

Transfer Pricing and Substance Requirements

March 2018

Agenda



- **Introduction**
- **BEPS Actions 8-10**
 - *Risk analysis*
 - *Intangibles*
 - *Low value added services*
 - *Commodities*
 - *Profit splits*
- **BEPS Action 13**
- **BEPS actions in practice: AM structures**

Introduction: The changing landscape

Drivers



- **BEPS:** Actions 8-10, Action 13
- **Brexit:** Access to clients/regulatory regimes
- **Jersey substance requirements**

Impact



- Changes to group structure, operating model, functionality, reporting obligations
- Requirement to re-visit, and opportunity to optimise, transfer pricing in light of business change
- Consider location of value drivers and ensure profit aligned with substance/people
- Need to adhere to new documentation requirements
- Need for consistent representation of business (website, marketing materials, email correspondence, transfer pricing documentation, regulatory submissions)



Jersey substance requirements

In order to secure its continued status as a cooperative jurisdiction, Jersey has made a written commitment to address concerns identified by the Code of Conduct Group, by the end of next year. These concerns specifically relate to a perceived lack of legal substance requirements that could lead to profits being registered in Jersey that do not demonstrate real economic activity.

The Chief Minister confirmed “I am pleased that Jersey has been rightly acknowledged for its cooperation in international tax transparency and compliance with BEPS requirements. We have committed to working with the Code Group on their concerns over economic substance and they have fully accepted that commitment. I look forward to entering into substantive dialogue in the New Year.

“Our discussions may include creating enhanced reporting obligations or changes to our legislation on economic substance. We have already begun the necessary preparations, having regard to the Code Group requirements and Jersey’s best interests. I am committed to ensuring that, working with the finance industry, this process will be completed by the end of 2018.”

BEPS actions 8-10

Risk analysis

Intangibles

Low value added services

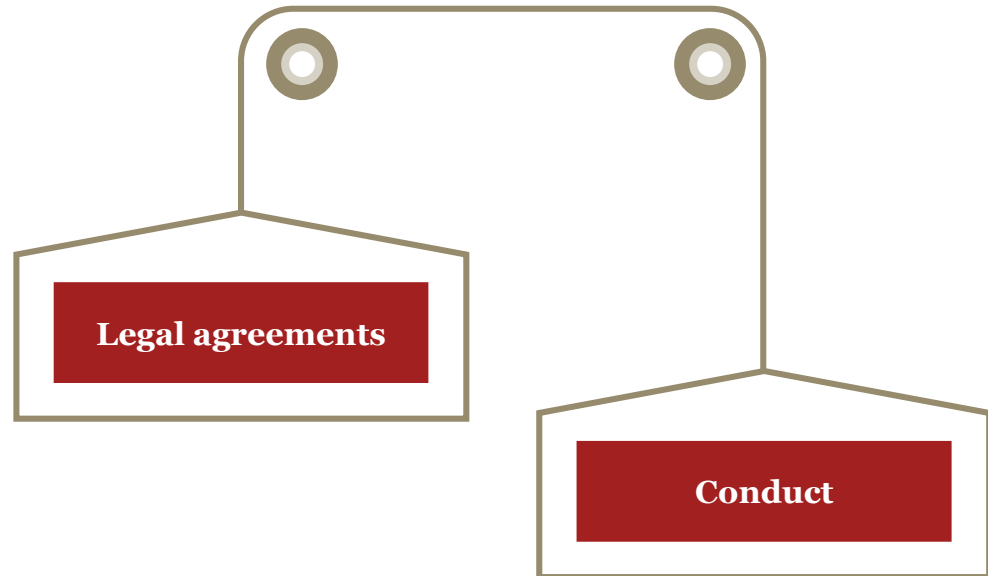
Commodities

Profit splits

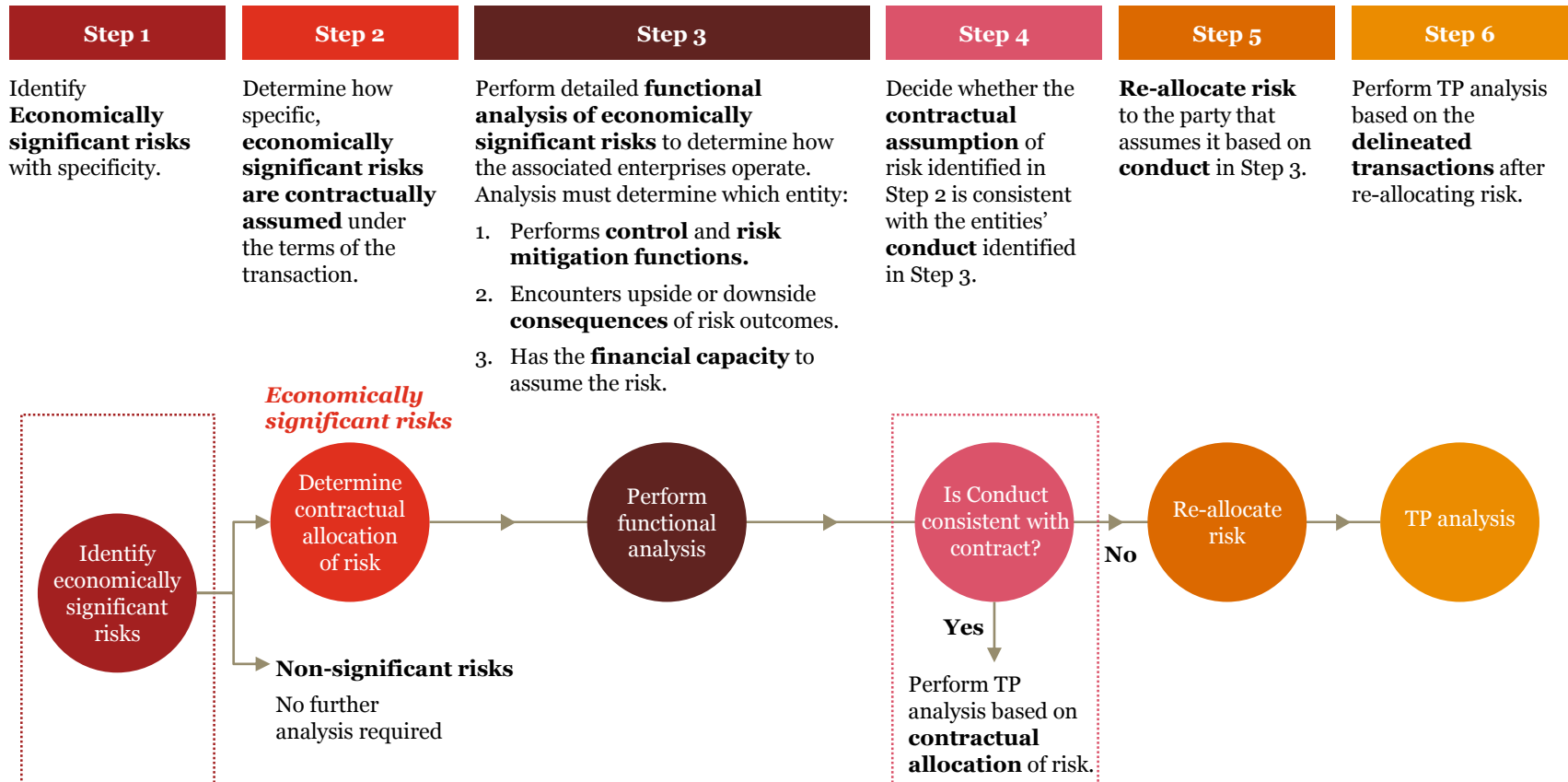
Risk analysis: Overview of BEPS guidance

