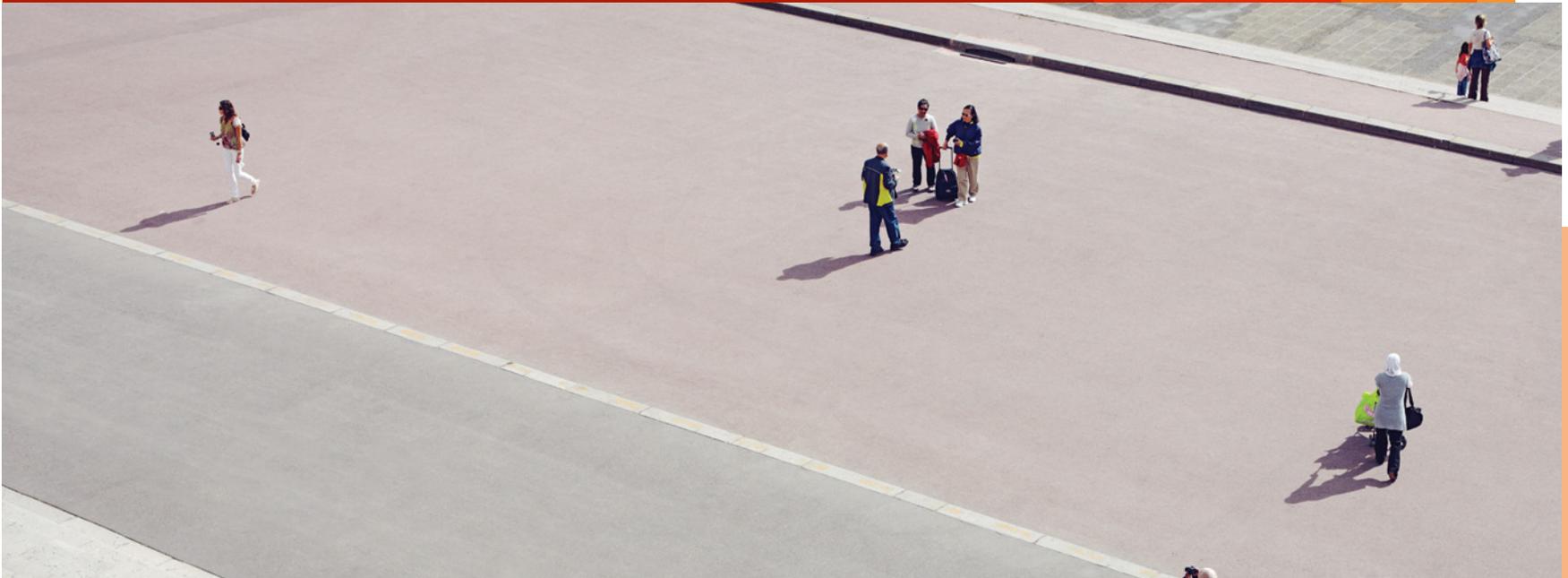


# *Transfer Pricing Perspectives:*

Sustainable transfer pricing in an era of growth and business transformation

*A collection of articles that discuss some of the significant policy and legislative changes taking place in transfer pricing.*

October 2011



# Foreword



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New trends in the transfer pricing environment, coupled with increased scrutiny from revenue authorities, mean companies have to work hard to keep abreast of the ever-changing landscape.

Momentum is building with companies aligning and rationalising their business supply chains, tax, and legal operating models to deliver sustainable financial benefits. Pressure to combat tax-driven business structures means defining sustainable transfer pricing strategies is a key priority on the agenda of multinational companies.

Written for the PwC<sup>1</sup> 2011 annual transfer pricing conference, *Perspectives: Sustainable Transfer Pricing in an Era of Growth and Business Transformation*, addresses some of the fundamental changes taking place in the tax landscape and provides additional content and depth to the conference sessions. Additionally, our first article, *Russia adopts new transfer pricing rules: time to change “wait and see” attitude*, provides insight into the new Russia transfer pricing rules that are coming into force on 1 January 2012.

To keep up to date with the latest transfer pricing developments around the world, sign up to our PKN alerts by visiting [www.pwc.com/pkn](http://www.pwc.com/pkn).

I hope you enjoy this edition of Transfer Pricing Perspectives.

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

**Garry Stone**

<sup>1</sup>PwC<sup>1</sup> refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network.

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01.01.2012

The new transfer pricing law will come into force on 1 January 2012

## **Russia adopts new transfer pricing rules: time to change “wait and see” attitude**

In July 2011, Russia adopted new broad-based transfer pricing (TP) rules, following general global trends and examples from other developing and developed countries.

On 8 July 2011, the lower chamber of the Russian Parliament (the State Duma) approved a bill setting out the new Russian TP rules during the final reading, which was subsequently approved by the Federation Council on 13 July and signed into law by President Dmitry Medvedev on 18 July 2011. The new TP law will come into force on 1 January 2012, although some provisions will be deferred until 2013 and 2014. There is a possibility that the new rules may be amended during autumn 2011 (i.e. before the new rules are enacted), to bring more clarity in certain provisions that are not clearly drafted.

There were many years of speculation as to when Russia would make this move, and what form the new rules would take. Until recently, the business community, especially large Russian vertically integrated groups had been adopting a “wait and see” approach to the Russian TP developments. However, now that the new TP rules seem to be inescapable, both foreign multinationals operating in Russia and Russian companies should increase the focus on their intercompany arrangements, which are now subject to TP control under the new TP law. They should identify what steps to take to sustain pricing under these arrangements from a Russian TP perspective.



### **Key features of the new Russian TP rules**

Compared to the current Russian TP rules, the new rules appear to be more technically elaborate and in broad terms better aligned with the international TP principles set out by the Organisation for Economic Cooperation and Development (OECD).

Based on the current wording of the new TP law, it may be concluded that only transactions involving goods, work and services can be subject to the new TP rules. Transactions dealing with intellectual property (IP) rights or other objects of civil rights, as well as transactions where the pricing mechanism is set as a rate (e.g. interest rate, commission) are not formally subject to TP control. However, as mentioned above, it is still possible that certain amendments will be introduced to the TP law, e.g. clarification on transactions that, as currently written, seem to be out of scope of the new rules.

Further in this article we provide a brief recap of the TP law, analyse potential pitfalls that taxpayers can face, as well as outline recommendations on how to prepare for the new TP rules.

### **I. Controlled transactions**

The TP law provides for a list of transactions subject to TP control by focusing more on related-party<sup>1</sup> transactions and including only certain types of third-party transactions.

### **Cross-border transactions**

As to cross-border transactions, the following operations will be subject to TP control:

- All related-party transactions, including supply arrangements with third-party intermediaries (no minimum financial threshold starting from 2014);
- Third-party transactions involving goods traded on global commodity exchanges that fall within commodity groups such as crude oil and oil products, ferrous metals, non-ferrous metals, fertilisers, precious metals and precious stones if aggregate income of such transactions exceeds 60m RUB (approx. US\$ 2m) per calendar year;
- Third-party transactions with parties incorporated in blacklisted jurisdictions<sup>2</sup> (i.e. offshore zones that grant beneficial tax regimes and do not exchange information with tax authorities of other countries) if the aggregate income from such transactions exceeds 60m RUB (approx. US\$2m) per calendar year.

### **Russian domestic transactions**

As to transactions in the Russian domestic market, only related-party transactions can be subject to TP control.

For the following domestic transactions, a 60m RUB (approx. US\$ 2m) financial threshold applies:

- The subject of a transaction is an object of an assessment to mineral extraction tax calculated at a percentage tax rate; or
- One of the parties to a transaction is exempt from profits tax or applies a 0% tax rate; or
- One of the parties to a transaction is registered in a special economic zone (such transactions will be controlled starting in 2014).

<sup>1</sup> The TP law provides for a list of criteria for recognising the parties as related and similar to international TP practice the main criteria is the direct and indirect ownership threshold of > 25%. However, the TP law reserves courts' right to recognise parties as related based on factors not specified in the law.

<sup>2</sup> The list of jurisdictions is determined by the Russian Ministry of Finance.

Starting in 2014, domestic related-party transactions will also be controlled if one of the parties to a transaction applies a unified agricultural tax or a unified imputed income tax on certain type of activities, and the aggregate income exceeds 100m RUB (approx. US\$ 3.5m) per calendar year.

For all other domestic related-party transactions, a 3bn RUB<sup>3</sup> (approx. US\$ 105m) financial threshold applies to identify if a transaction is subject to TP control under the new TP rules. Also, there will be certain domestic transactions of this type that are exempt from TP control, i.e. transactions between members of a domestic consolidated group of taxpayers<sup>4</sup> and transactions concluded between profit-making Russian companies registered in the same administrative region that do not have any subdivisions in other administrative regions within Russia or abroad.

## **II. TP methods**

The TP law outlines five methods similar to those used in the international TP practice (e.g. OECD TP Guidelines, US TP regulations, etc.), in particular:

1. Comparable uncontrolled price (CUP) method
2. Resale price method
3. Cost plus method
4. Transactional net margin method
5. Profit split method

The CUP method has the first priority, whereas the profit split method serves as a method of last resort. In all other cases, the best-method rule applies.

Although the TP law provides some guidelines on how to apply each of the methods, it is not clear whether the methods will work similar to those applied in the international TP practice.

Finally, the TP law envisages the possibility of establishing the transaction price/value involving an independent appraisal in the case of one-off transactions when none of the above TP methods can be applied.

## **III. TP reporting and documentation requirements**

Taxpayers will be obliged to file a notice on controlled transactions (i.e. submit some limited information on the nature of controllable transactions) and keep specific TP documentation, if the total amount of income received by the taxpayer from all controlled transactions with the same counterparty exceeds 100m RUB mln (approx. US\$ 3.5m) in 2012. It is intended that the above threshold will be gradually decreased.

<sup>3</sup>This financial threshold will be reduced to 2bn RUB (approx. US\$ 70m) in 2013 and to 1bn RUB (approx. US\$ 35m) in 2014.

<sup>4</sup>The law on consolidated taxpayer regime was approved by the State Duma in 2010 during the first reading [the law was approved in the first of three readings]. No subsequent readings have yet been scheduled. The law on consolidated taxpayer regime is expected to be enacted simultaneously with the TP law.

<sup>5</sup>Special criteria are set by the Russian Tax Code for companies to be regarded as major taxpayers, i.e. annual tax payments exceeding 1bn RUB (approx. US\$ 35m) or annual revenue/assets exceeding 20bn RUB (approx. US\$ 726m).

The deadline set for filing notices to the local tax office is 20 May of the year following the calendar year when the controlled transaction occurred.

As for the TP documentation, the tax authorities cannot request such documentation until 1 June of the year following the calendar year when the controlled transaction took place. Taxpayers will have 30 days following the tax authorities request to provide the TP documentation.

## **IV. Advance pricing agreements**

Only “major taxpayers”<sup>5</sup> may consider an opportunity to conclude an APA with the Russian tax authorities under the new TP rules. The TP law also provides for an opportunity to enter into a bilateral APA.

The Russian tax authorities will have six months to review an APA application, extendable to a maximum of nine months. Concluded APAs would be valid for three years and may be prolonged for an additional two years upon the taxpayer’s request.

## V. TP audits

The TP law contains transitional provisions on TP audits. In particular, a 2012 audit cannot be initiated after 31 December 2013, while a 2013 audit cannot be initiated after 31 December 2015. Starting from 1 January 2014, standard provisions on TP audits will apply, i.e. a TP audit may cover three years preceding the year when the audit was initiated.

## VI. Penalties

In 2012 and 2013, penalty provisions will not be applied. Starting in 2014, TP penalties of 20% of the amount of additional tax payable will be introduced. Starting in 2017, penalties will be increased up to 40%, but not less than 30k RUB (approx. US\$ 1k).

Penalties will be imposed if an underpayment of tax is identified as a result of a TP audit *and* if the taxpayer did not provide the requested TP documentation to the tax authorities.

## VII. Other important developments

- **Sources of information.** Information required determining the market price/profitability should be obtained from publicly available sources (the TP law provides for the open list of data sources, including information on internal comparables). The law specifically states that foreign comparables may be used to determine the arm's-length range of profit margins, provided that there are no comparable Russian companies. As such, it is recommended that a Russian comparable search should be completed first, but if such the search doesn't result in any acceptable comparables, then a search based on foreign comparables can be used.
- **Corresponding adjustments.** The TP law envisages corresponding adjustments to be available only for Russian legal entities and only in respect of domestic transactions.
- **Allocation of profit to a permanent establishment (PE).** The TP law highlighted the concept of allocation of profit to a PE under which taxable income of a foreign legal entity's PE in Russia should be determined, taking into account the PE's functional, assets and risks profile.

## Impact of the new TP rules

Introduction of the new Russian TP rules will definitely mean additional compliance burden for both foreign multinationals with Russian operations and Russian companies, as the Russian tax authorities will require taxpayers to be able to demonstrate their compliance with the new TP rules upon request.

For the vast majority of foreign-owned multinationals with Russian operations, the need to be compliant with the arm's-length principle already exists by virtue of the TP rules in the jurisdictions with which the Russian operations are trading. Foreign multinationals are, therefore, generally welcoming the new TP laws since, in many aspects, they follow the OECD principles and should, therefore, reduce the risk of a double taxation arising from their cross-border transactions with Russia.

Russian companies unaccustomed to documentation requirements, however, are facing a significant administrative burden. Among these companies, the TP law will have a primary impact on those companies that have export transactions relating to commodities, especially those involving the use of a foreign trading structure, as well as extensive domestic transactions within their groups.

***Starting in 2014, TP penalties of 20% of the amount of additional tax payable will be introduced***

### ***How to prepare for the new TP rules***

In the remaining months before the new Russian TP rules come into force on 1 January 2012, three steps are suggested so that organisations are prepared for the new TP regime.

# 1.

## Know where you stand

The unique aspects of Russia's new TP rules (such as TP control for both cross-border and domestic Russian transactions, and how some of the TP methods are applied) mean that the first consideration in assessing the impact of the new rules is to determine the extent to which they apply to the dealings of the company in Russia.

Best practice for both foreign multinationals and Russian companies would be to establish a file summarising all dealings and agreements in place at 1 January 2012, which can be kept as a reference to identify and monitor what arrangements fall within or outside the scope of the new Russian TP rules.

# 2.

## Gather documentation

For any arrangements that fall within the scope of the new TP regime, companies operating in Russia will need to assess whether appropriate TP documentation supporting the arrangement has been prepared elsewhere in the group. If none is available, companies should take steps to document the arrangements from a Russian perspective.

The TP law provides details on the expected content and timing of preparation of supporting transfer pricing documentation.

# 3.

## Think TP for new arrangements

As the 1 January 2012 “starting date” has not yet passed, companies considering changes to their operations in Russia need to consider the potential impact of Russia's new TP regime now. They should ensure any new dealings that will be subject to TP control in the future are entered into on an arm's-length basis from a Russian perspective, as well as from the perspective of the counterparty jurisdiction(s).

In many cases, this may be a significant change to the approach that would have been adopted prior to the introduction of the new Russian TP rules. Assessing the arm's-length position from the Russian perspective may lead, in some cases, to a different outcome than may previously have been the case.

### **Conclusion**

Unsurprisingly, the new Russian TP rules have generated significant interest and discussions both in Russia and abroad, given the importance of the Russian operations in the supply chain(s) of a large number of multinationals on the one hand, and the significance of cross-border and domestic intra-group transactions for Russian companies on the other.

The introduction of the new TP rules will require companies doing business in Russia to analyse and tailor their TP policies to comply with the new rules. Although the TP law contains certain transition provisions for taxpayers, such as larger thresholds for defining controlled transactions, penalty exemption for the first two years of the law and reduced penalties for the next three years, with a shortened period opened for transfer pricing audits in respect of the first two years, as well as some other provisions, the preparation for the new legislation is likely to be time-consuming.

We recommend taxpayers begin undertaking preparatory steps well before 1 January 2012.



*We recommend taxpayers begin undertaking preparatory steps well before 1 January 2012*

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## *The changing landscape of Value Chain Transformation*

The trend of centralisation in multinational companies (MNCs) has accelerated over time along with continued evolution of integrated business models, as new ways to unlock value in organisations are identified.



Hastened by advances in technology and growing globalisation of services industries, and also fuelled by the need to expand into new markets for growth, new and increasingly sophisticated players have come to the fore of regional and global Value Chain Transformation (VCT).

This evolution has extended to regulatory authorities, which have matured in their thinking and approach in parallel with MNCs. Motivated to share in the value globalisation has created, and more recently protecting their share in the face of global economic turmoil, regulatory authorities have paradoxically created both new opportunities and challenges for MNCs seeking to navigate business in an increasingly global business environment.

### ***The Traditional VCT Landscape***

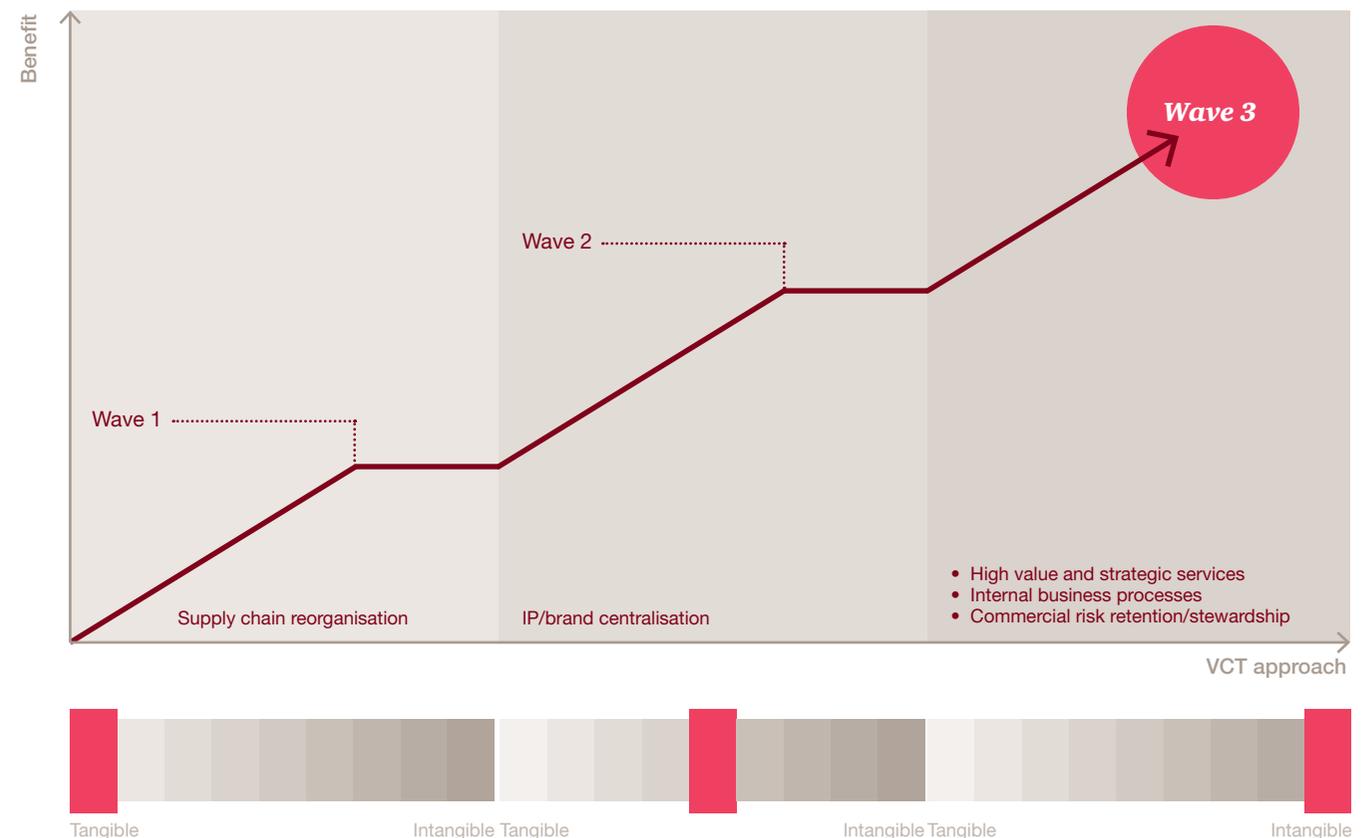
Historically, VCT models were commonly characterised by an emphasis on tangible goods and centralised supply chain management as MNCs sought to capture efficiencies and scale benefits afforded by centralised planning and consolidation of production activities. This extended to commercial activities, with a focus on leveraging intellectual property across territories and delivering central brand and product strategies for local execution.

