Financial Services
Tax and Transfer Pricing

FSTP Perspectives

A publication for financial services industry tax and transfer pricing professionals

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PricewaterhouseCoopers' *FSTP Perspectives* is a bi-monthly publication that offers an insight into trends and developments, tax authorities' approaches, and "hot" topic issues in financial services transfer pricing.

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Foreword

Dear Reader:

This year's February issue of Harvard Business Review contains a thought provoking article on leadership that might offer inspiration to tax legislators and authorities. A diagnostic template helps organizations to decide which goals are reasonable and where to focus performance-improvement efforts. The diagnosing tool is based on four principles. The most striking one says "simplicity gets results".

Although it is designed to help company leaders taking the right decisions, this article may also have potential merit to public servant decision makers in the field of taxation. The defence argument could be that the "race to the bottom" in terms of tax rates to attract investors necessitates a more agile response when it comes to deemed artificial tax base erosion through the violation of the arm's length standard when setting intra-group prices. The key question is presumably to figure out whether complexity in the policing is truly unavoidable?

This issue's country focus on the Chinese developments might give a flavour of the challenges outstanding and in some sense of overkill even though no one will ever doubt that balancing government budgets is a fair aspiration. Jobst Wilmanns' column talks about the dimensions of the in-house transfer pricing paradigm in the FS industry in Europe.

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Business welcomes the fact that the initiatives taken by the OECD and the Joint EU Transfer Pricing Forum are destined to step in the breach. The aim is to mitigate the risk that compliance efforts require a disproportionate cost to taxpayers taking into account the additional levies that can realistically be collected. The OECD's ongoing initiatives such as on Permanent Establishments, Business Restructurings and Dispute Resolution are just a few in an array of others.

The risk of failure to "put things right" from the outset with potential devastating consequences is probably one of the main reasons why the finalization of these projects may be somewhat time-consuming. The interview with Ms Mary Bennett, the OECD's Head of Tax Treaties, Transfer Pricing and Financial transactions will shed some light on the latest developments.

I grab the occasion to also underscore the efforts on improving the Mutual Agreement Procedure under Article 25 of the OECD Model Treaty. The (protocol to the) US-Canada, US-Germany and the new US-Belgium Treaty show that Binding Arbitration is included as an innovative technique to make the procedure more effective. A plea for wider proliferation of such dispute resolution tool appears no more than logical even though we're not yet home free. Despite the valuable efforts of the Joint EU Transfer Pricing Forum to make the Arbitration Convention actually work, some issues remain unsolved. Examples include so-called "triangular cases". Within the EU this appears to be a matter that can be solved relatively easy, i.e. to see "which EU country Competent Authority steps in when". Things might be getting more complex when non arm's length price setting in a non-EU country, provokes tax adjustments in the hands of an EU taxpayer where recourse to a swift remediation procedure seems less obvious at the current state of play.

Finally, in late February the Joint EU TP Forum embarked on its project around "centralised intra-group charges". It will be interesting to see how the Forum will address ideas from Business to make life easier when it comes down to cross border HQ charges and the countries' reactions thereto. Topics such as shareholder expenses, allocation keys, mark-up determination and supporting documentation will probably all take the stage. At the end of the day, the main goal is to reduce red tape for both taxpayers and tax authorities when dealing with compliance in an area where probably limited or no premium profit is left untaxed on the table… Challenging times ahead!

I have the pleasure to present you a "FSTP Perspectives" that once again results from the invaluable enthusiasm of our growing crowd of dedicated PwC experts across the globe.

Best regards,

Isabel Verlinden
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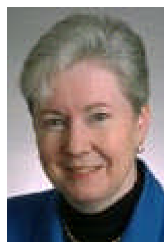
OECD: Interview with Mary Bennett



25 Questions for Mary Bennett:

Richard Stuart Collier, PwC's Banking & Capital Markets Tax Leader, met with Mary Bennet and asked her a few questions regarding the current OECD initiatives and herself:

General

***Richard Collier (*RSC): Please give an overview of your role in the OECD:**

Mary Bennett (MB): My role is as head of the division for tax treaties, transfer pricing and financial transactions. This is a very large area, although I am supported by Jacques Sasseville in relation to tax treaties and Caroline Silberztein in relation to transfer pricing. In my role, I report to Jeffrey Owens, the Director of the Centre for Tax Policy and Administration of the OECD.

RSC: Could you summarise the major issues on your agenda currently?

MB: It might be useful to summarise the work in progress in relation to the transfer pricing activities on the one hand and the treaty activities on the other. The transfer pricing activities relate to the ongoing project in relation to the attribution of profits to permanent establishments, which is near to closing, but also includes the tax issues relating to business re-structurings and work on the 1995 Transfer Pricing Guidelines. On the other hand, the treaty activities would include non discrimination, a special project on collective investment vehicles, some work on dispute resolution and also some issues affecting cross-border services. In addition to all these issues, the OECD is also interested in looking at tax and growth; tax and the environment; and there is an ongoing project to achieve OECD enlargement and enhanced engagement with non-member countries.

Article 7

RSC: Picking up one of the first issues you referred to, what is the current status of the Article 7 project on the attribution of profits to PE's?

MB: This project has been running for approximately 10 years. We now have a finalised text for Part I (General Considerations), Part II (Banking) and Part III (Global Trading) although it is possible that the format of these papers may change (but not the substantive content). Progress on Part IV (Insurance) is a little behind these other three parts. We are hoping to finalise Part IV shortly, following the public consultations at the end of last year. During 2008 we should also see a new version of Article 7.

RSC: In relation to Part IV on insurance, certain brief comments in the paper seem to suggest that internal reinsurance is not a KERT capable of locating a risk in a different location. This is on the basis of there not being sufficient active decision making in the process. In the banking report, however, there is a significant amount of focus on the assumption and management of risk – but in the insurance report the discussion just seems to focus on the assumption of risk. Why the difference?

MB: The comments in Part IV are simply a consequence of the factual input which we receive from our delegates. What became clear is that in the insurance sector there is not the same level or intensity of post-risk-assumption management of risk as there is in the banking sector and therefore the report concludes that, as a factual matter, the management of risk is less likely to justify a finding of an internal transfer of risk than in banking or global trading.

RSC: There does not always seem to be a complete consistency amongst the tax authorities in relation to their acceptance of and support for this project. How do you see this?

MB: I think the tax authorities do recognise the importance of uniformity in approaching difficult tax issues and it will be interesting to see how quickly the proposed new Article 7, once agreed upon within the OECD, will be picked up and incorporated into treaties. However, I do accept that the current version of Article 7 will be a reality for some time in the large number of existing treaties, although I expect tax authorities generally to shift over time to using the new Article 7 in their new treaties. Of course, the publication of new OECD Commentary for the existing version of Article 7 is also intended to achieve greater consistency in the way countries apply their existing treaties.

RSC: Do you see the US tax authorities also being entirely aligned with the OECD's work on the attribution of profits to PE's?

MB: I do think that the US tax authorities are taking a line which is entirely consistent with that of the OECD in the area of how to attribute profits to permanent establishments under Article 7. I think we will see more when the global trading regulations are released which I understand is intended to be soon.

RSC: I think it's fair to say that the industry regards the consultative process that is being followed on this project as having led to some pretty mixed results. Do you think the tax authorities really do listen to the voice of industry, or do they just do what they want to do anyway?