Final BEPS guidance on Risk – The highlights

- A six-step process for identifying and analysing risk
- Examining contractual terms and conduct of the parties (conduct prevails over contracts if there is misalignment between the two)
- Assumption of risk meant as ‘control over risk’ and ‘financial capacity to assume risk’
- In cases where risks are funded by an entity with no ability to evidence control, then returns should be limited to a risk free rate
- Recharacterisation still a last resort option for transactions that are not commercially rational



Risk analysis: Post BEPS risk framework



Two key judgements in process:

1 How do you distinguish between Economically significant/non-significant risks?

2 Is Conduct consistent with the Contract? Fundamentally this will be based on an analysis of 'Control over risk'

Risk analysis: Meaning of 'Control' over risks

3 Elements of risk management

1 Take on, lay off or decline risk bearing opportunity

2 Responding to risks associated with the opportunity

3 Mitigating risk

'Control' is where there is

Capability to make decisions and actual performance of decision making functions

Capability to make decisions and actual performance of decision making functions

Performance of (or oversight of parties performing) day to day risk mitigation

Conditions required to evidence control

Decision makers should:

- Understand the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business
- Have the competence and experience in the area of the particular risk and have an understanding of the impact on the business
- Have access to relevant information either by gathering the information themselves or through sub-contractors

Two scenarios where risk management may be outsourced without loss of control: i) information gathering; and ii) day to day risk mitigation. In such cases risk owner must:

- Determine the objectives of the outsourced activities
- Hire the sub-contractor
- Assess if objectives are met
- Decide to adapt or terminate the contract

Items which are not sufficient to evidence control

Formalising the outcome of the decision making process in the form of:

- Meetings organised for formal approval of decisions made elsewhere
- Minutes of board meetings;
- Signing of documents relating to the decision

Setting the overall policy environment at a group level (e.g. general parameter setting by a group board or executive committee does not generally constitute decision making with respect to the specific risks arising from a transaction as it is the individuals that make the decisions to take on, lay off, decline, or mitigate specific risks that is relevant).

Risk analysis: People substance

- Important/significant people to be present on the ground to carry out the risk assessment, mitigation and monitoring functions as part of assuming the risks.
- Three levels of people are required to manage risk:
 - **Level 1:** Strategic activities such as strategy setting, key decision making and high level risk management (e.g. Board members, Chief Investment Officer, etc.).
 - **Level 2:** Operational activities such as daily operations, controls, and day-to-day risk management (e.g. additional investment managers/ advisors or sub managers/ advisors, etc.).
 - **Level 3:** Administrative and support functions, such as HR, Accounting, Internal Audit and Finance (may be outsourced within the group).
- People substance is expected in many aspects of TP e.g. Functional Analysis, Intangibles, Risk.



Risk analysis: Risk substance

- Revised approach to risk – Based on ‘**control**’ and ‘**capacity**’
- Is the contractual allocation of risks under intercompany agreements aligned with the conduct and other facts of the transaction?
 - Does the relevant entity
 - Exercise control (i.e. take/decline risk, have the capabilities, knowledge and expertise to properly assess such risk, be able to respond to risk, undertakes risk mitigation); and
 - Have the financial capacity to bear the insurance risk (i.e. access to funding when managing risk, and absorbing the consequences of risk if risk materialises)?
- Focus on the decision-making **process**
 - Formalising decisions in a Board meeting with minutes and signing of documents does not constitute exercising control
 - Fly in, fly out board meetings will not be sufficient to evidence control over the management of risk
 - Risk mitigation and data gathering may be outsourced
 - Risk bearing entity must set the objectives of outsourced work and monitor the service provider
 - On-going monitoring of service providers will need to be evidenced



Intangibles: BEPS actions 8-10

Aims:



Intangibles: MF and LF requirements

Masterfile

Master file requirements	Historic OECD TP documentation	Master file
MNE's intangibles		
Ownership, use and location and strategy for development	Limited to relevant transactions	✓
Transfer pricing policies related to R&D and intangibles	If applicable	✓
Transfers of intangibles among associated enterprises	✗	✓

Local file

Master file requirements	Historic OECD TP documentation	Local file
Local entity		
Business restructurings or transfers of assets (especially intangibles)	If applicable	✓

Intangibles: Definition

“ Something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances ”

- Marketing vs. trade
- Unique and valuable

Intangibles

- Patents
- Know-how and trade secrets
- Trademarks, trade names and brands
- Rights under contracts and government licences
- Licenses and similar limited rights in IP
- Goodwill?

Not intangibles

- Group synergies
- Market specific characteristics
- Assembled workforce
- Goodwill?

Intangibles: Key definitional aspects

Group synergies

Remuneration only appropriate where there is 'deliberate concerted group action' providing material advantages. Benefits should be allocated based on contribution towards creation of the synergy.

Assembled workforce

Transfers/secondments shouldn't necessarily require separate compensation, though any associated know-how and time and expense savings (or any detrimental effects) should be reflected in the arm's length price.

Location savings

Not an intangible, but pricing where they exist and are not passed on to customers or suppliers should be based on comparable entities and transactions in the local market. Where such comparables cannot be identified, comparability adjustments may be required.

Group name

In general no payment should be made merely for use of group name. Any consideration paid should reflect the functions, assets and risks borne by the user of the name in enhancing the value of the name in its jurisdiction.