These business models commonly resulted in 'principal' structures which interposed a specific group entity into the supply chain with central ownership of high value functions, assets and risks, and the proliferation limited risk manufacturing and selling arrangements in local business units. However, principal structures are increasingly being adopted for centre-led and service-based structures, focusing on creating value through local operations without necessarily interposing the Principal in the MNC's transactional supply chain.

The growth of centre-led and service-based models has, in the large part, been driven by a change in business models from traditional 'bricks-and-mortar' operations, to globally mobile and virtual workforces. The continuing emergence of e-commerce and service-based industries has further underlined the changing VCT landscape.

Against this landscape is the growing sophistication of revenue authorities. Continuing exposure to VCT-based structures is resulting in increasing scrutiny of global and regional principal models, particularly with respect to any resulting exit charges, but also giving rise to an increasing number of jurisdictions offering principal-structure incentives. The relocation of business operations, including pre-existing regional structures, to the traditional principal locations of Switzerland and Singapore is being met with a rise in the level of competition from jurisdictions such as Malaysia and Thailand in Asia and Ireland in Europe. These countries are offering tax and operational incentives to retain existing MNCs and attract new investment.

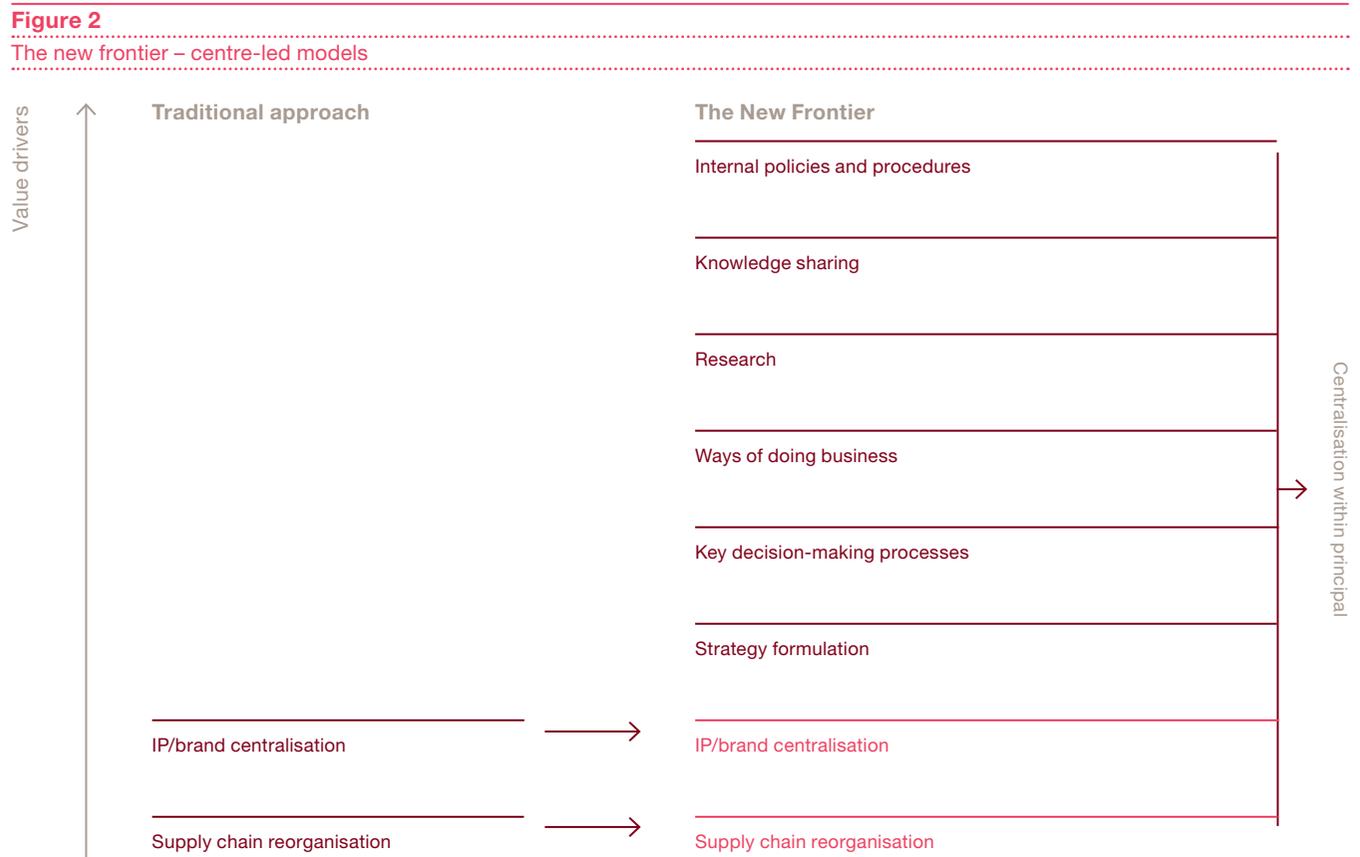
**Figure 1**  
The traditional VCT landscape



**The new frontier – centre-led models**

Supply chain coordination and intellectual property leverage continue to be core components of centralised business models. However, VCT models are increasingly encompassing inherent organisational value drivers through strategic centre-led functions. In particular, recognition and inclusion of key decision-making processes, ways of doing business and internal policies and procedures as key business differentiators, are driving commercial and business efficiencies leading to greater principal-related reward.

Nevertheless, the growing sophistication of revenue authorities' knowledge and understanding of VCT-based business models will require diligence by taxpayers to evidence the shift in functions, assets and risks from local country operations to the centre appropriately. Experience demonstrates that failure to evidence and support a shift of functions, and particularly risks; to the principal appropriately, creates a myriad of potential local tax and related compliance exposures.



### Services principal models – the emerging principal structure

Service-focused MNCs are increasingly looking to implement principal structures, with the services business development and delivery theoretically fitting neatly into a number of commonly recognised centralised operating models.

In considering the potential application of VCT to a services business, it is critical to consider what are the value drivers and processes associated with providing the services that will inform the appropriate business model:

- Do they differ from product-related businesses?
- Is there a need for more ‘local’ content and (versus remote services) local solutions?
- Where are the solutions coming from – are local services using IP from the ‘hub’, what if local relationships and local people functions are driving the value?

Having identified the value drivers and models, determination of how to remunerate local services will necessarily require consideration of:

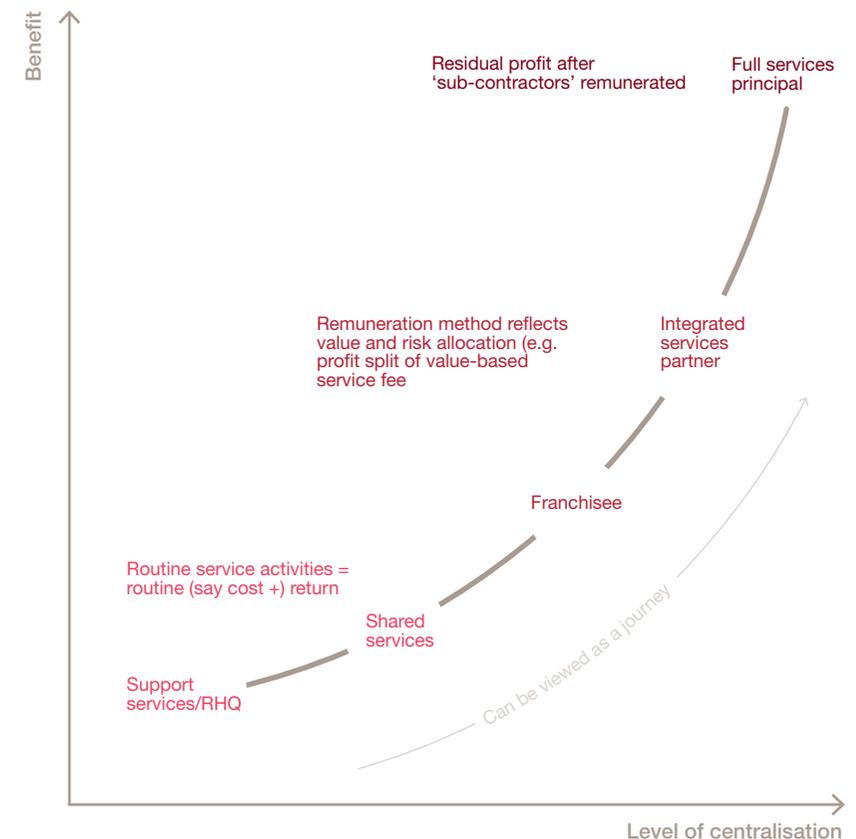
- The link to value drivers and risks
- Whether a routine level of reward for the local business units (e.g. cost plus) is reasonable
- Whether other pricing models (cost sharing, profit split) are more appropriate
- How to remunerate ‘down time’ or ‘excess capacity’

The foundation of such considerations is common across all principal models, be they supply chain, intellectual property or services-based models. However, there are specific considerations for service-based models, including:

- Multiple ‘hats’ - what if an employee in Country A provides services to Country A and Country B. Should there be a mark-up to Country A or cost allocation only?
  - What if Country B pays for part of the employee’s costs already?
  - Which entity should employ people – principal only or the principal and the local entity?
- Some customers require one global contract while others require contracts for each local entity:
  - Does this change the risk profile?
  - Is there value in the contract itself?
- Personal tax position of roaming employees and whether they will be subject to tax in multiple locations.

While specific service-related considerations will exist, the commercial benefits of a services principal model may be material and could extend to the centralisation of locally generated know-how, customer contracts, quality control standards and strategic business decisions.

**Figure 3**  
Service provider continuum



**Limited risk entities and true-ups under a principal structure: are they coming under threat?**

With the evolving nature of VCT-driven structures, revenue authorities are seeking to retain revenue at stake from outbound migration of local functions, assets and risks. Local entities are now viewed as more than just implementers, and should be rewarded for their skill and decisions to increase revenues or decrease costs. Consequently revenue authorities are increasingly challenging the concept of ‘low’ or ‘no’ risk entities. At issue is whether, under a centralised model, local factors and decisions as drivers of profitability are being appropriately remunerated.

This question is prompting some revenue authorities to adopt new approaches on how local operations should be remunerated vis-à-vis the key strategic decisions and initiatives driven by the centre. These may include:

- application of profit split methods that share potential upside between principal and local business units
- looking at profit share arrangements for higher value add services
- scrutinising appropriateness of guaranteed return approach for ‘limited risk’ entities.

Conversely, the shift in focus to alternate mechanisms with which to remunerate limited risk entities, coupled with concerns expressed by MNCs in gold-plating local business unit losses in the wake of the global economic downturn, brings with it a challenge to the concept of true-up mechanisms commonly relied upon under a centre-led business model.

This reflects the view by a growing number of revenue authorities and MNCs that low profitability or losses in local business units may arise from non-TP factors (affirmed in recent Australian court decision), coupled with reluctance by more and more organisations to fund loss-making companies continually.

**Figure 4**

True-ups, becoming increasingly more difficult

**Increased sophistication of revenue authorities**

**Greater scrutiny of true-ups**

Linkages between the commercial reasoning for the true-up payments and the amounts (e.g. market penetration strategy)

The substance of the commercial arrangement

Whether true-ups are inherent in the industry

Tax treatment of receipts or payments (e.g. are they deductible in accordance with tax law?)

Whether losses are the result of local factors or the principal’s direction/decisions

Evidence of true-ups in arm’s-length situations

**Implications for corporate tax, customs duty, withholding tax, cash position**

Approaches differ between revenue authorities, e.g.

- disallowance of deductions
- partial compensation based on specific costs
- full transfer pricing adjustments to targeted returns.

### **What does the shift in perception of limited risk entities under a centre-led model mean for taxpayers?**

To help mitigate potential claw-back of profits to, or retention of profits by, limited risk entities under a principal model, a thorough assessment of value drivers at the local entity level and in the principal is required:

- What has caused local entities' results to be outside an arm's-length range?
- Is it the result of local or principal-led decisions?

Taxpayers should supplement value-driver assessments with a critical analysis of their transfer pricing model:

- Is a profit/loss-sharing mechanism beyond the typical 'low risk' positive profit range appropriate?
- Can it be evidenced back to arm's-length arrangements and contractual agreement?

In such circumstances, certainty of risk and the profit outcomes of limited risk entities under a business model may be obtainable through Advance Pricing Arrangements (APAs). APAs can give taxpayers certainty under a principal model and manage potential double-tax exposures for non-treaty jurisdictions (e.g. Singapore and the US).

### **Exit charges... still evolving**

In some cases the transition by local business units to a fixed return, limited risk model following VCT, is resulting in long-term reduction of local operating returns. Increasingly, the issue is a key focus of tax controversies in relation to business restructurings arising from VCT. It has led some revenue authorities to deem exit charges on restructures as a mechanism to claw back the loss of potential future earnings.

In this regard, more than ever before, guidance to MNCs and revenue authorities now exists as to how to consider and analyse exit issues in the context of VCT-based restructures. In particular:

- OECD Guidelines reflect a strong attempt to highlight the issues and provide a framework with which revenue authorities should operate
- Country-specific guidelines (e.g. Australia) and prescriptive approaches have emerged (e.g. Germany).

With the growing focus on exit charges, several new issues are gaining momentum that will require specific focus by taxpayers implementing principal-based structures:

- Are intra-country exit charges applicable?
- Is an employee an organisation-owned asset – can an employee transfer create an exit charge?
- Is simply deviating from the existing trading model enough to trigger an exit charge?
- What are the expectations of the parties and does the transaction have real economic substance?

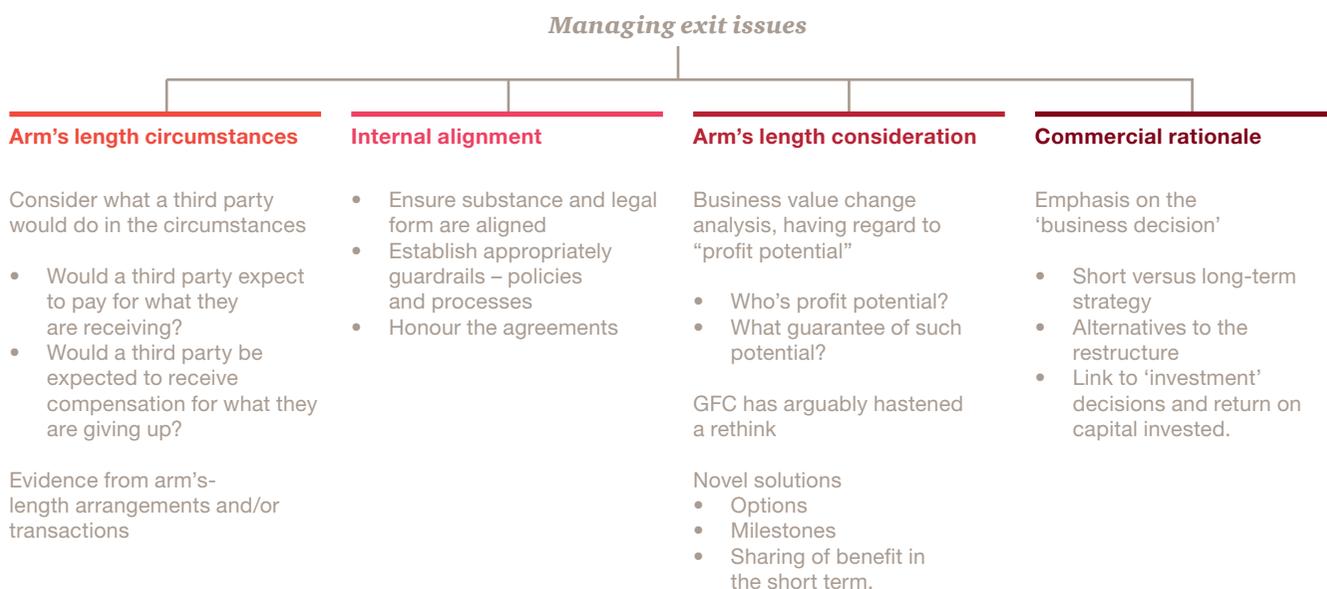
***Taxpayers should supplement value-driver assessments with a critical analysis of their transfer pricing model***

**Is it possible to mount an argument against exit charges when creating a principal model?**

We are also clearly witnessing a growing sophistication of revenue authorities’ appreciation and understanding of VCT models, as well as an acknowledgement of business value drivers that underlie the business transformation. This in turn however, brings an increasing level of challenge to principal structures and provides various avenues for constructive engagement on the issue of exit charges, which are commonly focused around:

- Sound commercial reasons supporting the business restructure from the local business unit’s perspective
- Availability of independent comparable arrangements that support the model and the local entity’s decisions
- Financial and other analysis that reconcile the movements in returns to the compensation received
- Robust policies and processes that ensure the substance and form of the new arrangements align.

**Figure 5**  
Exit charges: evolving solutions



**What is the role of the parent entity in a centre-led business model?**

Historically, under principal-model structures, activities performed by the parent entity may have been categorised as non-chargeable shareholder activities or have been remunerated on a cost plus basis reflecting ‘routine’ value.

At question is whether stewardship activities are being undertaken merely to protect the parent’s investment, or whether they are strategically driving elements of an MNC’s business, particularly under a principal structure.

For example, the parent may bear the risk of not just a lost investment but also the costs associated with ‘bailing out’ a subsidiary. Certain business decisions of a principal will also be made with key inputs of the parent, which brings into question how the parent should be remunerated for its input.

The Global Financial Crisis and the potential for a double-dip recession, amplifies the need to consider the role of the parent entity in any principal structure.

**Figure 6**

Considering the role of the parent entity in any principal structure

Parent may be required to intervene where the financial and functional capability of the principal is insufficient

Increasing focus by revenue authorities on

- the concept of ‘passive association’
- the value attributable to parent for intra-group funding

Parent’s stewardship role vs guarantee

Global markets are becoming increasingly volatile and ‘high risk’ events impacting on company/brand reputation must be managed

### ***Value Chain Transformation – beyond the horizon***

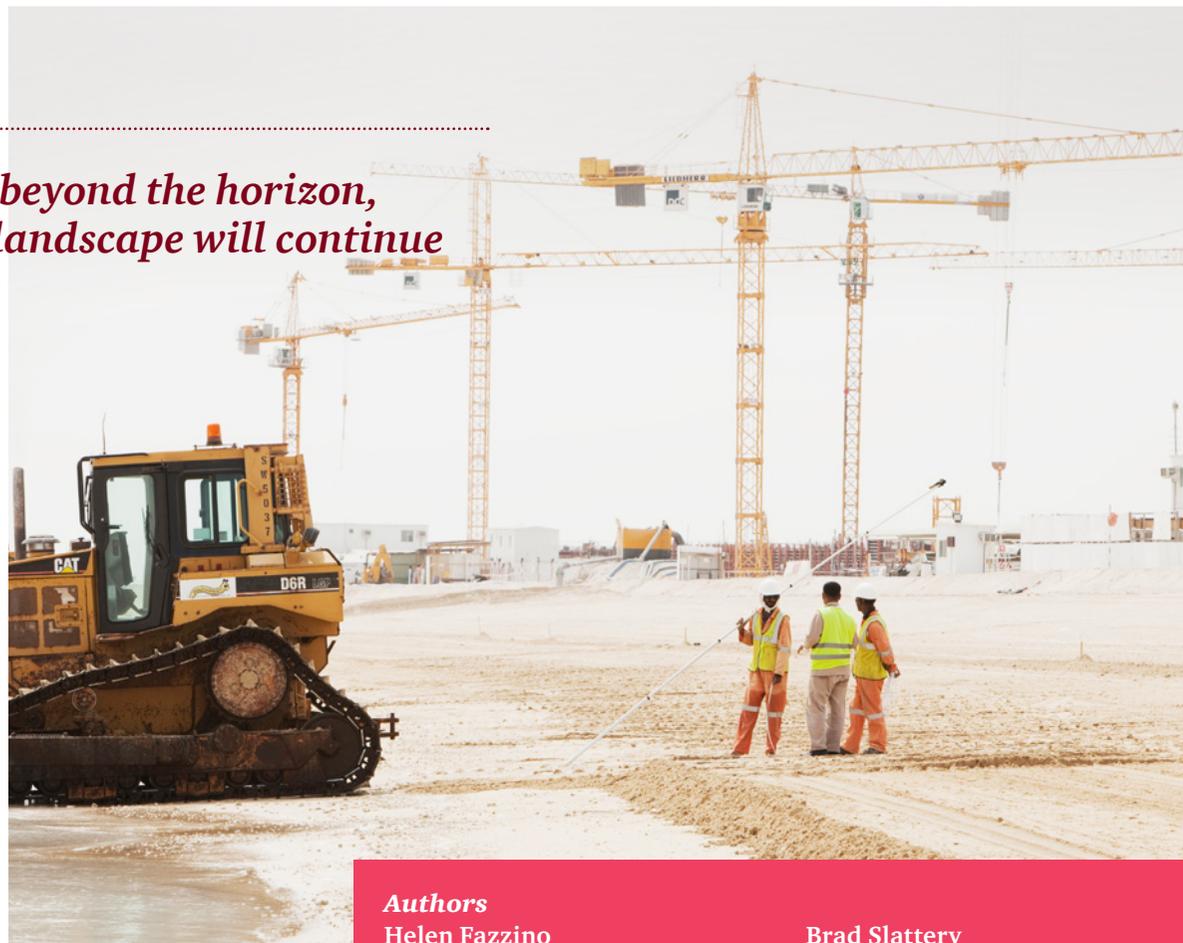
The Value Chain Transformation landscape is undergoing change from its historical roots of interposed supply chain and intellectual property based structures to centre-led and serviced-based models. At the same time, the evolution of the VCT landscape is being matched by a growing level of sophistication of jurisdictional revenue authorities.

