30 July 2014, when Comedy Central's "The Daily Show With Jon Stewart" and "The Colbert Report" each aired segments dedicated to mocking the growing trend of corporate inversions<sup>18</sup>, it became safe to say that international tax and transfer pricing controversy had gone outside of the technical tax world and into the mainstream.

In July 2013, it became clear that tax authorities around the world recognised that outdated tax rules have not kept pace with the technological advancements of the digital economy when the OECD designated addressing the tax challenges of the digital economy as Action 1 in its published BEPS Action Plan.

As a result, the OECD's Digital Economy Task Force was established in September 2013. Its assignment was to consider the taxation issues arising from digital business and to identify potential measures to remedy any shortcomings, considering both direct and indirect tax options. Widespread concern with the question of whether the existing international tax rules have kept pace with the emergence of new business models enabled by the rapid development of information and communication technology was a key driver behind the BEPS Action Plan<sup>19</sup>.

***BEPS Action Plan<sup>20</sup>***

On 16 September 2014, the OECD introduced agreed recommendations for changing the international tax rules under its first stage of work in connection with the BEPS Action Plan. As mentioned, Action 1 relates to the challenges presented by the digital economy. A primary conclusion is that the digital economy is so universal that it is not a special part of the economy, but the economy itself.

<sup>17</sup>Source: Revised Discussion Draft.

<sup>18</sup>Where a U.S. company and a foreign company merge, resulting in the foreign entity as the new parent. Through inversion, the former U.S. company converts to a non-US taxpayer—a shift from being subjected to U.S. tax on worldwide income to merely being subjected to U.S. tax on a territorial basis.

<sup>19</sup>Source: PwC Tax Policy Bulletin, 16 March 2014.

<sup>20</sup>Source: PwC Tax Policy Bulletin, 16 September 2014, unless otherwise noted.

## Technology – past, present, and future

As a consequence, it is not viable to isolate it and construct separate tax rules.

The report focuses on the fragmentation of international business models and advances in technology as the key tax area to address. Further, it identifies specific remedies to be considered by the other BEPS work streams - i.e., controlled foreign company rules; artificial avoidance of PE; and transfer pricing measures.

Furthermore, the report highlights the role of intangibles in fragmented business models and the increasing importance of data. It concludes that transfer pricing allocation methodologies that create allocations of profits across tax jurisdictions need to be reviewed. Further, it suggests that relying upon a model which allocates a routine return to a low risk subsidiary and the balance to a low tax entrepreneur company may not withstand scrutiny.

### **Eliminate uncertainty**

Chapter 2 of the OECD's BEPS Action Plan is based on the premise that "clarity and predictability are fundamental building blocks of economic growth". And this resonates with business leaders, executives, and investors, who constantly seek to eliminate uncertainty in all aspects of business.

To address this concern, PwC has identified a four-step process for business leaders and international tax professionals to assess, adjust, support, and plan a proactive transfer pricing strategy.

### **Step 1: assessment.**

This involves taking an honest and critical review of the existing transfer pricing structure. Consider whether or not the strategy and structure in place is capable of holding up against increased scrutiny, paying particular attention to the challenging areas of nexus, characterisation, and the attribution of value to data.

### **Step 2: action and adjustment.**

The appropriate actions and adjustments to be taken will depend on findings and analysis discovered during the assessment phase. Thorough functional analyses and evaluation of organisational and decision-making structures should be performed during the assessment phase, leading to corrective action and adjustment. Keep in mind, more substance is always better than less, and it is imperative for control and management to support value creation.

### **Step 3: preparing and providing comprehensive support.**

This includes all relevant transfer pricing documentation, in advance of when it may be required. Make sure to have all bases covered with a clear understanding of country-by-country filing requirements and how those requirements impact your organisation.

### **Step 4: collaborating with the entire organisation to establish and develop a proactive transfer pricing strategy.**

Do not simply sit idly and wait for controversy to arrive on your doorstep. Rather, take a proactive approach to eliminate uncertainty. From a transfer pricing perspective, a best practice for eliminating uncertainty is to engage governments in Advance Pricing Agreements (APAs). If possible, move away from entering unilateral agreements and focus on a multilateral approach. Multilateral APAs provide clarity across the board, from tax payer to tax authority.

### **Conclusion**

It is an exciting time to be involved in the technology industry. While opportunity abounds with respect to optimisation of global tax and transfer pricing policy, the ability of governments and tax authorities to modernise antiquated tax rules remains in question. Fortune will favour those able to gain transparency by proactively working in conjunction with tax authorities to eliminate uncertainty and find understanding, as well as those able to assess and adjust as the industry continues to evolve.

**Authors**

**Marios Karayannis**

PwC US

+1 408 817 7456

marios.karayannis@us.pwc.com

**Sanjay Jaggi**

PwC US

+1 408 817 5913

sanjay.jaggi@us.pwc.com

**Daniela Ielceanu**

PwC US

+1 408 817 5939

daniela.ielceanu@us.pwc.com

**Scott Singerman**

PwC US

+1 408 808 2935

scott.a.singerman@us.pwc.com

**Joshua Wiser**

PwC US

+1 408 817 3738

joshua.wiser@us.pwc.com



*In the current tax environment where more and more tax authorities are increasingly focussed on transfer pricing and, the compliance burden for multinational enterprises is growing, having a strategy for dealing with transfer pricing issues across several jurisdictions at the same time is becoming a necessity.*

## ***Juggling several balls at once: Handling multiple APAs and MAPs***



## Juggling several balls at once: Handling multiple APAs and MAPs

In the current tax environment where more and more tax authorities are increasingly focused on transfer pricing and the compliance burden for multinational enterprises (MNEs) is growing, having a strategy for dealing with transfer pricing issues across several jurisdictions at the same time is becoming a necessity.

Such an approach can cover both agreeing on future policies through advance pricing agreements (APAs) or dealing with past adjustments through mutual agreement procedures (MAPs). In this article we discuss the factors an MNE needs to consider when implementing a programme of multiple APAs or managing a number of MAPs at the same time.

### **Multiple APAs**

Here we describe the typical approach that an MNE might adopt in putting together a programme of APAs, whether multilateral, bilateral or unilateral either simultaneously or sequentially over a relatively short period of time.

### **Why the growing demand for a multiple APA approach?**

Uncertainty around transfer pricing policies and their acceptability to tax authorities is likely to increase considerably as countries around the world develop their response to the OECD's Base Erosion and Profit Shifting proposals<sup>1</sup>. This will see an increase in the premium of certainty that an APA provides.

Moreover, whilst the perceived value of an APA will increase, the cost "gap" between an APA application and a transfer pricing documentation approach will close due to the increased compliance costs associated with the masterfile/local file approach proposed in the new OECD documentation requirements. These developments also make an APA option more attractive to MNEs.

In this environment, a programme of multiple APAs may well be more cost-efficient than a one-off APA, as the basic information and the analysis required for the first application will generally form the basis of the applications that follow. In addition, where APAs are prepared sequentially, the experience gained from early applications can influence the approach for subsequent APAs.



### **Which groups would benefit most from an APA strategy?**

#### **Centralised structures**

A multiple APA approach will generally prove most efficient for centralised structures where a number of entities share a similar functional profile, such as principal and low risk entities or commissionaires.

One approach to a multiple APA approach is to use the first agreed APA as an "anchor" which can be presented, or described, to other tax authorities during the negotiation of subsequent APAs, particularly where the same transfer pricing policy is being applied. This can often help to reduce the negotiation period of these later APAs, particularly where tax authorities hold each other in high regard.

<sup>1</sup>Described in detail in the OECD's Action Plan on Base Erosion and Profit Shifting <http://www.oecd.org/ctp/BEPSActionPlan.pdf>

## Juggling several balls at once: Handling multiple APAs and MAPs

As part of the new country-by-country reporting requirements that have been proposed by OECD in its recent BEPS paper<sup>2</sup>, companies will need to disclose in their local file any APAs or rulings in place. Therefore, the policy agreed for one group entity will be visible by tax authorities in other territories and will likely influence their view on what the group entity in their territory should earn.

### Groups undergoing business change

Another case well suited to this approach is where a significant change in the business takes place leading to new transfer pricing policies and pricing which could other trigger a number of audits. A multiple APA approach enables MNEs to take a proactive approach prior to a series of audits being commenced and gives them a valuable opportunity to give a consistent explanation of the commercial reasons behind the change.

### Regional approach

A multiple APA approach is perhaps most effective when implemented on a regional basis. Markets in the same region are likely to be similar and the tax authorities may accept regional benchmarking, which is both cost-effective to prepare and potentially more reliable.

Tax authorities within the same region often take similar views and have comparable levels of experience. They are also more likely to have worked together previously and therefore have a better understanding of each other's level of experience and their ways of working.

### Putting such an approach into practice

The first step will be to identify those group entities for which an APA would be most worthwhile, and also which type of APA would be most beneficial.

### Consider the tax authorities involved

If the tax authority is very experienced then this can lead to a more efficient process. In addition, if an "anchor" approach is adopted, an APA agreed with an experienced tax authority will carry more weight with other tax authorities and could influence their decision. It may also help to ensure a mix of OECD and United Nations (UN) countries as an APA with an OECD country may not carry weight with a UN country.

One way of assisting inexperienced tax authorities could be to engage in negotiations simultaneously with an experienced tax authority.

There may be additional benefits to an APA in certain territories. For example, some tax authorities allow APAs with roll-back so that the policies agreed can also be applied to previous years without challenge.

### Plan the timescale

There is a lot of variation across tax authorities in the average time required to conclude an APA, so this should be taken into account at the planning stage.

In addition, when planning several APAs consider whether a staggered or simultaneous approach will be best – most likely a combination of the two will work whereby a few APAs are started together at the beginning and more are added at later stages. Some early wins can be very effective in helping to influence other tax authorities.

### Create efficiencies through a centralised approach

Each tax authority has its own template and/or specific requirements that need to be included in the application and some tax authorities require country-specific benchmarking.

However, there are many common elements that can be prepared centrally.



*Tax authorities within the same region often take similar views and have comparable levels of experience.*

These include:

- Industry analysis (although some countries will still require local industry analysis).
- Business overview.
- Functional analysis overview.
- Transfer pricing analysis and method selection.
- Regional benchmarking (where possible).
- Financial analysis e.g., group forecasts.

<sup>2</sup>Guidance on Transfer Pricing Documentation and Country-by-Country Reporting: Action 13 2014 Deliverable

## Juggling several balls at once: Handling multiple APAs and MAPs

This centralised approach is also in line with the new OECD documentation requirements. Similarly, once agreement has been reached, the APA agreement template and compliance reports can also be produced centrally.

### **Allocate sufficient resource**

A multiple APA approach should be centrally co-ordinated by the MNE who will be able to ensure that information is shared with tax authorities in a fair and timely manner and that the process continues to move forward.

