Transfer pricing perspectives

Thriving through challenging times

Navigate ▶ Next page | Foreword | Contents | Print

In this issue:

PRICEWATERHOUSECOOPERS

Foreword

Garry Stone
Global transfer pricing network leader
PricewaterhouseCoopers (US)

It is my pleasure to present this new edition of PricewaterhouseCoopers' Transfer pricing perspectives.

The past year had been tough for the world economy. Although now we are seeing signs of a recovery there are still potential troubles ahead, as several major territories adopt new or revised requirements for transfer pricing as well as the increase of disputes globally. Documenting and sustaining transfer pricing in this economic environment can also create many difficult issues for tax departments. The continuing uncertain tax positions generated by the transfer pricing process means that multinational companies are having to satisfy the increasing demands of tax authorities and stakeholders. The present economic situation — which has made the former more aggressive and the latter more cautious — has only aggravated this fundamental challenge.

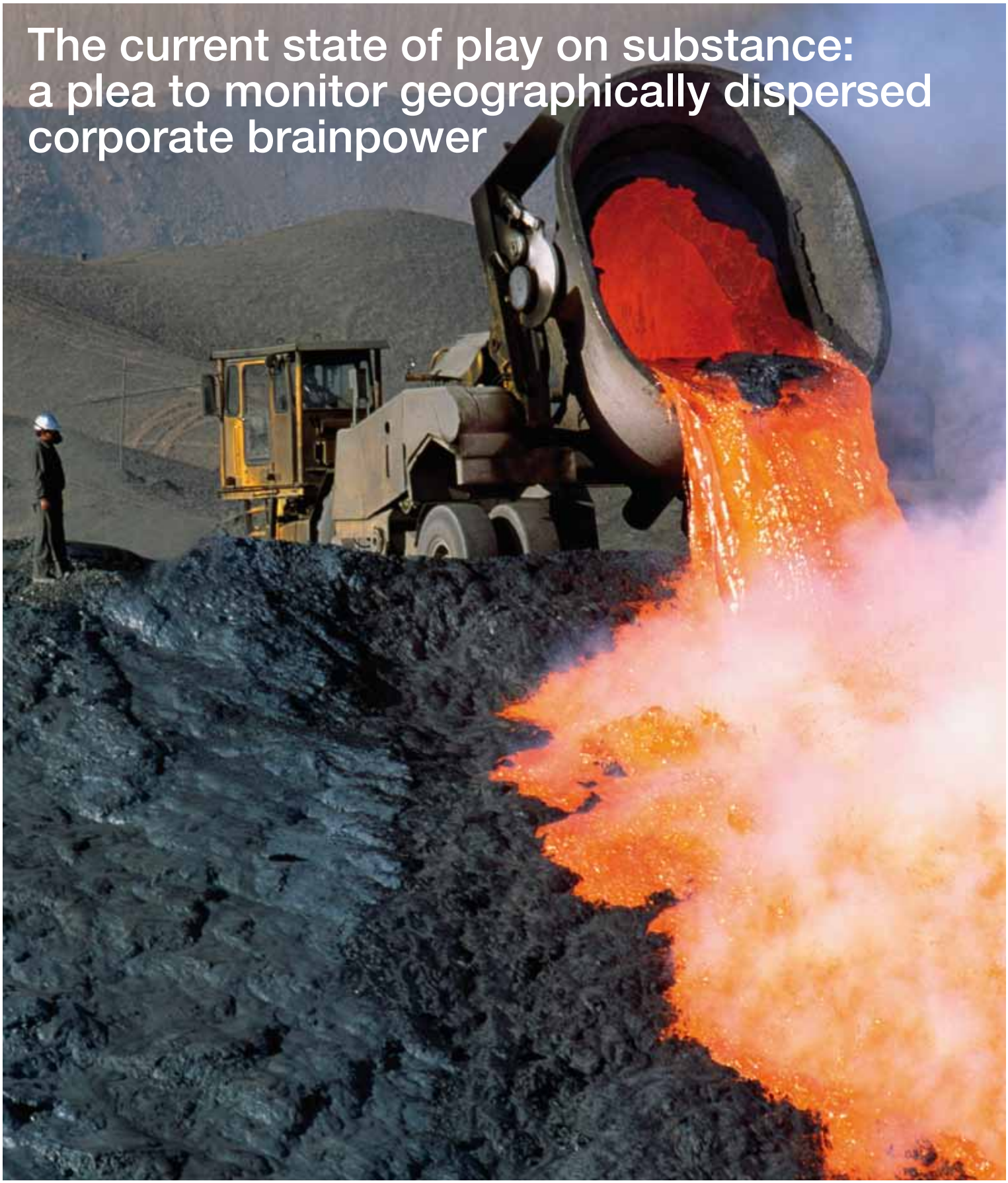
The articles in this edition remind us that a longer-term view with a global perspective is vital to achieving satisfactory results now and exploiting change for long-term benefit.

Perspectives: Thriving through challenging times offers strategies on how to meet the increased transfer pricing challenges and we hope that this edition will give you greater insights into how your business can better manage the risks and opportunities arising from these challenging times.

To keep up to date with the latest transfer pricing developments around the world, sign up to our PKN alerts by visiting pwc.com/pkn. Our 2010 Global Transfer Pricing Conference will be held in Budapest, Hungary from 20 to 22 October. Further details will be launched in late May/early June and will be available via your usual transfer pricing PwC contact. I look forward to seeing you there.

Contents

The current state of play on substance: a plea to monitor geographically dispersed corporate brainpower



The current state of play on substance: a plea to monitor geographically dispersed corporate brainpower

By **Axel Smits** (PwC Belgium)
and **Isabel Verlinden** (PwC Belgium)

Substance is not a new topic — it has been lurking in the shadows of international tax planning for decades. This is less the case in a transfer pricing context and the notion only seemed to come to the fore when people talked about "functional analysis". Indeed, there appeared to be a persistent tendency to consider substance as a "necessary evil", which presumably justified a minimalistic approach, reducing the exercise to completion of a checklist. Questions such as "Do I need a local board of directors?", "Do I need to organise physical (in-country) board meetings?", "How many people should I move?" or "Is it possible to merely allocate risk?" are quite common when the traditional analysis is done. But the days are gone when such a quantitative approach will do. Moreover, it has in fact opened doors for tax authorities and policy-makers around the world to challenge international tax planning and label it as (somewhat) artificial.