Looking beyond the horizon, the VCT landscape will continue to evolve. We expect to see revenue authorities deepen their understanding of VCT-based structures and for this to be matched with a growing selection of countries offering principal structure business and tax incentives.

It is expected that the focus on exit charges will continue to grow and evolve, however at the same time, it is expected revenue authorities will better understand the commercial drivers behind the rationale for change.

While risks will continue to exist with respect to VCT structures, it is expected that a heightened understanding of such structures and the operational benefits they deliver will lead to an increased prevalence of centre-led and service-based principal structures going forward.

***Looking beyond the horizon,  
the VCT landscape will continue  
to evolve***



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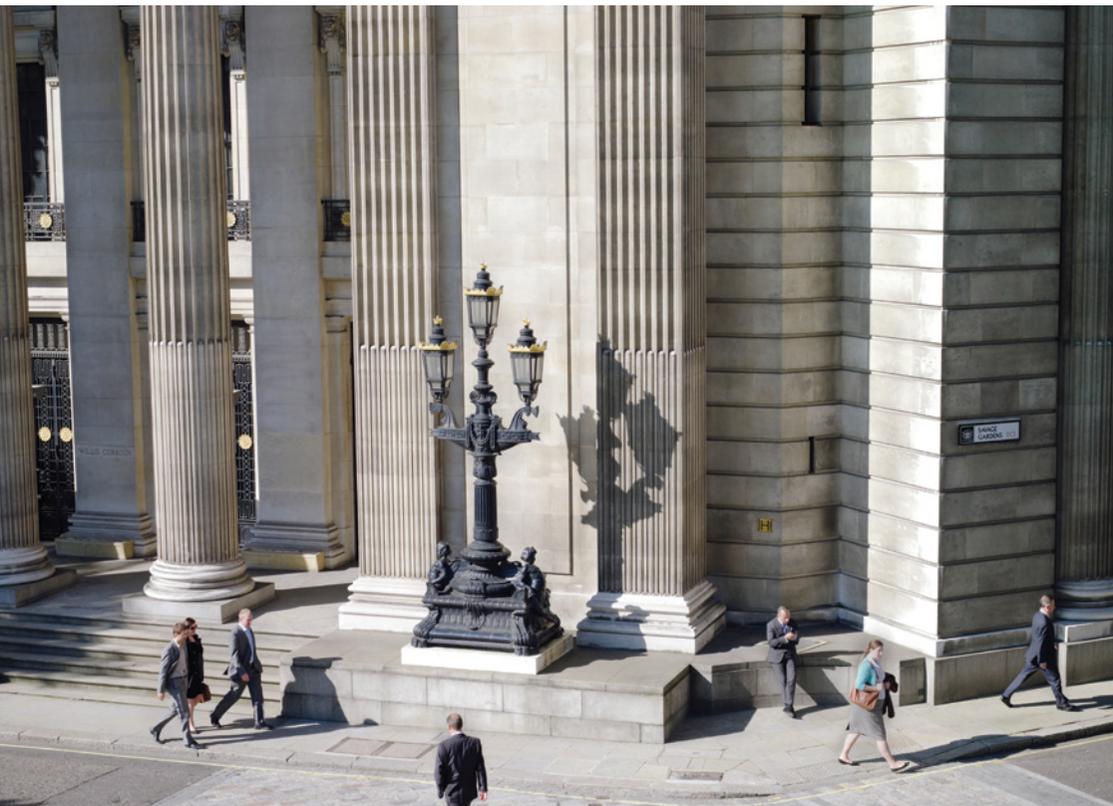
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## *Enhancing shareholder value with Transfer Pricing Integration – TPI*



Governments around the globe are focusing on transfer pricing enforcement as a preferred method of augmenting tax collections, and multinational companies are being targeted for increasingly aggressive tax and transfer pricing audits. Proactively managing transfer prices accurately and efficiently across different jurisdictions and developing strategic transfer pricing policies with effective tax rate benefits is critical. The following article addresses some best practices and potential approaches to more effective transfer pricing management that aim to achieve deeper integration with business and finance operations.

### **Current situation in transfer pricing management**

Historically, tax and transfer pricing monitoring and adjustments have involved many ad hoc processes and technology solutions, involving data manipulation, complex spreadsheet models, manual reconciliations and redundant effort to report and analyse. Additionally, these tools have typically developed as tax department-only solutions, not properly aligned with the rest of the company – whether across functions, such as business operations, accounting, treasury and IT, or across jurisdictions.

Some common symptoms of transfer pricing management challenges are:

- Large transfer pricing true-ups at year or quarter-end
- Time-consuming effort to document transfer pricing compliance
- Poorly controlled and overly complex spreadsheet models disconnected from financial systems to calculate and reconcile legal entity financials
- Difficulty obtaining accurate prices (standard cost versus true cost) and identifiers (location, ship from/ship to) at transactional level
- Lack of clear transfer pricing guidance and procedures at business level

Post SOX 404 and similar governmentally instituted developments require tax functions to operate with the same level of transparency and rigour as the rest of the finance organisation. While many tax departments have made great headway to improving direct tax reporting and compliance, integrating transfer pricing into the finance function and the broader enterprise is still a work in progress.

### **Transfer pricing integration – best practices to consider**

Transfer pricing integration (TPI) can be summarised as aligning a company's business, accounting, IT, legal and tax functions to implement and monitor transfer pricing policies and procedures more effectively.

While there is no single answer that fits the needs of every company, there are certain best practices common to successful transfer pricing integration.

### **Organisation/Strategy:**

Transfer pricing integration starts with organisational strategy. All company should have a comprehensive and proactive strategy to set and monitor its transfer price and to prevent and manage disputes. Companies' strategy should be reviewed regular basis to reflect any changes in business flows and organisational structure. The strategy also needs to be reviewed against regulatory changes since more countries adopt formal transfer pricing requirements each year.

Just one weak link in the chain may result in a wide range of impacts including financial exposure for unexpected tax assessments, interest, f.i.e. penalties, and even double taxation. Other consequences may include management disruption caused by a complex and prolonged tax dispute or negative impact to the company's corporate brand and reputation.

### **People:**

Successful implementation of a global transfer pricing strategy requires effective management of company staff and resources. Multinational companies should take proactive steps to identify, train and maintain adequate resources in accounting, tax and IT to address transfer pricing requirements.

Effective communication to all stakeholders is critical. Transfer pricing requirements can be quite complex to administer, constantly change and must be consistently monitored. Communication should include regulatory rationale behind transfer pricing policies, detailed procedural guidance, as well as mechanisms to address new fact patterns and obtain feedbacks. For example, companies undergoing significant and frequent business changes should put in added emphasis on monitoring how those changes impact the transfer pricing strategy set in place.

## Processes

Transfer pricing management rarely fails due to flawed strategy. Rather, failure is most often a result of not executing the strategy within the organisation, and not achieving cross-functional integration. Transfer pricing strategy should be supported not only by processes performed by traditional accounting and tax functions but also by such functional areas such as materials management, logistics, treasury, shared services and legal. Implementing transfer pricing policy changes often requires process changes to these 'upstream' functional areas as well as tax and accounting processes.

Therefore, it is optimal to incorporate transfer pricing-specific process best practices into transfer pricing procedures. Some examples are:

- Assess and update inventory of intercompany transactions
- Document transfer pricing processes in detail
- Review and update intercompany agreements to ascertain flexibility
- Create a centralised 'transfer pricing desk' and develop service level agreements to support the business with transfer pricing issues
- Define procedures for true-ups and periodical transfer pricing adjustments, and establish logical controls
- Create and update transfer pricing control documentation and test plans for compliance with internal audit standards
- Maintain global (master) and country-specific transfer pricing documentation

These new processes must not be a one-time effort, but should be integrated and internal i.e. so they ultimately become embedded into everyone along the value chain of the company.

## Technology

In the current economic environment, tax departments may find resistance to adding resources to support transfer pricing integration. As a result, successful integration depends in large measure upon the technology improvements in the company's finance and tax systems.

Some examples of opportunities to achieve transfer pricing integration through technology improvements include:

- Coordinate with IT to update ERP to be more TP relevant
- Configure Business Intelligence (BI) tools to build legal entity and segmented financials
- Deploy a tax data mart that stores extracted transactional data for TP analysis
- Configure reporting tools with TP-relevant reporting
- Create custom models for TP adjustments
- Create executive dashboard to monitor key TP KPIs
- Deploy Knowledge/Document Management tool to compile TP-relevant documents

Typically, ERP-enabled integration provides most opportunities in transfer pricing management, as ERP systems have effective automation and standardisation capabilities built in. For many companies, their ERP and related financial systems do not fully capture and report the complex mix of cross-border product, service, cost and intellectual property transaction data needed to support the transfer pricing strategy. Updating configuration of master data, intercompany accounting, pricing structure and parallel ledgers can enhance the effectiveness and efficiency of transfer pricing management.

Even if ERP enhancement projects cannot be undertaken for business reasons, tax departments are recognising that any technology innovations for transfer pricing integration should be geared toward enterprise-level, systematic solutions that leverage the ERP, financial reporting systems, tax applications and other enterprise collaboration tools, supported by organisational and process improvements. The trend is definitely to move away from department-level, desktop-level band-aids (e.g. Excel spreadsheets).

***The "TPi" platform vision represents PwC's thought leadership to achieve transfer pricing integration in a more efficient and accelerated manner at enterprise level***

***TPi – PwC's approach to transfer pricing Integration***

The "TPi" platform vision represents PwC's thought leadership to achieve transfer pricing integration in a more efficient and accelerated manner at enterprise level. It provides industry leaders with a new perspective on transfer pricing strategic planning and management, and has the capability to transform disparate data sources into a timely information source, communicated in a consistent reporting format. TPi enables leaders to:

- Proactively monitor transfer price targets across various economic entities globally so that action can be taken immediately to remedy outliers
- Plan and strategically execute new or complex transfer pricing policies by measuring and modelling the potential impact in future reporting periods, often without a substantial ramp-up in headcount
- Meet bottom-line objectives and deliver value to shareholders by enhancing effective rate benefits
- Achieve enhanced cost savings through automation

The TPi vision is a custom-configured, integrated process and technology solution. It is not about inventing new technologies or building new software or reports. TPi will leverage your company's existing infrastructure and data resources, tailor them to affect an enhanced tax solution, and provide a more effective management and reporting tool.

TPi vision focuses on two core features:

- Provide access to consistent, reliable and timely financial data across global business operations
- Summarise key data for easy viewing and fast decision-making in the form of a dashboard, based on user elections

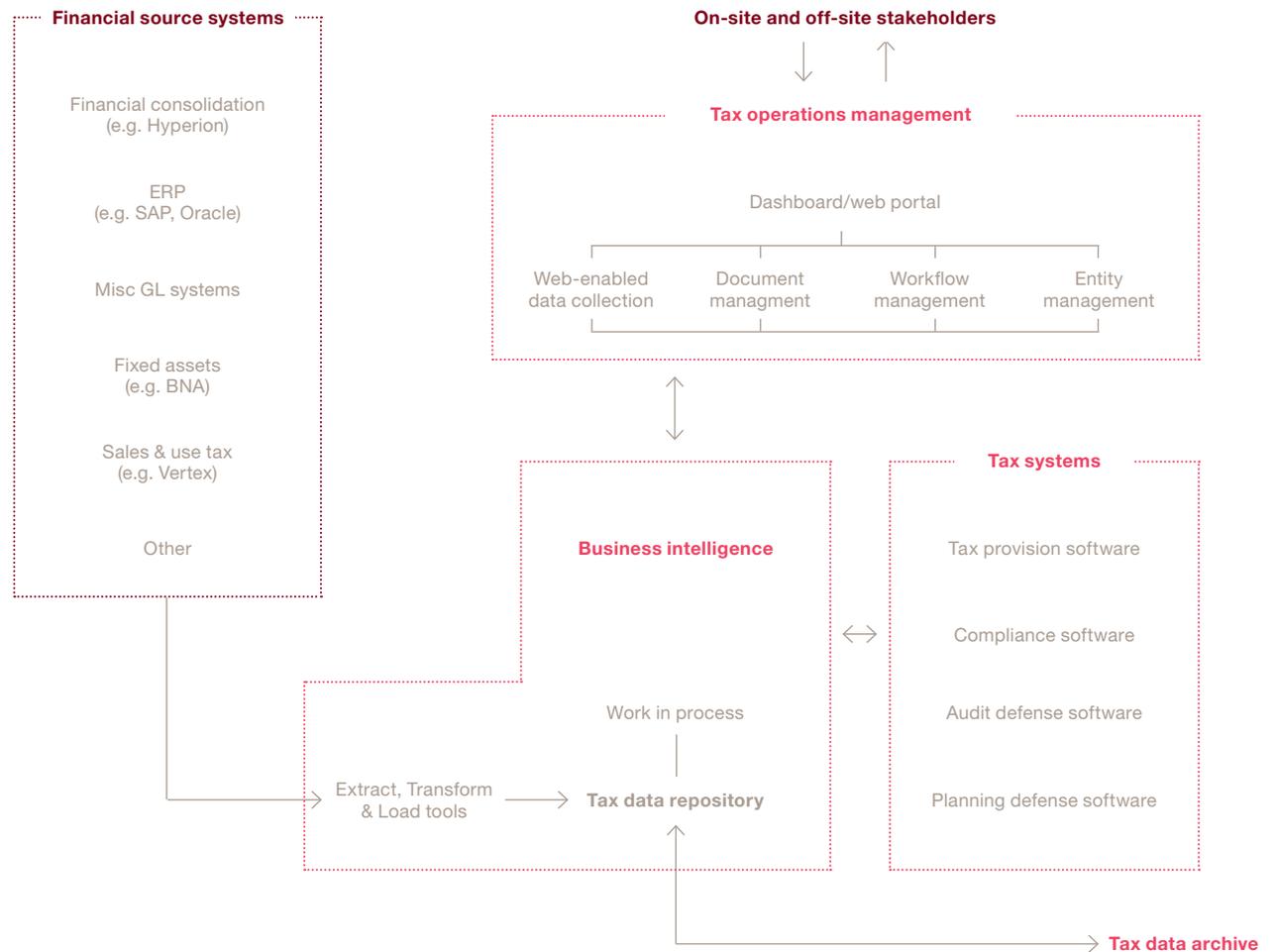
### TPI – Data Management

Most multinational companies typically use different enterprise resource planning ("ERP") systems for accounting and financial reporting globally. Different accounting principles and various ERP configurations result in challenges when trying to extract consistent tax data from different ERP systems. As raw data may be used across multiple tax processes, it is paramount that the data can be accessed in an effective and timely manner, and that there is accuracy, integrity and consistency in the data output.

The TPI Data Management approach focuses on leveraging the company's existing ERP, consolidation and business intelligence (BI) systems, storing tax-sensitive data in a repository and cataloguing them in a manner that supports additional modelling and analyses.

As illustrated here, the pillar of TPI is its platform, which has the capability to extract financial data across the company's various ERP and other financial source systems, and create an output of data in a consistent and streamlined format. The TPI platform can be activated and refreshed in a timely manner to support the Dashboard application.

**Figure 1**  
Illustration of TPI Data Management



## TPi – Dashboard

After the extraction process, the standardised and streamlined data is exported to the TPi dashboard. This presents the C-suite with a bird’s eye view of the overall transfer pricing activities across the global enterprise.

The dashboard shown here showcases four key applications in each quadrant:

- The upper left quadrant presents an overview of the economic structure of the global company including the legal entities and relevant business transaction flows.
- The upper right quadrant is the performance matrix. This is a high level representation of the global entities categorised by geographic region, transaction materiality and magnitude. The performance matrix uses a colour system to highlight where transfer pricing is out of alignment (i.e. the red box). By clicking on any box in the performance matrix, a new screen with a pie chart will open. The pie chart is designed using a layering concept; the more you click, the deeper the layers and the more detailed the information available (i.e. from high level financial information by function to financial information by product SKU).

- The lower-left quadrant presents an action calendar.
- The lower-right quadrant presents access to the “Transfer Price Adjustment” function. This function is designed for transfer pricing volatility analysis. Users can manually enter the transfer prices they desire to identify the financial statement impact.

The apps in the TPi Dashboard can be tailored to provide different views or tools as appropriate. For example, performance matrix by region and entities can be modified to track performance by value chain.

## TPi – our approach

While the core components of TPi – Data Management and Dashboard – are relevant for all companies, each company’s fact pattern and needs are unique and so are your business, tax and technology challenges. No commercial software currently works out-of-the-box to address the complex challenges of transfer pricing management.

The goal behind PwC’s TPi platform vision is to accelerate the integration and enhancement of transfer pricing management. Based on your company’s specific needs, we can leverage our know-how to provide technology services to build on your pre-existing technology framework and customise a solution specifically to your company’s transfer pricing needs. We believe you will make significant steps in enhancing your overall value chain, as well as reduce the risks of transfer pricing errors and audits.

Figure 2  
The TPi Dashboard

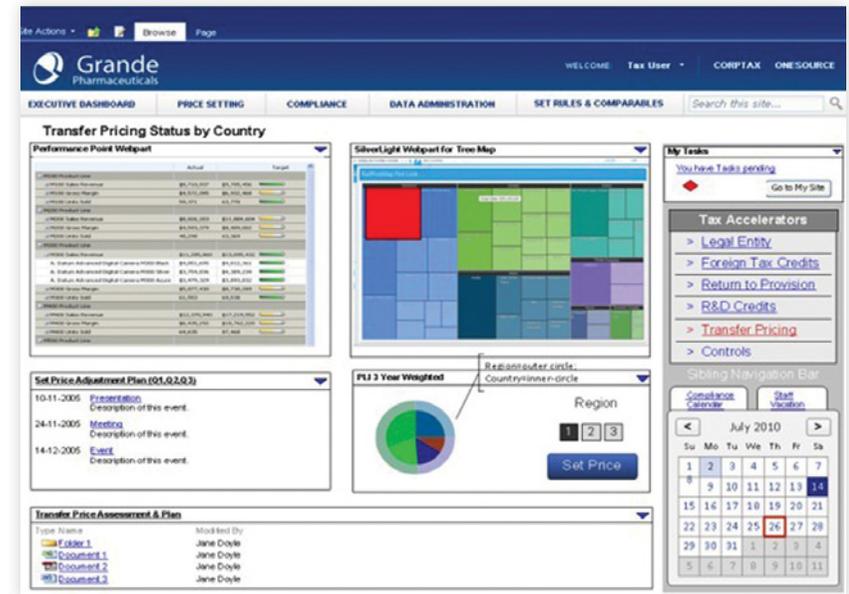


Figure 3  
TPi Process

Existing infrastructure



Existing data resource  
(e.g. ERP systems)



TPi solution



PwC’s  
knowledge of:

- Industry best practices
- Market trends



Tailored solution

### **Conclusion**

TPi changes the historic and tactical approach to tax technology from automating the data collection process and standardising compliance procedures to providing a window into the coming reporting periods. The future and strategic approach to tax technology is establishing a data collection process that is efficient, flexible, reliable and strategically aligned with business goals and objectives. In short, TPi will provide any multinational organisation with timely and accurate information for making strategic business decisions.