MB: Generally, I think the tax authorities do want to listen to Industry and that the consultative process can work quite well. Admittedly, there are varying practices amongst governments as to how they interact with taxpayers. For example, there is a great deal of interaction in the US and perhaps rather less so in some parts of Europe. For this reason, therefore, some countries are probably less familiar with the process of consultation and its potential advantages. At the OECD, however, we do spend a lot of time on this area and the recent project on collective investment vehicles is a good example where consultation and cooperation between the tax authorities and the industry is a pre-requisite for any progress to be made. That project is progressing well based on that cooperation.

RSC: What do you expect will be the likely take-up of the new Article 7 when it is released?

MB: As I mentioned, I do think the tax authorities are keen to maintain a uniformity of approach to key international tax issues where this is possible and therefore I do expect to see a shift to the use of the new Article 7 once it is adopted by the OECD. There may be some exceptions and of course the position may also be affected by non-OECD countries who may not want to follow the OECD line when they negotiate bilateral tax treaties.

RSC: What do you think will be the timescale before we can see the use of the new Article 7 in all double tax treaties?

MB: This is clearly a long time – even assuming uniform acceptance of the policy of following the new Article 7, it could take years or even decades for countries to re-negotiate all their existing treaties to incorporate the new language, which is one of the reasons the OECD thought it was so important to have as part of its implementation strategy the development of new Commentary for the existing text of Article 7 to clarify the extent to which the "authorised OECD approach" could be applied under existing treaties. We are also interested in exploring mechanisms which might speed up the process of re-negotiating treaties to reflect changes in the text of the Model itself, but as things stand we will have to be resigned to a gradual switchover.

Business Restructuring

RSC: In a relatively short time, the topic of business restructuring seems to have become one of the hottest issues in which the OECD is involved. How did the project come about?

MB: The work on business restructuring grew out of the recognition of the significant changes in the way in which business was being structured. These new developments pose significant revenue challenges to governments, but this is not just an anti-avoidance issue for tax authorities. There has been a recognition that these developments raise issues that need to be clarified, for example in relation to the Permanent Establishment threshold under Article 5 or how the arm's length principle, as articulated in the OECD's Transfer Pricing Guidelines, applies to the types of transactions and structures one sees in typical business restructurings.

RSC: What are the key issues that the OECD is investigating in relation to business restructuring issues?

MB: A Joint Working Group involving delegates from the OECD's Working Party No. 1 (responsible for treaty issues) and Working Party No. 6 (responsible for transfer pricing issues) was set up and its area of focus has included issues such as: the recognition of transactions; transfer pricing issues (such as whether compensation is required upon the restructuring itself, or post restructuring for services rendered or property provided); PE issues both in relation to whether or not a PE exists and also the quantum of profits that might be attributable to it. In the course of its preliminary work in preparing a draft for public comment, the Joint

Working Group has obtained informal input from a Business Advisory Group formed for that purpose and has solicited broader input through an invitation published on the OECD website.

RSC: How do you see the future discussion of this topic going?

MB: A draft is being prepared for public consultation, and we expect to be able to issue this draft before the end of 2008. This will probably focus mainly on transfer pricing issues relating to Article 9 but may also address some issues relating to attribution of profits to permanent establishments (Article 7). Depending upon the outcome of the public consultation, it may be that the Transfer Pricing Guidelines will need to be expanded to deal with the issues arising from our consideration of the business restructuring issue.

Art 5

RSC: The permanent establishment threshold issues (under Article 5) have come up in the conversation at various points. Would you accept that the threshold PE issues of Article 5 are currently under the spotlight?

MB: The relevance of those issues to the business restructuring developments and also the rejection of the "single taxpayer" approach in the documents on the attribution of profits to PEs project, have certainly helped to focus attention in this area. Of course, the PE threshold issues extend well beyond business restructuring situations, and the OECD has recently decided to pursue its examination of these issues in the context of its broader programme of work in Working Party No. 1 rather than through the more narrowly focused Joint Working Group on business restructurings.

RSC: The problem seemed quite acute given that some of the key concepts are not particularly clear. For example, the definition of "independent agent" in Article 5 is fuzzy, to say the least.

MB: Some of these issues have begun to be discussed already in the business restructuring project. As I've indicated, we expect to do a thorough examination of Article 5 PE threshold issues in an upcoming project in WP1.

Services PE

RSC: On a matter related to PEs, could you explain what has been driving the discussions at the OECD on the services PE concept, particularly in light of the public discussion draft on the Tax Treaty Treatment of Services released by the OECD in December 2006.

MB: The overall review of this area has been driven by OECD members who believe that business has evolved in significant ways in the service sector yet in a manner which is not fully accommodated by the fixed place of business PE test of Article 5(1). There is a view amongst some OECD members – although not a majority view – that these developments need to be taken account of in framing tax treaties.

The service PE provision is already in a number of treaties, including those of some countries which do not prefer the lowered PE threshold represented by the service PE concept – but this is simply a function of the bilateral negotiation process which has led to the treaty in question. The 2006 draft you referred to proposed to include in the OECD Commentary on Article 5, as an alternative to the standard Model provision, an approach to drafting a service PE provision for those countries which wanted to follow this view. Interestingly, a new Canada-US Treaty has already incorporated a similar services PE concept, reflecting that this is a matter that is of relevance and interest to certain developed countries as well as to developing countries.

1995 Transfer Pricing Guidelines

RSC: You mentioned that other work was also underway on the 1995 Transfer Pricing Guidelines. Could you explain what areas you are looking at in particular?

MB: There are two main areas we are looking. First, comparability issues and second profit based methodologies. In relation to comparability issues, our intention is to collate experience after 12 years of working with the Guidelines as to what issues have arisen. We are aiming to look at the issues arising on comparability and investigate what further guidance may be given. For example, some countries tend to approach the arm's length standard on the basis of a price comparison when setting a transfer price. Other countries seem to be more results focused and ask did whatever arrangements were put in place and whatever pricing was used lead to the right result. We are also looking at questions about which data is appropriate to be used, when it was available, etc. I would expect that ultimately the work would lead to a revision of Chapter 1 of the guidelines.

RSC: And the work on profit based methods?

MB: With the passing of time, tax authorities are generally much more experienced with profit based methods and it is in practice more difficult to see this as still being a "measure of last resort". Rather, as reflected in the discussion draft on profit methods we published on 25th January, the right transfer pricing

method should be the most appropriate method in the circumstances, not a consequence of applying slavishly a rigid hierarchy of stipulated methodologies. We are seeking comments on the discussion draft on profit based methods and ultimately I am expecting this to lead to a revised Chapter 3 of the Transfer Pricing Guidelines.

RSC: Do you think we will see a shift to more formulary apportionment given these developments and in the light of, for example, the project on Attribution of Profits to PEs?

MB: You will see from the discussion draft published on 25th January that the OECD is not proposing any fundamental change to the position reflected in the 1995 Transfer Pricing Guidelines to the effect that global formulary apportionment, notwithstanding the recognition that OECD-endorsed profit methods are no longer viewed as “exceptional” to the same extent they were in 1995.

Treaty Issues

RSC: Turning to a couple of treaty issues you mentioned, can you tell me what the current position is on the project on non-discrimination, i.e. relating to Article 24 of the Model Convention?

MB: This is certainly one of our more difficult projects but we are approaching the work in two phases. First, we have been working on collating experience on the existing article provisions and considering especially where we have consensus on the interpretation of those provisions and where this is lacking. The resulting discussion draft of proposed amendments to the Commentary on existing Article 24 which we published last May is now being finalized for inclusion in the 2008 update to the OECD Model Tax Convention. As a second phase, we are now starting to look more fundamentally at what the Model’s provisions on non-discrimination should be from a policy perspective and, where changes are required, how these might be effected.