### **Managing multiple MAPs**

In this section we focus on another increasingly common problem – how to deal with an adjustment in one jurisdiction that leads to a large number of potential instances of double taxation and therefore the potential for several MAP claims at once. This might for example include adjusting the costs deductible by a principal in an MNE and arguing that a greater share should be borne by several other entities.



This can result in an MNE facing the prospect of either pursuing a large number of MAP cases (we have seen instances of up to 40 different countries involved in a single case), or accepting significant double taxation.

*“There is merit in developing a truly multilateral MAP if the goal is to resolve multi-country disputes”.*

### **OECD’s response**

On 16 September 2014, the OECD published its first deliverable for Action 15 of its BEPS Action Plan<sup>3</sup> proposing the development of a multilateral instrument to modify or amend bilateral tax treaties and thereby incorporate changes resulting from the BEPS work in the most efficient way. The report states that “there is merit in developing a truly multilateral MAP if the goal is to resolve multi-country disputes”.

It suggests that the use of a multilateral instrument to implement this approach would be the most efficient approach and could also help to overcome any legal issues raised, as an international multilateral instrument could provide the necessary authority to conclude multilateral MAPs even in the absence of specific provisions in the relevant bilateral treaties.

In addition, Action 14 of the BEPS Action Plan<sup>4</sup> aims to make dispute resolution more effective, and MAP cases negotiated on a multilateral basis are likely to form part of the solution to this issue.

Until a multilateral instrument is available, there are a number of actions that an MNE with multiple MAPs can take.

### **Discuss the implications with the tax authority early on**

At an early stage the MNE should discuss with the tax authority making the adjustment the implications and likely scenarios resulting from the proposed adjustment. This could help to persuade them to reduce the scale of the adjustment before it becomes final. After all, multiple MAPs are potentially even more resource-intensive for tax authorities than for MNEs.

<sup>3</sup>Action 15: Develop a multilateral instrument to modify bilateral tax treaties

<sup>4</sup>Action 14: Make dispute resolution mechanisms more effective

## Juggling several balls at once: Handling multiple APAs and MAPs

### Consider MAP approach versus a legal approach

The MAP approach should also be weighed up against pursuing an appeal through the courts, as well as considering whether the legal process should be delayed until the MAP is concluded. In some countries, once a final decision has been made in court, the tax authority is unable to deviate from this position during MAP negotiations.

### Prioritise

Taking into consideration the level of the adjustment made and the tax authority's reasons for making it, the taxpayer must decide whether the adjustment should be respected, reduced or eliminated.

When faced with a multilateral adjustment or series of adjustments, a triage approach is likely to be the most effective – concentrating only on those adjustments which are material and where there is a reasonable chance that agreement with the tax authority may be reached through the MAP process.

### Make efficiencies where possible

As in the APA strategy discussed above, a centralised approach can provide opportunities for leveraging work. For example, where possible, a common MAP position paper could be prepared to be shared with all of the relevant tax authorities. This has the additional advantage that a consistent picture is presented to all parties. An MNE might even attend a meeting with a number of tax authorities all present to answer specific questions. This would ensure that all relevant information was quickly shared.

### Set a timeframe and consider arbitration

When planning a multilateral MAP strategy, consider how long the process is likely to take, bearing in mind both MAP time limits and the likely time for the tax authority in each jurisdiction to deal with the claim. The resolution of some cases early on could help to influence other slower or more hesitant jurisdictions.

Taxpayers should not overlook the possibilities of arbitration and its potential to move the process forward, including taking advantage of time limits and the requirement for resolution, which could encourage tax authorities to progress their cases.

The OECD's deliverable on BEPS Action 15 states that, if multilateral MAPs are implemented through a multilateral instrument, provision should also be made for arbitration.

### Plan for the future

For complex cases leading to significant adjustments, taxpayers should consider whether an APA or multiple APAs could prevent a recurrence of similar issues. Applying for an APA shows that a taxpayer is taking a proactive approach and could help to rebuild the relationship with a tax authority following a dispute.

### Conclusion

A proactive, co-ordinated approach to transfer pricing issues across a number of jurisdictions at the same time has advantages for both MNEs and tax authorities, and seems likely to become a key feature of MNE tax strategies. This approach can create significant efficiencies in both time and resource, but careful planning is required in order to fully reap the benefits.



*Until a multilateral instrument is available, there are a number of actions that an MNE with multiple MAPs can take.*

## Juggling several balls at once: Handling multiple APAs and MAPs

### Authors

 **Diane Hay**

 PwC UK

 +44 (0) 20 7212 5157

 [diane.hay@uk.pwc.com](mailto:diane.hay@uk.pwc.com)

 **Lyndon James**

 PwC Australia

 +61 2 8266 3278

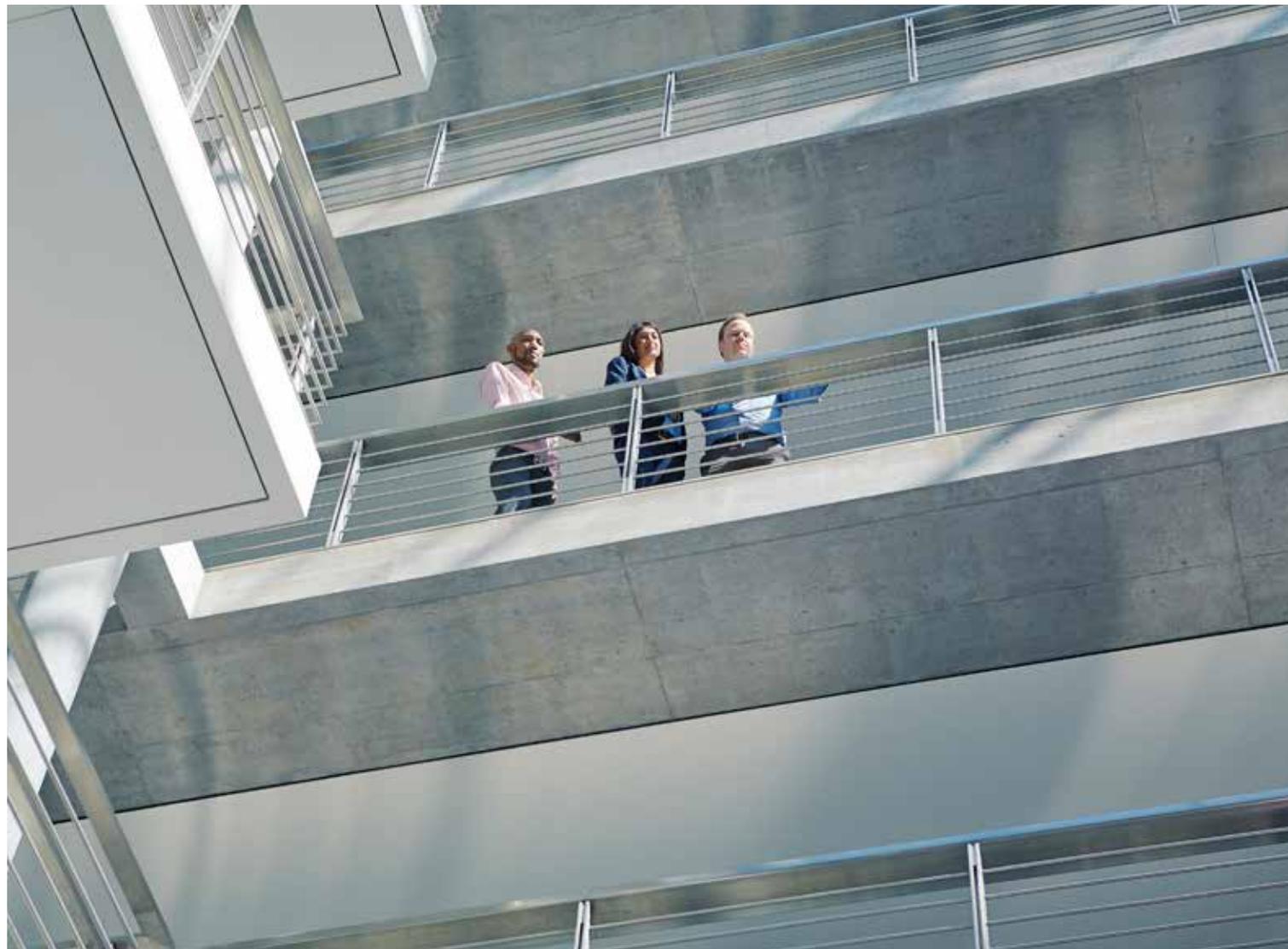
 [slyndon.james@au.pwc.com](mailto:slyndon.james@au.pwc.com)

 **Hannah Jaycock**

 PwC UK

 +44 (0) 20 7212 2249

 [hannah.r.jaycock@uk.pwc.com](mailto:hannah.r.jaycock@uk.pwc.com)



*Trends to serve consumers' demand for open visibility into companies' supply abilities necessitate operational and technology network changes that maintain companies' brand values and require careful consideration of transfer pricing issues.*

***Transfer pricing implications around providing consumers the 'total' retail and consumer experience demanded – 'anytime/anywhere'***



## Transfer pricing implications around providing consumers the ‘total’ retail and consumer experience demanded – ‘anytime/anywhere’

Many challenges for you as a professional at a consumer and retail company are being driven by the changing industry trends amidst a complex global economy. The expanded use of technology combined with consumers’ demand for an anytime / anywhere / personal shopping experience is driving both strategic considerations and operational change. To provide this demanded experience involves investing in information technology platforms that provide transparency to consumers around the breadth and availability of products. It also requires improved operational network efficiency to deliver that experience. Dealing with these issues also necessitate considering the transfer pricing implications.

Technology and e-commerce has had a tremendous impact on the consumer and retail industry. Consumers spend considerable time online researching, on social media, and shopping – which has led to geobytes of available data on consumer behaviour and spending patterns. It has also led to consumers’ demanding a more personalised shopping experience as well as the ability to see what products are available, from whom, where, and when they may take physical possession of them.

Serving today’s and the future consumer will require focused attention to maintaining a flexible, efficient supply chain and maintaining the value of your company’s brand in order to give consumers the shopping experience they desire. Delivering this will also result in intercompany transactions that require transfer pricing considerations to move products between entities efficiently, leverage technology, and share information as needed.

### **Personalisation**

In the current networked world, information on consumer behaviour – from, for example, websites visited, television shows watched, and items viewed or purchased online – is now captured and stored in databanks for use by companies. Furthermore, consumers have become more willing to proactively share such information in exchange for experiencing a more tailored shopping experience targeting their personal preferences. Some companies alert you to products of interest as you walk by them, others collect and arm salespeople with your buying preferences, and some recommend alternative products serving similar needs at various price points (and providing a comparison of product specifications).