*TPi will provide any multinational organisation with timely and accurate information for making strategic business decisions*



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## *The role of risk in transfer pricing*



The question of who takes risky decisions, and who bears the consequences of those decisions has always been very important in transfer pricing analysis. Chapter 9 of the OECD Transfer Pricing Guidelines features a section specifically on this subject, the publication of which has underlined the significance of the issue, particularly in the context of business restructurings.

This article considers the implications of the OECD guidance on situations where risky decisions are taken in a part of a multinational that does not naturally bear the consequences of the decisions. It goes on to consider techniques to address this issue, with particular focus on operational structures where entrepreneurial decision-making is centralised. Finally, we provide some insight on risk in the transfer pricing perspective from Germany, Canada and India.

### ***A simplified illustration of the issue***

The issue has traditionally arisen most frequently in practice in industries where long-term contracts are common and early-stage decisions on specification and price can have significant profit or loss repercussions over the life of a contract. These may relate to industries like professional services, financial or commodity trading, and construction, but for the purpose of illustration we will consider the kind of contract that a component supplier might enter into in the aerospace industry. For simplicity, assume all of the key contractual terms, including specification and prices are decided by a contracting committee in location A. That committee will also decide which of the manufacturing entities within the group should deliver the contract; in this case, location B delivers the contract in its entirety. The costs of the committee are recharged throughout the group on a cost-plus basis.

Location B sells finished parts directly to the customer. Six years in to a 25-year contract, location B is experiencing heavy losses, with no prospect of significant improvement. Mainly, this is a consequence of unrealistic assumptions made by A in the contracting process.

The OECD Guidelines say that if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax authority may wish to challenge the arm's-length nature of such risk allocation<sup>6</sup>. In this simplified example, location B did not have control over the decisions that gave rise to risks that it has borne to its detriment. One might say that, at arm's-length, B would have been more careful about accepting the contract, but in practice B had no choice, it was a 'done deal'. Cases like this often end up with a lump-sum transfer pricing adjustment between location A and B, such that A bears the portion of the loss which has arisen as a consequence of the decisions which it took during the contracting process. Important supplementary issues then need to be addressed, in particular in respect of the nature and timing of this adjusting payment and the associated accounting and tax consequences.

A critical aspect that is left out of this example in order to keep it simple is the location of the capital within the group which underpins the ability to take the contract risk in the first place. Often this is in neither location A or B, and also needs to be taken into account in the pricing solution. The main purpose of the illustration is to point out that the need for mechanisms to match the outcome of a risky decision with the location of the decision is not new. In practice adjustments of this nature have in the past been mainly about loss reallocation, because losses get most tax authority attention. But as the OECD Guidelines point out<sup>7</sup>, by definition there should be potential for upside and downside in the risk-taking location<sup>8</sup>. Just as there was no mechanism in the example to attribute losses to location A, there would equally have been no mechanism to attribute profits had the risks for which they were responsible resulted in higher profitability.

<sup>6</sup> OECD Transfer Pricing Guideli.e. Para 9.22.

<sup>7</sup> OECD Transfer Pricing Guideli.e. Para 1.45.

<sup>8</sup> "Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised" (OECD Transfer Pricing Guideli.e. Para 1.45).

### **Why cost plus might be the wrong policy for people who take key decisions about risk**

For many MNCs, significant strategic decisions that are taken in a central location have a material bearing on the ultimate profit or loss outcome achieved throughout the organisation. The issue becomes particularly noticeable and problematic in an example like the one given above, but it is inherent to some extent in all but the most decentralised organisations.

Traditionally, the costs associated with the senior decision-makers would probably have been part of 'head office costs' and recharged with a mark-up. For many MNCs this is still the most practical approach to dealing with this issue, especially where local operating companies play an active and influential role in the governance process, or where the assets and capital underpinning the risk-taking capacity of the group are spread around the operating companies. The OECD Guidelines stress though, that "it

is the low (or high) risk nature of a business that will dictate the selection of the most appropriate transfer pricing method, and not the contrary"<sup>9</sup>. Generally speaking, a given risk is 'moored' to a business if that business houses the people who take significant decisions about that risk<sup>10</sup>. It is clear that, on this basis, a cost-plus recharge is not inherently the right transfer pricing mechanism to remunerate the entity that houses the key decision-makers. The costs of employing the people who make the decisions bear minimal, if any, relationship to the financial consequence of the decisions. Charging out those costs on a marked-up basis means that, as a result of the transfer pricing mechanism, the employing entity bears virtually no risk at all.

### **If not cost plus, then what?**

The issue is essentially about creating a mechanism in which the entity or entities which house the risk-takers (or entrepreneurs<sup>11</sup>) get a return that varies depending on the success or otherwise of their strategies. Specifically, paragraph 9.39 of the OECD Guidelines states that the party bearing the consequence of the risk allocation should:

- Bear costs of managing and mitigating the risk
- Bear costs that arise from the realisation of the risk (including booking provisions)
- Generally be compensated by an increase in the actual return

This can happen naturally if transaction flows and the transfer pricing policy are capable of alignment. In the aerospace example above this would have happened if A, in addition to negotiating the contract, had actually entered into the contract with the original equipment manufacturer (OEM). In that case A would have sold parts directly to the OEM, and could have bought the parts from B at a price which gave B a return appropriate to its role in the arrangements (presumably a contract manufacturing type of return). Ultimately, under this model, A would naturally have made the loss that became a separate transaction in real life.

<sup>9</sup> OECD Transfer Pricing Guidelines, e. Para 9.46.

<sup>10</sup> Whilst the concept of 'significant people functions' explicitly makes the location of key decision makers a 'mooring' point for allocating profit to branches, the OECD Transfer Pricing Guidelines make it clear that Article 7 and Article 9 of the OECD Model Tax Convention on Income and on Capital 2010, don't work in the same way, and that for Article 9 contracts remain the starting point in analysing who bears what risk. Contracts are not definitive, though, and in several examples the OECD Transfer Pricing Guidelines imply that where the underlying substance (usually defined by who makes what decisions) is at odds with the contractual terms, then the substance will dictate the 'true allocation of risk' (e.g. OECD Transfer Pricing Guidelines, e. Para 1.66).

<sup>11</sup> Entrepreneur – a person who sets up a business or businesses, taking on financial risks in the hope of profit. Oxford Dictionaries, [www.oxforddictionaries.com/definition/entrepreneur](http://www.oxforddictionaries.com/definition/entrepreneur).



*If entities do not own any intangibles that are unique it may be possible to apply a TNMM*

This would also happen naturally in a typical principal structure, where the profits of the lower risk parties are generally stable as a consequence of the prices at which they buy from or sell to the principal, and the profits of the principal fluctuate as a consequence of the success or failure of their market strategy, and investment decisions.

Where substantially all of the significant decisions have been centralised, such that the business operating model has the characteristics of a principal structure in every respect apart from the fact that transactions do not flow through the principal, then it will be necessary to introduce a mechanism to deliver the appropriate, variable return to the decision-making entity. It will also be necessary for the entities that do not take significant decisions to have a less variable return that appropriately rewards them for their functions, assets and more limited risks. If those entities do not own any intangibles which are unique<sup>12</sup> it may be possible to apply a TNMM to these local entities, and ascribe the residual profit or loss to the decision-making entity. Where unique local intangibles or barriers to entry exist, it would be necessary to factor these in to the local return.

<sup>12</sup> See OECD Transfer Pricing Guidelines, e. Para 2.60 for a description of non-unique intangibles. Broadly speaking these might be the type of non-unique intangibles which one would expect potential comparables to possess.

It is not easy to deal with risk in a profit split model, especially if a contribution approach is used. In a profit split that allocates a portion of the total profits or losses of an MNC to each party based on a formula, the risk is spread amongst the profit-sharing participants. In some cases that will be appropriate. In cases where the significant decision-makers are centralised in one location, it will be necessary to introduce features that limit the extent to which the parties that do not take significant decisions experience volatility associated with the outcome of those decisions. In such case, a residual approach to the profit split method, separating routine reward and profits to be split on an economically valid basis may be more appropriate.

The end result of an approach of this kind is an overall allocation of profit or loss that is similar to that which would arise in a principal model, but it is achieved by introducing a payment between the entrepreneur and the local business to deliver an appropriate arm's-length, lower-risk return to the local business. This payment works in the same way as the adjustment described in the aerospace example.

Payments of this kind can be very large in amount, and will appropriately be the subject of scrutiny by tax authorities, particularly if they are payments out of a territory. The issues that will need to be addressed vary depending on the facts and circumstances of the case, and differ distinctly by industry and geography. However the following aspects are almost always challenging:

- How should the payment, and the agreement between the parties under which the payment is made be characterised?
- Will the payment be deductible under local tax rules, or will it be deemed to be a distribution?
- Is there a two-way flow of services, where the adjusting payment represents the net result of a barter? This may well have VAT implications in a number of territories
- Often in addition to control of risk, the entrepreneur owns rights to IP, which is made available to the local entities. Does this make a component of the charge subject to withholding tax?
- Are exchange control issues in point?

It is normally possible to overcome or minimise the impact of issues of this kind, but not always, and this is not an exhaustive list.

*It is not easy to deal with risk in a profit split model, especially if a contribution approach is used*

### **Why would a business agree to such a mechanism?**

There are innumerable instances of parties seeking to limit their risk at arm's-length. What they are prepared to pay in order to do so depends on the nature of the risk being minimised, and the techniques used will vary depending on the commercial circumstances.

In instances where parties are transacting with one another from an operational perspective, the risk can be managed through the contractual terms. In principal structures, risk can be determined in the contract and through the pricing mechanism, much in the way that it would be in any arm's-length sub-contracting situation, such that the sub-contractors do not bear risks over which they do not have control.

Where the parties are not transacting with one another operationally, then a separate mechanism is required to reward or penalise the party taking the risk. At arm's-length, the kind of mechanisms available will range from traditional insurance (which mitigates, rather than transfers risk) to complex risk-sharing mechanisms included in Public Private Partnership (PPP) contracts.

In the case of PPP contracts, significant risks may be transferred from government to a private sector company. The PPP contract will often set out in detail the potential risks, which risks each party should bear, who is responsible for arranging insurance, and the process for risks that become uninsurable.

In a typical insurance case, the insurer would not necessarily have control over the risk that is being underwritten, whereas the OECD Guidelines state that in arm's-length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control.

One may argue that in practice, for some types of insurance, the underwriting party will try to exert some control over the risk by way of conditions attached to the insurance (e.g. requiring to activate a burglar alarm in a home each time one leaves the house, the minimum requirements for locks, the use of fire alarms). However, in a commercial context, traditional insurance will not play a major role in controlling the risks which it has underwritten. But, it is important to remember that insurers are involved in many situations where risk events occur and insurance claims are made. This wealth of information and experience means insurers are often able to provide guidance around common risk causes and effective mitigation or control approaches. A good relationship with an insurer may enable one to tap into that experience to help reduce risks, become more attractive to insurers and hopefully achieve a lower premium.

Increasing outsourcing of services also allows transfer of some risks to the providers of these services. However, it's important to recognise that not all risks can be 'outsourced' and that some risks, even if managed by third parties, will ultimately remain with the company. A clear example of this is reputational risk.

### **Conclusion**

It will not always be the case that a cost-plus recharge is the right transfer pricing mechanism to remunerate the entity that houses the strategic decision-makers who take crucial decisions about risks within an organisation. Therefore, one may need to consider different recharging mechanisms to deliver the appropriate, variable return to the decision-making entity. Conversely, it may be appropriate for the entities which do not house significant decision-makers to have a less variable return, but one that appropriately rewards them for their functions, assets and more limited risks.

Depending on the facts and circumstances it may be possible to apply a TNMM to these local entities, and ascribe the residual profit or loss to the decision-making entity or apply a residual approach to profit split method, separating routine reward and profits to be split on an economically valid basis. However, there may be range of recharge techniques available including a payment between the entrepreneur and the local business to deliver an appropriate arm's-length, lower risk return to the local business. Different tax authorities will adopt different approaches to challenging structures of this nature and the primary objective of a defensible transfer pricing strategy would be to mirror, as far as possible, what third parties do in similar circumstances. This will normally depend on the risk being minimised and the commercial circumstances of the case but will usually range from traditional insurance to complex risk sharing mechanisms.

Given its importance to transfer pricing analysis, it is necessary to adopt a rigorous approach for identifying and valuing risk in a business. Increasingly, actuarial techniques are being adopted to support traditional transfer pricing analysis.

In the section below Alpesh Shah, from PwC's Actuarial Risk Practice provides us with his point of view on risk in general and the scenario outlined in this article in particular. We have also asked transfer pricing specialists from Germany, Canada and India for insights from their countries on how risk may be reflected in transfer pricing mechanisms, and how the tax authorities in their jurisdictions would approach these issues.

***Where the parties are not transacting with one another operationally, a separate mechanism is required to reward or penalise the party taking the risk***

### **Perspectives from an Actuary Framework for capturing risk**

The risks within a business that really matter should ultimately be tied to the business's strategy and objectives. Key risks are events that may disrupt the ability of the business to create or maintain value for shareholders or key stakeholders.

In order to ensure a comprehensive risk-identification approach, a variety of key ingredients are necessary. These include:

- Broad involvement in risk identification approaches from a range of people from different parts of the business to help drive a wider perspective of risk-identification. This includes involvement of more senior people in the process to draw out key strategic risks.
- Consideration of a range of risk areas, from a broader view than just safety and compliance to include strategic, financial and reputational risk drivers will be essential.
- Looking outside the company to competitor and industry experience for sources of risk to which others have been exposed.
- Consideration of 'black swans' may include risks that would have a very material impact on the business but have a very low likelihood of occurring. In such case rather than considering the likely cause, event and consequence of these very remote risks, focusing on the consequences will make it easier to capture these risks.

Many organisations will have identified a range of risks and captured them, typically in a risk register. However, these risks will often only be considered as discrete events (i.e. each risk will have a fixed likelihood of occurring and a fixed impact if it were to occur). More often than not, risks are not discrete but have a range of possible outcomes. Consideration of the range of outcomes of key risks allows a more comprehensive evaluation of the potential impact of extreme outcomes, which are often those that are of interest when considering who should bear the risk.

#### **Principal-type structures**

From the actuarial perspective, in the scenario where the local company bears no volatility of cash flows and all of the uncertainty of cash flows is borne by the central company, the key is to understand the nature of the variability in cash flows that is being borne by the central company. Historical cash flows will provide an evidence base as to what the volatility of cash flows is.

Where historical data is sparse, it may be possible to estimate the volatility of cash flows by making some assumptions around their distribution based on the limited data available or in an extreme case, by making an assumption as to how management would expect cash flows to vary.

Once a distribution has been identified, it will be possible to estimate the average expected cash flow and also the range around that average. This can be measured by way of standard statistical metrics such as standard deviations or the expected outcome at a given confidence level (e.g. 95th percentile outcome).

The reward expected by the risk-bearing company will be determined as the combination of the following factors:

- The average cost expected from the distribution of cash flows
- The cost of holding capital to ensure the entity can withstand volatility of cash flows to a particular level. As the company needs to hold this capital, the company should be compensated for the opportunity cost of doing so.

In such cases, the amount of capital needed will be determined by the difference between the average expected cash flows and the cash flows at a particularly adverse scenario. The level of severity of the scenario will need to be defined. In the insurance industry this is defined as the 99.5th percentile outcome (i.e. the one-in-two-hundred years adverse outcome). The extent of this over and above the average expected outcome will be the capital which will be needed by the risk-bearing company.

#### **Risks over which neither party to a transaction has control**

In a scenario when the party responsible for setting overall strategy and responding to changes takes the consequences of positive or negative changes and shelters other parties in the group from these kind of risks (economic conditions, money and stock market conditions, political environment, social patterns and trends, competition and availability of raw materials and labour) determining the effect of macroeconomic and other external factors on that party's cash flows and profiles may be complex. However, if the relationship between these factors and the company cash flows can be articulated as a formulaic relationship, then it is possible to model how the volatility in these external factors may drive volatility in company cash flows. However, some external factors are not quantitatively measurable and so may not lend themselves to the same detailed analysis as others.

### ***Perspectives on risk from Germany***

In German transfer pricing rules, the definition of function that applies to business restructurings does not apply in the very same sense for regular function, asset and risk analyses. For functional analysis purposes German transfer pricing generally distinguishes between functions, risks and assets. Accordingly, the definition for business restructurings seems to be broader. When defining a function for business restructuring purposes, the German transfer pricing regulations state that it should include the assets (especially intangible assets), advantages as well as the activity-related chances and risks.

In the reallocation of functions, reference is made to the functional analysis of the entity before and after the transfer. Accordingly, a risk is a part of the function, but the regulations remain relatively silent with regard to the relevance of risk as part of the overall analysis.

The Administrative Principles available in Germany, which are, however, not binding on a taxpayer, include examples for taxable restructurings. Examples provided include the conversion of a fully-fledged manufacturer to a contract manufacturer or of a fully-fledged distributor to a limited risk distributor. In the case of these examples, only risks may be reallocated.

The German regulations use the terms “chances” and “risks” in parallel; it should generally be possible to allocate certain profits to the risks. Accordingly, if the reduction in profits is commensurate with the reduction in risks, this should not, under arm’s-length considerations, give rise to an exit payment. Also from the perspective of the German rules, even though the transfer of risks may qualify as a potential “transfer of function” and the transfer package may come up with some result, this should still be negligible due to reference to arm’s-length behaviour.

Additionally, professional German tax practitioners may notice some inconsistencies between Chapter 9 of the OECD Guidelines and German transfer pricing package rules in relation to the reallocation of risk (these however, have not been considered by the German Ministry of Finance as problematic issues).

MNCs, when considering reallocation of risks, need to be careful of moving risks in isolation (e.g. via contractual allocation known for limited risk distributors and contract manufacturers). Otherwise the experience of the German tax authorities is rather limited.

Also, the valuation of risks for German tax purposes is rather difficult and not widely applied by tax authorities. Additionally, reallocation of risk may be seen as artificially structured, but this will normally depend on the industry (e.g. global trading in financial sector is rather common).

Finally, the most common German tax authority challenges relating to risk issues would be claiming more profits for valuable functions (which, for German purposes, includes risks) performed in Germany or challenging inbound fees.