RSC: Do you also expect to see changes arising out the collecting investment vehicles project?

MB: This project was sparked off by the increasing amount of cross-border investments held by mutual funds and similar investment vehicles and by the perception that these intermediated investment structures gave rise to a number of substantive and procedural difficulties in the application of tax treaties. The project is in fact a good example of the way industry and the OECD can work together on a matter driven by both the industry agenda and the tax authority agenda.

Enlargement of OECD and Enhanced Engagement

RSC: Turning to the project of enlargement and enhanced engagement, it is clear that this is an important project right across the work of the OECD. What does it mean in the context of Tax?

MB: In the Tax sphere as in other areas, it is important that the OECD has an influence across the globe and that this is not restricted to the traditionally developed countries alone, particularly given the huge developments in the economies of countries such as China, India, etc. On a more tax specific basis, the process we are pursuing of enlargement and enhanced engagement should in time influence currently non-member countries to move closer to practices and standards which are consistent with existing OECD members. This should be a positive development – for the operation of the tax system itself and taxpayers also.

RSC: Could you explain what the process of enlargement and enhanced engagement means in practice?

MB: The process of enlargement refers to the five countries -- Chile, Estonia, Israel, Russia and Slovenia -- the OECD has invited to be candidates for membership in the Organisation. As part of the process of admitting these countries to membership, the OECD will be undertaking a review of their policies and practices in tax and other areas to ensure that they are sufficiently consistent with the OECD’s core principles and standards. For example, each of these countries will agree to be the subject of a “peer review” by the OECD of their transfer pricing regimes.

A further number of five countries -- Brazil, China, India, Indonesia and South Africa -- have been identified as countries with which the OECD intends to pursue “enhanced engagement” in order to strengthen our dialogue with them and perhaps ultimately to lead to their candidacy for membership. Practical implications include much more regular and extensive contact between the OECD and those countries, including for example the participation of some of them as Observers in meetings of the OECD’s Committee of Fiscal Affairs and its working parties, as well as events such as the major OECD/IFA (India) conference held in Mumbai in late January.

Personal

RSC: Turning away from the technical issues, what attracted you to come to the OECD in Paris from your previous private sector role?

MB: As a tax partner in a large law firm, I had been advising MNCs for a number of years and I was increasingly finding that issues on the OECD agenda were of major importance to them. I think this reflects the significant growth and currency of the OECD's work programme over the years. I also thought then – and still do now – that by virtue of its nature as a forum for achieving consensus among 30 member countries, the OECD works to effectuate change in a way and on a scale which is not available to any individual government. I had worked in the US Treasury in the 1980s so had some exposure to international tax policy issues from the government perspective. Therefore, when I was offered the chance to head up the division responsible for tax treaty and transfer pricing issues, this sounded like something I would be very interested to do.

RSC: What have been the major challenges to the OECD in the time you have been here?

MB: The answer is undoubtedly, achieving consensus amongst participants. This has to be facilitated and built, not imposed – the OECD has an ability to influence but certainly no power to direct sovereign governments.

RSC: Have you enjoyed your time at the OECD in Paris so far?

MB: Yes, very much.

RSC: Thank you.

Mary Bennett will be one of the key note speakers during the 2008 FS TP Masters Series event in Amsterdam, where she will further discuss both the business restructuring and the PE profit allocation projects of the OECD. Invitations for the event will be sent out shortly.

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Transfer Pricing Key Issues: Reinsurance: a transfer pricing 'hot topic'

The transfer pricing of intra group reinsurance has become an increasingly high profile issue of late. This can be attributed to a number of developments

- The insurance sector has seen significant recent consolidation, resulting in post-integration restructuring with a strong focus on capital structure and capital management. At the same time, analysts have increasingly started to focus on insurance groups' management of effective tax rate.
- Historically, many tax authorities have put the transfer pricing of reinsurance into the "too difficult" category, focusing on industry generic transactions such as management services and brand royalties. However, recent work undertaken by the Organisation for Economic Co-operation and Development (OECD) in relation to the taxation of insurance branches has put the tax spotlight on the insurance sector.

These developments have resulted in reinsurance transactions, which are often the most material transfer pricing transactions within insurance groups, coming under increasing scrutiny.

Intra-group reinsurance arrangements

Within a group context, reinsurance may be purchased by each insurer independently with external reinsurers or, more typically, a group's reinsurance needs may be centralised within a group reinsurer (Group Re). Group Re may then choose to retrocede some or all of the risk based on a consolidated risk assessment of the combined/pooled reinsurance risks of the group. Utilisation of the Group Re structure typically offers diversification and capital benefits as well as the ability to command more favourable pricing from external reinsurers through a combination of bulk purchase and the centralisation of reinsurance expertise within the group.

Commercial rationale

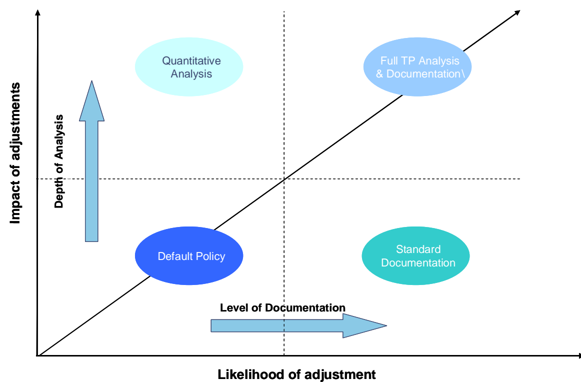
The commercial rationale for intra group reinsurance arrangements is critical for any transaction of this nature. Generally, reinsurance is purchased for any of the following reasons:

- To transfer insurance risk where risk of loss is above an acceptable level;
- Reduce volatility in annual results;
- Help to increase premium writing capacity on existing business;
- Facilitate growth of an insurer's new products or aid its entry in new business lines.

A strategic, risk based approach to reinsurance transfer pricing

In order to ensure that a robust support of intra-group reinsurance is in place, insurance groups are increasingly taking a risk based approach to categorising and supporting the arm's length nature of their reinsurance transactions. This is even more important where a group has several hundred intra-group reinsurance transactions, to ensure that time, effort and expense are spent where they are most valuable and that low risk contracts are supported and documented with minimum time and effort.

Transaction risk will be determined by the likelihood and impact of potential adjustments, as shown in the diagram below.



A risk based approach to the assessment of the likelihood and impact of a transfer pricing tax adjustment is essential to identify high risk areas and to shape the extent of transfer and pricing analysis and documentation. An assessment of high risk will generally apply to transactions in which:

- Large portions of originated business are ceded to related parties;
- The ceded business is very profitable;
- The nature of the risk ceded is complex and unique, with little likelihood of third party comparables being available to support the arm's length nature of the price.

Reinsurance Transfer Pricing Methods

Comparable Uncontrolled Prices

Using Comparable Uncontrolled Prices (CUPs) to demonstrate compliance with the "arm's length" standard is sometimes possible, when

a) the insurer has purchased the same reinsurance coverage externally in the recent past or

b) a third-party reinsurer shares the same terms as the group reinsurer, as a co-reinsurer or retrocessionaire.

One should bear in mind, however, that the reinsurance market is highly cyclical, hence pricing, policy terms and conditions and returns can erode the comparability very quickly. And in practice, there are many instances where CUPs are either not available or applicable, and the practitioner has to rely on alternative methods to assess demonstrate compliance with the "arm's length" standard.

