



# *Private Equity Country Survey* Transfer Pricing

## **In Brief**

In 2012, with contributions from our international network, PwC UK conducted an industry specific global survey entitled, “Private Equity – A transfer pricing evolution”, which explored the changing landscape of transfer pricing requirements within the private equity (“PE”) industry.

The responses to the survey highlighted issues such as the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation. This highlighted the importance of having a robust transfer pricing policy.

Over the last five years, the introduction of new legislation, coupled with increased press coverage and public awareness, has intensified the spotlight on transfer pricing. Transfer pricing has become increasingly important for the PE industry, and is firmly on management’s agenda for private equity houses around the world.

Our 2016 survey included contributors from 16 territories covering Europe, Africa, Asia Pacific and North America. The aim is to provide an unrivalled insight into the specificities of transfer pricing in relation to PE.

The composition of PE houses has changed drastically in conjunction with greater internationalisation and the fluid movement of skilled workers within the industry. The functions performed are more integrated than ever before which has resulted in a need for new and robust pricing policies that are capable of withstanding the increased audit focus.

The international tax landscape has changed dramatically in the last few years, and more so as a result of the introduction of the Organisation for Economic Co-operation and Development’s (“OECD”) Base Erosion and Profit Shifting (“BEPS”) initiative. Coupled with the increased growth and internationalisation of PE houses, this has led to a greater focus by tax authorities globally on transfer pricing arrangements.

Our findings show that tax authorities in both OECD and non-OECD jurisdictions have been monitoring the BEPS developments and in some cases implementation has already commenced.

Consequently, the reporting and compliance burdens of PE houses are likely to increase substantially as more information will be subject to disclosure. Additionally, reliance on existing transfer pricing policies may no longer be sufficient. Tax authorities globally are actively challenging PE houses’ transfer pricing arrangements through vigorous and determined enquiries and tax audits.

As a result, preparations should be underway, if they have not already begun, to adjust to these changes.

# Private Equity – A new transfer pricing landscape

## Introduction

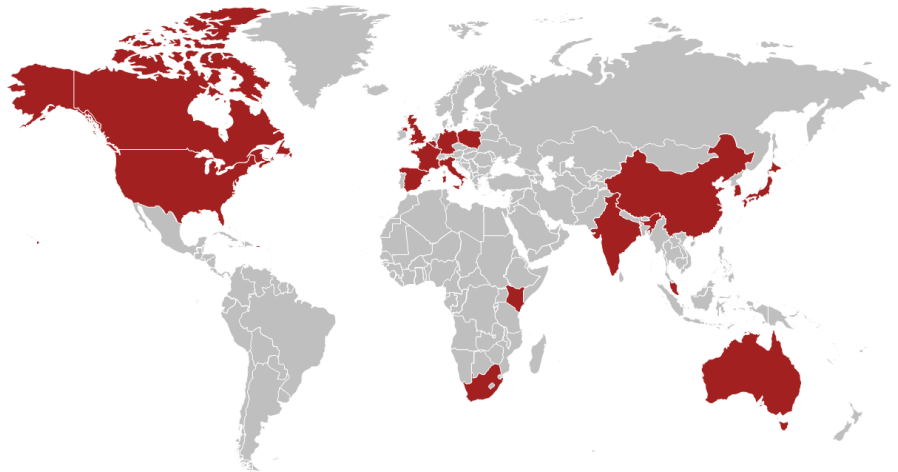
PwC works with a large number of PE houses around the world to ensure that the transfer pricing arrangements that are implemented match the underlying value chain of the business and the commercial contribution of each of the global offices.

In 2012 we undertook a survey to capture the experiences of PE houses in 12 major jurisdictions relating to issues they face from the evolution in transfer pricing.

The report provided clear conclusions around the necessity for producing a clearly documented analysis of the PE house's value chain and finding the appropriate methodology which recognises the value chain in its totality (e.g. locations where high value or routine functions are performed and risks are borne) in order for the transfer pricing methodology to stand up to scrutiny from the tax authorities.