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*Consumers are demanding a personalised shopping experience that is driving both strategic and operational change.*



## Transfer pricing implications around providing consumers the ‘total’ retail and consumer experience demanded – ‘anytime/anywhere’

*In delivering the demanded shopping experience to consumers, retail and consumer companies must invest in information technology platforms that provide transparency to consumers around the breadth and availability of products as well as building improved operational network efficiency.*

Using historical buying behaviour to customise their shopping experience is becoming critical to developing customer loyalty.

From a transfer pricing perspective, companies should be thinking strategically who is making these investments and developing this technology as well as who owns this valuable consumer information. Are there intercompany services being provided or is intangible property being developed and used?

### **Anytime / anywhere shopping**

With almost anything available at the touch of a button, consumers want it all – to be able to see what is available, when it is available, and to be able to get it wherever they wish. This ‘anytime / anywhere’ shopping experience demanded by consumers requires companies to consider their overall supply chain to determine needed changes as well as ensuring technology is embedded within the operational network to be able to relay in real time what products are in stock in which stores (on-line or bricks & mortar) and by when the consumer can expect to take physical possession.

Other relevant technology used includes hand-held point of sale devices, mobile payment systems, and matching returns to sales originators (e.g., online purchases returned to physical stores and vice-versa).

The operational considerations to deliver the ‘anytime / anywhere’ shopping experience carry forward transfer pricing issues to address as well.

### **Brand power**

Serving ever evolving consumer needs and preferences require more from retail and consumer companies in order to deliver the breadth of quality products and the shopping experience demanded.

*Will warehouses and distributors serve only certain regions or be accessible globally?*

*What pricing policies may need to be set up to allow for global access if distributors are limited risk operators?*

*Should intercompany commissions be earned if consumers visit a certain store, but because of stock limitations purchases from another (or online)?*

*Does your online presence drive store sales or the other way around?*

Ensuring the security of customers’ personal information to prevent breaches that open the way for scams, fraud, and financial loss is incredibly important. Leveraging social media to promote products as well as the company as a whole is a strategic consideration.

Doing all of these things effectively will maintain and reinforce the message and value of a company’s brand....missteps when delivering will damage the perceived value of the brand.

### **So what?**

Where historically only certain expenses were deemed to relate to maintaining and building brand value – is there room to argue that other operational expenses outside of traditional marketing and advertising may now have a role to play?

## Transfer pricing implications around providing consumers the ‘total’ retail and consumer experience demanded – ‘anytime/anywhere’

And if this is the case, in the current OECD / BEPS environment – careful thought should be given around who is making those decisions and bearing the risks that translate to a brand’s equity.

Strategic and operational changes coming from increased use of technology and e-commerce will require thought on transfer pricing implications around intercompany transfers of goods, intercompany services, developing and maintaining brands’ value, and key people functions / decision-makers’ locations.

These new business opportunities will certainly have transfer pricing considerations. Careful upfront planning is a necessity if you want to achieve objectives and avoid future surprises.

### **Conclusion**

These industry trends and their impact on your company’s operational framework should be on your agenda when formulating your company’s approach towards transfer pricing.

You need to ensure that you stay abreast of how your company’s changing operational model may impact the way in which you may need to approach intercompany transactions.

This upfront consideration will allow you to develop the optimal pricing strategy, building in flexibility as you gain success at local levels while looking to expand more globally, and consider potential areas of controversy and the best path to avoiding or mitigating the risks associated.



*Dealing with these strategic and operational issues will also necessitate considering transfer pricing implications with respect to inter-company transactions around product transfers, provision of services, and development and use of the brand intangibles.*

### **Authors**

 **Anthony Curtis**

 PwC US

 +1 646 471 0700

 anthony.curtis@us.pwc.com

 **Marc Diepstraten**

 PwC Netherlands

 +31 (0) 88 792 63

 marc.diepstraten@nl.pwc.com

 **Valeri Viladrich**

 PwC Spain

 +34 932 532 042

 valeri.viladrich@es.pwc.com

 **Jeff Yuan**

 PwC China

 +86 (21) 2323 3495

 jeff.yuan@cn.pwc.com

 **Brandee Sanders**

 PwC US

 +1 646 471 1796

 brandee.sanders@us.pwc.com

Transfer Pricing Perspectives:

*Preparing multinational taxpayers for a long-term multi-dimensional approach.*

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***Managing transfer pricing risks in India's evolving tax and regulatory environment***



## Managing transfer pricing risks in India's evolving tax and regulatory environment

*The Indian Government has used the G20 forum to express its support for the new standard on automatic exchange of information.*

We have seen a significant expansion of transfer pricing (TP) implications for multinationals operating in India in recent times due to the new compliance requirements under the Companies Act, 2013 or Securities Exchange Board of India (SEBI) Listing Agreement for related party transactions. The Customs or Service Tax authorities have also started referring to taxpayers' statutory TP documentation in course of investigations. Apart from an increasing statutory impact, the past five to six years have also witnessed a significant rise in TP linked tax disputes in India for multinationals, which have often resulted in high pitched tax assessments and consequent litigation.

Recognising the fact that the tax authorities' aggressive behaviour during tax assessments has not helped the cause of improving investor confidence, the Finance Ministry under the new Central Government has expressed their



interest and focus on improving the tax administration system by making it more taxpayer friendly and less adversarial. This objective, if properly implemented, will surely result in positive changes in the tax regime and the Revenue-taxpayer behavioural equation in days to come. The Indian Government has used the G20 forum to express its support for the new standard on automatic exchange of information. Steps are being taken by the Government to step up efforts against cross border tax evasion.

It has also welcomed the first set of BEPS deliverables while highlighting the need to have a consultative process to take into account the concerns of developing countries regarding BEPS (which may be different from those of developed countries).

Considering the current tax environment, it becomes extremely important for multinationals to develop a long term strategic approach for managing TP risks in India which covers not only corporate tax requirements but other associated statutory compliances as well. Further, internal controls for TP documentation will need active involvement of the business teams along with the tax and finance functions.

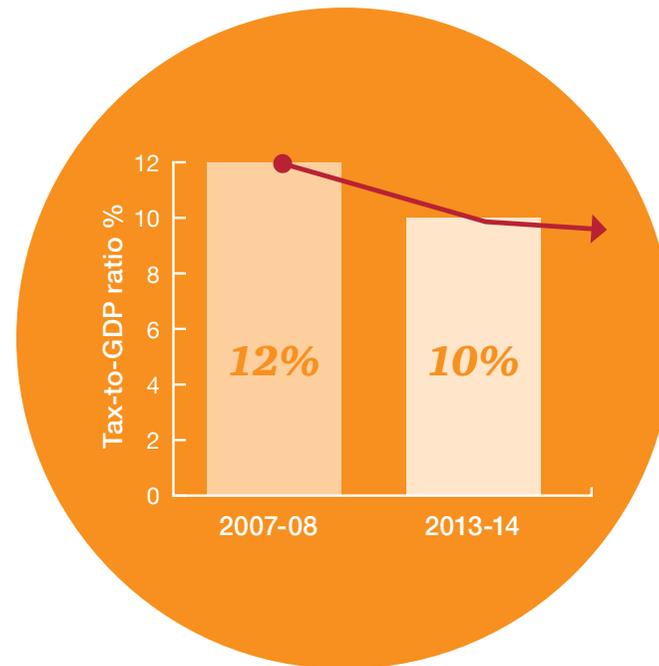
## Managing transfer pricing risks in India's evolving tax and regulatory environment

This multi-dimensional approach should help multinational taxpayers manage the multiple stakeholders who are concerned with the aptness of their intra-group TP policies.

Before we explore the approaches for managing stakeholders, it will be pertinent to briefly set the macroeconomic context of the current tax environment in India.

If we look back to the period starting from 2009, the Central Government was facing a gradual fall in tax-to-GDP ratio (which stood at a high of 12% during FY 2007-08 but since then has fallen to around 10% in FY 2013-14) and had to take steps to increase tax collection. This presumably led to an increased focus towards higher tax demands on multinationals along with other domestic taxpayers.

Over time, TP disputes increased since the Revenue took aggressive positions on various TP issues (which is reflected in the huge annual aggregate TP adjustments between USD 7.5–10.0 billion in the past few years). This has obviously resulted in significant increase in volume of TP litigation, much of which is still pending before the Tax Tribunals or judicial Courts (appellate authorities).



*It is extremely important for multinationals to develop a long term strategic approach for managing TP risks in India which covers not only corporate tax requirements but other associated statutory compliances.*

Now let us look at the trend in TP rulings from appellate authorities. Firstly, there are certain disputes which arise due to the interpretation and application of the TP regulations, where taxpayers rely on legal arguments to defend their cases before appellate authorities. On the other hand, there are a significant number of cases which are factual in nature involving the selection or application of TP methods or comparability issues.

Fact intensive cases need to be defended more carefully before appellate authorities to ensure that the factual aspects underlying the disputes are clearly presented along with the economic principles underlying the selection and application of TP methods. Recently, many complex issues like marketing intangibles, corporate guarantees, profit splits, location savings, start-up losses etc., have landed before the appellate authorities. If the factual information is insufficient, the appellate authorities can restore the case back to tax authorities for fresh fact finding and analysis which will extend the dispute resolution time frame.

## Managing transfer pricing risks in India's evolving tax and regulatory environment

For example, disputes around intra-group services, intangibles or tested party selections require detailed factual explanation to be provided before the tax authorities or appellate forums. Taxpayers should ensure that relevant factual information and analysis is presented in a succinct but effective manner. Details like employee profile, business strategies, supply chain design, operation manuals, customer contracts etc. often become useful facts to defend TP cases in India. This is where the role of business functions becomes important for extracting relevant operational information.

India has also seen an expanding importance of maintaining robust TP documentation for reasons beyond corporate tax laws. The new Companies Act 2013 and the amended Clause 49 of the SEBI Listing Agreement (which defines the terms and conditions that every company in India having listed securities has to follow) casts responsibility on the Audit Committee or Board of Directors or even the Shareholders of a company to ensure that all intra-group transactions are following the arm's length standard.

There are public reporting and shareholder pre-approval norms for listed companies which require supporting information at the very beginning. Due to these requirements, there is an increased focus on developing internal control systems for intra-group pricing and documentation.

Another aspect which needs mention is the higher public media focus on tax disputes. Over the last few years, we have observed that public media scrutiny on tax matters has increased, in terms of depth and speed of coverage. News on private tax litigation (i.e., sub-judice matters which are still not published in tax journals) often reaches the media through informal sources which in turn carries huge reputation risk for the taxpayer. Since the sources are informal, often the news may be inaccurate thus having a detrimental effect.