Broker Quotes

Reinsurance broker quotes are often put forward as potential evidence to support the terms of internal quota share reinsurance transactions. Broker quotes can often be valuable sources of market data to the extent that there is clearly some level of comfort in knowing that the ceding and profit commissions are broadly in line with what is seen in the market. However, the economic result of a reinsurance contract is so dependent on the specific terms and conditions of the contract; it is generally not possible to rely exclusively on broker quotes which refer only to headline rates of commission. In addition, many revenue authorities are very reluctant to accept quotes that are not associated with executed contracts as primary evidence of arm's length pricing.

Pricing Methodology

A common statement made in support of the arm’s length nature of inter-company reinsurance transactions is that “inter-company transactions are priced on exactly the same basis as for external reinsurance”. In principle, this is potentially good support. Indeed, the IRS temporary services regulations (U.S. Treasury Regulations Section 1.482-9T(c) (5)) explicitly approves this approach (known as the indirect evidence rule). However, this approach frequently falls down at the first level of scrutiny unless there is a sufficient audit trail to support that such a policy exists, that there are internal controls to ensure the implementation of the policy, that the same pricing models and assumptions were applied and that there is sufficient level of expertise at both ends of the transaction as well as evidence that genuine negotiation has taken place.

The major advantage of this approach is that, to the extent that it can be shown that the same pricing models and methodologies are applied for both internal and external reinsurance pricing, multiple transactions might be supported and documented on this basis, particularly if carried forward with an ongoing sample based review in the future.

Return on Allocated Capital

Reinsurance contracts can be highly complex. Some features of inter-company reinsurance contracts heighten the risk for the group. For instance Non standard coverage and policy terms and conditions may appear relatively benign but can have a significant impact on the overall transfer pricing.

For these transactions, a more actuarial approach is generally required to support the reinsurance pricing. In reinsurance pricing of specific contracts, there have generally been two possible approaches to take:

1. Using the cedant as the tested party; and
2. Using the reinsurer as the tested party.

On the face of it, using the cedant as the tested party appears to offer certain attractions. By applying the transactional net margin method (TNMM) the insurer

often seeks to demonstrate that the decision whether or not to enter into the reinsurance transaction is, at the very least, economically neutral with regard to return on capital. In other words, the compensation which the insurer receives in return for ceding the reinsurance is set at such a level that the return on capital is at least the same after as it was before the reinsurance. For proportional reinsurance, the balancing figure is the ceding commission. For an excess of loss contract or a loss portfolio transfer, the balancing figure is the premium itself.

However, this approach has a number of potential pitfalls:

- In the first instance, tax authorities are inherently sceptical about using the onshore party as the tested party, particularly where the line of business being reinsured is expected to be particularly lucrative and/or where the reinsurer is showing a particularly high return on capital.
- Secondly, reinsurers are more typically price setters and insurers price takers, rather than vice versa, with significant potential volatility in the reinsurance market based on reinsurance capacity and the position in the reinsurance cycle.
- Thirdly, this approach does not recognise any benefits enjoyed by the reinsurer, such as a lower tax rate, lower capital requirements, or diversification benefits from pooling reinsurance – effectively none of these benefits are shared with the cedant under this approach.
- Fourthly, many arm's length reinsurance transactions result in the cedant being worse off from an expected profit perspective as the ceded profits represent the price to pay for off-loading some of their risks to reinsurers. Using the cedant's position to test the arm's length nature of a reinsurance transaction can therefore lead to very uncertain conclusions.
- Finally, and perhaps most basically, this approach effectively allows all the profits on the ceded business to flow to the reinsurer.

The approach increasingly taken by insurers and tax authorities is to benchmark the return to capital of the group reinsurer. In assessing an appropriate return on the reinsurer's capital, it is essential to assess the extent to which the capital supporting the business is genuine risk capital as compared to excess capital, which is likely to be at a greatly reduced level of risk of loss. The benchmarked return to capital will thus be determined by the type of capital and the associated benchmarked level of risk.

Regardless of the primary pricing method used, the revenue authorities will want comfort that the primary insurer has retained sufficient profit on the ceded premiums.

Inevitably, the nature of transfer pricing disputes means that, for higher risk transactions, it will seldom be entirely comfortable to rely on a transfer pricing methodology which benchmarks only one side of the transaction, particularly where there is intellectual property or where the business line is particularly lucrative.

Regardless of the transfer pricing methodology used to support the pricing of the transaction, there is an overriding need to be able to be able to articulate clearly the commercial rationale behind entering into the reinsurance contract in the first place. The commercial rationale question is increasingly the first question asked by tax authorities, and must be satisfied as a matter of priority in any transfer pricing support/documentation.

Summary conclusions

A risk based approach to the assessment of the likelihood and impact of a transfer pricing tax adjustment is essential to identify high risk areas and to shape the extent of transfer and pricing analysis and documentation.

CUPs are a good starting point, but the reinsurance market is highly cyclical, hence pricing, policy terms and conditions and returns can erode the comparability very quickly.

The reinsurer is generally a 'price-setter' and the cedant is a 'price-taker', hence it is important to demonstrate that a reinsurer is expected to achieve a return commensurate with the expected returns of third party reinsurers over the same period.

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Trends & Developments:

Germany: transfer pricing implications of new German-US tax treaty

On December 14, 2007 the US Senate finally approved the new protocol amending the 1989 US-German income tax treaty. The protocol to the new US-German tax treaty was signed by both countries on June 1, 2006 and entered into force on December 28, 2007 with the exchange of the instruments of ratification.

The most relevant changes from a transfer pricing perspective are:

Mandatory Arbitration Provision

The ratification of the new protocol - including the mandatory arbitration provision - was a milestone in the US treaty policy, since a mandatory arbitration provision had never been included in any US tax treaty while it has since been included in treaties for Belgium and Canada. This incorporation into the tax treaty has in part been caused by the recently increased international attention to dispute resolution processes. Starting with the EU Arbitration Convention within the European Union and the OECD member states agreeing in February 2007 to broaden the Mutual Agreement Procedure ("MAP") and amending the OECD Model Tax Convention to ensure that issues preventing the competent authorities from reaching an agreement on a MAP are to be resolved within two years (for more details see OECD report "Improving the Resolution of Tax Treaty Disputes").

The scope of the arbitration provision is limited to cases dealing with the application of the treaty articles on residence, permanent establishment, business profits, associated enterprises and royalties. Beside these cases the provision allows the competent authorities to agree on the application of the binding arbitration for other matters as long as article 25 ("Mutual Agreement Procedure") applies to these cases as well.

Pursuant to the new provision cases including transfer pricing cases which have not been solved by the competent authorities within two years will go to arbitration and the arbitration process is to be completed within 6 months. Incorporated into the new protocol is also the "last best offer" or so called "baseball" arbitration process, according to which both competent authorities have to submit a proposed resolution, outlining the amounts of income, expenses, or taxation and their proposed positions. The board is then obliged to adopt one of the two proposals.

Business Profits

The German transfer pricing rules traditionally embraced transactional transfer pricing methods rejecting profit-oriented methods or only allowing them as a method of last resort for validation purposes. In the new treaty Article 7 - Business Profits, provides that any transfer pricing method described in the OECD Transfer Pricing Guidelines is accepted to determine the profits attributable to a permanent establishment. Hence, confirming Germany's acceptance to apply profit oriented methods as a last resort for cases where the transactional methods cannot be applied.