This bespoke survey identified and highlighted the specific PE transfer pricing issues prevalent in different countries. This evolution shows no signs of slowing and we have undertaken a second global survey to capture a contemporary insight into the issues facing PE houses in 2017.

## Global contributors



The 2017 country survey leverages the expertise of PwC teams from 16 other countries, based in Europe, Africa, Asia Pacific and North America. We have deliberately expanded the search to include both the traditional PE centres as well as the emerging markets to ascertain a more holistic view-point.

As economic conditions improved following the Global Financial Crisis, PE has experienced steady growth. The diversity of fund strategies has grown as managers and Limited Partners (“LPs”) target new areas to generate gains which has led to PE houses becoming increasingly international in their outlook and operations.

Consequently the activities of PE houses, and therefore their transfer pricing arrangements, are becoming more complex, with the key value drivers of the business being increasingly shared between a number of jurisdictions on an integrated basis.

The introduction of the BEPS initiative is set to have a significant impact on the way transfer pricing is documented, both at a local and global level. A number of jurisdictions have announced the timetable for the implementation of BEPS related actions, and we would expect a marked increase in compliance obligations and a noticeable upturn in tax authority activity, with taxpayers experiencing more detailed enquiries.

As a result PE houses, more so than ever before, are focused on implementing reasonable and defensible transfer pricing policies.

This report runs through the key findings of the 2017 survey.

*Countries contributing experience: Australia, Canada, China/Hong Kong, France, Germany, India, Italy, Japan, Kenya, Netherlands, Poland, Singapore, South Africa, South Korea, Spain, the UK and USA.*





Activities such as investment management, capital raising and support services are seen in markets such as Hong Kong, the Netherlands, Spain and France (although fewer capital raising activities are performed in France) whereas less developed PE locations such as India, Canada, Kenya, China and Poland would only perform support services and/or investment management services.

## Functions

As PE houses increase their international outlook and operations we are witnessing a diversification of the roles performed by satellite offices. Activities performed by PE houses outside their home territory are no longer limited to preliminary research and general marketing.

Many groups now include deal sourcing, analysis, research and deal execution (classified here as investment management services), investment committee representation, investor relations, capital raising, fund administration and back office support services, among the activities carried on overseas.

Typically these services are provided in an integrated manner from a number of locations, with the group's intellectual property often being created on a joint basis.

The graphic to the right shows the proportion of countries where the services listed above have been analysed as part of a cross-border transfer pricing review.

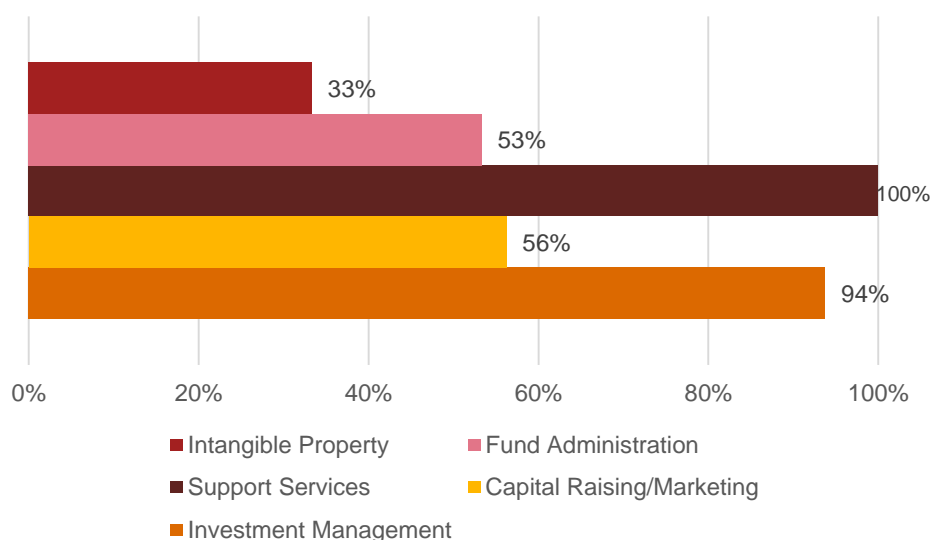
The plethora of activities performed means that typical transfer pricing analysis will need to cover the provision of a number of different services, often priced in the market on very different bases.