***The valuation of risks for German tax purposes is rather difficult and not widely applied by tax authorities***



***The recent decision of the Tax Court of Canada (“TCC”) in Alberta Printed Circuits Ltd. v. The Queen included some interesting observations regarding risks***

***Perspectives on risk from Canada***

The Canada Revenue Agency (CRA) was actively involved in developing Chapter 9 of the OECD Guidelines, but it is too soon to tell how it will interpret and apply this guidance. That said, the CRA has stated that business restructuring is a primary area of focus, and this is evident from its audit activity. Subsection 247 (2)(b) of Canada’s Income Tax Act actually gives the CRA a specific statutory tool (in addition to a broad General Anti-Avoidance Rule) to support “re-characterisation”. This subsection, which has been actively used by the CRA since its introduction in 1997, addresses transactions that “would not have been entered into between persons dealing at arm’s-length” and, in certain circumstances, authorises the CRA to amend these to transactions “that would have been entered into between persons dealing at arm’s-length” under arm’s-length terms and conditions. As of June 2011, 48 re-characterisation cases have been considered (such cases must be reviewed and approved by a senior CRA committee before they can be pursued by auditors), with 11 assessed and 10 ongoing. It is our experience that the allocation of risk is typically an important factor in these cases; audits routinely probe where risks are truly borne and whether the ‘risk-bearer’ has the financial capacity and managerial substance to bear the risk. However, even with Chapter 9 in hand as a defence, taxpayers should be aware that the CRA strongly endorses a transactional approach to transfer pricing. For example, a “risk-transfer payment” that reduces a Canadian entity’s profit to a certain level

must be strongly supported by evidence of the arm’s-length nature of the actual payment (i.e. matching the payment with what the payment is for) rather than relying on a TNMM analysis to support the profit left behind in Canada.

The recent decision of the Tax Court of Canada (“TCC”) in *Alberta Printed Circuits Ltd. v. The Queen* included some interesting observations regarding risks. The case involved *Alberta Printed Circuits Ltd.’s* (“APCI Canada’s”) payment of service fees to a related company in Barbados (“APCI Barbados”). The TCC found that APCI Barbados (as a captive service provider) bore the biggest market risk because it had only one customer (i.e. APCI Canada, the service recipient), leading the TCC to conclude that APCI Barbados could not be an appropriate tested party for application of the TNMM. As this scenario is common in related party transactions, a careful analysis of the balance of risks in service-provider transactions should be included in any Canadian transfer pricing documentation. Further, because the CRA places a lot of weight on the terms of legal agreements, companies that want to genuinely transfer the significant risks of a service provider should ensure that the relevant intercompany service agreement does achieve this risk transfer. For example, in the event of a closure (e.g. if services are no longer required), agreeing that the service recipient is responsible for closure costs is one step to support a lower risk profile for the service provider.

### **Perspectives on risk from India**

The Indian transfer pricing code does not specifically discuss the circumstances under which it may be appropriate for the Income Tax Department (ITD) to re-characterise a transaction based on a purported allocation of risk that does not accord with economic reality. The code envisages that the characterisation of an entity should be based on the functions performed, assets employed and risks assumed by the enterprise. Several Indian rulings<sup>13</sup> have generically endorsed the principle of aligning the economic substance of a transaction with its contractual terms, and stated that the higher the risks assumed by a party, its expectation of returns should also be higher.

For the ITD to disregard a transaction, it would have to demonstrate that the transaction is a sham (lacks substance) or is not permissible under law. In the absence of such a determination, while the ITD could re-price the transaction under the transfer pricing code, it may not disregard the transaction altogether. A transaction could be viewed as lacking commercial substance if the purported risk allocation is not consistent with the functions performed by the parties, or where risks are allocated to parties that do not have adequate control over the creation of such risks.

The following are some examples where the ITD has sought to reallocate risks (and the associated return) in specific situations.

In the case of an Indian taxpayer that provided contract R&D services to a global MNC (an associated enterprise, the ITD challenged the mark-up earned on total operating cost. It was alleged that the taxpayer performed key functions in India (which created R&D risk for the overseas MNC) such as:

- a. identification of products to be developed
- b. formulating R&D strategy
- c. approving the R&D budget
- d. decision to abort further R&D

There are also instances of high-pitched transfer pricing litigation in the Indian software industry, wherein the dispute appears to be whether the Indian taxpayer (a contract software developer) rendered a service or transferred an intangible asset to the overseas associated enterprise. The issue seems to be the same – whether the contractual allocation of risk between the parties was consistent with their conduct and where the significant people functions were located.

An opposite example is seen in regional principal structures, wherein the principal (entrepreneur) entity is located outside India and the Indian affiliate merely performs routine manufacturing and distribution functions relating to the domestic Indian market. This could create a situation where the entrepreneurial functions reside outside India, while the residual profits are trapped in India. At times, taxpayers have sought to remit such residual profit (after retaining a routine return for the Indian manufacturing and distribution functions) to the overseas entrepreneur through royalties, which are typically determined through a residual profit-split approach. In such cases, tax authorities have not only intensely scrutinised the royalty payment from a transfer pricing and tax characterisation standpoint, but also sometimes asserted the creation of a Permanent Establishment in India of the overseas entrepreneur.

It may be mentioned that classical principal structures, which typically envisage two different entities in India performing separate contract manufacturing and distribution functions for an overseas entrepreneur, are presently not feasible for regulatory reasons. Under exchange control law, an Indian distributor taking delivery of goods (belonging to the overseas entrepreneur) from an Indian contract manufacturer for sale in the Indian market, would not be able to pay the overseas entrepreneur for the goods as there is no importation into India.

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<sup>13</sup> Mentor Graphics (Noida) Pvt Ltd v. Dy. Commissioner of Income tax (ITA No. 1969/D/2006) and E-Gain Communication Pvt Ltd v. ITO (ITA No. 1685-PN-07).

## Successful management of the transfer pricing audit process

In 2008, we published an article entitled “Global best practices in preventing transfer pricing audits and disputes”. This was one of a number of articles contained in a special edition of *Transfer Pricing Perspectives* focused on what was then termed the “emerging perfect storm” of transfer pricing audits.

Three years later, and the “perfect storm” is upon us. It would be a challenge to find an MNC that has not been subject to at least one transfer pricing audit over the past three years somewhere in the world. Indeed, in most cases MNCs will have faced, and will continue to face, multiple examinations in multiple jurisdictions.

As part of corporate governance procedures, most MNCs attempt to use best efforts to follow the practices described in our 2008 article within the scope of the resources available to them in order to prevent audits from arising in the first instance. Even so, the number of transfer pricing audits being conducted globally continues to rise, in spite of the increasing number of taxpayers using advance pricing agreements (APAs) to manage their largest transfer pricing exposures.

With transfer pricing audits a virtual certainty, rather than a possibility, this article is designed as a “Part II” to our 2008 publication. That is, even if all the best practices for preventing a transfer pricing audit have been adopted, an investigation is still commenced – then what next? This article goes to the next stage in the transfer pricing audit life cycle by providing a “how to” guide for managing the actual examination process itself. Moreover, although there are of course distinct differences in how audits are managed and conducted by tax authorities around the world, the best practices described herein should be applicable regardless of the location of the audit. Likewise, while this discussion is specifically focused on transfer pricing audit management, many of the practices described are helpful in the management of any audit process, whether tax, customs, regulatory, or otherwise.



## **Best practices for transfer pricing audit management**

### **Understand the audit environment**

Unless the tax authorities have turned up at the door with armed police and are carting away documents in boxes (which unfortunately does happen in some jurisdictions), taxpayers usually have some advance notification that an audit will commence, even if it is only a few days. Within that time frame:

- It is critical to understand what type of audit is being conducted. Is this a dedicated transfer pricing audit, in which case transfer pricing will be the sole issue discussed? Or is it a general tax audit, during which transfer pricing issues will be only one of a number of tax issues covered?
- It is helpful to find out, if possible, the background to the members of the examination team that will be conducting the audit. How familiar are they with transfer pricing issues in general? How familiar are they with industry-specific issues that have an impact on transfer pricing? Will the revenue authority use any “outside” experts?
- It is also important to find out whether an audit has actually started or whether there is a prior process of ‘risk assessment’ which, if handled carefully, might mean that an audit is not required.

While it should be obvious, understanding the type of audit being conducted will lead to better decision making, both in relation to the taxpayer’s internal resource allocation and in relation to development of the audit strategy. A general tax audit, where transfer pricing may be further down the list of issues to be covered, is likely to require less input from the global or regional transfer pricing team, as many of the corporate income tax, withholding tax, or sales tax issues to be covered can only be addressed by the local finance team that manage the books and records of the local entity under audit. In the preliminary stages of such an audit, it may therefore be enough for overseas management simply to monitor the progress of the audit, having prepared the local finance team to recognise what questions asked or information requested by the tax authorities might lead into the transfer pricing area. In contrast, where the audit is to be solely focused on transfer pricing issues, the resource allocation from overseas may well be more intensive, and likely to start at an earlier stage of the audit process.

In the same vein, the type of audit being conducted will have an impact on development of the audit strategy in relation to transfer pricing. For a general tax audit, the best strategy is often to wait for transfer pricing issues to be raised by the examination team, i.e. to be reactive to requests for information rather than proactive. On the other hand, for a dedicated transfer pricing audit – where transfer pricing will be the only topic in the audit process – a taxpayer should typically be more active in laying out its position in relation to the pricing policies adopted early on, so as to control the direction and discussion of the audit more closely. This is particularly important in jurisdictions where the burden of proof rests with the taxpayer in the first instance; however, even in jurisdictions where the taxpayer does not have the burden of proof, such a presentation will ensure that there is no implicit shifting of the burden from the examination team to the taxpayer as a result of the taxpayer’s inactivity.

The taxpayer will also want to understand the key transfer pricing issues that the relevant tax authorities are focusing on and developing (e.g. impact of loss operations, transfers of intangibles, permanent establishment matters, business restructuring, allocation of management expenses). Further, it is important to understand how such issues have been resolved in other cases on their merits and through the alternative dispute resolution processes.

Further benefit may also come from understanding the experience and background of the specific members of the examination team. Although such information is not publicly available in all countries, even where it is not, experienced advisors may be able to provide valuable insight on this issue from their personal knowledge of the local audit environment. In conjunction with an understanding of the type of audit that is being conducted, knowledge about the specific examiners involved may help to drive a taxpayer's audit strategy. In a general tax audit, where none of the examiners are understood to have detailed transfer pricing experience, transfer pricing issues may well be moved further down the list of concerns to be dealt with in the audit. In contrast, in the same type of general tax audit, but where it is known that one or more of the examiners has transfer pricing experience, a taxpayer may adopt a slightly more proactive approach to presenting and explaining transfer pricing issues than would otherwise have been the case.

Likewise, where none of the examination team is understood to have any familiarity with the taxpayer's industry, particularly where industry factors play a large part in driving transfer pricing results or policies, more focus may be given to educating the team members about those issues and the industry itself at the start of the audit, before any discussion of specific transfer pricing policies is even raised. Moreover, even where the examination team is known to have some understanding of the industry, where economic conditions or other factors that may have an impact on transfer pricing or profitability have recently changed, it may be necessary to provide background and education on the changes that have occurred as well. Specific examples include impact of the global financial crisis (particularly on the financial services industry), the impact of natural disasters (such as the recent earthquake and tsunami in Japan) on the high tech manufacturing and automotive industries, and political unrest (e.g. recent turmoil in the Middle East and its impact not only on the oil industry itself, but also on secondary manufacturing industries that are heavily reliant on oil-based products, such as plastics).

*Further benefit may also come from understanding the experience and background of the specific members of the examination team*

*From the time notification of an audit is received, it will also be important for the global or regional tax/transfer pricing team to demonstrate their strong support for management of the local entity*

**Support local management**

From the time notification of an audit is received, it will also be important for the global or regional tax/transfer pricing team to demonstrate their strong support for management of the local entity, who will actually be meeting with the examination team on a day-to-day basis. This support generally comes in two parts:

- Ensuring local management that the global and/or regional tax/transfer pricing team is available at all times to provide information, answer questions, or assist with the audit in any other way that may be required during the audit process. Invariably, while local management are often quite comfortable negotiating with the tax authorities in relation to income tax, withholding tax, or sales tax issues, they are often less confident about discussing transfer pricing issues, an area about which they may feel less knowledgeable. Consequently, the knowledge that global and/or regional tax/transfer pricing teams are ready, willing, and able to help at any time can greatly smooth the management of transfer pricing queries from the examination team as they arise during the course of the audit.
- Providing local management with guidance about the transfer pricing issues that are likely to arise during the audit process (often based on experience with audits in other jurisdictions) and how questions about those issues should be answered. The issues raised will differ among taxpayers, but typically cover: unusual profit/loss results; transfer pricing policies outside of what is typically seen in the industry; management services charges; business restructuring transactions; treatment of intangibles; and problems arising from implementation of stated transfer pricing policies.

Although it is expected that discussions of this kind with local management will be held regularly as part of the general development and implementation of transfer pricing policies within an MNC, it is helpful to reiterate these points again once the start of an audit has been notified by the examination team. This is particularly the case in countries where the penalties for tax or transfer pricing non-compliance may have adverse consequences on business operations, such as loss of customer confidence or reputation in the marketplace, or regulatory implications.

Developing and maintaining a strong relationship with local management will ensure that transfer pricing questions raised by the examination team, including requests for information that are likely to lead to transfer pricing questions, are brought to the attention of the global or regional tax/transfer pricing team as early as possible. It should also ensure that there are no inaccurate explanations of transfer pricing policies to the examination team, which will be difficult to correct at a later stage in the audit process.

### **Proactive preparation**

Transfer pricing audits are inevitably time- and resource-consuming, and often involve the preparation and submission of copious amounts of documents and information to the examination team. Consequently, advance preparation of such information, however limited, can help to relieve pressure on staff resources once the audit has started. This will give more time for the taxpayer to focus on audit strategy during the audit itself, without losing valuable time to preparation of documentation for submission that could have been prepared in advance.

Where there are specific documentation rules in a particular jurisdiction, the transfer pricing information to be submitted may be clear and is likely to be readily available (in the form of transfer pricing documentation). In contrast, where there are no formal documentation rules, it may be more difficult to know exactly what information the examination team will request to be submitted. Nevertheless, an experienced advisor should be able to provide a summary of the typically requested information to enable certain advance preparation. Even where there is a clear documentation requirement in a particular jurisdiction, an experienced advisor should be able to confirm what additional information, if any, is also likely to be requested by the examination team.

In addition to documentation that may need to be submitted to the examination team, advance preparation may also cover briefing interviews with key members of local management who are likely to be called for interviews during the audit process. The purpose of these briefings should be (i) to alleviate potential uncertainty that the prospective interviewees may be experiencing, (ii) to reassure those interviewees that they will likely be able to answer questions asked, and that if they cannot answer, it is perfectly reasonable and expected to say so, and (iii) to define the one or two key messages that need to be communicated to the examination team. Indeed, it is important that interviewees are not overloaded with “points to remember,” as any advantage to having the briefing may well be lost in such cases.

### **Develop a strategy for meetings with the examination team**

A common response from global or regional tax/transfer pricing management in the event of an audit in a local jurisdiction is to request a meeting with the examination team themselves, to explain the group’s transfer pricing policies in person. Although this desire is understandable (and may be appropriate in certain situations) given that overseas management is likely to have the best understanding and overview of those policies, it is often not the preferred strategic approach, even if the common practical difficulties of language can be overcome.

In the case of a general tax audit, particularly in countries where such audits occur on a cyclical or regular basis, the attendance of overseas management at an audit meeting can raise questions and may even create confusion in what would otherwise be a regular audit process. In addition, in many countries where status is a critical part of the business environment, such as parts of Asia, attendance by overseas senior management at an audit meeting may require the examination team in turn to bring their senior personnel to attend the meeting as well. Raising the profile of the audit process to a higher level within the tax authorities in this way may not necessarily be the recommended approach.

On the other hand, there are some jurisdictions where it may well be helpful for overseas tax/transfer pricing management to attend one or more audit meetings as a sign of respect for the examination team. The timing and discussion content of such meetings, however, should be discussed well in advance with experienced advisors who have a good understanding of the local audit environment. Questions to consider include: Should the meeting be arranged as a brief “courtesy” meeting only? Should it be held at the company’s office or the tax authorities’ building? Is translation necessary? If so, should it be consecutive or simultaneous translation (both of which have different strategic advantages and disadvantages)? Such questions are all relevant to the establishing of a good working relationship with the local tax authorities, which is a critical factor in managing the audit process.

### Carefully monitor information requests and submissions

During the audit process, it is likely that the examination team will make a number of requests for information to be submitted by the taxpayer. Sometimes these requests are made in writing; however, it is not uncommon for many of them to be made orally to local management as they attend meetings with the examination team. Particularly where the number of requests is extensive, it is generally good audit management to ask that they be made in writing to facilitate the tracking and submission process. Whether it is appropriate to make such a request from a strategic perspective will depend on (i) the particular type of audit, (ii) whether written requests are commonplace, and (iii) if such a request is unusual, what impact it will have on the relationship with the examination team for the duration of the audit.

In addition, it may be that many of the requests made by the examination team appear unnecessary, and in some cases even unrelated to the transfer pricing issues at hand. In many jurisdictions, however, refusal to submit requested information may have an adverse effect on the audit process, and thus should be considered very carefully even if the taxpayer believes such information is unnecessary for determination of any transfer pricing issue. As a result, in some cases it may be more beneficial for a taxpayer to submit unnecessary information, simply to continue to maintain a cooperative relationship with the examination team. In other cases, particularly where the volume of requests is onerous or where the information-gathering phase of the audit has been underway for some time with no end in sight, it may be appropriate for the taxpayer to proactively negotiate with the examination team as to what information may not need to be provided (or may be submitted orally rather than in writing).

The timing of submitting requested information should also be managed carefully. To ensure that an audit progresses smoothly, requested information should be submitted without undue delay, often within two to four weeks, although this will depend on the jurisdiction, the type of audit, the stage of the audit process, and the information requested. For example, information that a taxpayer is legally required to have to hand, such as transfer pricing documentation (in some jurisdictions), intercompany agreements (in almost all jurisdictions), and accounting books and records (in all jurisdictions), may have a much shorter timeframe for submission (a few days or weeks), which may not be negotiable. In contrast, information that the taxpayer is not legally required to have at hand, or which may take time to collate, such as transfer pricing documentation (in some jurisdictions), segmented financial statements (in many jurisdictions), or financial information about overseas related parties (in most jurisdictions) may be submitted under more relaxed deadlines, which are often open to negotiation with the examination team.

Not only the timing of the submission, but also the form of submission of information, should be strategically considered and may be subject to negotiation with the examination team. For sensitive or extremely complicated information, a strategic decision will need to be made about whether the information should be submitted in writing only, or whether it should be accompanied by an explanation or presentation by the taxpayer as well. This may be the case for a particular type of industry or product with which the examination team may not be familiar; a transfer pricing methodology that is not commonly seen in the jurisdiction (or at least not commonly used for the transactions under audit) such as a profit split; or where the economic analysis contains certain steps not typically adopted in the jurisdiction (such as uncommon adjustments to comparable data, uncommon statistical analyses, or where the taxpayer's results are unusual or unexpected, e.g. long-term losses).

It is also not uncommon for audit requests to be badly drawn up and to ask for information or documents that either do not exist or are unlikely to shed much explanation on the transfer pricing issues. It is then worth considering whether it is better for a taxpayer to take the initiative and provide information or documents that have not been requested if this will shorten the process and bring the audit to a speedier and more successful conclusion.

### Dealing with risk assessments

Much of the above advice applies equally to a risk assessment. A number of tax authorities use a process of risk assessment before committing resource to a full-blown transfer pricing enquiry. This process allows a taxpayer to demonstrate that its transfer pricing is in order, that its policies are sound and that they are correctly implemented – in short, that it presents a low risk of transfer pricing non-compliance. This requires an understanding of how a tax authority views transfer pricing risk, but this will generally revolve around the size of the intra-group transactions, the complexity of these, (for example, whether they involve intangibles) and the taxpayer's compliance history (is there a track record of failure to apply transfer pricing policies properly?).

While risk assessments can deflect the onset of an audit if handled properly, care needs to be taken that the risk assessment does not slip into an audit by default, or become an opportunity for an extensive 'fishing expedition'. Advisers can usually help steer the path of a risk assessment and, if an audit is inevitable, make sure that this is opened and handled in the proper way.

*Care needs to be taken that the risk assessment does not slip into an audit by default*



*To set the base for such strategy, the likely outcomes for the audit process need to be clearly understood*

#### **Develop an audit strategy**

In addition to the practical management of the audit process discussed above, in terms of meetings with the tax authorities and the submission of requested information, an overall strategy for the audit needs to be developed. To set the base for such strategy, the likely outcomes for the audit process need to be clearly understood. If it is possible for the audit to be concluded with no adjustment, then the audit strategy is likely to be focused on educating the tax authorities about the reasonableness of the taxpayer's transfer pricing proactively, so that the examination team can reach their conclusion as quickly and efficiently as possible.