Recall the comments made by President Obama while he was still on the campaign trail with respect to Ugland House, the infamous office building in the Cayman Islands. This building houses more than 15,000 corporations and President Obama said of it that "either this is the largest office building in the world or it is the largest tax scam in the world". Of course, not all international tax planning is organised this way, but his point was probably valid and was picked up by other political leaders, making the concern of artificial international tax planning a fixed item on the agenda of the OECD and the meetings of the G20 for the past 12 months.

This does not mean that international tax planning will no longer work. Far from it! We feel, however, that companies should step up their efforts to address substance in a qualitative manner. Instead of asking, "How many people do I need to move?" the question should rather be: "What am I trying to achieve?" or "What kind of management capacity do I need in a certain jurisdiction to achieve my objectives?" This requires a more content-based approach, in an endeavour to align tax strategy with corporate business strategy. So, instead of taking the position that business people should not get involved because they risk blocking anything that might hamper operational efficiency, they should get involved prior to embarking on a project to ensure a solid business foundation exists for a (sustainable) tax strategy. In the end, goal-congruence reigns, with the aim of optimising company value for all stakeholders. Taxes are ultimately a cost of doing business, and trying to achieve an acceptable tax rate is a noble objective that merits effort.

It is important to note here the question of how economic substance is monitored. When a tax-effective model is implemented, the substance question will be addressed at the same time. The next question is who will take ownership of the monitoring going forward, in years to come? Who will see to it that a proper substance remains in place and who will police the eventuality of a challenge because certain rules might have changed in country X? From talking to a large number of executives on this topic, it is clear that when something goes wrong and the tax authorities conclude that, say, profits cannot be allocated to a certain jurisdiction because of a lack of economic substance, it is the tax people that tend to get the blame.

We therefore feel it is important to have in place a policy on substance and to organise substance reviews on a regular basis.

Building blocks for qualitative substance

Put simply in terms of international tax planning – where the aim is to achieve an overall acceptable tax rate – companies have a two fold goal:

1. to set up one or more entities in tax-efficient jurisdictions; and
2. to allocate a fair amount of profit to those entities.

One must ensure that the entities it is intended should be tax-resident in a certain jurisdiction essentially qualify as such and that the results allocated to them are fair under arm's-length conditions.

For the purposes of the substance analysis required, both aspects should be reviewed separately given the different rules that apply (especially from country to country). In the end, however, they should be merged to assess the company's overall position.

Figure 1:
Substance: The qualitative approach

Substance in operating models

Anecdotal evidence on fiscal residence and transfer pricing

This first illustration constitutes mere anecdotal evidence on the subject of residence and transfer pricing.

A classic interest-benchmarking study aimed at establishing a range of arm's-length, intercompany interest rates in relation to a syndicated third-party bank proved in the end to have a somewhat uncommon angle. The loan agreement contained a fairly peculiar provision stating: "no member of the group may change its residence for tax purposes". You might imagine this to be a valid issue relating to the residence of the borrowing entity given its withholding tax relevance. However, defining the purpose served in a broader context is harder. The question is whether any multinational enterprise that engages in external borrowing would be able to commit to such a far-reaching obligation in a loan agreement? Is this a foretaste of what the new (tax) world might look like? From a transfer pricing perspective, reference can be made to the September 2009 OECD seminar in Paris on Tax Treaties and Transfer Pricing Developments, at which Mr Owens, Director of the Centre of Tax Policy and Administration at the OECD, addressed the needs for transparency, integrity and good government in this new world. On the other hand, the hard experience is that tax authorities need money, as the fiscal crunch is not expected to recede in the short term. A number of tax authorities are behaving pretty vigilantly. Former OECD Working Party One chair, Mr Lüthi, already mentioned a year earlier at a similar OECD event that tax authorities might get greedy, aggressive and jealous, adding a "tax morality" aspect to the debate.

Entrepreneurial structures with seconded executives

Entrepreneurial structures are typically used to accommodate a group's strategic and operational desire to organise both its upstream and its downstream relationships in a slimmer manner on a regional, eg, pan-European, basis. Tax efficiency then predominantly stems from locating the principal company in a tax-effective jurisdiction. The sixty-four thousand dollar question is whether you have the right people in terms of skills and numbers to actually run a business credibly out of the principal entity. Experience tells us that global mobility issues related to key executives often come into play during the location-study phase of the entrepreneur company. As people often feel reluctant to move permanently with their families to the principal company's jurisdiction, the possibility of pursuing "dual employment" structures is generally raised. It might – when push comes to shove – be tempting to suggest that, provided proper, robust secondment agreements are in place, the substance requirements are adequately met to justify premium profit residing with the principal company. We feel that the principal should have substantial management control of key executives under secondment agreements and bear the entrepreneurial risk of their activities. From an economic perspective, one might have reason to believe that the principal acts as the employer of the secondees.

'The sixty-four thousand dollar question is whether you have the right people in terms of skills and numbers to actually run a business credibly out of the principal entity'

Recent developments in the area of business restructurings at the OECD might play a pivotal role here. The September 2008 discussion draft emphasises the need to analyse and substantiate who it is that actually controls entrepreneurial risk. This is easier said than done, as companies' value chains are seldom organised in a linear manner and senior management is often dispersed over various legal entities. The OECD could have taken a variety of positions in the discussion draft. First, it could have proclaimed that a multinational enterprise cannot allocate risk over its affiliates and that, consequently, risk cannot be diversified at all, so that it automatically lies with the parent company. Alternatively, it could have "taken everything the taxpayer says for granted", provided it is documented, ie, placing form over substance. Third, it could have made the so-called "comparable uncontrolled risk-allocation method" a default, meaning you should have to find out and advance what unrelated parties would have done. The risk would probably be a reversion to the first position: there would be no possibility to diversify risk whatsoever. The fourth option, and potentially or probably the preferred one could have been to respect what companies say they do, provided they have the economic and, to a lesser extent, the financial capacity to do so.

The OECD discussion draft simply urges groups to make sure that (1) the principal has the people with the expertise, ie, the capabilities and authority (decision-making power), to actually perform the risk-control function and (2) the principal's balance sheet demonstrates the financial capacity to absorb losses when things turn sour without endangering its survival as a going concern. Consequently, you could expect "control" to be seen as the capacity to analyse the decision to bear a risk, plus probably whether and how to manage the risk vis-à-vis the employees or directors. The issue of secondment is not addressed in the discussion draft and the message therefore seems to be that it is fair to strike an equilibrium between "pure" secondments, or dual-employment structures, and people exclusively on the payroll (or board). The expectation is that secondment arrangements risk being subjected to scrutiny by tax authorities. Parameters that might come into play in this debate include the essentially temporary nature of secondments (within the meaning of the EU's social security regulations, under which they should not exceed five years). The employees furthermore stay on the payroll of the assigning company and thus formally remain under its uninterrupted authority.