Whilst every territory surveyed indicated that support services were carried out in their jurisdiction, there was a notable difference in the number of activities performed by the more developed PE markets in comparison with those in less developed markets.

Typical PE centres such as the US, the UK and Germany perform the full spectrum of functions.

Singapore has experienced substantial developments in the PE space, where the activities undertaken by PE houses include investment management, capital raising, support services and fund administration.

### PE Functions Surveyed



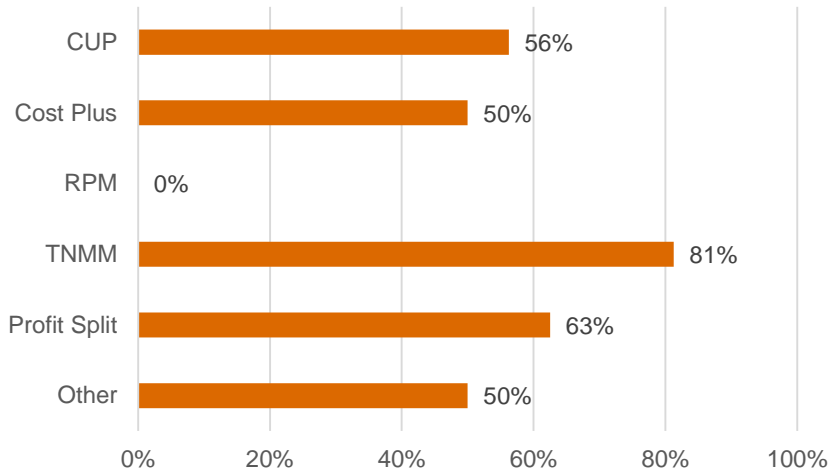
The global provision of internal capital raising and marketing activities by PE houses is on the rise. 56% of respondents indicated that a level of capital raising was performed in their jurisdiction, compared to only 33% in 2012. This provides further indication that significant parts of the value chain are performed outside the home countries.

As the level of activities in the overseas offices increase, there should be an awareness on the part of the PE houses that the transfer pricing analyses will have to be revisited. Contemporary transfer pricing needs to cover a wider variety of services and each service has the potential to require a separate transfer pricing analysis.

## Pricing methods

Implementing a robust global transfer pricing policy for a PE house continues to be challenging. This is due to factors such as the scarcity of data to benchmark the pricing of services on an arm's length basis, differing attitudes in tax authorities regarding what represents an acceptable pricing arrangement for a satellite office and the varying importance of these services at different points of the investment cycle.

### Transfer Pricing Methods Surveyed



In general, most countries surveyed stated that the methodologies prescribed by the OECD are used. Member countries follow the OECD Guidelines. Non-OECD member countries included in the survey such as India, South Africa and South Korea also generally follow the OECD Guidelines, although South Africa has reserved the right not to apply the 2010 Report on the Attribution of Profits to Permanent Establishments.

The graphic above summarises the results of the survey with regards to the implementation, by PE houses, of different transfer pricing methodologies around the world. PE houses are typically involved in numerous transactions therefore more than one method is usually applied.

A number of countries have experience in using the CUP methodology such as the UK, the US, Hong Kong, Italy, the Netherlands and Germany. However, factors such as the scarcity of data to benchmark the pricing of these services on an arm's length basis, the varying importance of these services and the changing attitudes of tax authorities regarding what represents an acceptable pricing arrangement means that CUP is not always possible.

Where the services that are carried out are considered to represent routine investment management activities, the income of the local satellite office has often been set historically on the basis of a recharge of the local costs plus a mark up to provide a level of profit that is subject to tax in that territory. This pricing method is referred to as a Transactional Net Margin Method ("TNMM") or Comparable Profits Method ("CPM").