In summary, today multinational taxpayers in India are facing a multi-dimensional challenge in managing TP risks in India which arises from aggressive Revenue behaviour, prolonged litigation process, expanding scope of TP documentation and media attention on tax disputes.

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*Details like employee profile, business strategies, supply chain design, operation manuals, customer contracts often become useful facts to defend TP cases in India.*

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As it is with any other aspect of tax risks management, taxpayers must develop a flexible and objective strategy for managing TP risks in India. This starts from internal aspects like quality and depth of TP documentation and extends to external aspects like litigation strategy and effective Revenue interaction.

The starting point is a comprehensive review of the group's internal documentation related to intra-group dealings. The Revenue and appellate authorities expect taxpayers to present and explain facts and numbers with clarity.

For example, transactions involving transfer of technology require robust supporting documentation to explain the taxpayer's intellectual property (IP) life cycle, nature of group level research and development (R&D) and localisation efforts. In cases like these, business teams can play an important role in collating functional information.

There is an increased focus on transactional information in course of TP audits or even Service Tax or Customs investigations. The compliance requirements under the Companies Act require pricing related analysis to be documented even before the transactions are undertaken.

## Managing transfer pricing risks in India's evolving tax and regulatory environment

Hence, taxpayers need to build up internal control systems to capture key documentation on functional/ risk profile and pricing related information which not only cater to the annual contemporaneous TP documentation requirement but other statutory compliance needs too.

Moving to external factors, the approach for framing a dispute resolution strategy needs a long term perspective. India offers multiple options to deal with tax disputes. While the classical appellate remedies can be availed in all cases, alternate routes like Advance Pricing Agreements (APA), Safe Harbour Rules (SHR), Mutual Agreement Procedures (MAP) and Writ Petition to High Courts can be explored as well.

The [APA regime](#), introduced in 2012 has seen an enthusiastic response from multinationals. More than 390 applications have been filed over the first two application cycles. APAs are considered more useful in fact intensive cases. The [APA roll-back](#) provisions introduced this year will provide further impetus to taxpayers for considering a long term dispute resolution strategy since the effective coverage of any concluded APA will be nine tax years.

The option for availing Writ Petition remedies before Courts is also available for taxpayers when the issue involves a gross misapplication of statutory authority. In recent times, action around Writ applications have increased in light of the aggressive Revenue action on issues like arm's length valuation of equity issues (which will normally not generate taxable income to the issuing company) since such disputes relate to pure statutory interpretation rather than any factual analysis.

The SHR were introduced in 2013 containing a comprehensive set of regulations. Taxpayers can explore SHR benefits if the prescribed eligibility conditions are met and if the prescribed operating margins or interest/guarantee rates are commercially viable. The SHR regime has seen a lukewarm response in its first year due to the general perception that the prescribed rates are not commercially attractive.

Coming to the issue of media attention and taxpayer-Revenue interaction, taxpayers should develop a public communication strategy and also ensure that they participate in discussions with senior Revenue officials so that industry perspectives are effectively conveyed.

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*More than 390 applications have been filed over the first two application cycles. APAs are considered more useful in fact intensive cases.*

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There are various tax / legal publishers or associations who conduct tax centric public conferences which can be used as platforms for taxpayer-Revenue interaction. It goes without saying that the challenges faced by taxpayers due to knowledge or information asymmetry between Revenue and taxpayers can only be resolved if taxpayers engage regularly with the Revenue.

The Government is also focussed on this initiative, as was evident from the Finance Minister's Budget 2014 speech where he announced the formation of a High Level Committee for interaction with industry and trade.

Multinational taxpayers in India are going through a phase of evolution in the Revenue administration under the new Government. TP issues can be managed more effectively through long term dispute resolution strategies and increased Revenue interaction.

There is a need to evaluate the internal controls around pricing policies and documentation which should roll up into the statutory requirements under tax and corporate laws. Business teams should be effectively used for transactional information gathering.

Taxpayers should also evaluate the optimal dispute resolution strategy based on the nature of TP issues in existence or expected to arise and also interact with Revenue for constructive feedback.

## Managing transfer pricing risks in India's evolving tax and regulatory environment

*It goes without saying that the challenges faced by taxpayers due to knowledge or information asymmetry between Revenue and taxpayers can only be resolved if taxpayers engage regularly with the Revenue.*



### Authors

 **Sanjay Tolia**

 PwC India

 +91 (0) 22 6689 1322

 [anjay.tolia@in.pwc.com](mailto:anjay.tolia@in.pwc.com)

 **Bipin Pawar**

 PwC India

 +91 (0) 22 6689 1320

 [bipin.pawar@in.pwc.com](mailto:bipin.pawar@in.pwc.com)

 **Amitava Sen**

 PwC India

 +91 (0) 124 330 6524

 [amitava.sen@in.pwc.com](mailto:amitava.sen@in.pwc.com)

## Transfer Pricing Perspectives:

*The Pharmaceutical and Life Sciences industry transfer pricing environment is living proof of how the past and the present shape the future in the context of consistently intense audit activity.*

***Diagnosis and  
prescription to stop  
the spreading of the  
marketing intangibles  
epidemic***



## Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic

The Pharmaceutical and Life Sciences (PLS) industry transfer pricing environment is living proof of how the past and the present shape the future in the context of consistently intense audit activity. It is well known that PLS multinationals have traditionally been the most targeted companies when it comes to transfer pricing challenges, especially with respect to intangible-related returns. In particular, tax authorities have always looked to address the presumption that profit resulting from locally-developed intangible property often goes untaxed in local jurisdictions. Following the industry's patent cliff and the even more stringent regulatory environment, intensely competitive market conditions have increased the importance of pre-and post-local sales activities, as well as the delivery of complementary services. As a result, PLS companies often end up in the spotlight when it comes to the risk of creating local marketing intangibles.

In order to better manage the transfer pricing pitfalls associated with the assertion of local marketing intangibles, PLS companies should revisit several aspects of their distribution and services businesses that could impact this determination.

Areas of focus include, amongst others, relationships with local healthcare professionals and regulatory bodies, skills and expertise of the salesforce, the use and funding of local Phase IV clinical trials as a tool to influence prescribers, and the current and future product mix. Getting ready to address these challenges requires not only an understanding of how tax authorities approached these audits in the past, but also anticipating how audits are being affected and will continue to change as a direct result of the OECD's [Base Erosion and Profit Shifting \(BEPS\) Action Plan](#).

### **The past**

A retrospective of the relevant past cannot omit one of the most notable cases evidencing this paradigm, i.e., the GlaxoSmithKline (GSK) \$3.4 billion settlement with the US Internal Revenue Service (IRS) in 2006, which remains the largest transfer pricing controversy in history. In this dispute, the IRS asserted that GSK US developed significant marketing intangibles by selling pharmaceutical products in the US market arguing that the success of product sales was substantially due to the marketing efforts of the local distributor. This GSK dispute is a legend from the past, but one should not assume this was an isolated case or such risks have subsided.



*In order to better manage the transfer pricing pitfalls associated with the assertion of local marketing intangibles, PLS companies should revisit several aspects of their distribution and services businesses that could impact this determination.*

## Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic

There are several other similar cases that are worthwhile mentioning, including the GSK Consumer Healthcare case in India where the focus of the challenges was on brand advertising and promotional expenses that were incurred in addition to regular selling expenses. Closely related to this topic is also the approach taken by the independent expert collaborating with the Australian Tax Office (ATO) in the Roche Australia case, whereby the transfer pricing method applied by the ATO gave a separate “advertising agency” return to the marketing expenses incurred by the local distributor.

*Is your company equipped to defend its position on marketing intangibles in today’s environment?*

### **The present**

Today’s transfer pricing audit activity in the field of marketing intangibles is already being conducted under the framework of numerous and significant OECD developments and the new interpretations thereof. Although the BEPS project is not expected to be complete until December 2015, several tax administrations have already created, assembled, and deployed formal and informal BEPS “Special Task Teams” to accelerate audits. For example, consistent with the BEPS themes, Western European tax authorities are already issuing PLS companies very comprehensive and inquisitive information requests purported to assist in the assessment of any local marketing intangibles. Such requests come in the form of granular questionnaires intended to enhance transparency with regards to the local sales, promotional and detailing functions of the local PLS distributors.



*Indeed, tax authorities around the world are more frequently challenging the use of a “standard” distribution benchmarking study for local PLS distributors.*

## Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic

Companies are being requested to disclose the extent to which certain functions are performed locally as opposed to globally, including;

- the interplay of the global/regional and national marketing strategies and the local implementation thereof.
- the local involvement in product pricing and the regulatory approval process.
- management of e-marketing functions.
- participation in local Phase IV clinical trials, and other activities.

In this context, tax authorities are increasingly using such information to assert that these types of activities contribute to the development of local marketing intangibles, which they argue should warrant local intellectual property (IP) related returns.

A new PwC study of current PLS transfer pricing audit activity highlights trends consistent with the above remarks. For example, some tax authorities are already intensely focused on the role of local sales and marketing functions, having asserted that such activities create significant value that cannot be reflected by a standard benchmarking approach. Indeed, tax authorities around the world are more frequently challenging the use of a “standard” distribution benchmarking study for local PLS distributors.

They argue that such distributors engage in effort-intensive local sales and promotional activities to sell their own proprietary products, which is not expected to be the case for independent wholesalers that generally distribute pharmaceutical and other medical products of several unrelated companies.

Therefore, the time has come to move away from the old and simplistic approach to the economic analysis of returns earned by local distributors, which may not always properly factor in the value add of all local activities. It is imperative to now take a fresh look at how local distributors operate and are compensated in the context of evolving business models where there is more and more emphasis on localisation of promotional strategies, as well as local customisation of products and after-sales services offered to patients.

These market developments represent first a risk if companies take no action to rethink the current approach to distribution returns, but also a solid argument to substantiate the business trigger of transfer pricing policy changes. To be clear, most localisation activities bear routine risks and should be properly compensated with routine returns. PLS companies will now be severely pressured to produce the necessary economic, legal, and accounting evidence to prove it.

This trend related to marketing intangibles challenges is observed not only in Europe, but it is also spreading across the Americas (e.g., Canada and Mexico) and many developed and emerging markets in Asia. Such observations on current audit trends blur the line between where we are today relative to the PLS transfer pricing audit timeline and what will happen tomorrow, but do not mistake this for uncertainty! It is clear that PLS companies must be fit for the future now, even if passing local legislation to specifically address these issues might still lag behind.

Is your company confidently fit for the future of marketing intangibles challenges?

### *The future*

A more specific question in anticipating the future is: to what extent local sales, promotional and detailing activities create valuable intangibles that differentiate the local entity from market competitors?

There is no doubt that PLS distributors engage in complex multi-channel promotional activities and employ a highly educated and specialised sales force which is a differentiating factor as compared to other consumer goods sectors.