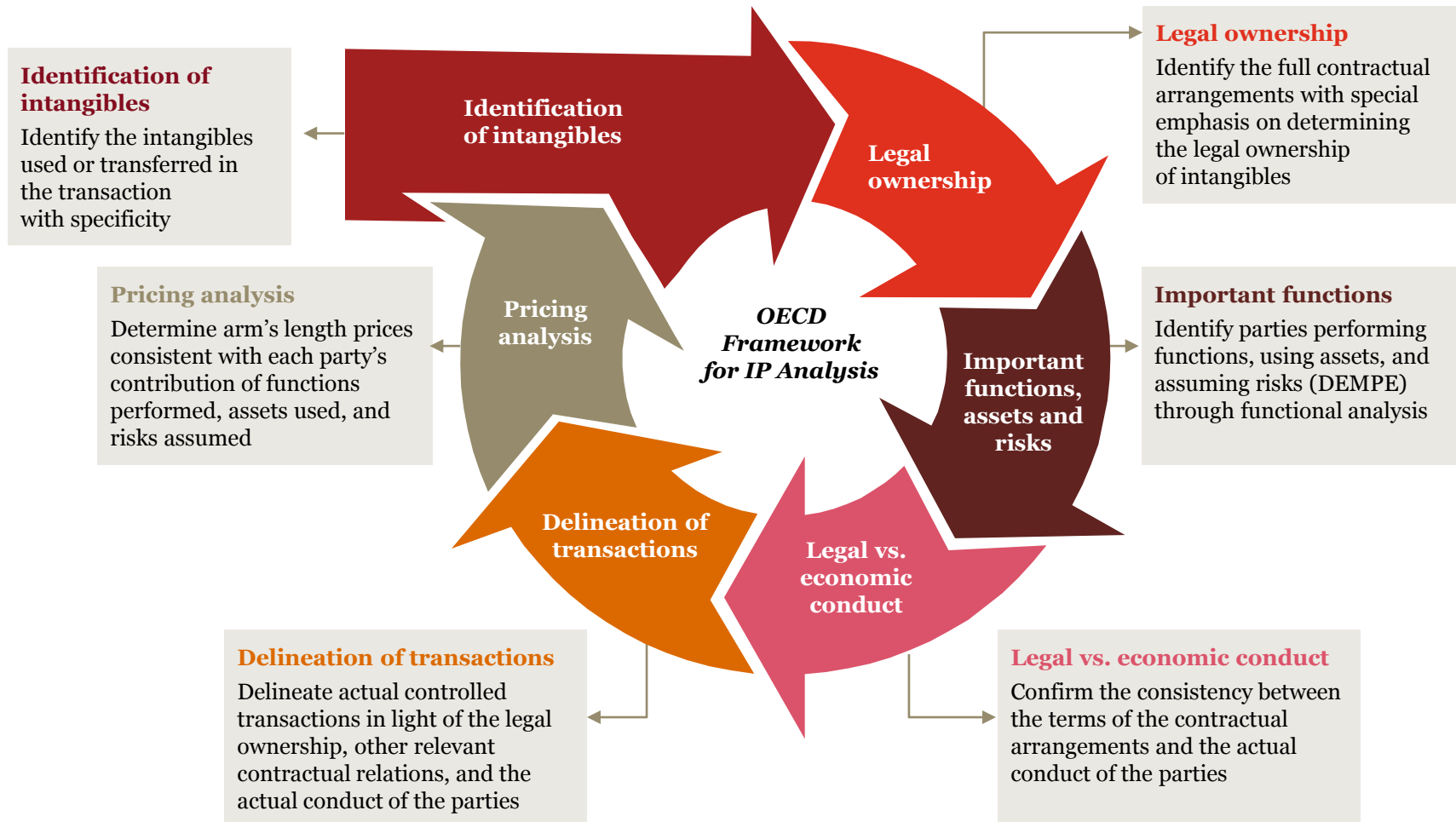
Brand

Can represent a single intangible or a combination of intangibles (i.e. broader than trademarks or trade names).

Goodwill

It is important to recognise, that part of the compensation paid between third parties when some or all of the assets of a business are transferred may represent compensation for goodwill.

Intangibles: IP analysis framework



Intangibles: Functional analysis – DEMPE

DEMPE	Defined	Example
Development	The origination and evolution of IP	R&D
Enhancement	The improvement and/or advancement of already existing IP	Clinical trials
Maintenance	The preservation of IP (typically involves navigating passive obstacles such as regulations and registration requirements)	Quality Compliance
Protection	Defending IP against challenges (typically involves shielding against external threats such as lawsuits or patent challenges)	Legal
Exploitation:	Making use of and monetising IP	Strategy Marketing Commercial

Intangibles: Functional analysis

Self developed intangibles

Important functions for self developed intangibles

- Design and control of research and marketing programmes
- Direction of and establishing priorities for creative undertakings including determining the course of 'blue-sky' research
- Control over strategic decision regarding intangible development
- Management and control of budgets

Important functions for all intangibles

- Important decisions regarding defence and protection
- Ongoing quality control over delegated functions

All intangibles

Low Value-Adding Intra-group Services

- **Application of the benefits test**
- **Determination of cost pools**
 - Calculation, on an annual basis, a pool of all costs with respect to relevant services.
 - Remove from the pool those costs that are attributable to services performed by one Group member solely on behalf of one other Group member.
- **Allocation of low value-adding service costs**
 - The choice of appropriate allocation key for each category of services and the calculation of costs for each Group member.
- **Profit mark-up**
 - A single mark-up (5%) will be utilised for all low value-adding services irrespective of the categories of services.
- **Charge for low value-adding services**
 - $(\text{direct costs} + \text{mark-up}) + (\text{share of pooled costs allocated to the party} + \text{mark-up})$.



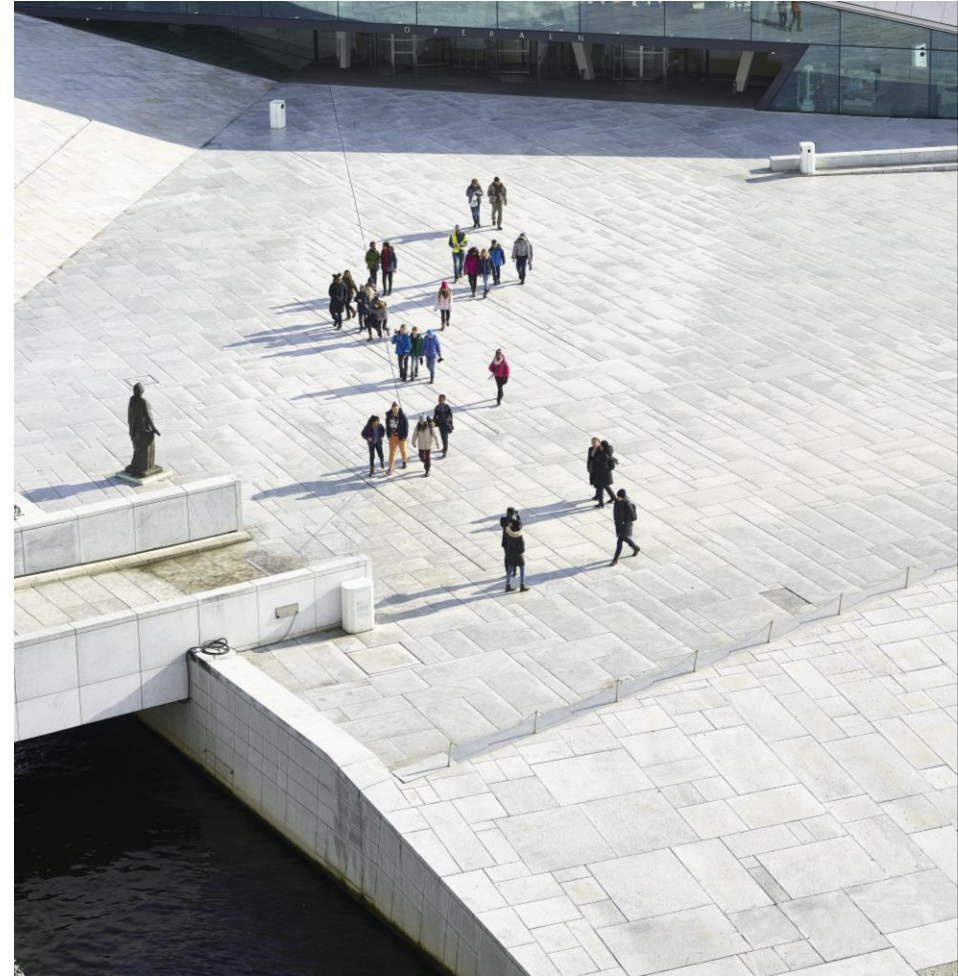
Low value-adding intra-group services: Examples