The new protocol to the German-US treaty treats a permanent establishment as if it were a separate distinct enterprise for the purpose of determining the profits attributable to the permanent establishment. This is in line with the OECD's functionally separate enterprise approach as outlined in the OECD "Report on the attribution of profits to permanent establishments" and can be seen as an initial step towards an official acceptance of this approach in Germany. However, the German tax authorities have not yet officially recognized their acceptance.

Dividend withholding tax

The protocol imposes a new zero percent dividend withholding tax rate for dividends paid by an enterprise to its parent company if the dividend receiving enterprise owns directly at least 80% of the dividend paying enterprise's voting rights

(ii) for a 12 month period up to the date of the dividend resolution and

(iii) the conditions of the "Limitation of Benefits" clause are met.

Alongside with the zero percent withholding tax rate the tax treaty provides for a 5% withholding tax rate for direct investments of at least 10% of the dividend paying enterprise's voting rights or a 15% withholding tax rate for shareholdings of less than 10% respectively.

The protocol further contains specific provisions on the dividend withholding tax rates for RICs, REITs or German Investmentaktiengesellschaften ("Investmentvermögen").

Entry into force of the new protocol

The protocol shall be effective as of January 1, 2008 whilst the new provision regulating the reduction of the withholding tax rates shall be effective as of the year where the instruments of ratification have been exchanged, i.e. are applicable to all payments made on or after January 1, 2007.

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OECD Paper on Transactional Profit Methods: Discussion Draft

On 25 January 2008 OECD published a series of draft Issues Notes (www.oecd.org/dataoecd/18/48/39915180.pdf) for comment in relation to Transactional Profit Methods (i.e., the transactional profit split and the transactional net margin methods). Public comments are requested by April 30, 2008.

As part of its procedures for monitoring the implementation of the 1995 Transfer Pricing Guidelines, Working Party No. 6 of the OECD Committee on Fiscal Affairs is examining the application of transactional profit methods. In February 2006, the OECD released its first invitation to comment on issues in relation to profit methods and attracted many detailed responses from the public.

The current draft takes into account comments received in 2006, builds further on experience acquired by countries in applying transactional profit methods since the adoption of the TP Guidelines in 1995 and reviews the status of the profits methods as exceptions to the preference for traditional and CUP methods. The potential change in the status of profit methods would mean that they in practice will rank equal to CUPs and traditional transaction methods. OECD further provides additional draft guidance on how profit methods are to be applied in practice.

The issues addressed in 2008 discussion draft are following:

- Status of transactional profit methods as last resort methods
- Use of more than one method (use of a transactional profit method in conjunction with a traditional transaction method, or sanity check)

- Access to the information needed to apply or review the application of a transactional profit method
- Application of transactional profit methods and unique contributions
- Application of the transactional net margin method: standard of comparability
- Application of the transactional net margin method: selection and determination of the net profit margin indicator
- Application of a transactional profit split method: determining the combined profit to be split
- Transactional profit split method: reliability of a residual analysis and a contribution analysis
- Application of a transactional profit split method: how to split the combined profit
- Other methods (use of internal pricing models, pricing models such as option pricing formula, use of a discounted cash flow analysis, fair market valuation approaches and other) and Global Formulary apportionment

Some Specific Comments regarding the Discussion Paper

In supporting that change, the OECD has made several important comments on a range of issues:

- The application of a second method is valid as a sanity check to identify unusual outcomes or otherwise review the use of a primary method and its application including comparability analysis in particular;
- Access to information is critical for all transfer pricing methods, which necessitates access to qualitative information to be collected on the non-tested party (irrespective of whether the non-tested party is a foreign or domestic entity);
- The lack of significant intangibles does not mean the TNMM is the only method to be used, since it is possible that a party with unique contributions other than intangibles (e.g. unique functions, assets or risks) should be entitled to profits (and presumably losses) falling outside the typical ranges of a TNMM result;
- The paper confirms the approach of excluding revenues and costs not connected to the revenues and expenses of the comparable transactions, unless it is appropriate to aggregate transactions in accordance with the Guidelines.
- In the calculation of a net profit margin, the Paper suggests exclusion of non-operating items, financial items, and foreign exchange gains or losses where they are not related to the tested transactions. Other costs are treated on a case by case basis include depreciation and amortization, start-up and termination costs
- For financial activities however, the OECD notes that where interest is trade interest – as well as other situations where the capital structure may heavily influence prices, it will be generally appropriate to consider the effect of interest when determining the net profit margin.
- The application of different net margins (return on sales, assets, costs) is discussed in detail concluding that the appropriate net profit margin should be the one which is most relevant to the circumstances of the case and where the availability of information on uncontrolled transactions enable a meaningful and reasonably reliable comparison.

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India: Supreme Court reaffirms position on taxability of BPO units

In a recent development, the Supreme Court in India rejected a review petition filed by the Revenue seeking to tax a portion of the global income of foreign companies, earned on account of their captive BPO units in India.

Background

In July 2007, the Supreme (Apex) Court of India had pronounced a landmark Ruling in the case of Morgan Stanley ('MS Co'), an investment bank incorporated in USA. The Ruling dealt with whether Morgan Stanley had a Permanent Establishment (PE) in India as a

consequence of the back-office operations outsourced by the US entity to its captive Business Process Outsourcing (BPO) unit in India ('MSAS'). The attendant question was of profits attributable to such PE, on which, the Supreme Court ruled that once Transfer Pricing to the Indian BPO unit adequately takes into account functions, assets and risks of the PE, no further profits are attributable to the PE.

Specifically the Supreme Court held that MS Co. would not have a Fixed place PE or Agency PE in India but would constitute a Service PE since MS Co was responsible for the work of the employees deputed and the employees continue to be on the payroll of MS Co or they continue to have lien on their jobs with MS Co. It further held that Transactional Net Margin Method ('TNMM') was the appropriate method for determination of the arm's length price in respect of the back office support services provided by MSAS and ruled that though MSAS constituted a Service PE, it was remunerated on an arm's length basis taking into account all risk taking functions of MSAS. Hence, nothing further would be left to be attributed to the PE.

Review Petition by the Indian Revenue

Subsequently, the Indian Revenue filed a review petition with the Supreme Court in October 2007, with a request to reconsider the above judgment. The outcome of such a petition was crucial as it would have a bearing on about 110 captives operating in India that serve global parent companies. The Indian Revenue sought a revision on the ruling as it felt that even an arm's length relationship (between MS Co and MSAS) cannot absolve a foreign entity from potential PE exposure. Further, this was based on their view that such captives often function as cost centres and the only way to tax foreign entities would be a portion of their profits that could be traced to such captives.

Typically once a review petition is moved, the Judges review the petition internally without a public hearing and notices may be sent to initiate review process.

The Supreme Court finally dismissed such review petition filed by the Revenue. As a result, the earlier judgment of the Apex Court is final and the law on this issue is thus settled.

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HMRC's New Approach to Transfer Pricing Work

Following a public consultation, in October 2007 HMRC announced in the document "Making a difference: clarity and certainty" that it will implement the introduction of a new approach to transfer pricing enquiries involving greater specialisation and team work, focus on issues of higher risk, action plans for enquiries, and active monitoring of progress.

The revenue authorities are launching a radically new technical specialism to support all of its units to deliver the approach. HMRC's Transfer Pricing Specialists have been appointed and additional training is provided to enhance their specialist skills. HMRC plans for resolving transfer pricing enquiries within 18 or 36 months, depending on the complexity, are largely in place. From January 2008 a new internal governance process will address issues around consistency of approach, allocation of resource to risk and wider departmental strategic objectives.