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*The time has come to move away from the old and simplistic approach to the economic analysis of returns earned by local distributors, which may not always properly factor in the value add of all local activities.*

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Nevertheless, all PLS companies tend to engage in promotional efforts of relatively similar intensity that are necessary to compete in the marketplace and that generally do not produce a lasting and measurable commercial advantage in a competitive market. Therefore, these high value-added local promotional activities should be viewed as an important and necessary cost of doing business in the industry. In other words, these are functions that may command a higher distributor return relative to independent mass wholesalers, but not a separate intangible-related return in a competitive market.

## Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic

When addressing audit challenges, a clear functional and economic analysis should demonstrate the true drivers of value in the supply chain and also demonstrate how the high value-added promotional efforts of local distributors are specifically compensated through the increased distribution return. It is therefore important to ensure local distributors earn an appropriately high return to compensate them not only for the local distribution and logistics activities, but also for the intense promotional and detailing activities specific to this industry.

In addition to setting the appropriate transfer pricing policy, it is also necessary to ensure the process and technology is able to support accurate implementation of this policy.

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*These high value-added local promotional activities should be viewed as an important and necessary cost of doing business.*

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In addition, PLS companies must be aware of specific product lifecycle events during which local costs exceed the typical promotional spend of a routine distributor. This above-normal marketing spend, for example in the form of product launch costs, could also be construed as a strategic investment in the local market that has the potential to create local marketing intangibles. To mitigate the risk of challenges in this regard, it is advisable to have the local distributors recharge to the supply chain entrepreneur all local costs that relate to strategic market development or product positioning.

All these past, present and future considerations should be high on your agenda when formulating your company's transfer pricing strategy to respond to marketing intangibles challenges.

You may consider kicking-off your analysis by first reviewing the following checklist, while staying abreast of OECD developments:

- Functional analysis of local distribution business with emphasis on local sales, detailing and promotional activities.
- Market position of the local distributor and specific market circumstances, including levels of marketing spend of local competitors.
- Transfer pricing policy and end-to-end process to implement this policy.
- Current and forecasted local distribution returns.
- Revisited approach to economic analysis and benchmarking, including robust and detailed analysis of comparable transactions and companies.
- History of local audits on marketing intangibles and position taken by local tax authorities.

### **Conclusion**

As transfer pricing audit trends continue evolving to adapt to the rapid OECD developments, marketing intangibles are definitely an area of focus that will develop into a more serious audit threat. This is certainly a controversy topic with the potential to bring tax authorities a high return on their investigation efforts as successful challenges are expected to result in material adjustments.

In this dynamic environment, proactive diagnosis of your marketing intangibles risk profile is the best prescription to be fit for the future and mitigate potential audit challenges.

## Diagnosis and prescription to stop the spreading of the marketing intangibles epidemic



*All these past, present and future considerations should be high on your agenda when formulating your company's transfer pricing strategy to respond to marketing intangibles challenges.*

### **Authors**

 **Horacio Peña**

 PwC US

 +1 646 471 1957

 horacio.pena@us.pwc.com

 **Brian Burt**

 PwC US

 +1 646 471 8386

 brian.t.burt@us.pwc.com

 **Blanca Kovari**

 PwC US

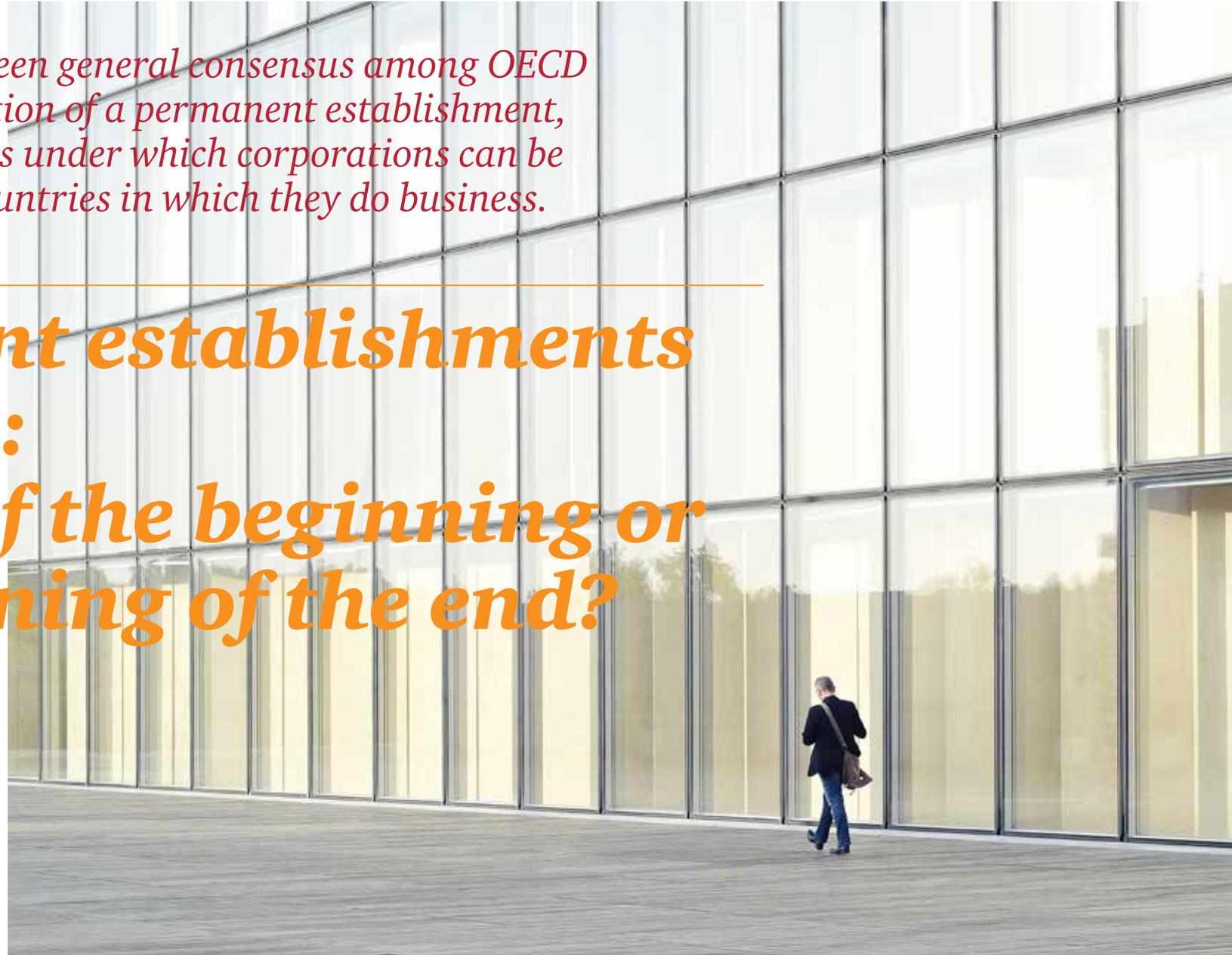
 +1 646 471 6817

 blanca.v.kovari@us.pwc.com

*In the past, there has been general consensus among OECD countries on the definition of a permanent establishment, which sets out the terms under which corporations can be taxed by the foreign countries in which they do business.*

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***Permanent establishments  
and BEPS:  
The end of the beginning or  
the beginning of the end?***



## Permanent establishments and BEPS: The end of the beginning or the beginning of the end?

### Introduction

In the past, there has been general consensus among OECD countries on the definition of a permanent establishment, which sets out the terms under which corporations can be taxed by the foreign countries in which they do business. However, there appears to be a growing disparity between residence-based and source-based countries on the concept of permanent establishment, which may lead to more disputes on basic taxing rights and tax principles. The [OECD's Action Plan](#) outlines specific tasks to resolve differences, modifying the definition of “permanent” to prevent companies from avoiding taxation in a market where they have major activities, such as through the use of commissionaire arrangements. In recent years, however, several high profile cases concluded that taxpayer’s commissionaire arrangements did not create permanent establishments. It remains to be seen whether the OECD will reach a consensus with the courts on this issue or side with the position of tax authorities, but, as differences continue to emerge over the interpretation of the permanent establishment concept, they increase the potential for lengthy tax disputes and double taxation.

### Commission agent and dependent agent structures

Referring to convention law, the OECD Model Tax Convention (OECD MTC) provides requirements for triggering the recognition of a permanent establishment; on the one hand, according to Art. 5 Sec. 1 OECD MTC, a fixed place of business, in which the business is mainly carried out, creates a permanent establishment. On the other hand, according to Art. 5 Sec. 5 OECD MTC, a dependent agent is a person who is acting on behalf of an enterprise and has, and habitually exercises, in a contracting state the authority to conclude contracts in the name of this enterprise.

The consequence of this action is the recognition of a permanent establishment in this state for these actions undertaken by the person. Contrary to this, a general commission agent, i.e., an independent agent, does not trigger according to Art. 5 Sec. 6 OECD MTC the existence of a permanent establishment. Due to this regulation, multinational companies (MNCs) frequently switched from fully-fledged distribution structures to commission agent distribution structures in order to gain more operational advantage, legal certainty and to avoid the creation of permanent establishments.



*There appears to be a growing disparity between residence-based and source-based countries on the concept of permanent establishment, which may lead to more disputes on basic taxing rights and tax principles.*

However, as some high profile cases now show, this change does not automatically prevent them from creating a permanent establishment. In the following paragraphs, we will summarise the court decisions of three cases to show the current court trends.

## Permanent establishments and BEPS: The end of the beginning or the beginning of the end?

### **Court decisions on dependent and independent agent structures**

We will start with the Zimmer case where the British Zimmer Ltd. entity was engaged in the production and distribution of medical technology products. In 1995, the French distribution subsidiary, Zimmer SAS, acting as a dependent agent for Zimmer Ltd. in France up to this point of time, switched to a commission agent arrangement. This led to the fact that Zimmer SAS sold products on its own behalf for Zimmer Ltd. Due to this change Zimmer SAS was allowed to receive requests from customers to negotiate price discounts or terms of payment. In the first court instance the court concluded that Zimmer SAS creates, as a dependent agent, although it acted as a (independent) commission agent, a permanent establishment, since Zimmer SAS was able to economically bind Zimmer Ltd. towards customers. The highest court instance did not share the opinion of the tax authorities or the first court instance.

It concluded that, following a strict legal view according to Art. 5 Sec. 5 and 6 OECD MTC the Zimmer SAS did not have authority to conclude contracts in the name of Zimmer Ltd, which leads to the fact that Zimmer SAS is not able to legally bind Zimmer Ltd. towards the customers.

Therefore Zimmer SAS does not represent a permanent establishment of Zimmer Ltd.