The indicative price range is dependent on the territory in question as well as the nature of the services performed. Deal sourcing activities may be priced as high as 20% in some jurisdictions (as evidenced in India), although generally lower in most others. What is apparent is that there is no one size fits all policy and it is becoming increasingly important to review selected methodology on a case-by-case, as well as a territory-by-territory basis.

This sort of cost mark-up approach becomes more difficult to maintain as the office matures and both the scope of activities and level of influence that are provided from that location increase. This is often the result of highly skilled and experienced investment professionals being brought into the business; either as local hires or through the relocation of what is generally a highly mobile workforce. At this point, more complex solutions often need to be developed.

*With regards to pricing policy, "What is apparent is that there is no one size fits all policy and it is becoming increasingly important to review selected methodology on a case-by-case, as well as a territory-by-territory basis".*







Tax authority challenges are becoming relatively common. Tax audits are conducted periodically in certain territories, typically targeting large PE houses on different transactions.

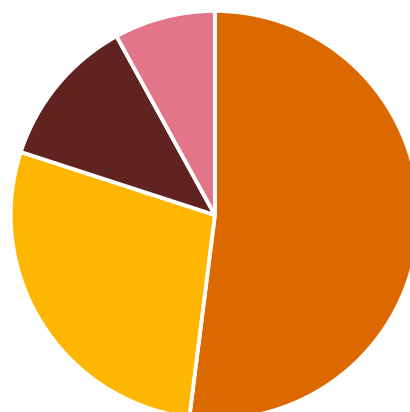
Generally, in each territory surveyed, there is a strong preference from the tax authority for the taxpayer to use local pricing data to support the transactions. However, the availability of benchmarking and comparative data varies among territories, therefore, for example, in Canada, US comparables are accepted; in Hong Kong, Pan-Asian comparables are accepted; and in South Africa, European comparables are accepted.

### Data Sources

Where the CUP methodology has been used, the sources of the comparables were more likely to be external CUPs as reported by the UK, Germany, the Netherlands, Hong Kong and Singapore. In most instances, this was in relation to pricing the capital raising fees.

In the majority of territories, the TNMM is applied in relation to some of the services and comparables are derived from statistical databases. Global databases of investment management fee data and statutory corporate financial data are commonly used, a number of countries such as South Korea, China, Hong Kong, Singapore and India also cited the use of local databases.

### Allocation Key Used



- Headcount
- Compensation
- Number of Transactions
- Other

### Allocation Keys

Where it is necessary to share the returns of a particular activity between a number of jurisdictions, one or more allocation keys are identified that will split the profit between the parties in proportion to the economic contribution provided by each party. The graphic below identifies the different allocation keys used around the world.

The most popular allocation key is based on the number of personnel undertaking a particular activity. Furthermore, 40% of respondents who selected headcount as their preferred allocation key specified weighted headcount, suggesting that increasingly the contributions from each jurisdiction represent a complex mix of ongoing activities such as: decision making, risk assumption and the utilisation of intangible assets.

### Documentation

Transfer pricing documentation requirements are in the process of significant upheaval as a result of the BEPS related changes.

In terms of the time limit for the preparation and submission of transfer pricing documentation following a request from the tax authorities, most jurisdictions require that the transfer pricing documentation be provided with the tax return, or within a very short period of time following a submitted request.

The time period for preparing TP documentation after a tax authority request is anywhere between 7 and 60 days depending on the jurisdiction. Knowledge of the local environment is, therefore, crucial to avoid paying penalties for failing to produce documentation on time.

Penalties may be either monetary or non-monetary in nature. Monetary fines vary drastically in size: in Italy fines may be anywhere between 100% and 200% of the transaction value; in South Korea up to KRW100 million (c. \$90,000); and in India as little as 2% of the transaction value. Additionally, in South Korea, taxpayers may lose the right to submit the requested documentation at a later time.