Services	Description
Accounting	Maintenance of accounting records, preparation of financial statements, budgeting, processing of accounts receivable and payable, billing, credit control, etc.
Human resources	Staffing and recruitment, training and employee development, performance management, remuneration services, payroll services, etc.
Information technology	Installing, maintaining and updating IT systems and networks used in the business, telecommunications services, IT helpdesks, IT security systems.
Communications	Internal and external communications and public relations support (but excluding specific advertising or marketing activities as well as development of underlying strategies).
Legal	Services performed by in-house legal counsel such as drafting and reviewing contracts, legal consultation and opinions, legal representation of the company, registration and protection of intangibles.
Tax	Preparation of tax returns, making tax payments, responding to tax administrations' audits, giving advice on tax matters.
Other	Monitoring compliance with health, safety, environmental and other standards regulating the business; general services of an administrative or clerical nature.

Commodities

BEPS approach

- Preference for the use of CUP to benchmark commodities related transactions.
- Choice of the pricing date for the application of the CUP method is essential.
- Use of publicly reported price data as well as quoted prices, provided that these are widely used as reference prices in transactions between 3rd parties.
- Likely to result in additional documentation requirements in terms of understanding, analysing, and documenting complex commodity supply chains and pricing mechanisms.
- Increased focus record keeping to justify the prices applied to each transaction.



Profit splits: Revised (draft) guidance

The Profit Split method as it currently stands is intended to provide solutions for highly integrated operations for which a one-sided method would not be appropriate.

Need to further consider clarifying, improving, and strengthening the guidance on when it is appropriate to apply a transactional profit split method and how to do so.

Most appropriate method

Potential for the PSM to be misused, depending on the nature of the transaction and functional circumstances of parties.

Highly integrated business operations

Significant levels of integration alone should not be enough to justify use of a PSM.

Unique and valuable contributions

Further attempts to define 'unique' and 'valuable'.
This will link to revised guidance on intangibles.

Profit splitting factors

Need to ensure that there is a strong correlation between profit allocation factors and value creation.

Interaction between profit split and TNMM

Additional guidance to be provided on circumstances where PSM can be used as a secondary 'sense check' for TNMM.

Synergistic benefits

Additional guidance to be provided on circumstances where PSM could be appropriate for dealing with scenarios with significant Group synergies.

BEPS Action 13

Post BEPS TP documentation

The three tiered approach

Master file

- Contains ‘common standardised information **relevant for all MNE group members**’
- Prepared either for ‘**the MNE group as a whole or by line of business**’
- Purpose is to ‘elicit a reasonably complete picture of the global business’

Local file

- Provide information that **supplements the master file** and aims to ensure **compliance in a specific jurisdiction**
- Focuses on ‘information relevant to the transfer pricing analysis related to the transactions taking place between a local country affiliate and associated enterprises in different countries’
- Information to include detailed financials relevant to the specific transactions
- Changed risk framework will require significant consideration (see risk analysis framework)

Three tier TP Documentation

Country by country reporting (CbCR)

CbCR contains a breakdown of:

- Revenue between third party and related party
- Profit before tax
- Income tax (paid and accrued)
- Capital
- Earnings
- No. of employees; and
- Tangible assets (excl. cash)

Does not contain any disclosure of **royalties, interest or services/WHT**, although this will be kept under review until 2020

Purpose

- Ensure appropriate consideration given to TP requirements when pricing intercompany transactions
- Provide the information necessary for a TP risk assessment
- Provide information for the purposes of a TP audit

Master file vs. historic OECD TP documentation

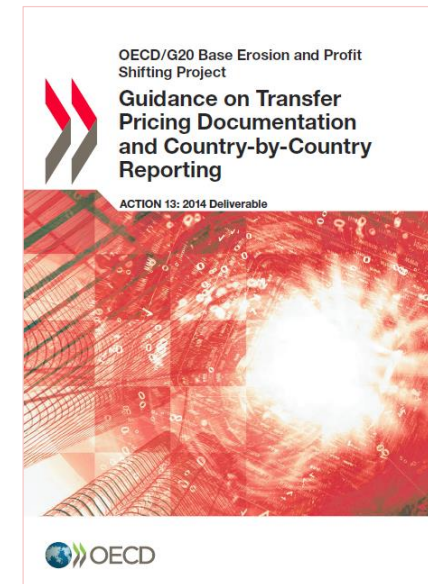
Master file requirements	Historic OECD TP documentation	Master file
Organisational structure		
Legal and ownership structure and geographical locations	✓	✓
Description of MNE's business		
Description of supply chain and main geographic markets for five largest products/services > 5% of turnover	Limited to relevant transactions	✓
Business restructuring transactions (e.g., M&A)	Limited to relevant transactions	✓
MNE's intangibles		
Ownership, use and location + strategy for development	Limited to relevant transactions	✓
Transfer pricing policies related to R&D & intangibles	If applicable	✓
Any transfers of intangibles among associated enterprises	✗	✓
MNE's intercompany financial activities		
Group financing, related and third-party	Limited to relevant transactions	✓
Transfer pricing policies related to financing arrangements	If applicable	✓
MNE's financial and tax positions		
Group's annual consolidated financial statement for financial year	✗	✓
Unilateral APAs, Advance rulings	✗	✓
Tax rulings related to the allocation of income between jurisdictions	✗	✓

Local file vs. historic OECD TP documentation

Local file requirements	Historic OECD TP documentation	Local file
Local entity		
Management structure + local organisation chart (include heads of management, their reporting lines and location)	✓	✓
Business restructurings or transfers of assets (especially intangibles)	If applicable	✓
Controlled transactions		
Detailed comparability and functional analysis of the taxpayer and relevant associated enterprises	✓	✓
Other controlled transactions of the taxpayer that can directly or indirectly affect the pricing of the controlled transaction being documented	✓	✓
Most appropriate transfer pricing method for transaction & the reasons	✓	✓
Reasons for performing a multi-year analysis	✓	✓
Explanation of selected comparable uncontrolled transactions	✓	✓
Whether any comparability adjustments are performed	✓	✓
Reasons for concluding that transactions were arm's length	✓	✓
Financial information used in applying the transfer pricing methodology	✓	✓
Unilateral and bilateral/multilateral APAs, Advance rulings	✗	✓
Financial		
Annual local entity financial accounts	✗	✓
Reconciliation of financial data used and transfer pricing methodology	✗	✓
Financial data for comparables used & the source of data	✗	✓

OECD guidance on CbCR and TP documentation

- Who?** CbCR initially multinational enterprises ('MNE's) headquartered in G20 and OECD countries with **revenue > 750M euros**.
- What?** CbCR to be **submitted annually**; Master and Local files are to be updated as best practice.
- Where?** CbCR to be filed with ultimate parent's home tax authority; master file and local file to be filed (as required) directly with relevant tax jurisdictions.
- When?** Implementation date for CbCR, master file and local file – of **1 Jan 2016** in the UK.
- How?** MNE will file the CbCR with the tax authority of the ultimate parent of the MNE who will share it via treaty network; master file and local file will be filed directly with local tax administrations in local jurisdictions.
- Why?** **Enhanced transparency/risk assessments.**