The second famous court decision on this topic is the Dell case. Here the question that needed to be clarified was whether the Norwegian distribution entity Dell AS, represented a permanent establishment of the Irish Dell Products Ltd. entity, which was mainly engaged in the purchase and distribution of computer hardware products that were produced by the parent company. It is important to know that Dell AS acted as a commission agent for Dell Products Ltd, but contrary to the Zimmer case Dell AS did not inform its customers that it acts on its own behalf but for Dell Products Ltd.

Moreover, Dell Products Ltd.'s staff were not located at Dell Products Ltd.'s office, but at the office of its parent company. These circumstances led to the fact that tax authorities as well as the first court instance concluded that Dell Products Ltd.

Due to the lack of substance needs to be classified as a pass through entity and that Dell AS is able to economically and factually bind Dell Products Ltd. towards the customers. The highest court instance contrary to the above came to the conclusion that following Art. 5 Sec. 5 OECD MTC,

Dell AS, as a commission agent, acts on its own behalf and is not able to legally bind Dell Products Ltd. Furthermore, the court emphasised that not the economical but the legal ability of binding the parent company is relevant for the creation of a permanent establishment.

The final important court decision, the Roche case, shows a surprising different interpretation of the model convention and commentary.

In 1999 the Spanish fully-fledged distributor Roche Vitamins SA switched its fully-fledged production and distribution structure due to a business restructuring to a contract manufacturer and sales agent structure of its Swiss parent company, named Roche Vitamins Europe Ltd.

The contract manufacturing included the production of medical products ordered by Roche Vitamins Europe Ltd. The sales agent function included the obligation to promote certain products ordered by the Swiss parent company. For both activities Roche Vitamins SA did not have the authority to conclude contracts with the customers.



## Permanent establishments and BEPS: The end of the beginning or the beginning of the end?

Nevertheless, the highest court decided that Roche Vitamins Europe Ltd. creates a permanent establishment in Spain, because the Spanish subsidiary acts as a dependent agent and all the activities carried out by Roche Vitamins SA could also have been carried out through a fixed place of business according to Art. 5 Sec. 1 OECD MTC. Furthermore, the absence of the authority to conclude contracts, does not automatically negate the classification as a dependent agent, since a person can also be classified as dependent agent by taking into account other circumstances such as the obligation to promote products ordered by Roche Vitamins Europe Ltd. Thus, the court's argumentation and reasoning goes far beyond the legal aspects.

Summarising these three court decisions, it can be stated that the interpretations of the requirements for the creation of a permanent establishment vary between legal and economic views. Whereas the first two decisions were based on a strict legal interpretation, the third decision was only justifiable by taking up a position that emphasises a broad and economically-driven view. This is conflicting and confusing for the MNCs. The current commentaries on the OECD MTC do not clarify whether a strict legal view or an economical and factual view should be hold.

### **Action plan on BEPS as a consequence**

As well as the above, the OECD developed and presented the Action Plan on Base Erosion and Profit Shifting (BEPS), consisting of 15 actions that need to be undertaken in order to decrease tax avoidance, double non-taxation as well as no or low taxation.

~~Two of these actions may cause changes for~~ the handling of permanent establishments:

- Firstly, the action of addressing the tax challenges of the digital economy will probably affect permanent establishments, because current governmental conceptions regarding the handling of "classical" permanent establishments do not provide, due to physical absence, sufficient link to tax digital businesses. Therefore the OCED is currently discussing alternative approaches such as the "significant digital presence" concept. Summarising these alternative approaches, it can be stated that the all of these are in early stages of development.



*Did the Norwegian distribution entity Dell AS, represent a permanent establishment of the Irish Dell Products Ltd. entity?*

## Permanent establishments and BEPS: The end of the beginning or the beginning of the end?

- Secondly, the action of preventing the artificial avoidance of permanent establishment status will affect the handling of permanent establishments. Referring to the discussion of the relevant court decisions presented above, the OECD is looking at revising the definition of permanent establishments. In this context they are trying to solve the problems MNCs who have frequently switched their business models from fully-fledged distribution functions to commission agent structures face, as well as MNCs who have built structures that allow to split activities into supporting activities that are explicitly excluded as auxiliary according to Art. 5 Sec. 4 OECD MTC.

The cases presented above show that the topic on permanent establishments will be subject to several significant changes in the near future. As a consequence, these changes might have impacts on taxpayer's business structure and strategy in certain countries. Therefore, recent and future developments of OECD's Action Plan should be watched with great interest by the taxpayer.

### **Conclusion**

To avoid negative surprises, such as an unintended creation of a permanent establishment, MNCs should therefore analyse their distribution structures, focusing on the legal and economical binding of independent and dependent agents and – if required – adjust their current business structures. In case of an unavoidable creation of a permanent establishment, it is recommended that they follow a proactive optimisation such as the deliberate establishment of a permanent establishment. In case of triggering the creation of a permanent establishment, the allocation of profits with reference to the Authorized OECD Approach (AOA) is one of the main challenges for the taxpayer.

*Referring to the discussion of the relevant court decisions presented above, the OECD is looking at revising the definition of permanent establishments.*



### **Authors**

 **Susann van der Ham**

 PwC Germany

 +49 (0) 211 981 7451

 susann.van.der.ham@de.pwc.com

 **Mark Uttendorf**

 PwC Germany

 +49 (0) 211 981 7454

 mark.uttendorf@de.pwc.com

*In the energy sector, the international oil and gas market remains primed for ongoing growth through acquisitions and organic expansion.*

# ***Transfer pricing for an industry in transition – Oil and gas***



## Transfer pricing for an industry in transition – Oil and gas



*As existing fields mature and decline, growing demand is driving exploration and development throughout the world, and the development of new technologies such as those being employed in the North American tight oil or shale gas fields.*

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### Overview

In the energy sector, the international oil and gas market remains primed for ongoing growth through acquisitions and organic expansion.

As the era of “easy oil” approaches its end, industry players are looking to diversify portfolios by tapping into emerging opportunities in unconventional oil and gas and frontier areas, such as:

- shale gas.
- coal seam gas.
- light tight oil.
- liquefied natural gas liquefaction.
- oil sands.
- ultra-deepwater.
- the Arctic.

To commercialise these opportunities as well as unexploited conventional reserves, companies are increasingly engaging in multi-billion dollar technically and operationally demanding projects. As existing fields mature and decline, growing demand is driving exploration and development throughout the world, and the development of new technologies such as those being employed in the North American tight oil or shale gas fields.

In addition to the North American arena, widespread interest and expansion is focused on Africa, Brazil, Norway, Russia, and other locations around the world. As a result, every stage of the production pipeline from exploration and drilling to trading and distribution offers opportunity for new alliances and investment in uncharted territories. However, significant investment risk remains due to regional instability, political unrest, regulatory issues, contested ownership of fields, and potential environmental impacts.

### Introduction

The key and largest barriers to market entry in the energy industry are the need for significant capital expenditures and the functional capacity to manage the capital and associated risks. Such capital expenditures come with long investment horizons to develop and market product or services, which create substantial business risk. From a transfer pricing perspective, the ownership of the capital assets and the allocation of the business risk require careful planning with an understanding that markets can change. Currently, the significant activity in the current liquefied natural gas (LNG) sector is a prime example and similar issues can be observed in many other sectors of the energy industry.

## Transfer pricing for an industry in transition – Oil and gas

Few developments in energy markets attract as much interest as LNG. Following the spectacular success of shale gas in the US, analysts around the world see LNG as a solution to:

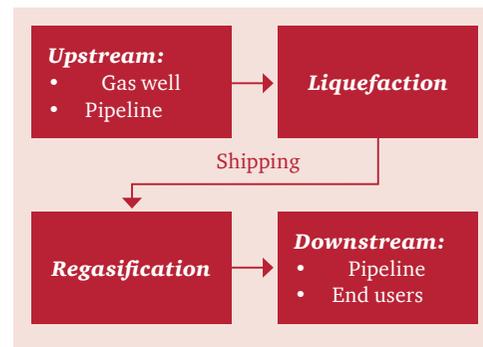
- energy independence – for example, through reducing dependency on supplies from unstable locations.
- a solution to global warming – for example through reducing the use of coal for power generation.
- an economic growth engine– for example through lowering costs of local manufacturing and in-sourcing activities to boost employment.

From the transfer pricing perspective, LNG is seen as an example of two facts often overlooked in applied transfer pricing, namely:

- the difficulty of establishing transfer pricing policies in a promising industry.
- high costs to adjust transfer pricing policies in light of market developments.

### **Background and importance**

The supply chain of LNG summarised below is one of the most capital-intensive in modern economies.



Not surprisingly, when faced with investments on this scale, investors and operators seek assurance that they can recover their costs. Accordingly, third party contracts as well as intercompany contracts often have terms that run decades, and often include take or pay commitments, which ensure a counterparty receives monies even without physical delivery.

Such were the contracts signed in the early to mid-2000s, when the US was posed to become an LNG importer and multinationals set up local trading offices in anticipation of volumes to be shipped to North America. Following the shale gas revolution when the US became largely self-sufficient in terms of gas, the import effectively ceased and instead the industry started to prepare for exporting LNG out of the US.

*Following the shale gas revolution when the US became largely self-sufficient in terms of gas, the import effectively ceased and instead the industry started to prepare for exporting LNG out of the US.*



From a transfer pricing perspective, this constitutes one of the most exciting real time transformations within the industry. Similar dynamics can be observed across the energy industry as seen in the offshore drilling industry with the significant investments made for high-specification dynamically positioned drilling rigs and drillships or the move from 2D and 3D seismic data processing technologies to more advanced 4D technologies.

## Transfer pricing for an industry in transition – Oil and gas

### **Lessons learnt**

Faced with continued capital investments and with market dynamics continuing to change, many international energy companies find it a challenge to:

- establish an operating model/transfer pricing policy that can evolve as energy markets change.
- ensure parties have the functional and financial wherewithal to manage their risks and capital.
- establish transfer prices which adequately remunerate each segment of the value chain given the level of investment, function, and risk.
- ensure that the outcome in terms of profitability is consistent with market benchmarks.

Within the supply chain, it is critical to ensure all group entities along the supply chain realise remuneration based on their contribution to the value chain. A key component of the proposed guidance in connection with the action plans on Base Erosion and Profit Shifting issued by the Organisation for Economic Co-operation and Development (OECD) is ensuring the “entrepreneurs” within the controlled group that bear risk and provide capital also have the functional capacity to manage the risks and capital.

While contributions relating to risk and capital are key in the energy industry, consideration should also be given to group entities with the functional or management wherewithal to manage the risk and capital.

### **A global approach to commodity trading Introduction**

As oil and gas and mining markets become more interconnected, there is a need to take a more global approach to commodity trading.

Centralising trading and marketing activities in one or a few locations allows companies to consolidate sources of supply so they can better manage and meet customer demand. Around the world, many locations have attracted a critical mass of commodity trading companies and emerged as important hubs for global commodity trading.