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Country focus: China

Shyamala Vyravipillai is a manager in PwC's China/Hong Kong Transfer Pricing practice, specialising in Financial Services. The Chinese transfer pricing services team is lead by Spencer Chong. It was voted ‘leading transfer pricing firm 2006/07’ by the International Tax Review. Our dedicated team is strategically located in major cities across China including Beijing, Tianjin, Shanghai, Guangzhou, Shenzhen, Dalian, Xian and the Hong Kong SAR and assists multinational businesses including financial services firms with transfer pricing exposures and opportunities. Numerous multinational corporations are currently relying on us to guide them through the complexities of transfer pricing issues in China.

Introduction

Shyamala Vyravipillai is a manager in PwC's China/Hong Kong Transfer Pricing practice, specialising in Financial Services. The Chinese transfer pricing services team is lead by Spencer Chong. It was voted "leading transfer pricing firm 2006/07" by the International Tax Review. Our dedicated team is strategically located in major cities across China including Beijing, Tianjin, Shanghai, Guangzhou, Shenzhen, Dalian, Xian and the Hong Kong SAR and assists multinational businesses including financial services firms with transfer pricing exposures and opportunities. Numerous multinational corporations are currently relying on us to guide them through the complexities of transfer pricing issues in China.

Country profile

Despite China's size, the abundance of its resources, and having about 20% of the world's population living within its borders, for the last two centuries its role in the world economy has been relatively small. However, China has been the fastest growing nation for the past quarter of a century with an average annual GDP growth rate above 10%.

This drastic change in growth started approximately in 1978 when the Chinese government reformed the economy from a centrally planned economy that was largely closed to international trade, to a more market oriented economy that has a rapidly growing private sector and is a major player in the global economy. The government has allowed foreign investors to manufacture and sell a wide range of goods on the domestic market, eliminated time restrictions on the establishment of joint ventures, allowed foreign partners to become chairs of joint venture boards, and authorised the establishment of wholly foreign-owned enterprises. In addition preferential tax treatment was granted to wholly foreign owned enterprises and contractual ventures which invested in selected economic zones or in projects encouraged by the state, such as energy, communications and transportation.

Many of the liberalisation policies have been part of China's accession to the World Trade Organisation ("WTO"). China's effort to join the WTO began in 1986 and was officially completed in November 2001. The 15 years leading to WTO accession involved removing many barriers to trade such as implementing a reformed foreign trade regime and a reduction in tariffs. There were also many domestic reforms implemented to support trade, such as development of the legal system. China has viewed the award of the 2008 Summer Olympics as an affirmation of these economic reforms as well as social reforms made in the same period.

The removal of trade related investment measures and hence the opening up of the China market has led to foreign multinational nationals expanding their operations in China at an accelerating pace. This trend in liberalisation has prompted the Government to introduce new laws relating to tax, regulations, and administrative measures in order to monitor and control the foreign investment surge into China.

Introduction of new tax law

In order to entice foreign investment into China, the government historically offered certain preferential tax treatments for Foreign Investment Enterprises ("FIEs") and Foreign Enterprises (“FEs”). Despite the legislated 33% corporate tax rate for FIEs in China, the government estimates that the average tax rate for FIEs and FEs was approximately 15% while for Chinese Domestic Enterprises ("DEs") it was 25%.

On 16 March 2007 China's top legislature, the National People's Congress (“NPC”), passed the long awaited China Corporate Income Tax Law (“CIT Law”)

by dominant majority vote. This CIT reform is undoubtedly a significant milestone in China's tax history since the turnover tax reform in 1994.

This reform aims at establishing an income tax regime that reflects a level playing field for DEs and FIEs. In addition, the Law provides for a fundamental change in China's tax incentive policy in shaping and directing the future development of the country.

The biggest change under the new law involves the revision of the corporate income tax rate to 25%, although there will be a 20% rate for small and thin profit companies and 15% for qualifying firms that are deemed to be developing high technology. The 25% rate will apply to DEs, FIEs and FEs.

Given the possible permutations of the tax benefits an FIE could have enjoyed under the old tax regime, many FIEs will now face a higher tax burden. The Chinese authorities felt that the 25% rate was still competitive for the region, and that interest in investing in China is robust enough not to suffer from the increase.

Like previous income tax laws, the CIT Law mainly provides a framework of general tax provisions. Important details on the definition of numerous terms as well as the interpretation and specific application of various provisions are left to the Detailed Implementation Regulations ("DIR") and supplementary tax circulars.

On 6 December 2007, the State Council approved the DIR to China's new CIT Law. The Ministry of Finance and the SAT prepared the final version of the DIR, which was finalised after rounds of consultations with local governments, central ministries, multinational companies, domestic groups, scholars and professional firms.

Specific transfer pricing implications

Legislation relevant to transfer pricing is mainly found in Chapter 6 of the CIT Law titled 'Special Tax Adjustments' ("Chapter 6"), which deals with tax avoidance and transfer pricing issues. It contains enhanced legislation and regulations, including the introduction of new concepts to strengthen tax avoidance and transfer pricing enforcement.

Below are the key concepts of Chapter 6 as they apply to related party transactions:

- Transfer pricing documentation
- Special interest levy on tax adjustments
- Anti-avoidance
- Controlled foreign company ("CFC") rules
- Thin capitalisation
- Cost sharing arrangements
- Advance pricing agreements

Transfer pricing documentation - tax filing requirements

Chapter 6, the DIR and the set of administrative measures for transfer pricing documentation (to be called "Documentation Requirements[1]") provide the legal framework for transfer pricing enforcement. Specifically, the transfer pricing regulations provide that with respect to transactions on and after 1 January 2008, taxpayers must provide related party transaction information to the tax authorities at the point of tax filing. In addition, taxpayers must submit transfer pricing documentation within 30 days upon request by the tax authorities when investigated.

It is important to note that the law is silent on the transfer pricing documentation requirements for transactions prior to 2008. However, given China's uncertain tax climate and increasing transfer pricing scrutiny, it is recommended that taxpayers should at the very least have some form of adequate transfer pricing documentation in place for related party transactions prior to 2008.

Special interest levy on tax adjustments

One of the most significant practical impacts of Chapter 6 on transfer pricing is the imposition of a special interest levy on anti-avoidance tax adjustments made by the tax authorities. Before the CIT was introduced, there was no penalty for transfer pricing adjustments made by the tax authorities, except for the tax on the adjustment itself. As such, there was limited incentive to comply until faced with a transfer pricing review or audit situation. The implementation of the special interest levy will now significantly increase the financial cost associated with any anti-avoidance tax adjustments, including transfer pricing tax adjustments.

The DIR clarifies that the interest levy shall comprise two parts:

(1) financing charge for the delayed tax payment; and

(2) an additional 5% penalty interest.

The interest levy is expected to act as a new deterrent to aggressive tax avoidance schemes.

[1] Soon to be issued

It is also unknown at this time whether there may be some ways to mitigate the penalty component of the special interest levy through 'good behaviour' on the part of the taxpayer, for example, through the preparation of appropriate contemporaneous transfer pricing documentation.

Anti-avoidance

The Legislation introduces a general anti-avoidance rule which formally authorises Chinese tax authorities to make an adjustment where the taxpayer enters into an arrangement 'without reasonable commercial purpose'. This is a strong signal of the tax authorities growing scrutiny on anti-avoidance schemes.