It does not seem advisable to have the decision-making process governed by a form-over-substance type of analysis. Recent developments at OECD level might offer more ammunition to tax authorities in their bid to scrutinise true substance in terms of entrepreneurial risk control and, generally, in terms of functionality and risk profile within the principal company. This debate might even show signs – though not formally – of the notion of significant people functions drawn from the OECD proceedings on permanent establishments, the very essence of the significant people functions notion being the ability to assume responsibility over a certain activity.

'It does not seem advisable to have the decision-making process governed by a form-over-substance type of analysis'

‘The message is to knit things together from a transfer pricing perspective even before the international tax side is looked at’

New US perspectives on defining intangibles

Our last case illustrates some potentially worrying developments, particularly from the perspective of a non-US transfer pricing practitioner, with the growing risk of attendant double taxation. This concern could be premature at this stage because the issue stems from proposals from the Obama administration. It boils down to the consequences of a possible codification of mere “value drivers” as intangibles under US transfer pricing legislation or tax legislation in general. Fundamentally, you might question whether the ‘classification’ question is at all relevant from a transfer pricing perspective. Indeed, the governing principle should be whether a third party would be willing to pay for something. Consequently, characterising an intangible as such seems to be less relevant from a transfer pricing perspective. Characterisation is pertinent from the viewpoint of article 12 of the OECD Model Tax Convention (MTC), informally referred to as the “royalty article”. You might infer from this that intangibles are restricted to intellectual property and know-how and, if you look at section 10.1 of the Commentary to the OECD MTC, it appears as if value enhancers are not to be viewed as intangibles. From a transfer pricing perspective, you are ordinarily assumed to conduct a transfer pricing analysis based on a functional analysis in which functions, risks and assets take centre stage. One concern is that, if assets are already identified under US legislation, there is a risk that the possibility of taking a zero-based approach for the functional analysis will be compromised. At the end of the day, there risks being a preponderance of profit potential for the US participants in an intercompany arrangement.

It is unclear at present whether an authoritative source such as the OECD will embark on a project to align the thinking process within a broader perimeter around extension of the classification of “soft-intangibles”. Personally, we feel that any initiative by the US Congress in that area might ultimately be a short-lived victory, especially as labour-intensive countries such as China and India might welcome the idea of codifying notions such as ‘workforce in place’, ‘going concern value’ and goodwill.

Concluding thoughts from a transfer pricing perspective

The message is to knit things together from a transfer pricing perspective even before the international tax side is looked at. Addressing substance requires you to look to the OECD proceedings on business restructurings and assess “who controls entrepreneurial risks”. The OECD proceedings on permanent establishments are also relevant, and raise the question “what about significant people functions?” Finally, there have also been interesting recent developments in the OECD Transfer Pricing Guidelines. Since 1995, most of their content has not been revised and the new draft chapters 1 to 3 that were launched in September 2009 placed emphasis on the qualitative nature of functional analysis. This once again underscores the fact that the days seem to be gone when you could conduct a functional analysis and present the outcome based purely on a spreadsheet grid in which you ticked boxes on functions, risks and assets. Taxpayers have an interest in making proper efforts to come up with a high-quality narrative of functionalities and entrepreneurial risks, fully tailored to the operational context.

Substance in corporate structures

Even though the main focus of this contribution is on transfer pricing, a substance analysis cannot rule out a review of potential challenges by tax authorities in the area of tax residence. Even if profits are allocated fairly under the arm's-length principle, with the right people in the right places, issues could still arise if the tax residence of the entities concerned were treated as if located in another (less-favourable) jurisdiction. Especially in times of government budget pressures, challenging the tax residence of companies is a fairly soft target for fiscal authorities in search of additional revenues.

The main concern here stems from the significant discrepancies in how different jurisdictions determine corporate tax residence.

Today, only a limited number of countries still use the place of incorporation as the main criterion, the US probably being the best-known example. Although the benefit of the place of incorporation rule is clear, ie, simplicity, it is also easy to abuse. Even the US now seems to be considering proposals by Senator Carl Levin to step away from the concept as the sole test and introduce some form of management and control standard.

Most countries already apply a 'real seat' test, but it is a common mistake to assume that this just boils down to the place of effective management. True, it is the concept under article 4 of the OECD MTC, but this concept has (to date) never been clearly defined and is usually interpreted under domestic tax law. In considering domestic rules, a difference in interpretation can be discerned between common law and civil law countries. The former tend to consider the board of directors as the "pinnacle of power" and focus predominantly on where its meetings take place to determine a company's tax residence. The latter, on the other hand, consider a board of directors as a company body with a supervisory role and assign more importance to day-to-day management. Having surveyed more than 40 countries for our publication 'Substance: Aligning international tax planning with today's business realities' (pwc.com/substance), we can state that there is, nevertheless, little consistency in how individual countries apply these principles in practice.

A recent example can be found in the 2009 case of Laerstate (Laerstate BV v HRMC) in the UK, in which two comments made by the court are of wider relevance. The first is that, although the UK is a common-law jurisdiction and the board's role is considered to be of key importance, the board of directors can only be taken as a criterion for tax residence if it is functioning properly. The second interesting point is that it is not merely the board decisions that should be looked at, but also the wider course of business and trading of the company (ie, you should consider the company's management throughout the year and not merely at board meetings). It is not enough to document the company's decisions as being taken outside the UK, but actually run the company from another jurisdiction.