CbCR is an annual disclosure, targeted at large companies. The OECD recommends that information disclosed is not released to the public, but there are signs that this may change (e.g. also consider EU CbCR)

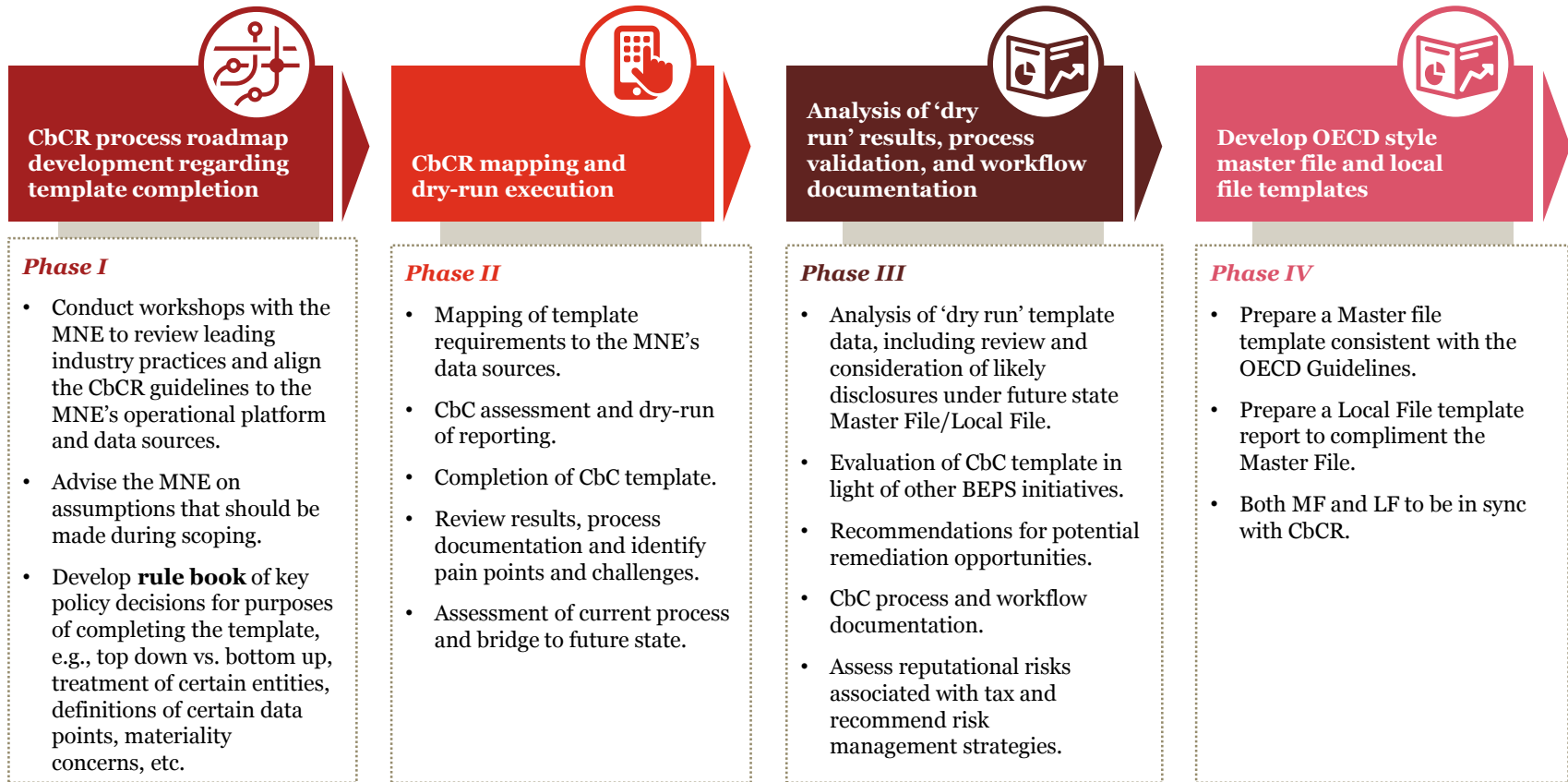
A model template of CbCR

Overview of allocation of income, taxes and business activities by tax jurisdiction – what MNEs need to submit to the Tax authorities

Name of MNE group: Fiscal year concerned:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued - Current Year	Stated Capital	Accumulated earnings	Number of Employees	Tangible Assets other than cash and cash equivalents
	Unrelated Party	Related party	Total							

Name of MNE group: Fiscal year concerned:														
Tax Jurisdiction	Constituent entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of residence	Main business activity(ies)											
			Research and development	Holding or managing intellectual property	Purchasing or procurement	Manufacturing or production	Sales, marketing or distribution	Administrative management or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant

CbCR compliance – PwC's approach

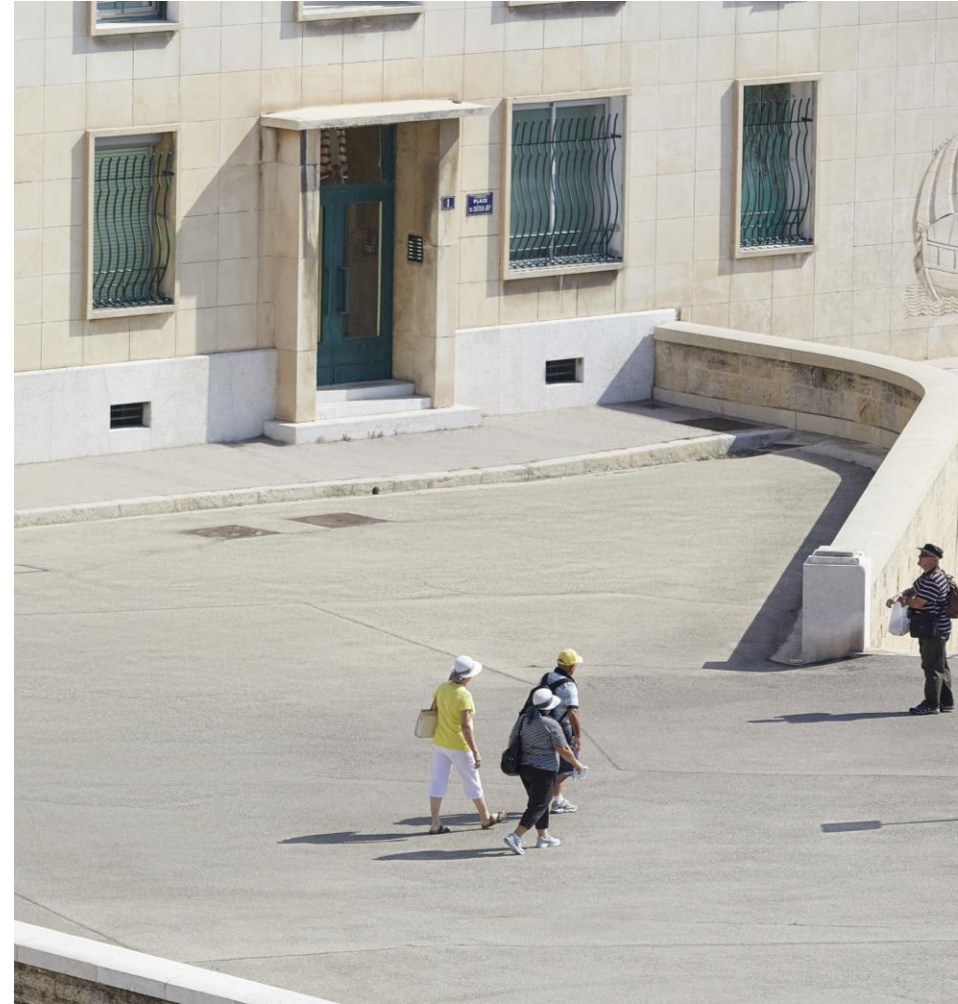


Automated CbCR reporting tool

Design and implementation of IT solution capable of process management, document management, collaboration, management insight and reporting.