## Tax Authorities

In recent years, governments have faced budget shortfalls coupled with public opinion on whether multinational companies have paid their 'fair share' of taxes. In response to the multi-step action plan developed in the BEPS project, some countries are already using ideas set out by the OECD for tax examinations and to change tax laws which have been inconsistent with the BEPS recommendations. These events are causing additional tax uncertainty for companies in general including PE houses. The risk of double taxation and protracted cross-border disputes has increased significantly, with inadequate procedures for intergovernmental dispute resolution.

Most of the tax jurisdictions covered by our survey have seen transfer pricing enquiries into the level of fee income and profits recorded by the local office. Factors such as key personnel, investors, and portfolio companies located in that territory have all lead to challenges to cost mark up pricing and a number of adjustments being made.

### BEPS

Released at the end of 2015, with further updates, the final BEPS package pertaining to the reform of the international tax system to tackle tax avoidance, is expected to result in significant changes to the transfer pricing policies of PE houses. The Action Papers most relevant to transfer pricing issues for PE houses are set out below.

***Action 7 – Preventing the Artificial Avoidance of a Permanent Establishment Status;***

***Actions 8-10 – Aligning Transfer Pricing Outcomes with Value Creation; and***

***Action 13 – Guidance on Transfer Pricing Documentation and Country-by-Country Reporting.***



The formal implementation of BEPS by tax authorities in the countries surveyed is starting to be seen in 2017. The changes necessary for BEPS readiness have been cited as one of the major issues facing PE houses in each surveyed country.

### Action 7

Most PE houses are waiting to see how tax authorities will adopt an approach to prevent the artificial avoidance of permanent establishments as specific legislation with regards to Action 7 has yet to be formally adopted by a number of countries. Given the nature of the activities of the modern PE house, where its personnel may travel to territories outside their home base in the conduct of business, it will be crucial that internal guidelines in relation to how activities should be conducted are clearly set out in order that the lower PE thresholds are not exceeded.

Among the OECD member countries, rather than formally adopting Action 7, Australia has instead introduced the Multinational Anti-Avoidance Law from 1 January 2016 on permanent establishment issues.

In France, Action 7 is expected to be implemented as part of a multilateral instrument. One of the main areas of focus for the French Tax Authorities is for sufficient remuneration to be allocated to a French permanent establishment.

Although the Italian government's plans to implement Action 7 are yet unclear, the tax authorities are raising permanent establishment and Controlled Foreign Company issues more frequently. Therefore, the implementation of any transfer pricing policy should also consider wider issues, such as permanent establishments, sufficiently in order to stand up to scrutiny.

### Actions 8-10

A number of areas set out in Actions 8-10 are pertinent to the operations of PE houses, such as the determination of group transactions particularly with reference to risks, and whether the contractual assumption of risk is consistent with the conduct of the parties. Additionally, the party assuming the risk should have control over it and the financial capacity to assume it. As the level of activities in the overseas offices increase, so does the level of associated risk management.



Another area of particular significance to PE houses are intangibles, where Actions 8-10 set out the guidance in relation to the identification of intangibles, the ownership of intangibles and in particular the development, enhancement, maintenance, protection and exploitation of the transactions in relation to the use and transfer of intangibles.

Satellite offices are increasingly involved in more complex roles such as deal sourcing and investment decision making. Asset managers in local jurisdictions have built a wealth of knowhow through years of experience. This knowhow may be seen as a key value driver of the business. Therefore the value chain of the entire PE house should be revisited, to ensure that the pricing mechanism implemented is consistent with the value generated and the risks assumed in the respective jurisdictions.

Some OECD member countries have made formal announcements on the adoption of Actions 8-10 into the local transfer pricing legislation, whereas others have not. However, as the OECD Council has approved the Actions 8-10 amendments into the official OECD Guidelines, the updated Guidance will apply to OECD members.

The approach taken by the non-OECD member countries appears to be varied. China's transfer pricing rules are set out in SAT Circular Guoshuifa No.2 and work has been underway to revise this circular to localise the BEPS papers specific to China, including Actions 8-10 recommendations.