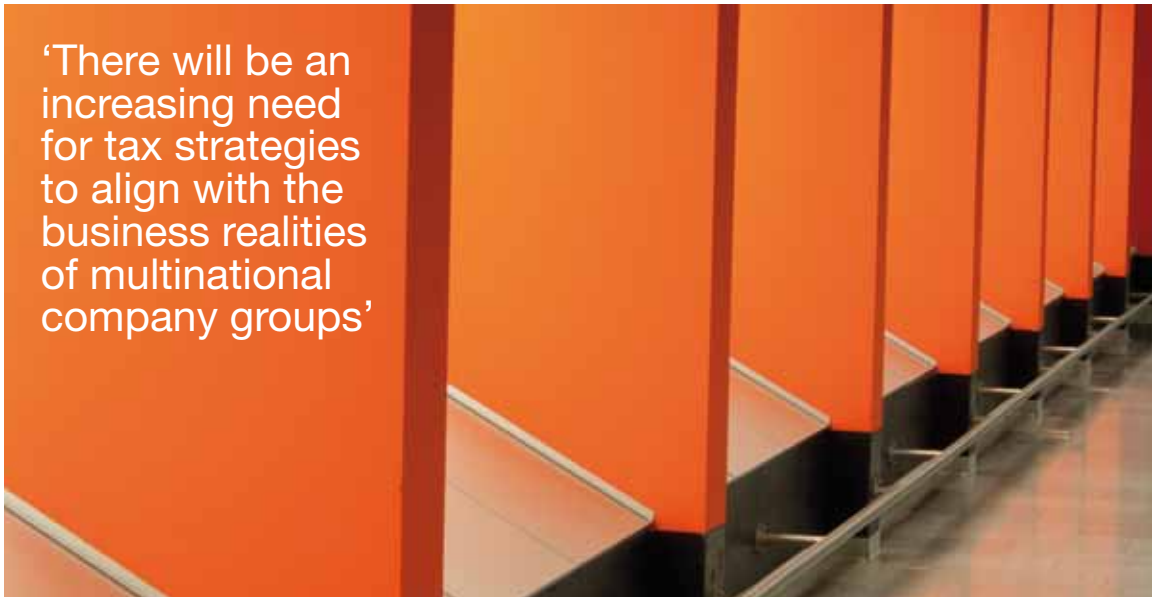
Multinational companies have an interest in carefully considering the type of jurisdiction they deal with and reviewing the rules that apply under domestic law (not so much in the country of incorporation as in the country where the real seat could be deemed to reside). As mentioned above, no clear definition of the place of effective management concept is available in article 4 of the MTC. In June 2008, the remaining reference to the 'board of directors' criterion was removed from the OECD Commentaries and a formal option to use a mutual agreement procedure (MAP) introduced. This procedure – a part of US treaties for years – is now to be found in, say, the new double taxation treaty between the UK (a common-law jurisdiction) and the Netherlands (a civil-law jurisdiction). This trend will only increase the importance of interpretation under domestic tax rules.

Finally, in an EU context, it is worth noting that an additional defence might be found in the freedom of establishment concept. Although not absolute (a rule of reason should be considered), some guidance can be found in recent ECJ case law prohibiting tax authorities from applying local anti-abuse provisions that are not aimed at preventing wholly artificial arrangements. As long as the appropriate staff, premises and equipment are in place, it should be possible to invoke the freedom of establishment in the case of scrutiny by the tax authorities.

Conclusion

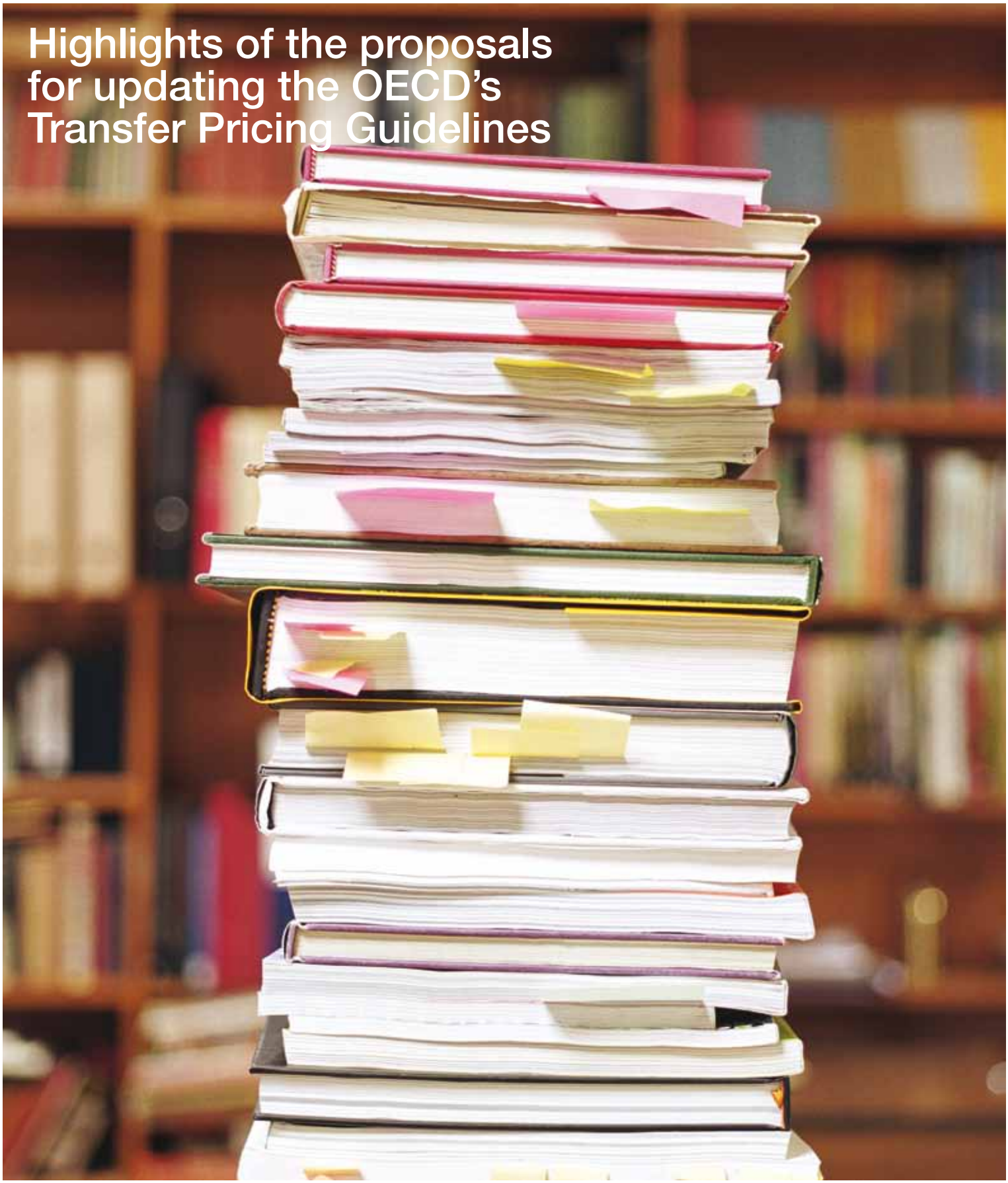
With tax authorities around the globe stepping up their efforts to challenge what they might deem to be artificial tax structures, we feel that tax departments should review their international strategies, including transfer pricing, in terms of compliance with various substance requirements. There will be an increasing need for tax strategies to align with the business realities of multinational company groups. Tax authorities are only likely to prevail over taxpayers in cases where economic substance is absent or incomplete. If substance is addressed in a qualitative manner and clear policies are put in place to monitor compliance, there is no reason to assume that effective tax strategies should not be sustainable for years to come.