Action 13 Implementation

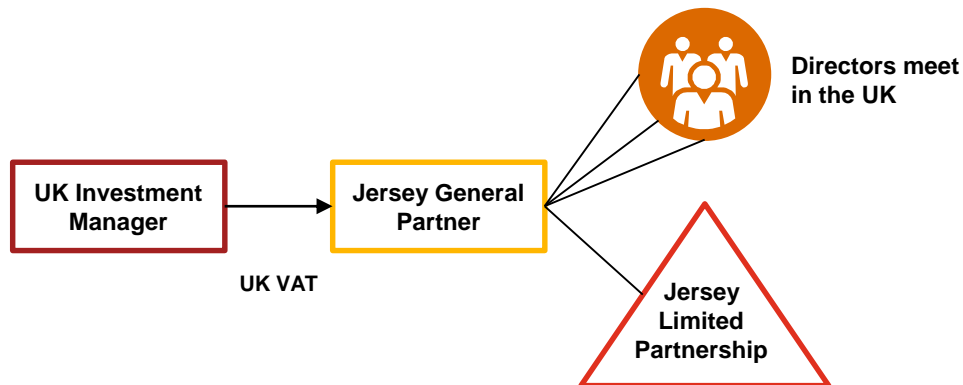
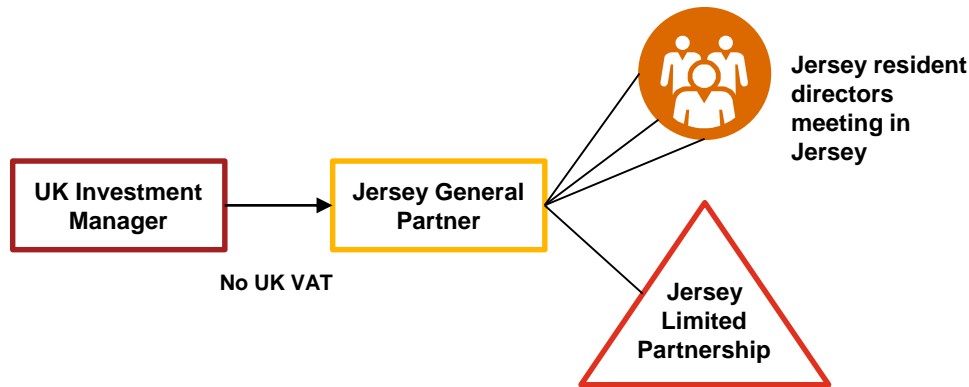
- Over 30 countries around the world have already adopted OECD MF and LF.
- It is expected that more jurisdictions will follow suit shortly.
- Over two thirds of the countries which have adopted MF and LF impose significant penalties for non compliance with the new regulations, for example:
 - **Germany** – Penalty for late presentation of TP documentation (LF) amounts to EUR 100 per day up to EUR 1,000,000; penalty for missing TP documentation (LF) amounts to 5% to 10% of the adjusted income, or at least EUR 5,000.
 - **Spain** – If the tax authorities do not make a transfer pricing adjustment, a tax penalty of 1,000 euros per item of data and 10,000 euros per group of data omitted or misleading documentation may be imposed; If the tax authorities do make a tax adjustment, the penalty would be equal to 15 percent of the TP adjustment.
 - **Poland** – If no LF is prepared and the tax authorities conduct TP income assessment, penalty tax rate of 50% is applied on the additional income. Additionally, personal penalties are levied on company employee, not company.



VAT: A constant hot topic

Jersey and funds

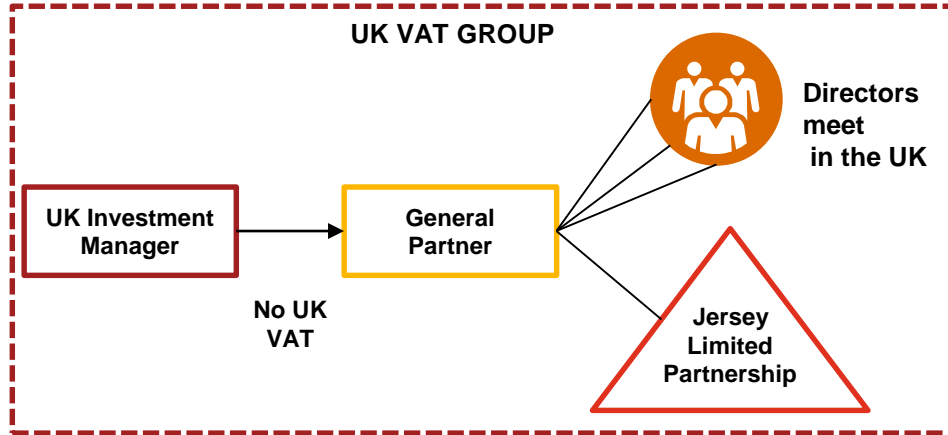
VAT considerations



- UK VAT will apply to supplies that are received in the UK, unless VAT exemption applies or there is a VAT group in place.
- UK VAT would not apply if the supplies are received in Jersey.
- Where board meetings take place in the UK, or UK resident directors dial in from the UK, UK VAT is likely to apply.
- If UK VAT is incurred by an investment fund, we would usually expect this VAT to be a cost, either in whole or in part.

Jersey and funds

VAT considerations (cont.)