### **Background and importance**

International trading companies in the oil and gas and mining industries generally conduct two types of trading:

1. **Supply chain trading**, where traders work to meet customers’ needs with available supplies.
2. **Proprietary trading**, where traders play the commodities markets using their first-hand knowledge of supply and demand.

Other common trading techniques include asset optimisation, derivative market-making, arbitrage, and dynamic hedging of asset portfolios.

Like any global business, international trading companies and their parents need to manage a host of direct and indirect tax matters. If a trading desk is located in a jurisdiction that is different than the source of production, tax authorities will often take a closer look to determine whether the trading company’s activities and functions added value to the business and whether it is reasonable for the operations to compensate that entity. As a result, those activities and functions should be supported by commercial reality and be properly documented.

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*Within the supply chain, it is critical to ensure all group entities along the supply chain realise remuneration based on their contribution to the value chain.*

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### **Lessons learnt**

Tax authorities may challenge transactions with international trading companies on the basis of their transfer prices. In most countries, transfer pricing rules only apply to related party transactions but other countries’ rules may apply more broadly. The entire business relationship must be considered in any event. Generally, under the guidelines set forth by the OECD and adopted by most countries, companies must be able to show that intercompany prices approximate the prices that would be agreed on by unrelated parties. This entails detailed documentation to support the company’s transfer pricing methods and practices.

## Transfer pricing for an industry in transition – Oil and gas

*In addition to arm's length terms, most tax authorities will consider the spot price for commodities in determining the price at which those commodities are sold to the trading company.*

Transfer pricing disputes are often about the allocation of profit, based on the amount of value added at each step along the supply chain – including financing, development, production, marketing and sales, transportation, and delivery. Transfer prices should clearly reflect the risks at each stage and be flexible enough (e.g., through gross-up clauses) to respond to changing circumstances, such as civil unrest, commodity price fluctuations or extreme weather events, which could change the expected outcome.

In addition to arm's length terms, most tax authorities will consider the spot price for commodities in determining the price at which those commodities are sold to the trading company. The trading company's functions and risks must support the methodology applied to the profits earned, whether through a fixed commission or support for a price that varies from spot.

Given the complexity of this determination, many Latin American countries are introducing their own specific rules to protect the price at which national resources leave the country. Brazil, for example, recently introduced rules that apply deemed profit margins for determining intercompany prices rather than the OECD's arm's length principle.

The Brazilian legislation is moving toward a change that would consider the spot prices parameter based on international commodities exchanges or even on international independent indices. Other countries are aware of such practices, and some may follow suit, especially in Latin America.

Commodity trading companies can reduce the risk of a transfer pricing challenge by entering into advance pricing agreements (APA) with tax authorities. In the jurisdictions that offer them, APAs offer security that the tax authorities will accept the selected transfer pricing methodology for related party transactions over a fixed period of time.

### **Factors to consider to manage transfer pricing risk**

- Develop a strong transfer pricing framework that meets the compliance needs of all relevant jurisdictions and make sure it is properly implemented, documented, and followed.
- Fully document transfer pricing policies, including the choice of transfer pricing method and the inapplicability of other methods.
- Identify, quantify, and document the value added and risks assumed at each stage of the supply chain.
- Be prepared to engage in tax disputes with local authorities, and develop a strategy for driving audits and disputes in advance.
- Gain more certainty that transfer prices will be accepted by entering into an APA with the relevant tax authorities.

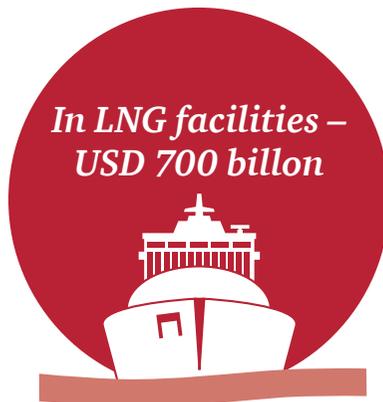
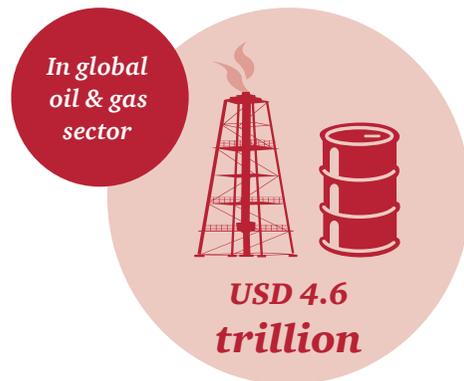


*Commodity trading companies can reduce the risk of a transfer pricing challenge by entering into advance pricing agreements (APA) with tax authorities.*

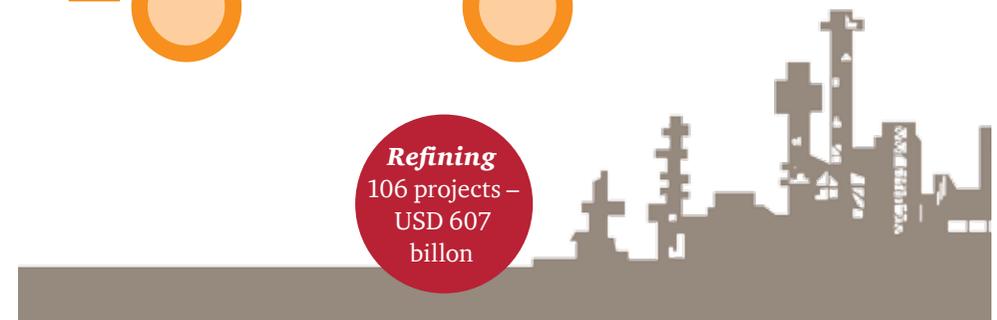
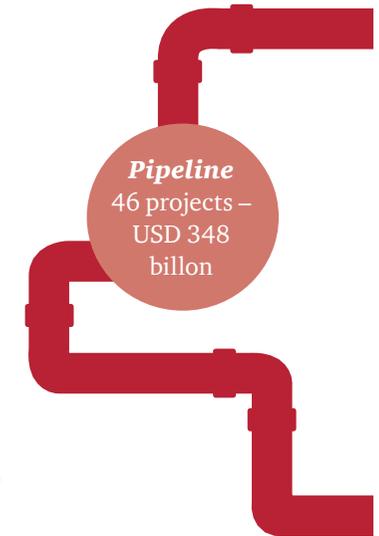
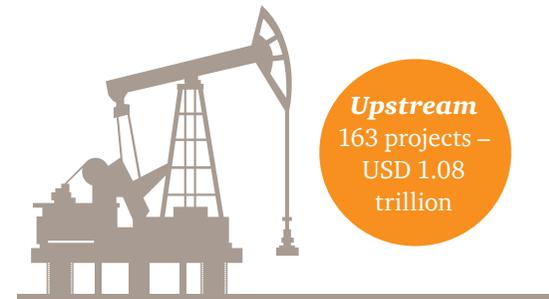
## Transfer pricing for an industry in transition – Oil and gas

Companies are increasingly engaging in multi-billion dollar, technically and operationally demanding projects, to commercialise unconventional and frontier opportunities as well as unexploited conventional reserves.

*Estimated cumulative investment (2014 – 2035):<sup>1</sup>*



*Investment by segment (active as of 1/1/2014)*



<sup>1</sup>World Energy Investment Outlook, International Energy Agency, June 2014

## Transfer pricing for an industry in transition – Oil and gas

*Regional cumulative oil and gas investment (2014-2035)<sup>2</sup>*



<sup>2</sup>World Energy Investment Outlook, International Energy Agency, June 2014

### ***Authors***

 **Dale Bond**

 PwC US

 +1 713 356 4156

 dale.bond@us.pwc.com

 **Szymon Wlazlowski**

 PwC UK

 +44 (0) 20 7212 1889

 szymon.wlazlowski@uk.pwc.com

 **Chet Patel**

 PwC US

 +1 713 356 4010

 chetan.patel@us.pwc.com

 **Anne Nzomo**

 PwC Kenya

 +254 20 285 5000

 anne.nzomo@ke.pwc.com

*Governments around the world are engaging in the tax transparency debate and are arguing for more disclosure from multinational enterprises regarding their tax affairs.*

## ***Financial services tax transparency – aligning processes, policies and messaging***



## Financial services tax transparency – aligning processes, policies and messaging

### Introduction

Governments around the world are engaging in the tax transparency debate and are arguing for more disclosure from multinational enterprises (MNEs) regarding their tax affairs. However, with increased disclosure also comes an increase in potential misunderstanding of the information that is made available. With the release of the latest proposals on transfer pricing documentation and country-by-country reporting (CbCR) by the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) initiative, and the new CbCR obligation under the EU Capital Requirements Directive IV 2013/36/EU (CRD IV), financial services (FS) firms will soon be faced with increased compliance burdens and placed under additional scrutiny by both tax administrations and the public.

In this article we set out the current tax transparency CbCR landscape, while also looking into the unduly narrow focus on corporate income taxes paid. This article also seeks to encourage businesses to evaluate these potential disclosure requirements and utilise them as a means to communicate more broadly regarding their total tax contributions.

### Current landscape

#### OECD's BEPS Action Plan

The BEPS action plan specifically targets transparency and disclosure through updates to the transfer pricing documentation guidance. As provided in the *BEPS Action 13*, the OECD has been tasked with re-examining transfer pricing documentation in an effort to enhance transparency and to aid with risk assessment for tax administrations.

As part of this action item, the OECD released a revised discussion draft on 30 January 2014 (with additional comments provided in an update webcast on 2 April 2014 and final guidance was issued on 16 September 2014 by the OECD), which detailed the CbCR disclosures that may be required by taxpayers to tax authorities. Proposed disclosures include revenues, earnings before income tax, income tax paid, number of employees, current year tax accruals, tangible assets and nature of activities performed.

In addition to the final report we expect guidance to be released shortly regarding implementation, as well as the mechanism to share the CbCR information between countries / tax authorities which addresses the associated confidentiality concerns.

.....

*Governments around the world are engaging in the tax transparency debate and are arguing for more disclosure from multinational enterprises (MNEs) regarding their tax affairs.*

.....

#### CRD IV CbCR

CRD IV is primarily designed to implement Basel III within the European Union. However, it also introduced CbCR to certain financial institutions.

The directive was required to be transposed into domestic legislation of each EU member state by 31 December 2013. We are aware that there are a number of member states that did not transpose the directive by this date and so may have later implementation dates than those set out in the directive and which we refer to below.

The regime came into force as of 1 January 2014, and requires in-scope 'institutions' to 'disclose annually, specifying by member state and by third country in which it has an establishment, the following information on a consolidated basis for the financial year:

- a) name and nature of activities,
- b) number of employees,
- c) turnover,
- d) profit or loss before tax,
- e) tax on profit or loss and
- f) public subsidies received.'