The key focus is on commercial reasonableness, which could be controversial. Since the onus of proof falls on the part of taxpayers, it is imperative to justify any special deals with sound commercial grounds, and to compile sufficient documentation in case of enquiry and challenge by the tax authorities.

Controlled foreign company ("CFC") rules - aimed at DEs

Rules regarding CFCs were introduced to address situations where the profits of an enterprise that one controlled by a Chinese tax resident are not distributed or distributed in a reduced amount without reasonable commercial purposes. Chapter 6 empowers the tax authority to deem such profits as the Chinese tax resident's revenue and therefore subject to Chinese corporate income tax.

Thin capitalisation

Chapter 6 contains a specific thin-capitalisation rule to disallow interest deductions on borrowings from related companies if the interest-bearing loans of the enterprise exceed certain prescribed safe-harbour debt-equity ratios. The DIR provides definitions for debt and equity but the prescribed debt-equity ratio was intentionally left out to be addressed by future circulars.

Cost sharing arrangements ("CSAs")

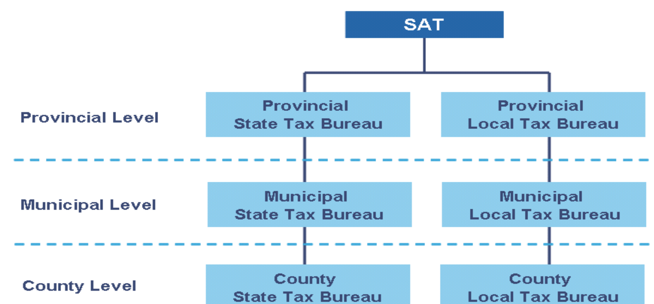
In the past, multinational companies were less willing to share IP or services with Chinese subsidiaries for various reasons – a key factor being that shared costs were non-deductible in the hands of the Chinese subsidiaries. Additionally, although there were a few reported cases and circulars providing the green light on CSAs, it seemed in practice that the acceptance of a CSA at the local tax bureau level was difficult. The new provision in Chapter 6 formally introduces and provides the legal framework for CSAs, paving the way for China to attract more advanced IP and sophisticated services from overseas which should benefit the whole country in long term.

Advance pricing agreements ("APAs")

Finally, it should be noted that the Chinese tax authorities have given enhanced legal status to APAs which companies can potentially use to manage ambiguity under the new tax regime. The first bilateral APA between China and Korea was completed in November 2007, which was China's third bilateral APA after Japan and the United States. It is expected that APAs will grow in importance and be extended to more complex transactions such as financing activities.

The tax authority

The fiscal system in China is characterised by the sharing of tax revenues between the central government and local governments. The State Administration of Tax ("SAT") is the highest tax authority in China. The SAT is the ministry level department directly under the State Council, which is the functional department in charge of the State revenue work. The SAT Headquarters exerts line authority over the SAT local offices at various levels and together with local governments, guides the work of provincial, municipal and county tax bureaus (as shown below).



In general, the taxpayer must deal with a number of quasi independent tax authorities, depending on the location of the taxpayer. These local authorities report to the SAT, but in practice have much latitude in how they carry on their enforcement activities. Furthermore, their levels of expertise and their interpretations of relevant fiscal law can vary which presents a challenging environment for tax planning for multinationals.

Implication for the financial services industry

The business of foreign financial services organisations in China is booming as the Chinese middle-class takes root, foreign investment in the industry soars and China's regulatory environment

governing the sector continues to open up under WTO rules.

According to a recent survey conducted by PricewaterhouseCoopers (May 2007), the majority of the banks surveyed predict annual revenue growth rates of at least 20% per annum for 2007. The optimism of the foreign banks going forward was very evident with 100% of the respondents predicting that in the next three years, their profits will be greater than at present, up from 85% in 2005. Assets are expected to double by 2010 to over US$100 billion.

In March 2007 the most important change taking place in the financial services market in China, was the move towards local incorporation of foreign banks. The impact of this move to incorporation is expected to have far-reaching implications for foreign banks, particularly in the areas of increased capital requirements, wider supervision, greater transparency and new product opportunities. The PricewaterhouseCoopers survey states that appropriately 20 to 30 banks will incorporate locally by 2010. This enables banks to offer new retail products e.g. credit cards, investment products, mortgages and new wholesale products such as Renminbi denominated interest rate and currency swaps, structured products and debt capital markets into the China market.

Given China's accession to the World Trade Organisation, the trend of growth predicted for the financial services industry in China and the fact that China's tax authorities have been increasing their transfer pricing enforcement, we expect the Chinese tax authorities will gradually expand their transfer pricing enforcement into the financial services sector as they learn from their overseas counterparts and become more sophisticated.

Although there have been no transfer pricing audits in the financial services sector to date, it is evident that the China tax authorities have been adopting an increasingly aggressive stance in protecting their tax base in face of China's burgeoning foreign investment. This is evident in the significant increase in the number of transfer pricing audits and associated transfer pricing adjustments, which provide a clear indication of the China tax authority's attitude towards transfer pricing enforcement.

Considering China's dynamic liberalisation of its banking and financial services sector, and the tremendous growth opportunities now available, multinational companies may rank transfer pricing at a low priority. However with heavier transfer pricing penalties such as the interest levy, impact of which could be substantial given China's 10-year statute of limitations, companies must now carefully assess their transfer pricing risks and ensure compliance to the new transfer pricing requirements.

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Jobst Wilmanns: 'From my Perspective'

The FS industry is confronted with an increasing requirement for the determination, organisation and documentation of transfer pricing. The crucial question internal transfer pricing specialists are facing these days is whether the definition and subsequent defence of a uniform transfer pricing system is sustainable within the increasingly dynamic market developments. Bilateral coordinated transfer pricing systems to ensure worldwide enforceability could be an alternative but increase the risk to create internal comparables.

The interpretation of articles 7 and 9 of the OECD Model Tax Treaty, both through the OECD itself and incorporation of these principles into the local legislations, has caused a complexity in determining a unique transfer pricing approach. One example is that the OECD established the functionally separate enterprise approach which provides a framework for dealing with permanent establishments. The implementation of the authorized OECD approach on the attribution of profits to permanent establishments requires the FS industry to focus on the identification and application of the Key Entrepreneurial Risk-Taking (KERT) functions. From an industry perspective, it is difficult to clearly identify which part of the entity performs the KERT functions.

A second example is that each jurisdiction imposes specific local regulations, divergence in the implementation of profit oriented approaches, while the associated documentation requirements increase the complexity of applying internationally consistent standards. The application of these standards and principles requires comprehensive knowledge of the matter including in-depth knowledge of the value chain and the associated implications in order to define the "Best Practices". To make this work, in-house tax departments need to posses necessary expertise and ability to gather the relevant information real-time.

In addition to OECD, other factors driving the FS Industry include the capital markets pressure which in turn requires an optimization of the transfer pricing systems and cash-flow positions, the developments in other industries, the desire to streamline operational processes and the outsourcing of compliance activities, including for example aggregation of transactions for documentation purposes, to achieve cost-savings. As result, sometimes the economic rational for global restructurings may become overruled by financial objectives (like minimization of tax burden or elevated cash-flow position), which may lead to significant tax risks if no sufficient attention is given to documentation and compliance with local regulatory requirements. Tax departments alone would not be able to manage these factors independently; thereby, involvement and coordination of multiple departments in different jurisdictions is necessary. In practice, for example, "Task Forces" are formed to control and ensure that in each jurisdiction only relevant information is provided during a tax audit.