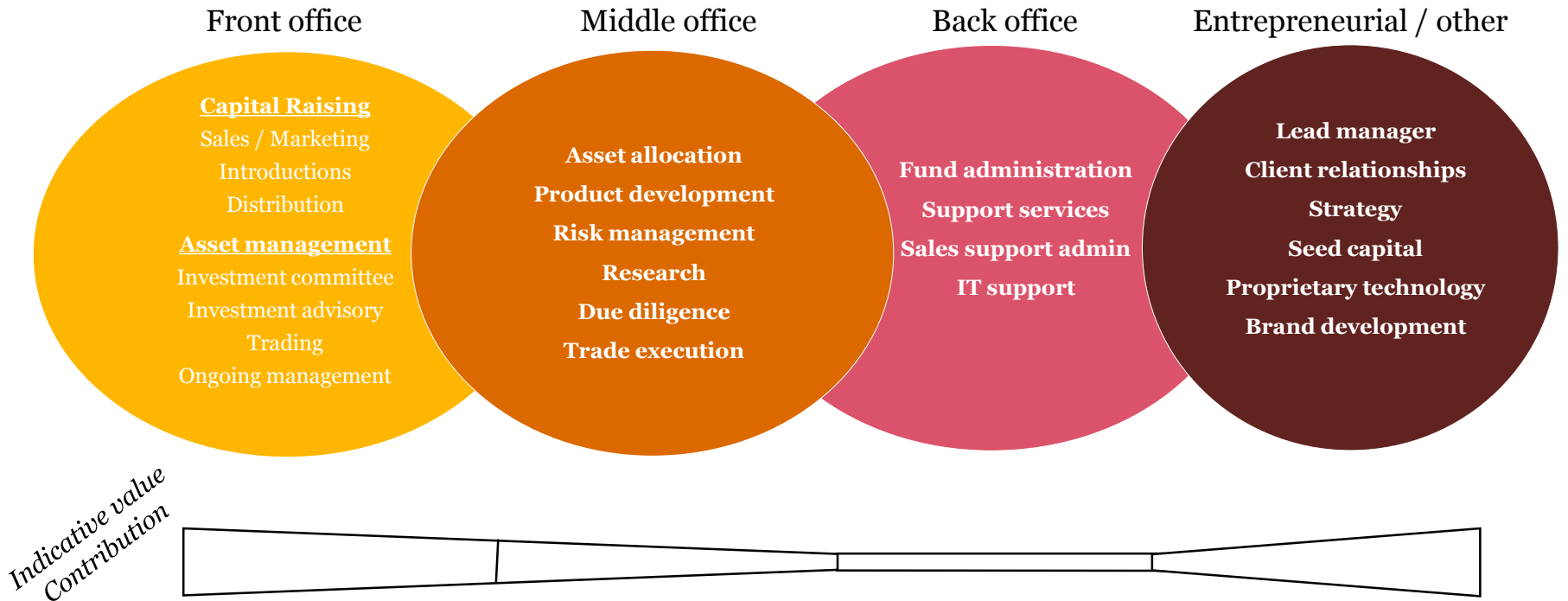
- In principle, possible for a Jersey LP to join a UK VAT group, (some complexity /HMRC consulted).
- Different types of Jersey entities have particular VAT considerations:
 - Jersey Incorporated LP have a different legal status, affecting UK VAT analysis and the ability to join a VAT group.
 - Certain fund marketing requirements can affect the regulatory position for the general partner, which may have UK VAT consequences.

- With any fund structures involving a UK manager, and/or where the general partner may have a UK presence, it is important to consider UK VAT matters at the outset.
- Ongoing fund governance, and documentation of the fund governance procedures, are also crucial. The UK tax authorities typically request a significant amount of information where offshore structures are used, and the consequences of not being able to demonstrate sufficient substance in Jersey can be severe.