'There will be an increasing need for tax strategies to align with the business realities of multinational company groups'



Transfer pricing perspectives
May 2010

Highlights of the proposals for updating the OECD's Transfer Pricing Guidelines



Highlights of the proposals for updating the OECD's Transfer Pricing Guidelines

By **Garry Stone** (PwC US)
and **Diane Hay** (Special advisor to PwC UK)

Over the past few years the OECD has been working hard to provide revised and additional guidance on two major areas of transfer pricing: 1) business restructuring and 2) transfer pricing methods and comparability. Taxpayers and tax authorities need to be aware of the ramifications of these developments as they will generally guide future country-specific transfer pricing regulations and will provide the basis for future competent authority (or MAP) negotiations. In this summary we evaluate some of the highlights.

Business restructurings

In September 2008, the OECD released a discussion draft outlining the application of the current OECD Transfer Pricing Guidelines to the difficult issues raised by business restructurings, involving the cross-border redeployment of assets, functions and risks between associated enterprises and the consequent effects on the profit and loss potential in each country. A large number of comments were received from various quarters and significant commentary has been provided on the draft. Because of the large number of comments, and also because the OECD lacks a clear consensus of its members on some of the items discussed below, there will be further refinements and developments of these positions.

In our view, there are seven key areas where the draft puts forward helpful changes and explanations.

1. The draft states that tax authorities should normally respect the taxpayer's business operational changes, and should not impose reinterpretations of the operational structure, so long as the changes meet the test of commercially rational behaviour, which is linked to the notion of "would two unrelated parties have operated in the same manner?" What this means, according to the draft, is that any attempt to argue that a transaction is not commercially rational must be made with great caution and only in exceptional circumstances.

2. The draft indicates that for the new structures to be respected there would need, first of all, to be appropriate intercompany contracts in place that lay out the key relationships between the parties, in order to effectively allow those parties to assume the appropriate risks that are associated with the new operational structure.

3. Very importantly, however, the contractual allocation of risk assumed via the contracts is to be respected only to the extent that it has economic substance (ie, the risks must be allocated to the entity that has the ability to manage or control those risks and the financial capacity to reasonably absorb them).

‘Taken as a whole, the business restructurings draft, together with the comments made on the draft, move the debate forward in a substantial way from where the OECD was several years ago’

4. The draft also looks at the issue of compensation when assets, functions and risks are transferred in a restructuring and, as a result, there is a transfer of profit (or loss) potential from one entity to another. It notes that profit potential is not an asset in and of itself, but is a potential carried by certain assets and, consequently, profit potential does not require its own compensation under the arm’s-length principle.

5. If changes occur in the location of assets as a result of the restructuring, any compensation should reflect the changes that have actually taken place and how these affect the functional analysis and the relative bargaining power of the parties involved in the change, including the options realistically available to the parties as a result of the restructuring changes.

6. Finally, the draft makes the important point that there should be no presumption that, because third parties do not allocate risks in the same way as unrelated parties, the resulting allocation should not be treated as arm’s length and that there should be no presumption that all contract terminations or major renegotiations would give rise to compensation at arm’s length.

7. Taken as a whole, the business restructurings draft, together with the comments made on the draft, move the debate forward in a substantial way from where the OECD was several years ago. The six key areas provide a good insight into the thinking of the member countries and should help taxpayers better organise their affairs until such time as final revisions to the guidelines are issued.

Transfer pricing methods and comparability

The second area of key transfer pricing developments concerns revisions to the first three chapters of 1995 OECD Transfer Pricing Guidelines. These cover issues around the choice of transfer pricing methods, with specific reference to profit-based methods, and the whole area of comparability. There are four key areas in respect of these proposed revisions that reflect the comments that PwC has recently provided to OECD.

1. The proposed revisions move away from a hierarchy of methods approach to one based on the "most appropriate method to the circumstances of the case." This is an important development because often for practical reasons the data available would warrant the application of a method such as the transactional net margin method (TNMM) rather than a traditional transactional method.

2. The current text provides much more detail on the application of TNMM (with explicit recognition of the applicability of Berry ratios) and profit splits. However, the new comparability standard for TNMM might make the application of this method more onerous and could give tax authorities a preference for profit splits.

3. The proposed revisions provide reassurance that the "most appropriate method" approach does not require taxpayers to test every other method in depth and the use of a second is not compulsory except in difficult cases. However, there is an expectation that some qualitative information will be provided on the non-tested party, including a functional analysis, in the case of TNMM as well as the traditional transactional methods.

4. The aim of the proposed new guidance on comparability is to arrive at the "most reliable comparables." While this might appear to be setting a standard that will be difficult to reach, the draft also recognises the need to be pragmatic and provides helpful guidance on the use of internal and non-domestic comparables. It also includes a 10-step process for performing a comparability analysis as a guide to good practice.

All the changes and additions to the current Transfer Pricing Guidelines address many of the practical issues found today when using the existing guidelines and ought to provide taxpayers and tax authorities with much greater clarity on how they should conduct their transfer pricing affairs in the future.

To read our full response on the proposed revision of chapters I-III of the OECD Transfer Pricing Guidelines click here.