In response to these changes and developments, many countries are now considering how to implement the authorized OECD approach to the attribution of profits to permanent establishments as well as other international initiatives into local legislation. Local governments and tax authorities have demonstrated their continuous focus on transfer pricing through ongoing tax audits, creation of dedicated resources and training of transfer pricing specialists. In Germany, tax authorities hire more and more economists, in contrast to the traditional preferences for lawyers, and assign them into specialized industry clusters.

Moreover, there have been on-going issuances of new transfer pricing rules, administrative principles and specific court rulings in various jurisdictions which increase the risk of double taxation. At the beginning of this year for instance, Germany included specific rules on business restructurings into its legislation, whilst the OECD is only planning to publish its own paper illustrating its position on this topic by the end of 2008. As for the US, the implementation of the recently introduced Service and FIN 48 Regulations has led to a new transfer pricing trend. In addition, countries like China and India have made an internationally coordinated transfer pricing system more complicate by applying non-OECD compliant definitions of permanent establishments (e.g. Services PEs) or the requirement of governmental contract approval. Given these differences in local interpretation and application, an increasing acceptance of international binding arbitration processes such as mandatory arbitration clauses, e.g. the new protocols to the US-Germany or US-Belgium tax treaties, or Advance Pricing Agreements (APAs), enables the companies to achieve a certain level of comfort with regards to the acceptance of their transfer pricing systems.

In conclusion one can constitute that the ongoing development of international standards and initiatives requires FS companies to carefully assess the feasibility of a global transfer pricing system and upon its implementation constantly monitor its compliance with new standards. This becomes even more important with the tax authorities tending to assume the existence of a permanent establishment in case of insufficiently planned and documented transfer pricing systems. It is therefore, in the interest of every industry player to ensure that they posses the necessary expertise to cope with this challenge and utilize the possibility of achieving a higher comfort level by using APAs or mutual agreement procedures more often.

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Future Events:

Global Transfer Pricing Masters Series for Financial Services Professionals*

*connectedthinking

Our 2008 global Masters Series for Financial Services Industry Professionals will be held in:

April 2, 2008, Singapore;

May 15, 2008, New York, USA;

May 21, 2008, Amsterdam, Netherlands

Financial services transfer pricing specialists, together with guest speakers, will guide the discussion around the complex and unique environment issues including a discussion on the OECD final papers and ramifications of the November 2007 US Treasury Department Report to Congress around earnings stripping, transfer price and US income tax treaties.

The focus will also lay on global experiences related to FIN 48, as well as inter-company lending, guarantees and thin cap and many other hot topics.

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April 2, 2008, Singapore:
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May 15, 2008, New York:
Adam Katz adam.katz@us.pwc.com

May 21, 2008, Amsterdam:
Michel van der Breggen michel.van.der.breggen@nl.pwc.com

Hugo Vollebregt hugo.vollebregt@nl.pwc.com

Hungary & Switzerland

2nd Treasury Breakfast, Zurich, Switzerland

April 2, 2008: Topic: Managing FX Risk - Policies, Tax, Transfer Pricing

For more information please contact:

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FSTP Breakfast Briefing Meeting, Zurich, Switzerland

May 29, 2008: Topic: US Transfer Pricing Update

For more information please contact:

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Transfer Pricing Financial Services for Non Financial Institutions, Budapest, Hungary

29 February, 2008

Topic: Key practical issues with regards to documenting related party debt from a Hungarian Transfer Pricing perspective as well as using Transfer Pricing techniques for planning future related party transactions.

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Recent FSTP Publications

As part of a dedicated series written by PwC financial services tax and transfer pricing practitioners for the Transfer Pricing Report the following articles have been published recently:

The Agency PE Conundrum

Authors: Richard Collier, Sanjay Tolia and Prashant Bohra

Publication: Tax Management Transfer Pricing Report, Date of Publication: October 18, 2007

This article discusses the key issues of the Agency E threshold as well as the recent OECD developments n the subject of profit attribution to PEs and how they apply to Agency PEs.

Financial Services Transfer Pricing, Special compilation for 61st congress of IFS in Kyoto

Publication: BNA Tax Management Transfer Pricing Report, Special Report, Date of Publication: September 25, 2007

Hedge Funds - Fringe No More. The Tax Man Cometh...

Authors: Aamer Rafiq, David McDonald, Lirize Loots, Mimi Wang, Adam M. Katz, Frank Douglass, Mac Calva, Irina Diakonova, Ryann Thomas, Florence Yip, Mariana East and Paul Lau

Publication: Tax Management Transfer Pricing Report, Date of Publication: September, 2007

Does Debt Matter? The Transfer Pricing Perspective

Authors: Michel van der Breggen, Barry Dennis, Irina Diakonova, Aamer Rafiq, Jeff Rogers, Mohamed Serokh and Bill Yohana

Publication: Tax Management Transfer Pricing Report, Date of Publication: July 11, 2007

Recent litigation on guarantee fees between Canada and two financial institutions—General Electric and HSBC—and a recent case on interest rates in Sweden highlight that nations are becoming more interested in assessing whether intercompany financial transactions are at arm's-length prices. Practitioners from PricewatershouseCoopers' offices in Amsterdam, Calgary, London, Melbourne, New York, and Zurich provide an overview of the issues arising as companies and governments estimate the pricing of these transactions, with a focus on intercompany debt.

BPO units in India: Recent Supreme Court Ruling in the Case of Morgan Stanley on PE and Profit Attribution

Authors: Rahul Krishna Mitra and Sanjay Tolia

Publication: BNA's Tax Planning International Review, Date of Publication: July, 2007

Rahul Krishna Mitra and Sanjay Tolia, PwC India, analysed the Supreme Court of India's ruling in the case of creation of PE and allocation of income of the business process outsourcing ("BPO") of a global bank. As India is an established outsourcing hub for information technology, research & developments services and back-office functions in the financial services industry, these recent developments help to clarify the grounds and implications for PE and profit attribution issues.

Financial Services and Transfer Pricing in Italy:

Authors: Fabrizio Acerbis, Alessandro Caridi

Publication: Tax Management Transfer Pricing Report, Date of Publication: May 16, 2007

Fabrizio Acerbis and Alessandro Caridi of PricewaterhouseCoopers in Milan review the recent increase in Italian transfer pricing audit activities in the financial services industry—a trend they say is likely to continue as use of derivatives, complex financial transactions, and the lack of transparency compel further monitoring of the capital market and the financial sector.

Financial Institutions - Profit Split's New Frontier

Authors: Lucia Fedina, Adam Katz and Stan Hales

Publication: Tax Management Transfer Pricing Report, Date of Publication: May 2, 2007

Lucia Fedina and Adam Katz of PricewaterhouseCoopers LLP in New York and Stan Hales of the firm's San Francisco office examine tax authorities' increasing use of the profit split method for financial institutions.

Financial Services Transfer Pricing Trends and Developments

Authors: Aamer Rafiq, Annie Devoy, Adam M. Katz, Irina Diakonova, Ryann Thomas and Ana Carolina Albero

Publication: Tax Management Transfer Pricing Report, Date of Publication: April 18, 2007

Practitioners from PricewaterhouseCoopers' offices in New York, London, Zurich, and Tokyo examine draft reports released in December by the Organization for Economic Cooperation and Development on the attribution of profits to permanent establishments, which they say highlight the unique nature of the transfer pricing issues faced by financial services organizations.

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