In contrast, if the taxpayer may anticipate that the ultimate conclusion of an audit will result in an adjustment regardless of how reasonable the taxpayer's tax or transfer pricing policies are (frequently the case in certain Asian countries). In this case the audit strategy is likely to be focused on identifying those issues that are non-negotiable from the taxpayer's perspective and those on which the taxpayer may be willing to compromise, with the ultimate aim of achieving the next best result to no assessment at all – that is, as small an assessment as possible. In a general tax audit, the taxpayer may have a number of issues upon which it is willing to make certain compromises. The taxpayer may be more willing, for example, to accept an adjustment on the reclassification of certain expenses as non-deductible than it may be willing to accept the examination team's selection of an alternative transfer pricing methodology or set of comparables leading to a higher range of possible transfer prices. In contrast, in a specialist transfer pricing audit, the list of technical issues may provide less room for such negotiation, unless the taxpayer has multiple intercompany transactions. Nevertheless, it may still be possible to negotiate in such cases, e.g. across taxable years rather than on the technical issues covered by the audit.

Once a taxpayer has identified its (non-) negotiable issues, the focus of the audit will be to direct the examination team's questions to those areas where the taxpayer can most comfortably agree to accept an assessment. This may be managed through the manner in which information is submitted, or in the drafting of the submitted data itself.

Some tax authorities have published deadlines for completing an audit. In the UK, for example, the typical time to complete a non-complex transfer pricing audit is 18 months, and the tax authority officials have to report to their management on their progress at regular intervals. This is often supported by an agreed plan drawn up by the taxpayer and the tax authority, setting out a detailed timetable of actions, specifying how the audit will proceed, when information requests will be made, at what date information will be provided, and when meetings will be held to review progress or reach a conclusion. This may well be a useful approach in other jurisdictions, as it shows a positive and willing approach by the taxpayer and helps to manage the progress of the audit. It is however important that the taxpayer shows its commitment to the plan and ensures that resources are made available to complete their side of the plan's steps on time. *If possible, negotiate a successful resolution of the audit.*

In those countries where an audit adjustment is inevitable, the taxpayer's attention will eventually turn to negotiating as successful a resolution of the audit as possible. Of all the stages in the audit process, and of all the practices discussed above, the process of negotiation is likely to be the most impacted by cultural differences among jurisdictions. As a result, this is the area most likely to be best handled by local management or experienced local advisors. Nevertheless, to ensure that the negotiation discussions operate as smoothly as possible, the global or regional tax/transfer pricing team must provide clear guidance and direction on what may and what may not be conceded, i.e. what the parameters of the negotiation are and what is considered to be a successful resolution of the matter. This process will be helped if the person conducting the negotiation has been involved in the entire audit process, and has full background on the life of the audit (e.g. what issues were not raised, what issues have been conceded by either the examination team or the taxpayer, etc.). For this reason, if third party advisors are to be involved in negotiation discussions at some stage, it is helpful if those advisors are involved in the audit from the start (even if they do not necessarily attend all meetings with the examination team) and are provided with timely updates of meetings, information submitted, etc.

A successful negotiated conclusion to an audit that satisfies both the examination team and the taxpayer is obviously the preferred outcome in most cases. Taxpayers should be wary, however, of making compromises to settle an audit unless they are clear about what the consequences of those compromises are on the settlement process. For example, to secure a lower assessment amount, a taxpayer may be pressured to give up its rights to legal appeal or mutual agreement procedures. Although certain taxpayers may accept a compromise in these circumstances if the resulting benefit in terms of reduced assessment amount is sufficiently large, it is important that the taxpayer understands clearly the implications arising from any compromises made on current and future audits and settlements. In such cases, an experienced advisor is invaluable for explaining the possible outcomes and implications of the final negotiated resolution.

There will often be cases which are very difficult to settle. This may be because both sides have taken positions on the audit that make it very hard for them to find a way to reach a satisfactory resolution. On other occasions a tax authority audit team may well continue to ask for more information without giving any clear idea of what their concerns are. In these situations, an advisor can often help to break the deadlock, by finding a way to bring a fresh look at the dispute, moving away from the detail and focusing instead on the principles involved and the bigger picture.

Finally, there may be cases where the examination team's position is completely untenable, yet they are unwilling to listen to any counter argument raised by the taxpayer. In such cases (and depending on the jurisdiction), there may be occasions when it is necessary for a taxpayer to raise its concerns to a higher level within the local tax authority, either to provoke a more reasonable response from the examination team (in many cases unlikely), or to place the tax authority on notice that the taxpayer feels strongly about the particular issue (and thus may be likely to pursue its remedies further). As this approach frequently has a negative impact on the relationship with the examination team, it is generally only used in the most severe cases; literally, cases where the audit position could not deteriorate much further. Moreover, understanding the structure of the local tax authorities and identifying the appropriate senior person to be approached are also key to obtaining benefit from such a strategy. Consequently, it is not recommended that a taxpayer adopt such approach without the benefit of consultation with experienced local advisors.

### **Lay the groundwork for post-assessment options**

During the course of an audit, it may become clear that the examination team is intent on making an audit assessment, and that such assessment is unlikely to be something to which the taxpayer can agree (e.g. a significant transfer pricing assessment that will have an impact on future as well as past years). In such cases, it is important that the taxpayer use the remaining time available in the audit to start setting the stage for a future appeal (whether administrative or judicial), or use of mutual agreement procedures. In many countries, unless information is submitted during the audit process, it cannot be submitted at any subsequent hearing. In other countries, despite whatever view the examination team have themselves taken on the taxpayer's transfer pricing, they are under an obligation to hand over any alternative written position submitted by the taxpayer when the case is referred for administrative appeals, court proceedings or mutual agreement procedures. Consequently, regardless of how futile the matter may seem in the face of an unyielding field examiner, it may be important for the taxpayer to prepare and submit a written submission paper outlining its position and the reasons for disagreeing with the position taken by the examination team.

In the case where an audit adjustment is going to produce a material instance of double taxation and the taxpayer is determined to use the mutual agreement procedure to try to resolve this, it may be possible in certain jurisdictions to get the competent authorities involved before the assessment is finally determined and possibly even before the audit is formally concluded. Again, this is an area where a local advisor will be able to share their experience and give a view on whether an early approach to the respective competent authorities might be appropriate.

Whatever the options available for post-assessment action, it is critical not to overlook possible time limits for action, especially if the audit is protracted and the years slip by. The importance of making early claims under the mutual agreement procedures, for example, cannot be over emphasised.

## **Conclusion**

Although it goes without saying that doing everything possible to prevent a transfer pricing audit from commencing is an important tax management tool and should not be disregarded, it is no longer enough to hope that by doing so a transfer pricing audit will not eventuate. Instead, it is also incumbent on the taxpayer to be aware of best practices for managing the audit itself, so that if an audit does begin, it is handled so as to achieve the best possible outcome for the taxpayer, bearing in mind that in many countries the best outcome is a relatively small audit adjustment (where the possibility of no adjustment being made at all is less likely).

Through the adoption of the best practices discussed above, it is hoped that taxpayers will be able to achieve this goal, while at the same time reducing the pressure on time and resources that the typical transfer pricing audit produces.



*To set the base for such strategy, the likely outcomes for the audit process need to be clearly understood*

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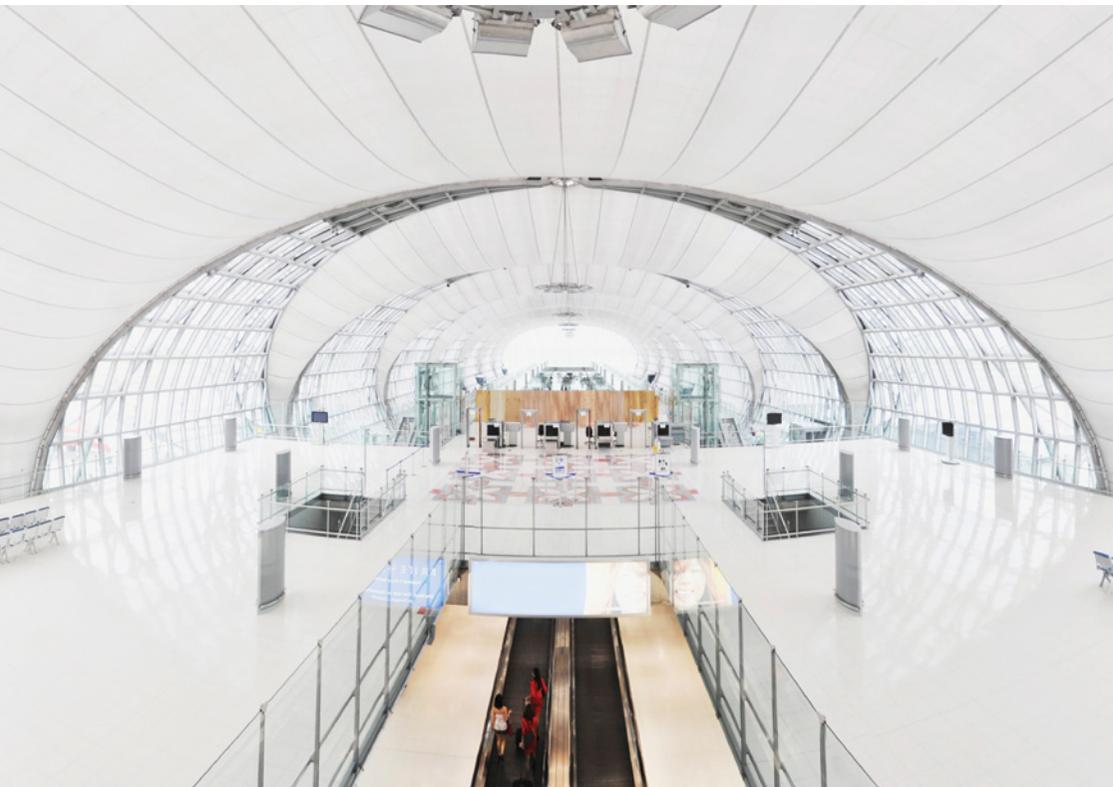
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## *Advance Pricing Agreements in the Asia Pacific*



The Asia Pacific (APAC) region is increasingly regarded by multinational corporations (MNCs) as the key driver for global growth and expansion. This has led to a surge in cross border transactions within APAC region and between the APAC region and the rest of the world. Furthermore, as corporate structures are less driven by geographies and more by other business drivers like product/business units, corporate structures are ever more crossing geographical regions and country boundaries. However, tax authorities are still, and will always be, dictated by national boundaries. As such, in recent years transfer pricing has become a central issue for MNCs and the relevant tax authorities. While the arm's length principle is followed by most tax authorities in the APAC region to evaluate inter-company transactions, different interpretations and emphasis may lead to different outcomes. Hence, tax authorities see transfer pricing as a soft target with the potential to produce a sizeable increase in tax revenue. This potentially results in economic double taxation and an increase in the effective tax rate of MNC

As MNCs look to Asia to drive their global revenue and profits, countries such as China and India are mindful of the importance of their markets and will seek to attribute more profits to their jurisdiction. As emerging markets, they will seek to challenge and to develop new and innovative means to achieve this outcome, for example, expansion of permanent establishment concepts and location savings. Revenue authorities in headquarter locations such as Singapore will also seek to build substance in their country and will zealously guard any attempt to allocate or transfer profits out through the use of purely tax driven structures to tax haven countries.

In order to manage the increasing uncertainty in transfer pricing across the APAC region and to strive for known tax treatment of complex business structures or changes, MNCs are once again looking to engage with tax authorities prospectively with the greater use of Advance Pricing Arrangements (APAs). APAs are binding advance agreements between the tax authorities and the taxpayers that set out the method for determining transfer pricing for specified inter-company transactions under specified conditions.

In the past, transfer pricing documentation provided MNCs with a front line of defence should the tax authorities come knocking on their doors. Increasing levels of scrutiny and disclosure requirements globally are now challenging MNCs to manage their tax risk more proactively. The ever evolving and increasingly complex tax environment and uncertain tax disclosure requirements, is forcing global tax directors to think beyond the traditional transfer pricing documentation and to consider how to manage their tax and transfer pricing risks with greater certainty.

Revenue authorities are increasingly focused on scrutinising operating structures perceived to lack “economic substance”, and the new chapter in Organisation for Economic Corporation and Development (OECD) guidelines for transfer pricing on business restructuring (Chapter IX) has given tax authorities clear guidelines on how to approach such issues. Tax authorities in the APAC region are applying these principles in testing whether MNCs are implementing business transactions which are operationally driven, not merely tax driven. Japan, China, and Singapore tax authorities have clearly stated these requirements in bilateral APA cases. In short, the message to MNCs is not to rely just on traditional transfer pricing documentation but also to ensure that there is evidence of the operational changes/benefit that underlie any tax benefits associated with business change. This is the test that tax authorities in these countries are using in negotiating APAs.

The remaining discussion in this article provides a snapshot of the APA developments in APAC countries where we assess the countries in terms of the complexity of their local transfer pricing environment and their relative experience on bilateral/multilateral APAs. The discussion also includes a statistical representation of the total bilateral/multilateral APAs concluded by the respective countries.<sup>1</sup>

*Revenue authorities are increasingly focused on scrutinising operating structures perceived to lack “economic substance”*

<sup>1</sup> Statistics provided up to 2009 based on information published by revenue authorities in the region.

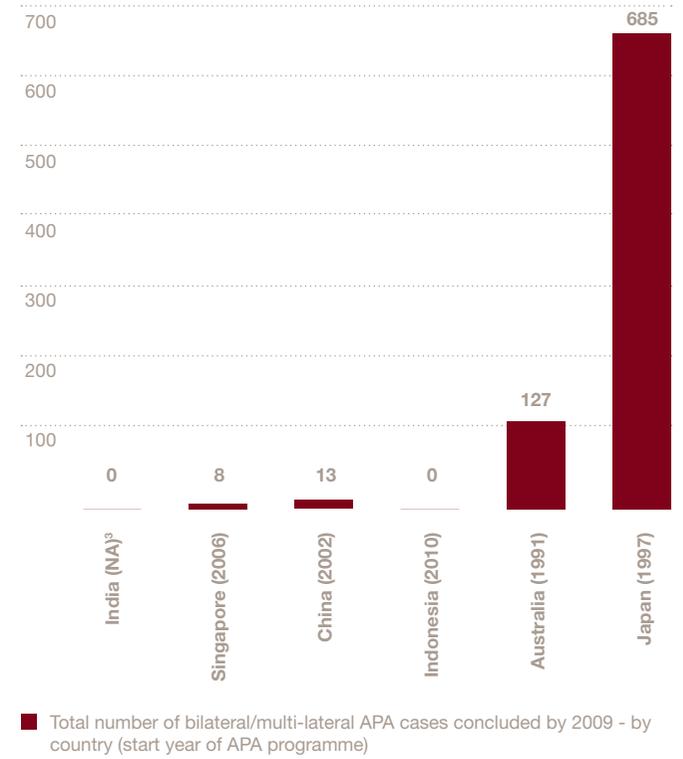
As can be observed from the diagram opposite tax authorities in the APAC region have varying degrees of experience in APA negotiations and outcomes. However, that does not necessarily coincide with the level of attention and scrutiny given to inter-company arrangements by the revenue authorities. This potentially presents a challenge to many MNCs considering APAs as a strategy to manage their tax risk in the APAC region.

Considering this snapshot of issues and the overview provided above of APAs in the APAC region, a number of questions may arise for MNCs. If a company has undertaken business restructuring for its APAC operations for example, how should APAs be utilised strategically to manage associated tax risks? What about MNCs who have not undertaken business restructuring but have a stable business and transfer pricing model though are prone to challenge by the tax authorities – is an APA an option for them? Would it mean that taxpayers in countries which have significant experience in negotiating bilateral APAs, will experience fewer issues when approaching the tax authorities for an APA? For countries that are still in the early stages of developing an APA programme, should taxpayers still be looking at APAs as a way to manage tax/transfer pricing risks? Fundamentally, given the disparity in the APA experience and approach of different APAC tax authorities, can tax directors in the region use APAs effectively as a cornerstone to support their transfer pricing policy?

There are no easy answers to the questions above. However, it is interesting to note that many MNCs have navigated the above challenges to their advantage to manage the risk proactively by strategically using the APA regime.

It is a known fact that many MNCs have set up regional headquarters or trading operations in Singapore and that income tax rates in Singapore are predominantly lower than the income tax rates of the majority of Singapore's primary trading partners. Despite this, the Inland Revenue Authority of Singapore (IRAS) is increasing its focus on transfer pricing issues. The treaty provisions and the domestic provisions enable the IRAS to accept requests from taxpayers to enter APAs. What does this mean for MNCs who use Singapore as regional headquarter location and in many cases restructure their business operations to use Singapore as a hub for inter-company trading activities?

**Figure 1**  
Overview of APAC APA landscape



<sup>2</sup>The statistics are based on certain published information and some other information which comes, to the best of our knowledge, from our interaction with the tax authorities.

<sup>3</sup> N.A. refers to not applicable.

As more transactions involve Singapore as a location for MNC headquarters or trading hubs, Singapore will increasingly be a party to issues of double taxation that may arise in the region. One strategy to manage this could be to use the Mutual Agreement Procedures (MAPs) in the event that the tax authorities of Singapore's trading partners attack such business restructuring. This may be a reactive approach to managing double taxation which does not provide upfront certainty to MNCs and their tax directors. In such cases, APAs could be used as an alternative or complimentary strategy to apply a proactive approach to seeking certainty and managing the transfer pricing risks associated with business restructuring. The attractiveness of APAs is also enhanced by the fact that IRAS has historically shown a willingness to adhere to the principles outlined in the Chapter IX of the OECD Guidelines, on business restructuring.

***As more transactions involve Singapore as a location for MNC headquarters or trading hubs, Singapore will increasingly be a party to issues of double taxation that may arise in the region***

MNCs could take advantage of the opportunity this presents to manage their transfer pricing risks and the potential for double taxation by opting for bilateral APAs with countries who also have experience in dealing with bilateral APAs, such as Japan or Australia. In these jurisdictions, the revenue authorities, in principle, both follow the guidance outlined in Chapter IX of the OECD Guidelines. MNCs may also consider using the bilateral APA mechanism as an option to resolve related tax issues such as exit taxes on conversion of the business models. In adopting this strategy, MNCs should equip themselves with robust transfer pricing and tax analysis if they are willing to use the APA mechanism to resolve potential issues.

While MNCs can consider applying for APAs to deal with a change in the business structure, APAs can also be used effectively to gain certainty on existing structures for future years where business and transfer pricing models are prone to challenge by tax authorities. In doing so, there is also a potential to resolve issues arising in years prior to the APA. The new APA programme introduced by the Australian Taxation Office under Practice Statement Law Administration 'PSLA 2011/1' earlier this year for example, indicates that such opportunities may be available to taxpayers, where the facts and circumstances are sufficiently similar, and therefore methods and outcomes agreed under an APA may be used to resolve issues arising in years prior to the APA. In fact, the newly released programme has reignited, with the encouragement of the Australian Taxation Office, the interest of Australian taxpayers in APAs as a potential solution to their transfer pricing and related tax challenges after a number of years of reduced confidence in the programme.

In spite of this, it is still challenging to negotiate a bilateral APA successfully without proper preparation and careful management of the discussions with tax authorities. As is the case for MNCs, tax authorities also need to commit significant resources to bilateral APA negotiations and accordingly, a commitment to provide adequate support and cooperation is required from the taxpayers.

Unfortunately bilateral APAs are not the answer to all transfer pricing concerns. Many MNCs who have tried to negotiate bilateral APAs in China have been frustrated by a long pipeline of APA applications for consideration by the Chinese Competent Authority (CA) due to the increased demand for APAs from Chinese taxpayers in recent years. The APA programme has long passed the "infant stage" and all the teething problems associated with that, and is rapidly growing in popularity. Therefore, the State Administration of Taxation (SAT) has become highly selective in accepting APA applications and taxpayers now need a creative and compelling strategy to give their case some priority.