BEPS actions in practice

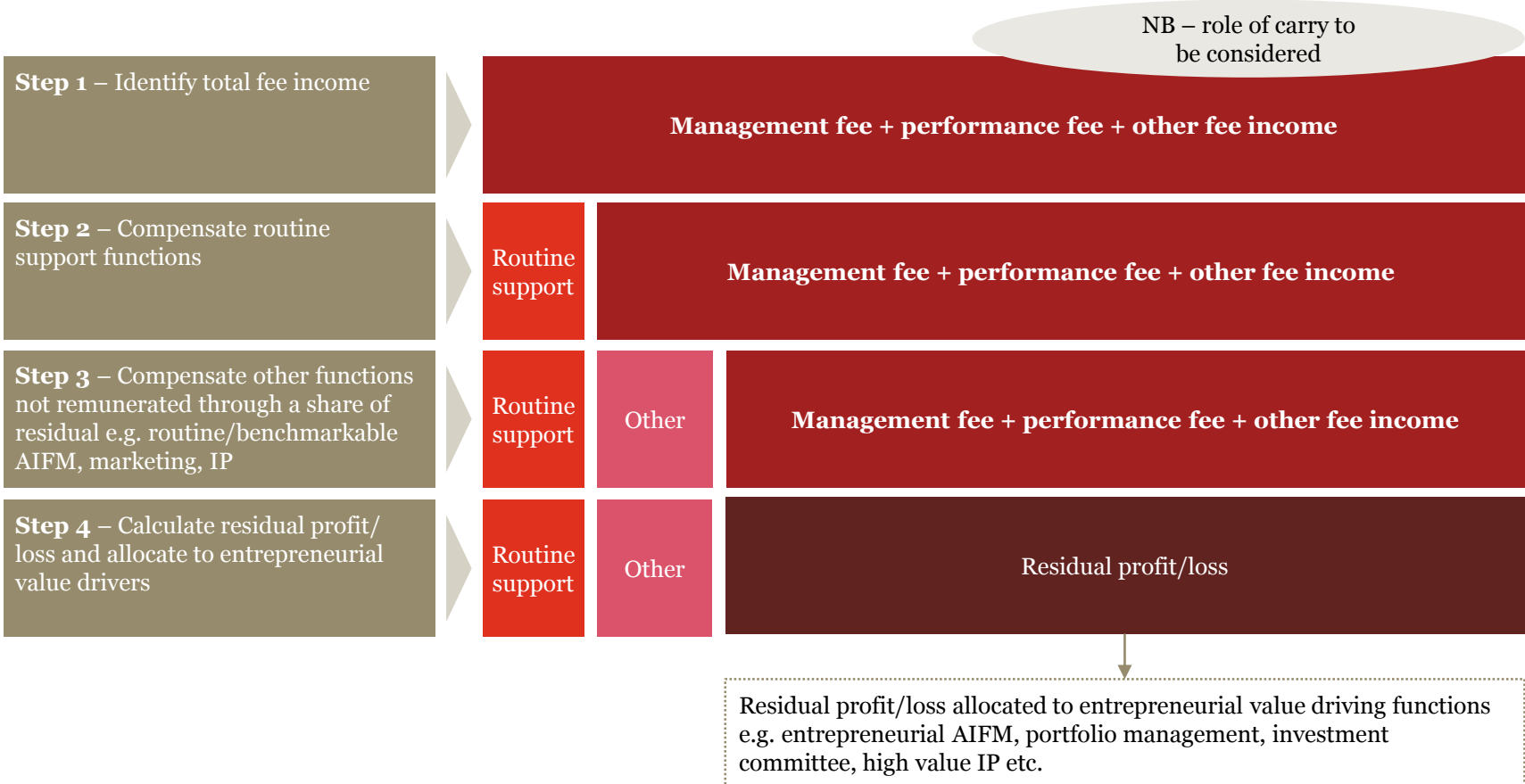
AM structures

Typical AM Value Chain Components



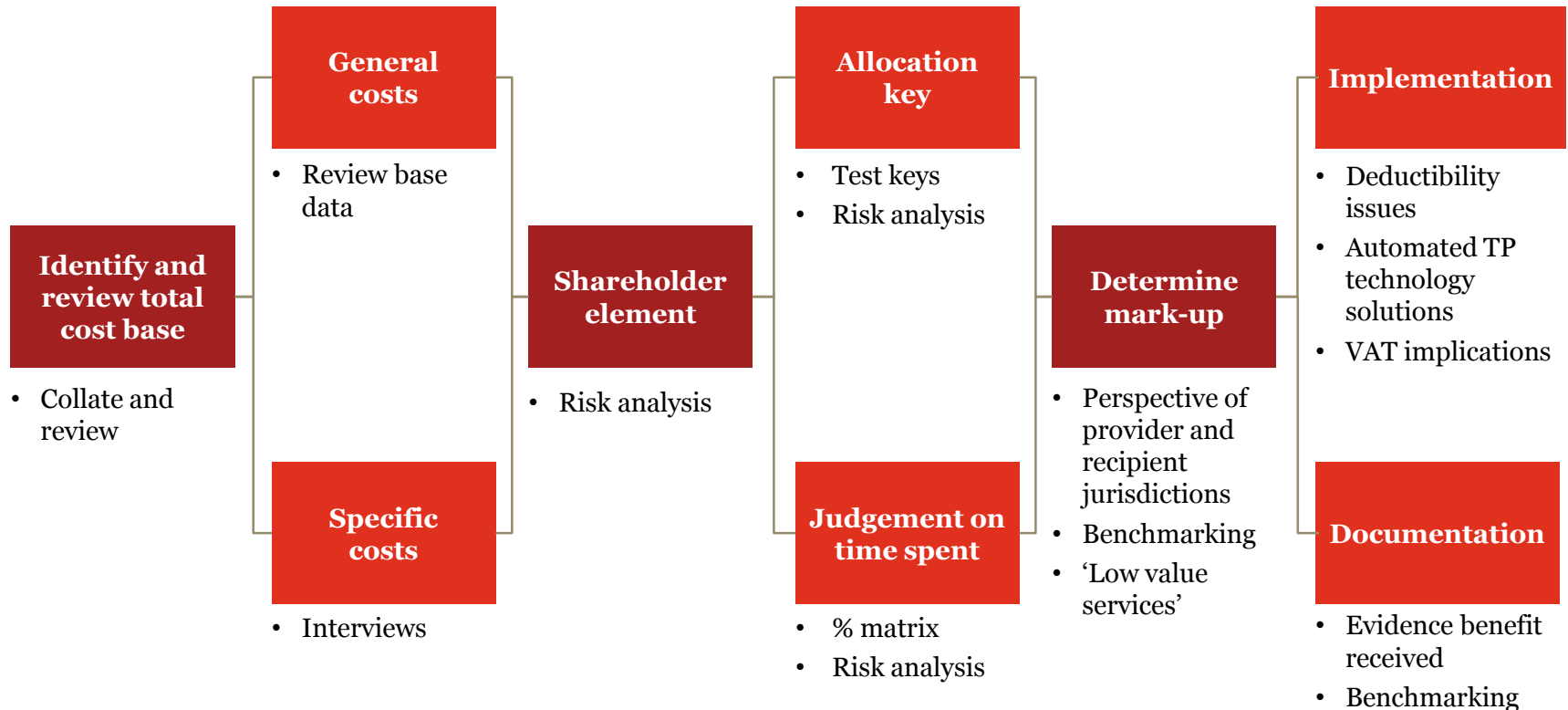
Waterfall approach

- Assess value of each function/activity and interaction with wider value chain based on detailed functional analysis exercise.
- Transfer pricing analysis will need to be considered in light of a number of other issues including (but not limited to) VAT; DPT; DIMF; and regulatory submissions.



Head office costs

While relatively routine in nature, head office charges still remain a prime target for tax authorities.



Marketing/capital raising

Marketing/capital raising can incorporate a vast range of activities, and each different activity will attract a different level of reward.

Value may be associated with people functions (investor relations, capital raising, marketing strategy), track record, technology.

Fees paid by manager to third party distributors, or fee arrangements between independent parties, may be used to support internal pricing.

Mobile individuals may give rise to permanent establishment risk if appropriate controls are not in place.

Lead manager may earn a reward for certain people functions it performs e.g. setting marketing strategy



Intellectual property

Becoming an increasingly valuable aspect of the business in light of technological developments and operational changes.

Marketing intangibles

- Trademarks
- Trade names
- Brand
- Customer/distribution lists
- Local marketing intangibles

Front office intangibles

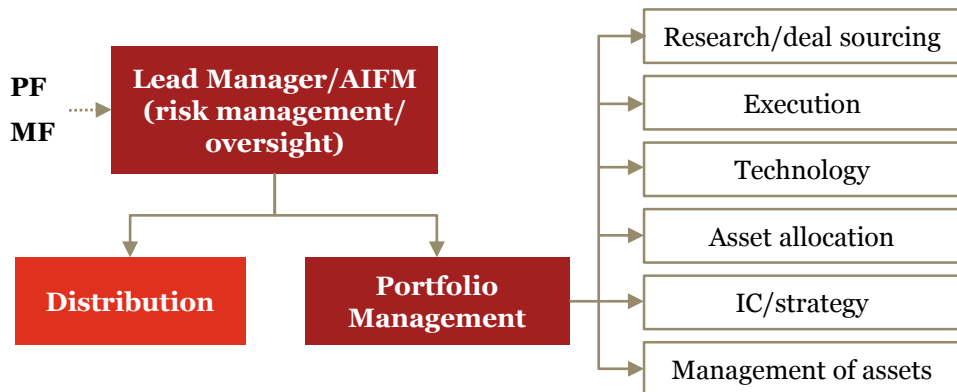
- Know-how
- Patents/designs
- Strategy
- Algorithms
- Risk analytics

Back office intangibles

- Computer software
- Trading platforms
- Clearing and settlement system

- IP attracting increased tax authority focus in light of BEPS.
- Definition of IP for transfer pricing purposes will be particularly important in determining an appropriate reward.
- Level of reward could range from cost plus to a percentage of fees or percentage of residual depending on nature of the IP.
- May be an opportunity to consider incentives e.g. R&D tax credits, patent box.
- Must be considered in light of DIMF rules.

Lead Manager/AIFM/Portfolio Management



- Relative contribution (and associated return) of lead manager and portfolio manager (or sub-advisor) assessed through functional analysis.
- Value of AIFM services may be benchmarked through survey data.
- Allocation of residual to entrepreneurial value driving activities will be subject to detailed quantitative and qualitative analysis e.g VCA, PDI analysis, DEMPE analysis.
- Return attributed to these activities will be dependent on substance and need to be supported through detailed transfer pricing analysis.

	Regulated AIFM, delegated portfolio management	Regulated AIFM, some involvement in strategy/ investment decisions	Regulated AIFM, ongoing active involvement in strategy/ investment decisions
Activity/ substance	Risk management/oversight, some back office support.	Investment Committee, risk management/oversight, some back office support.	Portfolio management, Investment Committee, other Committees (Asset Allocation, Marketing Strategy), risk management/oversight, some back office/middle office support.
Risk/reward			
Indicative TP approach	Cost plus/Bps on AuM	Bps on AUM/fixed percentage of fees	Fixed percentage of fees/percentage of residual profit/loss

Thank you

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