The first year will see a limited scope disclosure, whereby all 'institutions' must disclose publically items a, b and c (above) by 30 June 2014. In addition, Global Systemically Important Institutions will be required to make private submissions to the European Commission on items d, e and f.

The requirements apply to credit institutions and investment firms within the scope of CRD IV. In practice it will predominately apply to banking groups as well as certain insurance and asset management groups to the extent they have CRD IV regulated entities within their group.

## Financial services tax transparency – aligning processes, policies and messaging

*CRD IV is primarily designed to implement Basel III within the European Union. However, it also introduced CbCR to certain financial institutions.*



### Comparison between BEPS and CRD IV

While the BEPS and CRD IV initiatives have been developed by different governing bodies, there are overlaps within the CbCR requirements detailed within each regime. The following table aims to show the comparison between the two initiatives:

Disclosure required	Original BEPS	Revised BEPS <sup>1</sup>	Final BEPS <sup>2</sup>	CRD IV
Constituent entities organised in the country (including geographical location)	✓	✓	✓	✓
Place of effective management	✓		✓	
Specific business activities	✓	✓	✓	
Nature of activities			✓	✓
Revenue/turnover	✓	✓	✓	✓
Profit <sup>3</sup> before tax	✓	✓	✓	✓
Income tax paid (on cash basis) <sup>4</sup>				✓
- To country of organisation	✓	✓	✓	
- To all other countries	✓	✓	✓	
Withholding tax	✓			
Income tax accrual (current year)		✓	✓	
Stated capital and accumulated earnings	✓	✓	✓	
Employees				
- Number	✓	✓	✓	✓
- Expense	✓			
Tangible assets (other than cash/cash equivalents)	✓	✓	✓	
Royalties paid to/received from constituent entities	✓			
Interest paid to/received from constituent entities	✓			
Services fee paid to/received from constituent entities	✓			
Public subsidies received	✓			✓

<sup>1</sup>As described in the 2 April 2014 OECD webcast 'Update on BEPS Project'.

<sup>2</sup>As described in the 'Guidance on Transfer Pricing Documentation and Country-by-Country Reporting' report released on 16 September 2014.

<sup>3</sup>OECD discussion draft describes this as 'earnings'.

<sup>4</sup>CRD IV is not yet prescriptive on the extent of the disclosure required.

## Financial services tax transparency – aligning processes, policies and messaging

Taking the above into account, it is also important to highlight two fundamental differences between the scope of the CbCR regimes under CRD IV and BEPS.

### 1. Companies in scope

The BEPS proposals are intended to apply to all MNEs engaging in inter-company cross-border transactions, and where a group is within the scope, its entire worldwide operations will be relevant. This is fundamentally different from the CRD IV requirements, which place the reporting obligation on the ‘institution’ (i.e. the European based, CRD IV regulated entity), which must report for itself and all of its establishments.

The implication of this is that many groups (e.g. insurance groups) will only be partially caught by the CRD IV requirements, because much of their group is outside the scope of CRD IV.

### 2. Disclosure required

Additionally, the CRD IV requirements are for public disclosure, while the BEPS requirements are currently for private submissions to tax authorities.

As can be seen, there is overlap in a number of disclosure requirements, but the majority differs. However, given the amount of detail requested and the narrow focus on corporate income taxes, it does appear that these disclosures do not represent a full, accurate picture of a company’s total tax contribution. We seek to explore this point further in the next section.

### *Total tax contributions*

While it is easy to get caught up in the transparency debate, it is imperative that businesses also focus attention on their total tax contributions. It is a fact that MNEs pay many more taxes than just corporate income tax and at times these additional taxes may comprise a large percentage of their total contribution to the global economy.

Over the years PwC has carried out six studies for the City of London Corporation to gauge the total tax contribution of the FS sector in the UK. As reported in this year’s survey (for the accounting period ended 31 March 2013), the Total Tax Contribution of the FS sector to the UK economy was £65 billion, which is 11.7% of government receipts from all taxes for the whole of the UK. It was also found that the profile of the taxes that these companies bear continues to move from corporation tax to labour and indirect taxes. For every £1 in corporation tax paid by the FS sector, it paid £4.26 in other business taxes.

Therefore, if tax administrations are focusing transparency initiatives on corporation tax, it is likely that they are not getting the full picture.

### *What business should be thinking about*

- **Focus messaging on total tax contributions**  
Governments and organisations are currently arguing for more disclosure and businesses can use this as a means to get their message out into the public domain. Specifically, businesses should focus their messaging to ensure that a wider, broader picture, which represents their total tax contributions to the global economy, is reflected.
- **Determine system capabilities and readiness**  
This is also the perfect opportunity for FS companies to evaluate their position in relation to both the OECD BEPS initiative and CRD IV. Now is the time to consider the preparation required to comply with CbCR and conduct a readiness review. The focus should be around technology / systems, controls and assurance. Companies should understand how the CbCR compliance process is integrated within their existing reporting process and consider whether they should invest in technology solutions in order to ease the compliance burden.

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*While it is easy to get caught up in the transparency debate, it is imperative that businesses also focus attention on their total tax contributions.*

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## Financial services tax transparency – aligning processes, policies and messaging

- **Perform public information reviews**  
In addition to focussing messaging and determining system capabilities and readiness, public information reviews are critical. Companies disclose information about themselves across a wide range of websites (e.g., company website, LinkedIn, Facebook, Twitter, etc.). To ensure companies are making the best use of these communications, reviews should be performed to ensure this publicly available information conveys a clear, consistent message that the public can easily understand.

To date we have seen some MNEs start to take action and perform reviews of their policies. They are performing thorough analyses of external information to ensure that it is consistent with the company's policies and they are also preparing total tax contribution messaging. As indicated previously, corporate income tax is only one of many contributions of companies to the economy.

### **Summary**

Tax transparency is on the agenda for tax authorities around the world. The release of the final BEPS guidance on CbCR and the CbCR requirements under CRD IV is a clear indication that change is coming. These reporting requirements will increase the amount of information available to tax authorities (and potentially the public). Therefore, the current environment presents a unique opportunity to focus businesses' messaging and to ensure that this information conveys an accurate representation of their total tax contributions.

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*Governments and organisations are currently arguing for more disclosure and businesses can use this as a means to get their message out into the public domain.*

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### **Authors**

 **Peter Maybrey**

 PwC UK

 +44 (0) 20 7804 4403

 peter.c.maybrey@uk.pwc.com

 **Amanda Brown**

 PwC UK

 +44 (0) 20 7804 8268

 amanda.m.brown@uk.pwc.com

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**Isabel Verlinden**  
Juan Carlos Ferreiro

Robin McCone

Pete Calleja

Herbert Greinecker

Patrick Boone

Cristina Medeiros

Irina Tsvetkova

Charles Theriault

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Robin McCone

Lorenz Bernhardt

Cecilia SK Lee

Zaid Sethi



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isabel.verlinden@be.pwc.com  
juan.carlos.ferreiro@ar.pwc.com  
robin.mccone@ge.pwc.com  
pete.calleja@au.pwc.com  
herbert.greinecker@at.pwc.com  
patrick.boone@be.pwc.com  
cristina.medeiros@br.pwc.com  
irina.tsvetkova@bg.landwellglobal.com  
charles.theriault@ca.pwc.com  
roberto.carlos.rivas@cl.pwc.com  
spencer.chong@cn.pwc.com  
carlos\_mario.lafaurie@co.pwc.com  
lbrlek@hr.pwc.com  
nicos.chimarides@cy.pwc.com  
david.borkovec@cz.pwc.com  
jju@pwc.dk  
pablo.aguirre@ec.pwc.com  
sari.takalo@fi.pwc.com  
pierre.escaut@fr.landwellglobal.com  
robin.mccone@ge.pwc.com  
lorenz.bernhardt@de.pwc.com  
cecilia.sk.lee@hk.pwc.com  
zaid.sethi@hu.pwc.com

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Fridgeir Sigurdsson  
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+234 1 271 1700 ext. 6117  
+47 95 26 0650  
+511 211 6500  
+63 2 459 2020  
+48 22 523 4985  
+351 213 599 631



fridgeir.sigurdsson@is.pwc.com  
rahul.k.mitra@in.pwc.com  
ay.tjhing.phan@id.pwc.com  
gavan.ryle@ie.pwc.com  
gerry.seligman@il.pwc.com  
gianni.colucci@it.pwc.com  
akio.miyamoto@jp.pwc.com  
peter.burnie@kz.pwc.com  
titus.mukora@ke.pwc.com  
henryan@samil.com  
pavel.x.sarghi@lv.pwc.com  
nerijus.nedzinskas@lt.pwc.com  
begga.sigurdardottir@lu.pwc.com  
thanneermalai.somasundaram@my.pwc.com  
neville.gatt@mt.pwc.com  
fred.barrett@mx.pwc.com  
chantell.husselman@na.pwc.com  
michel.van.der.breggen@nl.pwc.com  
erin.l.venter@nz.pwc.com  
seun.y.adu@ng.pwc.com  
morten.beck@no.pwc.com  
miguel.puga@pe.pwc.com  
carlos.carado@ph.pwc.com  
mike.ahern@pl.pwc.com  
leendert.verschoor@pt.pwc.com

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Ionut Simion

Svetlana Stroykova

Nicole Fung

Christiana Serugová

David Lermer

Javier González Carcedo

Pär Magnus Wiséen

Norbert Raschle

Lily Hsu

Peerapat Poshyanonda

Zeki Gunduz

Annie Devoy

Horacio Pena

Sergio Franco

Elys Aray

Van Dinh Thi Quynh



+40 21 202 8708

+7 495 967 6024

+65 6236 3618

+421 2 59 350 614

+27 21 529 2364

+34 915 684 542

+46 8 555 33 295

+41 58 792 4306

+886 2 2729 6207

+66 2 344 1220

+90 212 326 6080

+44 20 7212 5572

+1 646 471 1957

+598 29160463

+58 241 8252361

+84 4 3946 2246 ext. 4202



ionut.simion@ro.pwc.com

svetlana.stroykova@ru.pwc.com

nicole.fung@sg.pwc.com

christiana.serugova@sk.pwc.com

david.lermer@za.pwc.com

javier.gonzalez.carcedo@es.pwc.com

paer.magnus.wiseen@se.pwc.com

norbert.raschle@ch.pwc.com

lily.hsu@tw.pwc.com

peerapat.poshyanonda@th.pwc.com

zeki.gunduz@tr.pwc.com

annie.e.devoy@uk.pwc.com

horacio.pena@us.pwc.com

sergio.franco@uy.pwc.com

elys.aray@ve.pwc.com

dinh.quynh.van@vn.pwc.com







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