### Action 13

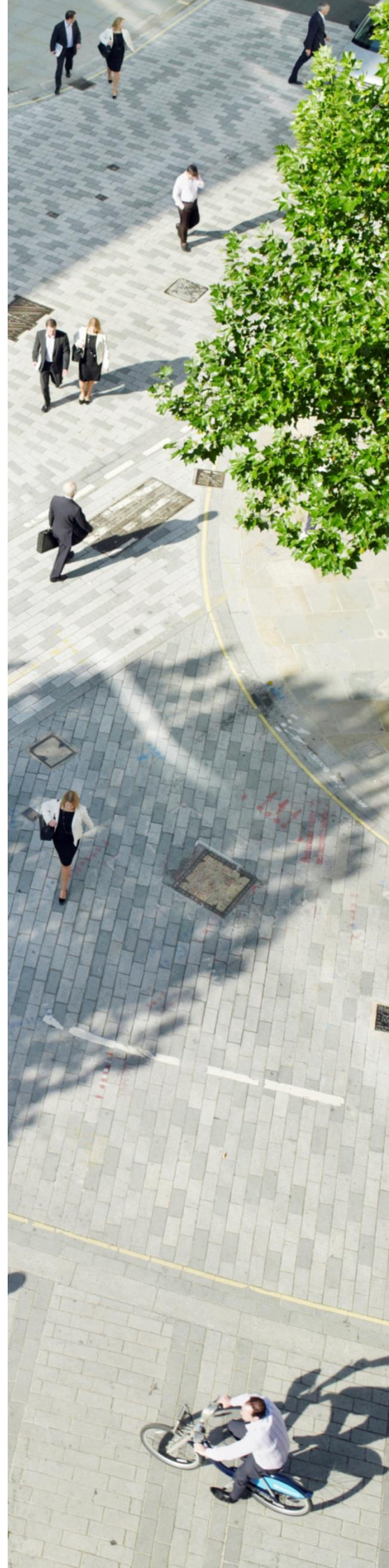
73% of respondents to the survey indicated that local tax authorities were likely to introduce some sort of documentation in line with Action 13 of BEPS within the next 12 months. As part of continuing efforts to boost transparency by multinational enterprises, the OECD announced on 13 February 2017 that 57 countries<sup>1</sup> had signed the Multinational Competent Authority Agreement ("MCAA") for the automatic exchange of Country-by-Country Reports ("CbCRs").

The Internal Revenue Service ("IRS") issued final regulations on CbCR in June 2016, which will apply to US parented multinational enterprises with annual revenue exceeding \$850m. This will apply from financial years beginning on or after 30 June 2016.

In the context of CbCR and PE houses, it is still uncertain as to how many will be above the OECD threshold of €750 million for the purpose of having to prepare documentation. Most PE houses do not consolidate the reporting of the financials of the house with that of the portfolios, and on this basis it is likely that these thresholds would not be met. However, it has become evident since the last survey in 2012 that due to tax authority activity, there has been a change in clients' attitudes towards documentation.

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<sup>1</sup><https://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf>.





## **Conclusions**

As evident from the above, tax authorities in both OECD and non-OECD jurisdictions have been monitoring the BEPS developments and in some cases implementation has already commenced.

The new reporting requirements, in particular for larger companies, will make detailed country-by-country tax and financial information visible to many eyes, possibly (in the future) not just those of tax authorities. In addition, the volume of data disclosed will be much more than companies are currently reporting worldwide and the compliance burden will likely grow substantially.

It is clear that the transfer pricing landscape has changed radically since 2012 and PE houses are under pressure to react to the uncertainty of legislative changes in a world where scrutiny by the media has never been as intense.

Many PE houses are large multinational corporations with ever expanding international presence which can only be sustained with increasingly global business models. The integration of activities at local level is unprecedented and more sophisticated tax authority audits are making simple, centralised transfer pricing arrangements more difficult to sustain.

Reliance on existing transfer pricing policy, no matter how clearly documented, may no longer be sufficient. Tax authorities are actively targeting companies' transfer pricing arrangements through enquiries and tax audits. Due to these factors, and their repercussions on business, which will continue to evolve beyond 2016, preparations should be underway if it has not already begun.



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# Appendix I

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