Similarly, the National Tax Agency (NTA) in Japan also has a large inventory of bilateral APA cases, and the number of submissions annually continues to increase (partly due to increasing numbers of APA renewal applications). In order to address this increasing inventory, the NTA has implemented accelerated review of APA applications and, additionally, is reaching agreement on bilateral APAs with treaty partners in fewer meetings than historically.

Despite the increasing popularity in some countries in the region, there are still countries in APAC which do not provide formal APA guidelines or have as much experience in APA negotiations such as India and Indonesia. In these territories, a robust strategy to building the case before the tax authorities is imperative. India and Indonesia for example, are well-known to be aggressive on the audit front for transfer pricing matters. To the extent available, the APA mechanism would therefore provide an important avenue to taxpayers to manage their transfer pricing risks in these territories.

However, the formal APA regime in India is still being designed. The proposed draft Direct Tax Code which will replace the existing Income Tax Act (and is proposed to be effective from April, 2012), includes provisions for taxpayers to apply for an APA. The tax advisory community of which PwC has been at the forefront of discussions has been pushing the government to incorporate global best practices in drafting the APA rules. While the currently proposed draft legislation is silent on the matter, senior government officials have expressed a view that India may include a bilateral APA mechanism which would be welcomed by tax directors of MNCs operating in the region.

On the other hand, the Indonesia Directorate General of Taxes (DGT) released APA regulations in Indonesia on 31 December 2010, providing some guidance to taxpayers on the application of and process for APAs in Indonesia. Based on interactions with the Indonesia Taxation office (ITO) to date, it is clear that the ITO is keen to implement the APA mechanism and anticipates success from the process.

Based on this, it can be expected that given the increase in local transfer pricing disputes involving increasingly complex issues in the region, many MNCs will be considering adopting a proactive approach to managing their transfer pricing risk. In this increasingly complex environment with an intensified transfer pricing compliance focus by tax authorities, MNCs are wise to consider a strategic approach to managing their risks. As a key plank to these strategies, tax directors should consider using APAs as a way to seek certainty and reduce the risk of double taxation in the region.

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# Transfer pricing for financial transactions



## **Conceptualising the challenge**

Intra-group financial transactions, including related party loans, guarantees, cash pooling and other forms of financing, are increasingly receiving close attention from tax authorities around the world. There are four major reasons for this increased focus:

- The pricing of financing arrangements is complex and has been exacerbated by the financial crisis
- The amounts at stake can be significant
- There has been limited guidance from the Organisation of Economic Cooperation and Development (“OECD”), which has required taxpayers and local tax authorities to interpret best how the arm’s-length principle should be applied, often with differing outcomes
- These issues are being tested in the courts and recent decisions have required taxpayers to consider the impact of passive association when pricing financial transactions at arm’s length.

The onset of the financial crisis in 2007 resulted in a reduction in liquidity, a spike in both short-term and long-term funding costs, an increased requirement for parent companies to provide subsidiaries with guarantees in order to access third party bank funding, and increased corporate bond issuance to replace traditional bank funding. Changes in the availability, structure and cost of funding at both an industry-wide and group level has implications for internal financing arrangements for all types of MNCs. These arrangements are further complicated by the extent to which MNCs have branch and/or subsidiary structures, as tax rules in many countries often discriminate between these two forms when applying thin capitalisation rules and the arm’s-length principle to pricing financial transactions. This type of concern and the lack of OECD guidance are increasing tax risk for most multinational groups in this area of transfer pricing.

At the same time, the regulatory landscape has continued to evolve with increasing reporting and documentation requirements, stricter penalty and interest regimes as well as a higher visibility of transfer pricing to management through reserves for uncertain tax positions and losses incurred during the financial crisis.

## **Thin capitalisation and funding transactions: approaches across Asia**

In most jurisdictions, tax authorities focus both on the pricing of related party debt both as well as whether the quantum of the debt complies with the arm’s-length principle. This second test is known as thin capitalisation and it is utilised by tax authorities to limit tax deductions on excessive levels of debt. Often, there are different rules (normally more beneficial) for the amount of debt a financial institution is able to hold compared to companies operating in the non-FS sector.

Some countries adopt safe harbour rules in relation to the amount of debt a company may hold (e.g. debt-to-equity ratios) or the rate at which interest paid to related parties may be deducted (e.g. LIBOR caps). Increasingly, tax authorities without safe harbour rules are comparing the results under the safe harbour rules of other countries with levels that would be derived under an arm's-length debt test and taxpayers are expected to defend the difference. Conversely, for countries that have safe harbour rules, tax-payers may be looking to depart from these on the rate of interest paid in favour of the arm's-length principle as borrowing costs have significantly exceeded LIBOR base rates since the global financial crisis.

The thin capitalisation landscape across Asia is diverse but many tax authorities have paid attention to strengthening thin capitalisation regimes over recent years.

While Singapore does not have any specific thin capitalisation regulations, the transfer pricing and the anti-avoidance provisions contained in the domestic legislation may be invoked to challenge related party financing arrangements. In China however, since 2008, if an enterprise wants to claim a tax deduction for interest expenses in excess of the prescribed debt-to-equity ratio (which is 2:1 for non-financial and 5:1 for financial institutions), it can do so only to the extent that it has prepared thin capitalisation documentation to demonstrate that the amount, interest rate, term, financing terms, etc. conform to the arm's-length principle.

In Japan, in broad terms, the thin capitalisation rules set out that if the annual average balance of interest-bearing debt to a foreign controlling shareholder exceeds three times the capital contributed by the foreign controlling shareholder (or debt-to-equity ratio of a corporation with a similar type of business), the excess interest expense paid or payable to the foreign parent corporation is not deductible.

More recently, in June 2011, Taiwan issued new thin capitalisation rules applicable to non-financial institutions. The new release requires companies to disclose their debt-to-equity ratio with their tax return. Interest on debt exceeding the prescribed ratio (3:1) versus equity cannot be recognised as an expense and deducted in the tax computation.

Thin capitalisation regulations are yet to be introduced in India. The General Anti-Avoidance Rules, if finally enacted in the form in which it has been incorporated in the draft Direct Tax Code placed before the Parliament, would empower the tax authorities to recharacterise loans into equity (by introducing guidance on thin capitalisation), which the tax authorities were hitherto not authorised to do under the existing Indian TP Rules.

The Indian transfer pricing regulations, while being wide ranging, do not address specific positions and treatments on all types of transactions. The definition of international intra-group transactions includes the borrowing and lending of money and any transaction that has an effect on the profits, losses, incomes and assets of an enterprise. Accordingly, all kinds of financial transactions (e.g. loans, guarantees, cash pooling arrangements) would appear to be covered by the ambit of the transfer pricing regulations. However, there are no defined positions around the treatment of financial transactions from a transfer pricing perspective, unlike the position papers that have been issued by the Australian Tax Office (ATO). Accordingly, for financial transactions involving India, one would have to fall back on international principles that provide guidance around intra-group services and judicial precedents, both nationally and internationally.

During the course of recent transfer pricing audits, the Indian tax authorities have sought to challenge interest free loans, particularly in an outbound loan context. Adopting scientific approaches to credit rating and benchmarking is an increasing expectation of the Indian tax authorities from Indian tax-payers wishing to develop sustainable positions in the area of intra-group loans. Similarly, intra-group guarantees have also been a matter of intense discussion in India, necessitating a careful and detailed approach towards such arrangements.

In Australia, the ATO has recently issued final guidance on the interaction of transfer pricing and thin capitalisation. The tax ruling reiterates that transfer pricing rules apply first to determine an arm's-length interest rate for a related party loan, which is then applied to the actual amount of the debt. The thin capitalisation provisions then operate to determine the debt deductions based on prescribed ratios. Australian taxpayers (including branches) are generally restricted under Australia's thin capitalisation rules to 3:1 measured with reference to eligible assets net of eligible non-debt liabilities. All debt is included, whether from related or unrelated parties. It is also possible to rely on an 'arms-length debt' test to support a higher level of debt. Australian financial entities (including branches) are restricted to a 20:1 ratio measured in basically the same way but with concessions for on-lending and borrowing against cash and certain highly-rated assets (e.g. REPO securities, A-rated subordinated debt and BBB-rated senior debt).

While the thin capitalisation provisions continue to govern the actual amount of debt, in the ATO's view, the arm's-length interest rate must 'produce an outcome that makes commercial sense'.

### **Interest rates**

Local transfer pricing rules across Asia require that interest rates on intercompany loans should be consistent with the arm's-length principle. Typically, in order to determine the arm's-length rate on a related party loan, taxpayers need to go through the following steps:

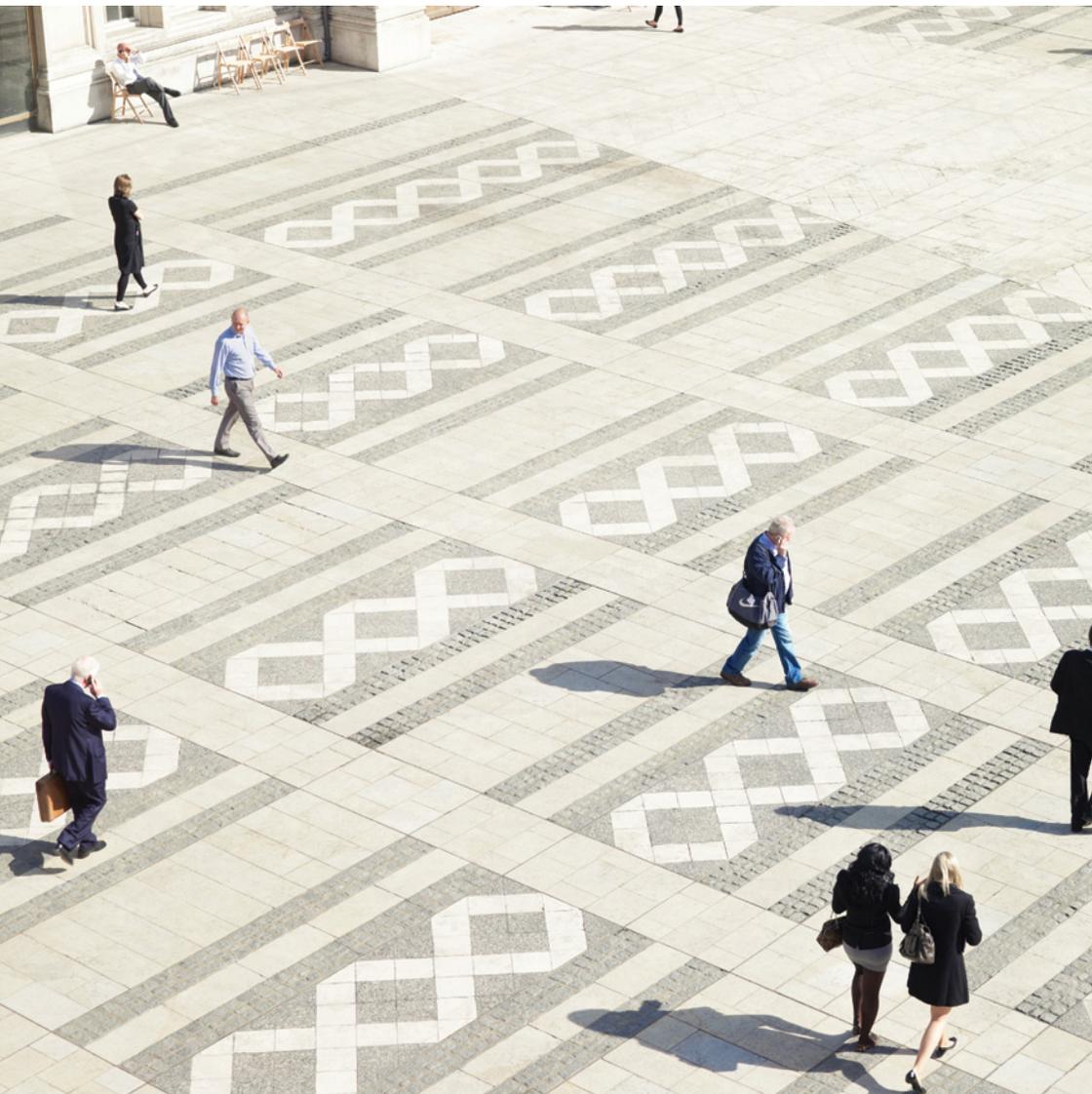
- Compare the loan parameters of the tested transaction to the loan parameters of transactions between third parties
- Assess the stand alone credit rating of the borrower
- Substantiate the economic rationale of the terms and conditions of the transaction
- Where there are no internal comparables, determine the price through a robust economic analysis and benchmarking of external comparable interest rates or credit spreads for the given credit rating of the borrower and the specific terms and conditions of the transaction
- Document the arrangement with transfer pricing documentation and retain agreements, calculations, etc
- Review and monitor the arrangement regularly (especially in case the transaction includes call or prepayment options).

Although this process appears straightforward, there is little guidance on how it should be applied in practice either from the OECD or from most local tax authorities.

### **Loan guarantees**

A loan guarantee is a binding arrangement where one party, the guarantor, assumes the debt obligation of a borrower in case of default. Many subsidiaries relying on local financing from third parties face demands for such guarantees. Where an explicit guarantee is made by the parent or another group company and the benefit of providing the guarantee (in terms of interest saved) can be clearly demonstrated, a guarantee fee should generally be charged for transfer pricing purposes. For branches however, it is generally not appropriate to charge a guarantee fee as, in accordance with the OECD Guidelines, a branch is deemed to have the same credit rating as its head office.

Local transfer pricing rules across Asia require that inter company guarantee fees should be set at levels that are consistent with the arm's-length principle.



In setting related party guarantee fees, taxpayers will need to consider the following key questions:

- Has an explicit guarantee been provided?
- What is the nature and background of the guarantee?
- Would a third party lend at all without a guarantee?
- Can the guarantor charge for it?
- What is the borrower's credit rating and borrowing ability without the guarantee?
- What is the interest benefit received by the borrower from the guarantee if compared to the interest rate that the borrower would have achieved without the guarantee?
- Based on a range of arm's-length prices, how would third parties split the benefit the guarantee creates and ultimately what is the appropriate guarantee fee?

One approach to setting guarantee fees is the interest saved approach. Under this approach, the difference between the interest rate charged on the guaranteed loan and the interest rate that the borrower would have paid on a standalone basis is the maximum guarantee fee that the guarantor could charge. This fee could be reduced so that both guarantor and borrower benefit from the arrangement. Another approach to setting a guarantee fee is to focus on the guarantor.

Theoretically, a guarantor would charge a price that reflects the probability of default, the expected loss in the event of default plus a certain profit element.

***Traditionally, many taxpayers have evaluated the credit rating of their subsidiaries on a standalone basis***

### **Passive association**

In performing a transfer pricing analysis of guarantee fee arrangements, explicit guarantees, as described in the previous section, should be differentiated from implicit guarantees, where only the behaviour of the parties suggests that a guarantee exists (e.g. a parent company providing financial assistance to a strategically important subsidiary). The OECD Guidelines state in paragraph 7.16 that “[...] an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member [...]”.

Traditionally, many taxpayers have evaluated the credit rating of their subsidiaries on a stand-alone basis (i.e. under the assumption that the borrower is an independent entity that is not related to the lender). This approach is arguably consistent with the separate entity approach formulated by the OECD in Article 9 of the OECD Model Tax Convention and referenced in the OECD Guidelines.

From a practical perspective, although the concept of passive association seems inconsistent with the arm’s-length principle, several tax authorities appear to have embraced the concept that the credit rating of the parent has a “halo-effect” on its subsidiaries.

The Canada Revenue Agency has attempted to argue in the context of pricing intra-group credit guarantee fees that a third-party lender would lend to a subsidiary of a major multinational group (or, more broadly, assume its credit risk) at a lower rate than that implied by a pure “stand-alone” result in light of its affiliation with its parent. Such a “passive association” argument raises several key issues, ranging from the empirical (to what extent do lenders account for group affiliation of subsidiaries that are not formally guaranteed by their parent) to the transfer pricing specific (such as whether a consideration of the potential links between a parent and its subsidiary are consistent with the arm’s-length principle).

On December 4, 2009, the Tax Court of Canada ruled in favour of General Electric Capital Canada Inc. and allowed the company to maintain deducted guarantee fees of CAD 136 million for financial guarantees provided by its US-based parent, observing that the 1% guarantee fee was equal to or below an arm’s-length price. The decision was later confirmed by the Federal Court of Appeal in December 2010.

Both Moody’s Investors Services and Standard and Poor’s provide some notching guidance on how to account for the “halo effect”. However, this adjustment still remains quite subjective and is treated differently by different tax authorities. Taxpayers will therefore need to balance carefully their intra-group financial transactions policy depending on the jurisdictions in which they operate.

### **The building blocks**

The building blocks for a defensible approach to financial transactions transfer pricing are:

### **The blueprint**

Stakeholders across tax, accounting/controlling, treasury and the CFO need to be involved in the process and their buy-in secured.

### **Building the policy**

The transfer pricing policy in this area should be flexible enough to balance the types of transactions and requirements of different countries with the magnitude and often large volume of transactions. The transfer pricing mechanism should be reviewed regularly to consider the impact of changes in the market, regulations or the underlying transactions.

### **Documentation**

Appropriate transfer pricing and commercial documentation (e.g. executed agreements specifying terms and conditions) supporting the arrangements, both at a headquarter and local level, should be maintained in case of a transfer pricing audit. Companies need to make a strategic decision on their documentation approach, ranging from a centralised 'masterfile' approach to local 'standalone' documentation which includes local agreements. The quantum of the transactions and associated tax risk should help inform this decision.

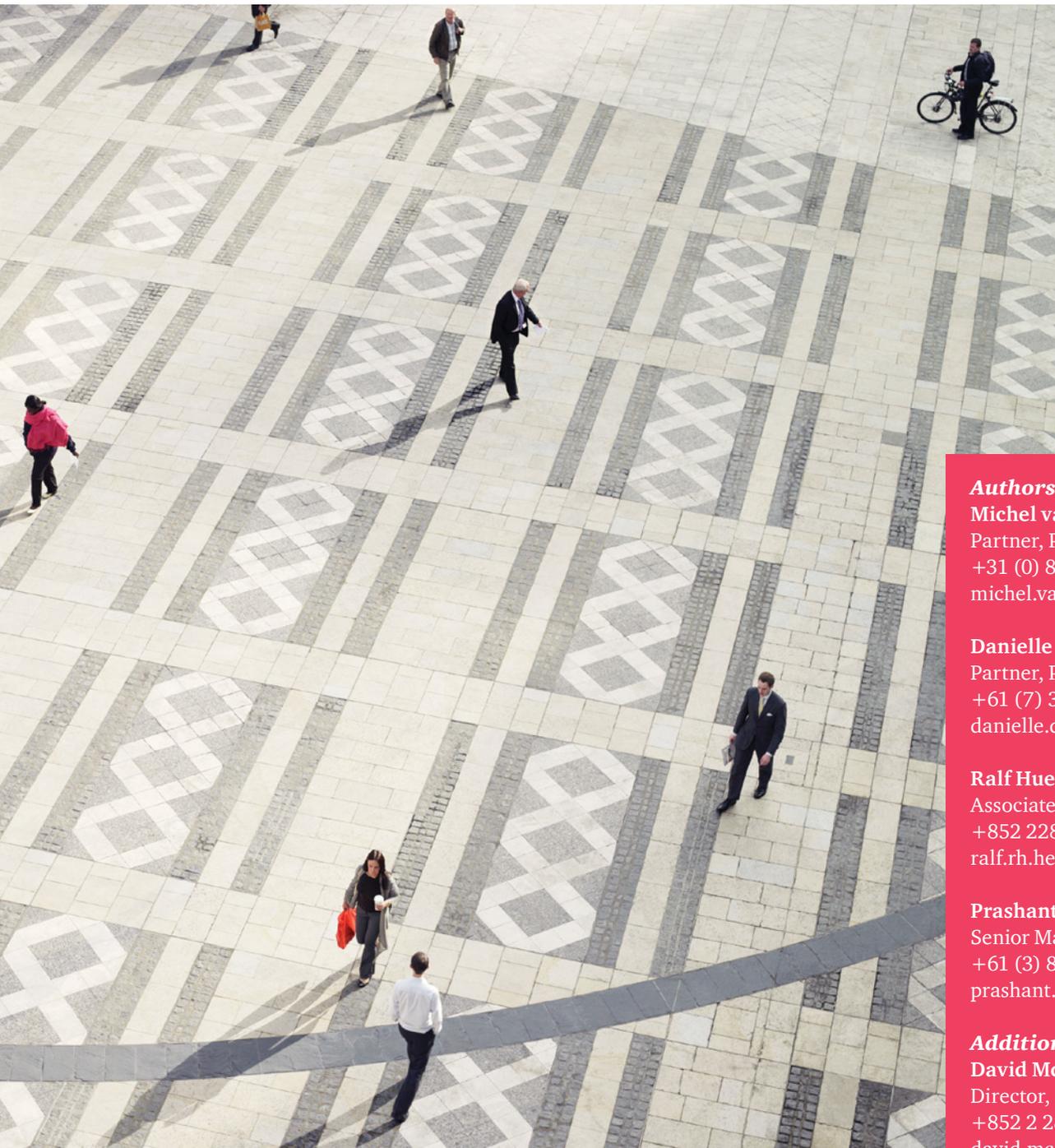
### **Defence under audit**

Controversy management requires key stakeholders to deal with the tax authorities and to give consistent messaging, supported through the provision of the 'right type and amount' of information. Taxpayers should know the options that are available to them and monitor regulatory developments and trends. Companies should reconcile the TP policy in place with the actual amounts that get booked in the accounts to ensure the policy is implemented appropriately and can be defended as such under an audit.