'All the changes and additions to the current Transfer Pricing Guidelines address many of the practical issues found today when using the existing guidelines and ought to provide taxpayers and tax authorities with much greater clarity on how they should conduct their transfer pricing affairs in the future'

Transfer pricing perspectives
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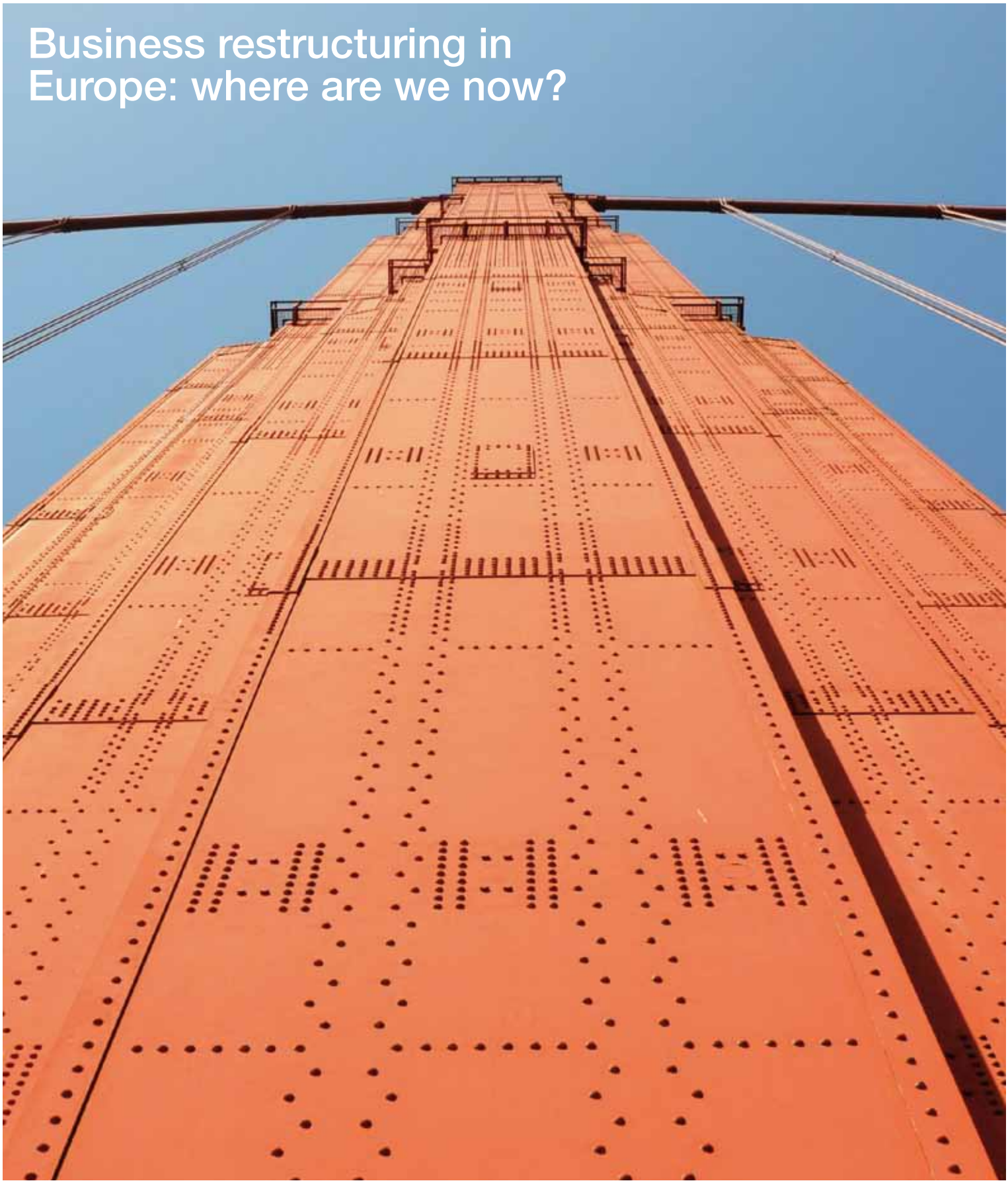
Business restructuring in Europe: where are we now?



Business restructuring in Europe: where are we now?

By **Ian Dykes** (PwC UK)
and **Yvonne Cypher** (PwC UK)

Given the number of uncertainties around specific areas of business reorganisation expressed in the Organisation for Economic Co-operation and Development (OECD) Discussion Draft, strategic management of engagement with tax authorities and documenting new business structures from the foundation and throughout the process is critical.

Businesses are subject to competitive pressures and changing market demand to structure their worldwide operations effectively and efficiently. In reaction to market forces, a multinational group might only be able to protect its profit margins by restructuring its business.

Tax authorities generally recognise that businesses are free to reorganise themselves as they see fit. Nevertheless, they have also made it clear that companies that engage in business restructuring are likely to receive scrutiny, and, indeed, this is what we have observed.

The debate has intensified since the publication of the Discussion Draft on Transfer Pricing Aspects of Business Restructurings issued by OECD in September 2008 (the Discussion Draft).

While the Discussion Draft reflected consensus among OECD member countries across many issues, it also suggested quite openly the existence of differences of opinion between governments and businesses on some critical issues, examples of which include:

- the definition of intellectual property;
- permanent establishment positions;
- the occasions on which exit charges will arise;
- circumstances in which governments may disregard taxpayer initiated restructuring transactions in their entirety;
- circumstances in which individual terms of taxpayer contracts may be disregarded or rewritten by taxing administrations;
- indemnification of individual participants in a restructuring transaction; and
- the location of significant decision makers where risk and consequence of risk ultimately settles within multinational company (MNC).

The above and other key topics were covered by the Working Party 6 during their Public Consultation held in Paris on 9 and 10 June 2009 in Paris. These have been summarised in more depth in the previous edition of “Perspectives”.

In articulating the foregoing principles, the Discussion Draft displays common sense, balance, and pragmatism. The concerns that we have with the Discussion Draft generally involve issues where these key foundational principles could be undermined to some degree.

Having this in mind, the tax authorities have already begun to challenge business reorganisations by applying arguments based on the Discussion Draft. In this article we have focused on showing more practical aspects of how MNCs considering restructuring might deal with the issues raised in the Discussion Draft and prepare themselves in case of potential tax audits, which are becoming more frequent and better informed.

The optimal approach will be based on a strong theoretical foundation that will inform all aspects of the reorganisation and that should include economic analysis of actual behaviour, third-party evidence and an analysis of relative bargaining power on the understanding that challenges and fundamental disagreements are likely to arise. It should be determined what an MNC can practically do to prepare for the challenges based on the areas raised in the Discussion Draft in order to ensure a robust and optimised defence position. It is critical to be prepared to respond affirmatively in the likely event of an audit, considering the following likely areas of tax authorities' scrutiny:

Commercial rationale

The business records that reflect the consideration of the drivers and commercial rationale for the changes (such as presentations, board minutes, etc) should be retained and it ideally would reflect the thinking at both an MNC level and at a stand-alone entity level. These records would be collateral throughout the process from early idea conception through to the final implemented structure.