### **Advance Pricing Agreement**

Financial transactions do not traditionally feature in many APAs, however, taxpayers may want to reconsider this avenue as a way to eliminate or reduce tax risks surrounding financial transactions. The decision to do so should depend on the strategic importance and quantum of the transaction.

*Stakeholders across tax, accounting/controlling, treasury and the CFO need to be involved in the process and their buy-in secured*



### **Conclusions**

Transfer pricing for financial transactions is still evolving at the same time as it increases in prominence. Companies need to develop a strategy for dealing with the issues, documenting them and dealing with the transfer pricing audits that will inevitably arise in this area.

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## Case law developments: transfer pricing meets business reality



### **Let's talk business realities!**

While TP regulations were envisioned to be an anti-tax avoidance tool to curb shifting of profits, they have also caused uncertainty due to the evolving nature of the subject. As a result, TP has become one of the biggest tax issues being discussed in the boardrooms of MNCs.

The situation today is perhaps not just due to the tax authorities' approach to TP, but also due to complex business realities and innovative structures being adopted by MNCs to generate operational efficiencies in this competitive global market. Many MNCs now have a network of independent units that utilise their strategic attributes in a complementary fashion, which makes it imperative for MNCs to have a robust TP strategy that is grounded in commercial reality and economic substance.

While TP as a subject has been around for a while, one can say that with the increasing pace of globalisation, it still seems to be evolving, with principles and judicial precedents emerging in relation to the approach to be adopted in case of various business realities.

The above scenario is being analysed in light of some of the recent landmark TP court cases around the world.

### **Pharma trend-setters – holistic approach**

In the landmark case of *GlaxoSmithKline Inc. (Canada)*, the taxpayer imported Active Pharmaceutical Ingredients (APIs) from its associated enterprise (AE) and manufactured Finished Dosage Forms (FDF) of the product Zantac. As part of the arrangement to use the Zantac trademark, it was required to purchase the API from its AE. In the years in question, Zantac sold at a considerable premium to the generic versions of the product.

In the Tax Court of Canada, the Minister of National Revenue argued for the use of the external Comparable Uncontrolled Price (CUP) method, using prices of generic APIs purchased by generic competitors after undertaking appropriate adjustments. It was contended that business circumstances allowing Zantac to sell at a premium were not relevant. The product comparability was exact and the external business circumstances were ignored.

On the other hand, the taxpayer adopted the Resale Price Method (RPM) which was supported by transactions with unrelated licensees. These licensees obtained the API and the rights to sell under the Zantac name and earned gross margins similar to the taxpayer. The Tax Court preferred the CUP method.

On appeal, the taxpayer contended that business circumstances such as the use of the brand name must be considered and only in a fictitious world could a company buy the API at low generic prices and sell Zantac at a prevailing premium.

The Canadian Federal Court of Appeal found favour in the contentions of the taxpayer and acknowledged that the holistic approach towards the business environment needed to be considered and a single-dimensional approach was not appropriate. Recognising the intricacies of the business arrangement which involved a licensing arrangement for the use of brand name along with purchase of the APIs from the related party, the Federal Court of Appeal supported GSK's TP strategy.

In a similar case in India involving *Serdia Pharmaceuticals*, the issue revolved around preference for the CUP method over the Transactional Net Margin Method (TNMM) adopted by the taxpayer. Though the Indian Tribunal deliberated on the GlaxoSmithKline Canada ruling (as described above), the principles laid down in that case were not fully embraced primarily because the relevant arguments were not put forth by the taxpayer. In this case, the court ruled against the taxpayer and mentioned that the focus should be maintained on the specific international transaction rather than the overall business environment. Further, the Court upheld the preference for using a traditional transaction method, after making appropriate adjustments in order to account for transaction-related differences, rather than routinely relying on a transactional profit-based method. However, the Tribunal left a silver-lining in its ruling – while referencing the Canadian case, it mentioned that the business realities needed to be considered on a holistic basis and the future cases must be evaluated keeping in mind the commercial aspects and facts of those cases.

The lesson was well learnt and reflected in a subsequent ruling of the same Tribunal in another case, *Fulford India*, involving closely similar facts and issues. The principle of considering the macro picture and the economic characterisation of the transacting entity was favourably considered. This ruling merits significance because it appreciates that the CUP method could not be blindly applied for any and every import of generic APIs. One must consider the functional, asset and risk (FAR) profile or characterisation of the secondary manufacturer, which the Tribunal found to be a value-added distributor in this case. It was thus entitled to profits commensurate to its FAR profile, instead of premium or entrepreneurial profits, which the tax authorities sought to attribute by applying the CUP method.

### ***Substance is the essence***

The experience from the United Kingdom further emphasises the fundamentals of transfer pricing as it underscores the need for looking at the larger picture rather than adopting a myopic approach. In the case of *DSG Retail*, the taxpayer adopted a structure that interposed transactions with an unrelated entity in between its AEs, attempting to avoid triggering the transfer pricing regulations. However, the taxpayer failed to demonstrate the uncontrolled nature of the transaction in substance, despite an unrelated party being involved.

A key element in the dispute was whether an aggregated approach towards transactions undertaken by multiple entities, as argued by the UK tax authorities, or an isolated approach looking at individual transactions, as employed by the taxpayer, would be appropriate. The case was settled in favour of the tax authorities, with the tribunal ruling against attempts to arrange operations artificially; instead one must consider the commercial and economic substance in the operational structure.

There is an evolving consensus across the globe that the TP audits should acknowledge broader business dynamics and market realities faced by the MNEs, at the same time considering the principle of substance and significant people functions.

### ***Direct methods most likely to stand test of time***

MNCs are effectively compelled to respond to the challenging business environment by using intricate business strategies including (amongst others):

- market positioning through brand names
- adopting penetrative pricing for gaining entry into a new geographical market
- importing goods instead of localisation in initial years
- incurring start-up losses.

In today's global scenario, a substantial component of this response would involve developing an effective TP policy that would address the position adopted through the business strategy. The TP policy would be based on, amongst other things, the characterisation of the transacting entities, objectives of the taxpayer and the contractual relationship of the taxpayer with its AEs.

Let's look at the recent Court case of *SNF Australia*, where the taxpayer was primarily a distributor of unbranded chemicals, which were sourced from its AE located in France. The taxpayer adopted a penetrative pricing strategy to gain market entry and presence in the Australian region. It could purchase the products from its AE at a relatively lower cost as compared to third parties. SNF Australia established the arm's-length principle by adopting an internal CUP based on the fact that the AE in France sold similar products to third party distributors situated in different countries at higher prices as compared to the supplies made to the taxpayer in Australia.

Since SNF Australia had consistently incurred losses over an extended period (over 10 years), the Australian Taxation Office (ATO) challenged the taxpayer's contention that the internal CUP was an arm's-length price in these circumstances. The ATO adopted the TNMM arguing the losses incurred were the result of non-arm's length pricing. The Australian Federal Court held that the taxpayer had appropriately identified an arm's-length price as required by Australia's transfer pricing legislation and interestingly, commented that the standard of comparability the ATO expects from taxpayers was unrealistic and beyond that set out in OECD guidance. This result brings into question the efficacy of Australia's transfer pricing rules and the ATO's approach to transfer pricing generally. It is likely the ATO will seek to rewrite Australia's transfer pricing legislation.

The appropriateness of using a traditional transaction method over a transactional profit method was also supported by the American Tax Court in the case of *Veritas* (USA). This case involved a transfer of technology intangibles from the US-based taxpayer to its AE in Ireland. The Internal Revenue Service (IRS) argued that the technology intangibles had a perpetual life and, hence, valued them using a Discounted Cash Flow (DCF) method based on all the residual profit expected to be generated by the Irish AE in the future. The IRS rejected the taxpayer's Comparable Uncontrolled Transaction (CUT) method, which compared the amount charged to the Irish AE with the royalties charged in the taxpayer's agreements with third party licensees. However, the American Tax Court found the IRS to be unreasonable in attributing all future residual profit to the transferred technology. The Court recognised the business reality that future profits were attributable in large part to the development efforts funded by the AE after the transfer. The Court allowed the plea of the taxpayer and accepted the CUT method of establishing arm's-length price.

Once again, the key take away from this case is to document the use and basis of a traditional transaction method robustly, especially the CUP method, if it is available given the facts of the case.

### ***Staying Ahead***

The emerging premise from the cases discussed above is that of incorporating business realities into the transfer pricing strategy and approach adopted by both the taxpayers and the revenue authorities. The business environment surrounding an MNE and its response of using specific strategies to adapt cannot be isolated from the overall profitability and pricing of transactions between group entities.

Whether it is robust documentation of operations, or the choice of the most appropriate method, the taxpayer would do well to understand and proactively outline arguments that align with the business realities in which it operates.

There is a growing acceptance as well among the revenue authorities across the globe that TP principles must reflect the business circumstances faced by MNCs. By emulating the fundamental principles and best practices in TP, one can happily marry the overall global tax strategy with business realities in this uncertain world of transfer pricing.

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## *OECD: where to from now?*



Following the completion of the revisions of Chapters I-III and the new Chapter IX, the OECD has decided to embark on two new transfer pricing projects: a review of administrative aspects of transfer pricing, and an ambitious project on transfer pricing and intangibles. The transfer pricing and intangibles project has already generated a significant amount of interest from the business community. Furthermore, other organisations, such as the United Nations, are also undertaking transfer pricing-related initiatives, which the OECD will certainly keep track of in the coming years. There is no doubt that exciting times lie ahead for the OECD.

### ***Administrative aspects of transfer pricing***

On March 9, 2011 the OECD released an invitation for comments associated with the administrative aspects of transfer pricing. The work is regarded as important in order to strike a balance between the development of sophisticated guidance for complex transactions, and the cost-effective use of taxpayer and tax administration resources.

The OECD is currently being encouraged to consider a variety of tools to help facilitate the administrative aspects of transfer pricing, including for example, safe harbours, risk assessment, operational guidance, and the use of APAs, to name a few.

Also note that in April 2011, the UK HM Revenue & Customs announced it had agreed to take the lead on preparing a survey into the practicality of global transfer pricing guidelines (relating to the OECD Forum on Tax Administration), which will also consider issues connected to the OECD's project.

The OECD did not encourage the use of safe harbours in the past, out of fear that such rules could negatively impact the subsequent mutual agreement process, and increase the risk of double taxation. However, implementation of certain safe harbour rules for low value services could potentially help relieve some administration costs (both for tax administrations and taxpayers), without necessarily having a material impact on a jurisdiction's taxable income. The OECD's concerns associated with the resulting mutual agreement process could also be alleviated by making it explicit that the mutual agreement procedures take priority of safe harbour rules.

The OECD is also being encouraged to take a closer look at risk assessments, and develop guidance on risk assessments for member states. This is to avoid situations where both tax administration and taxpayer engage in lengthy and costly audits for what should be considered to be low risk or immaterial transactions. Greater openness and transparency associated with the triggers of an audit, as well as the scoping of the agenda, could also lead to improvements. It could, for example, be helpful to see the fact-finding process being elaborated in advance and including an analysis on which documents will need to be requested. Subsequent treatment by trained transfer pricing officials is then also a key success factor, as it would ensure that tax administration resources become focused on the important issues.

Operational guidance as an effective tool will also hopefully be considered by the OECD. Transparency, effectively achieved by the publication of operational guidance can drive cooperation. Annual APA reports, training materials and announcement of transfer pricing enforcement plans, such as those including an outline of the industries that are likely to receive increased attention, are welcomed.

Additional operational guidance would be particularly welcome in the area of comparables and data used for benchmarking purposes, especially in the absence of local comparables. Guidance – with respect to the use of multiple-year data – may also be helpful.

Another tool that can help alleviate some administrative aspects associated with transfer pricing is the greater use of APAs. Although several OECD countries do have APA programmes, many are under-staffed, making the process extremely lengthy. Dedicating more resources to APA programmes would allow tax administrations to deal with potentially complex transactions in a more open and cooperative environment, in the long run freeing up resources that can be dedicated to less-cooperative taxpayers.

Similarly, the OECD is also encouraged to think about a broadening of the combination of APAs with rollbacks as well as an effective use of mandatory arbitration (Art 25(5) OECD Model Tax Convention, with an ever-growing group of countries including this possibility in their bilateral treaties.

***Operational guidance as an effective tool will also hopefully be considered by the OECD***



Finally, another concern raised relates to delays and maintaining momentum throughout audits. Some of the information requested is not readily available or cannot be obtained, or if obtained, needs to be translated from English into a local language. These challenges could be overcome by scoping the audit intelligently so that both tax administrations and taxpayers know ‘what’s on and what’s off the table’.

It is not clear at this stage how far the OECD is willing to go in providing guidance on administrative aspects of transfer pricing. However it is no doubt a positive sign that the OECD, through the initiation of this project, appears to acknowledge that there is room for improvement in the administrative aspects of transfer pricing.

### ***Transfer pricing and intangibles***

The OECD announced in July 2010 that its next ambitious project would be a review of the guidance on the transfer pricing aspects of intangibles, and in particular Chapters VI and VIII. Working Party 6 (WP6) is working hard on this project, and has already been very active in seeking input from businesses at an early stage.

The OECD’s work in transfer pricing aspects of intangibles can, to a large extent, be broken down to the following three questions:

- What is an intangible?
- Who owns the intangible?
- How should the value of the intangible be determined?

Some particular challenges associated with the first two questions are discussed below.

### **Definition of intangibles**

Definitional issues relating to intangibles are nothing new to the OECD. Recall (during revisions to Chapters I-III) the struggle encountered when trying to find the right terminology to describe that “special” thing that should give rise to a profit-split method (non-benchmarkable, unique, non-routine, etc). Chapter IX also makes reference to “something of value” which is not explained in great detail in the revised OECD Guidelines.

In a scoping document released in January 2011, the OECD indicated that relevant factors to consider when determining whether or not an intangible is used or transferred includes, amongst other things, the ability to produce future economic benefits to a business activity, the availability of legal protection and whether a specific intangible can carry value if it cannot be transferred in isolation.

Of particular interest is the last factor – whether a specific intangible can carry value if it cannot be transferred in isolation. This, to a large extent, introduces the challenges associated with so-called “soft intangibles”. Typical “soft intangible” examples include workforce in place, network intangibles, goodwill and business opportunities (to name a few).

What will be particularly interesting is whether WP6 will be able to avoid revisiting some of the difficult challenges encountered during Chap I-III and Chap IX. Suppose the OECD concludes that a “soft intangible” has been transferred and does constitute an intangible that should be compensated for tax purposes. Does this imply that sufficiently detailed comparable data will need to be available to distinguish between returns when “soft intangibles” are present and when they are not? And would this imply that a profit split method should have been applied before the “soft intangible” was actually transferred?

Bearing in mind the challenges posed by trying to find a consensual definition of intangibles, in recent communications the OECD has made clear that although the definitional issues regarding intangibles are still an important part of the project, the focus of the OECD is shifting towards providing guidance on whether a transfer has occurred and the corresponding pricing or valuation of those intangibles that have been transferred.

### Who owns the intangible?

Another equally challenging issue is determining who should, in fact, own the intangible. Despite the fact that a legally protected intangible is, according to the OECD, also considered an intangible for transfer pricing purposes, the January 2011 scoping document specifically mentions that, in the context of transfer pricing concepts, “economic ownership”, “beneficial ownership” and “functional ownership” are also relevant.

There is currently no guidance in the OECD Guidelines on the role of legal ownership or on determining ownership of intangibles that are not legally protected. Moreover, the OECD currently does not clearly advocate either legal or economic ownership as the basis for determining the appropriate owner of the asset.

A strict reading of the current version of Chapter IX of the OECD Guidelines as well as recent discussions by the OECD about this matter seems to indicate that legal ownership is just the starting point. The owner, for transfer pricing purposes, could be considered to be the party that has incurred the costs of developing the intangible and that will be able to share in the potential benefits from those investments. A typical example where this issue arises is in the context of marketing intangibles, where determining which level of licensee’s marketing costs would render an intangible fully or partially owned by the licensee is far from certain.

However, as mentioned above, the OECD seems more focused on issues surrounding the valuation and whether intangibles have been transferred.

One can hope that the OECD will be able to establish some factors that can be used when determining which entity or entities are the owners of the intangibles, even though this will be no easy task.

One of the particularly interesting ownership issues relates to unique and high-value services. The WP6 provide a good example of this issue in the January 2011 scoping document when they raise the question of whether it is appropriate to compensate a service provider with a cost-plus fee, if the service provider is providing services that are unique and carry high-added value.

This really hits the heart of the matter – specifically whether incurring the financial risk of developing the intangible is sufficient to be the sole owner of the intangible, or whether in some circumstances it is also necessary to have a functional role in developing the asset.

The above are simply examples associated with some of the challenges WP6 will need to deal with in the future, and there are by all means countless other examples of difficult issues that WP6 will need to attempt to deal with over the course of this ambitious project. It will be interesting to see how far WP6 is willing to go, and whether it will be ultimately forced to revisit some of the issues discussed in previous projects.

### ***Transfer Pricing developments in the United Nations***

The United Nations recently began drafting a practical manual on transfer pricing for developing countries, and released five draft chapters during the autumn of 2010. This project is starting to draw a significant amount of interest, as it is the first time that non-OECD member states are engaged in developing some form of guidance relating to transfer pricing (and not merely observers).

This subcommittee on transfer pricing was established in 2009, and is comprised of both OECD and non-OECD member states. As implied by the title of the project, it is intended to provide transfer pricing guidance specifically for developing countries.

Although the current draft chapters seem to address a range of different aspects in connection with transfer pricing, there are what can be interpreted as some subtle contradictions to some of the text in the OECD's Transfer Pricing Guidelines, and this gives rise to some concern. For example, a number of remarks in the existing draft chapters of the manual appear to imply a broader use of the profit split method than what can be interpreted in the existing OECD Guidelines.

The OECD is, in all likelihood, monitoring the United Nations developments closely, as any explicit or direct contradictions between the existing OECD Guidelines and the manual will give rise to some serious concerns for OECD member states. However, given that the manual is still far from complete, it is too early to tell what impact the United Nations' transfer pricing work will have on the OECD.

### ***Conclusion***

As a result of the various OECD initiatives, and the current United Nations work, it will be interesting to monitor the OECD developments in the coming years, both in terms of how much detailed guidance the OECD can provide relating to the intangibles project, but also the OECD's reaction to the manual prepared by the United Nations once complete. These developments could have a material impact on the way we do transfer pricing in future years.

*It will be interesting to monitor the OECD developments in the coming years*

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