Transitional considerations

A transition period is usually required to implement a business restructure. The business requirements that drive the timetable should be well documented to show whether and how the events that occur during the transition period are attributable to the same business restructure.

Demonstrating the nature of the business change

The Discussion Draft implies that a reorganisation equates to a transfer of a business from one entity to another. Reorganisations are rarely this simple, and usually amount to a transformation of the operational paradigm. It is important to reflect this in your support files.

Compensation issues

Assets carrying profit potential that have been changed or transferred in the restructuring process should be remunerated to the extent that they have economic value. In this regard it is important to identify and define all rights and assets that exist in the original structure and analyse the compensation provisions within the existing framework of legal contracts, ie, indemnity rights within existing legal framework — eg, termination provisions. It is also important to collate and analyse any third-party evidence in this respect.

Non-recognition of transactions or contractual forms

The Discussion Draft recognises that MNCs enter into transactions that independent parties wouldn't (or couldn't), but provide little guidance on what happens when this occurs. One of the key tests introduced asks whether the transactions or contractual form within a transaction would be contemplated or accepted by third parties. In this regard it will be important to generate appropriate evidence including external terms, conditions and pricing in the transactions that are structured similarly with independent parties.

Economic substance

Under the approach presented in the Discussion Draft the legal position will be recognised only if it aligns with the underlying economic substance. It will be therefore important to document the fact that the economic substance is consistent with the legal form of the new operating structure. In addition to collecting this evidence at the time of the restructuring review it is crucial to document the position periodically thereafter to ensure continued alignment of legal form and economic substance.

Economic significance of risk

It is imperative to analyse and document the business risks present in the organisation and their location before and after a restructure has occurred. Moreover, the location of the strategic management (also being a crucial element of the economic substance) and control of the risks should be consistent with the economic result, ie, contractual risk allocation should align with economic substance.

Intangible assets
Identification of the intangible assets in the business and their legal ownership profile usually forms the cornerstone of the transfer pricing analysis. It is important to reconcile the legal and economic ownership position.

Restructuring costs
These will arise as a consequence of the change in operational structure — for example redundancy costs and systems costs. It is necessary to establish who is responsible for bearing these.

Permanent establishment
Typically with a business restructuring, both during the transition period and under the new business model, there can be risks of the central, entrepreneurial entity creating a permanent establishment in the restructured local entities territory. This needs to be evaluated during the planning stages of a restructuring when determination of the new operating model is made. It should also be managed and reviewed on an ongoing basis to ensure the integrity of the new operating model is retained.

Remuneration of post-restructuring controlled transactions
On determination of the final business model post-restructuring, a detailed functional, financial and economic analysis is required to design and support the arm's-length transfer pricing policies for all intra-group transactions.

The analysis should be driven by business realities of the industry reorganisation. Businesses should be ready to justify the profit and loss outcomes in all parts of their organisation and should be ready to engage with tax authorities' early if necessary and consider interactions between tax authorities (including consideration of unilateral or bilateral Advance Pricing Arrangements for new structures, if appropriate).

The issue of business restructuring will clearly continue to be one of intense interest to both governments and taxpayers. Such transactions must have functional substance and business motivation if they are to be respected. Some critical issues in the Discussion Draft are likely to be clarified further and some might be removed in order to maintain consensus, but its basic approach is likely to be preserved and will be highly influential.

It would be unrealistic to say there is a solution that guarantees a given reorganisation is well protected and safe from challenge by tax authorities. However, if a good strategic plan is developed and implemented, businesses should be able to maximise their chances of success.

Conclusion

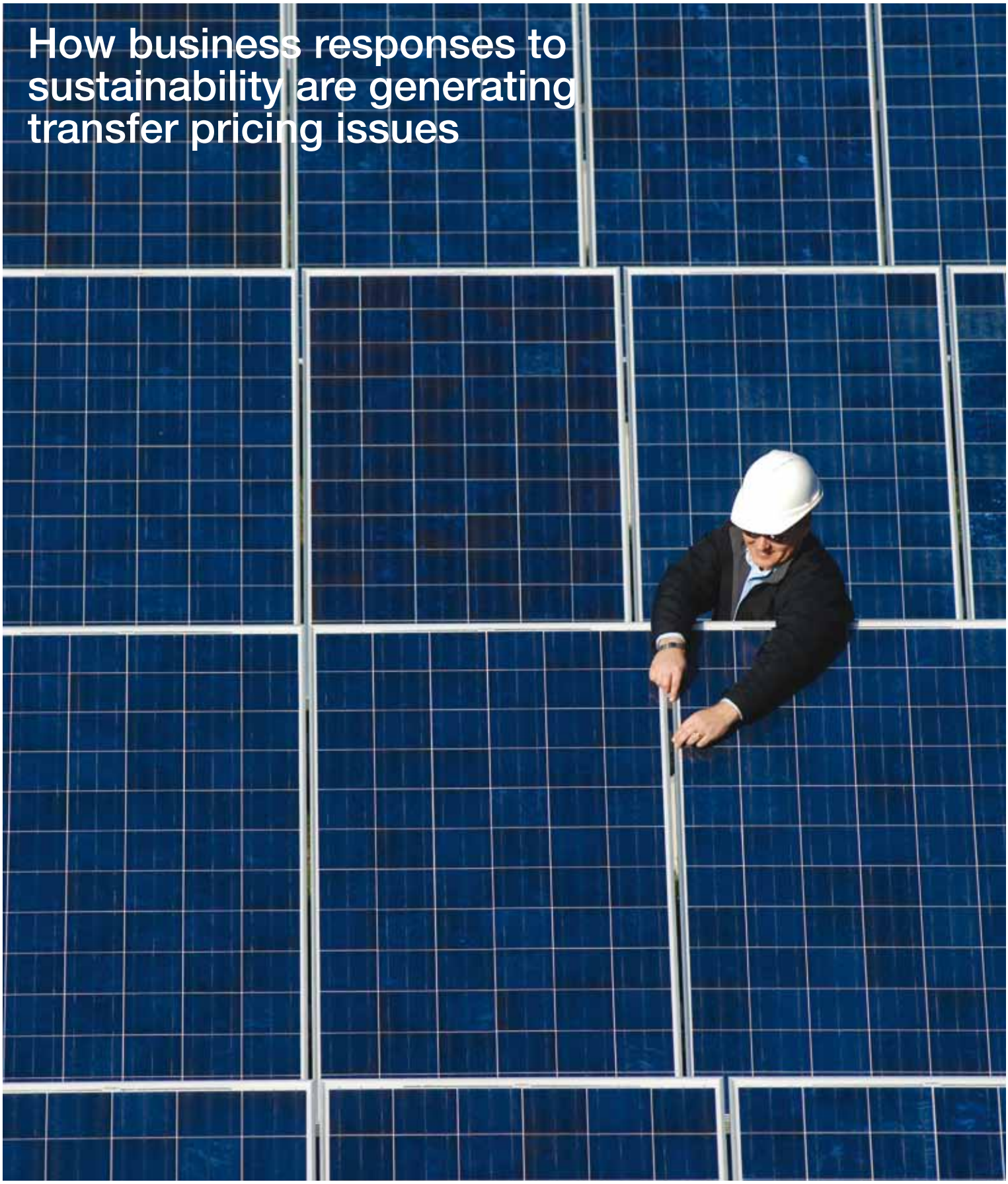
In the current economic climate, governments are under pressure to raise revenue and issues such as transfer pricing, international tax and permanent establishment are "high value targets" for enforcement by tax authorities worldwide. Also, governments are co-operating as never before to share taxpayer and industry information.

Given the progressing debate around most controversial issues arising from the Discussion Draft, there is only a very limited possibility that any given business reorganisation will not be subject to tax investigation. Therefore it is advisable that MNCs who are driving commercial changes to their operational approach develop a fact-specific strategy including audit-ready defence files. Also, it is crucial that their stakeholders understand the possible exposures and are aware of mitigation strategy and likely cost.

'Issues such as transfer pricing, international tax and permanent establishment are "high value targets" for enforcement'

Transfer pricing perspectives
May 2010

How business responses to sustainability are generating transfer pricing issues



How business responses to sustainability are generating transfer pricing issues

By **Duncan Nott** (PwC UK)
and **Yvonne Cypher** (PwC UK)

Unveiled at the World Economic Forum in Davos, January 2010, PricewaterhouseCoopers' Appetite for Change survey[1] examines the attitudes of the international business community towards environmental regulation, legislation and taxes. With almost 700 interviews conducted in 15 countries, it is the most comprehensive survey of its kind yet completed, giving an insight into both companies' expectations and what they are doing now to adapt their businesses to the regulations and requirements of sustainability.

This report shows that businesses globally are already tackling the challenges of sustainability. Many are approaching this centrally, seeing opportunities to improve competitiveness through changes to areas such as branding, technology and the business model as a whole.

This survey illustrates that transfer pricing policies will need to keep pace with these sustainability developments with considerations including:

- the creation of new transaction streams;
- changes to existing transactions to embrace changes in functions, assets and risks;
- potentially complex questions surrounding the interaction of central and local strategy and execution and the appropriate arm's-length attribution of cost and benefit that results;
- the need to keep transfer pricing policy, comparables and documentation current to meet compliance requirements; and
- the ability to identify and secure planning opportunities if transfer pricing is linked into business change early.

The survey's clearest message is that addressing climate change and sustainability is a current issue for companies, not just a challenge for the future. More than half of respondents, in particular the largest companies, have observed a 'fairly' or 'very big impact' on their business already. This rises to 90% who have seen at least some impact. The majority of companies are also expecting to change the way their businesses operate in the next two to three years as a result of climate change. "We've gone from being pulled by customers to seeing this as a financial imperative."

This is a global picture, with only small regional variations. Multinational companies make up two-thirds of respondents, and the global scope of the challenge is frequently found to be met with a centrally driven response: "We have a unified global standard in every country we operate in, whether or not that country has

[1]Appetite for change: Global business perspectives on tax and regulation for a low carbon economy www.pwc.com/appetiteforchange

the legal requirement for that environmental standard." The global standard applied by businesses often exceeds territories' minimum regulatory requirements, especially amongst larger companies with environmental reporting requirements: "There are many areas where we go beyond the mandatory level of legislation on a voluntary basis – we wouldn't do that of course if we didn't see value in it." This is influenced by a range of factors, including compliance (85%), corporate reputation (74%) and competitive advantage (67%). How these factors mix, however, was found to be highly specific to the facts and circumstances of each company.

Achieving this value will give rise to new and changing provisions or transactions between group companies in multinational businesses that will need to meet the arm's-length standard and be robustly documented to comply with national transfer pricing rules. This covers a wide range of areas, from the adoption of regulatory schemes such as emissions trading to reshaping a company's business model. Changes might also arise in product pricing, the value of intangibles, services and financing. Transfer pricing is therefore at a minimum an urgent compliance requirement, however potential planning opportunities also exist to align intercompany relationships and business models in a tax efficient manner. Transfer pricing policies will need to adapt to ensure that, for example:

- appropriate transactions are recognised and addressed;
- comparables are reviewed for effectiveness, for example where existing ranges reflect a cost base that has been superseded by the 'environmental' model; and
- documentation remains current and robust.

Where a group's response to sustainability requirements exceeds local minimum standards, the drivers of the additional costs this creates must be understood and appropriate remuneration identified. The considerations revealed by the survey suggest that spending in support of brands or to fulfil shareholder requirements might play a major role, and so should be considered carefully. The same is true where cost savings are achieved.

Major changes to business models present more fundamental transfer pricing and tax implications. In our experience, this could involve considerations surrounding the ownership of key assets such as intellectual property, centralisation of procurement functions or restructuring of group activities to accommodate a reduced mileage distribution network. How responses to environmental regulation are built into groups' existing transfer pricing models can also be critical, as activities such as emissions credit trading or administration of the EU's regulation on Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) programme can alter the risk profile of companies.

The costs and appropriate rewards for research and development will also need to be addressed, and consideration given to the most appropriate location for the resulting intellectual property. Incentives prove popular, and the benefits of these should be integrated with how the related activities are structured and rewarded.

Building emissions into supply chain pricing was identified as the main single issue concerning respondents. An emissions trading scheme (ETS) was narrowly favoured over a carbon tax by 68% to 62%, although the 17% already involved in

‘Tax departments will need to understand both the changes and their impacts, and take action to optimise their transfer pricing policy going forward’

such a scheme showed much stronger support with 81% in favour. This suggests that an ETS is potentially the most popular approach, but to the unfamiliar it suffers from a lack of transparency and, in some regions, the feeling that it could lead to unfair gains by those who work the system best. This view could be picked up by tax authorities and reflected in challenges to how businesses price credits are traded between group companies. The existence of different schemes and variations in value of credits to different business units, coupled with the fluctuating price of carbon, mean transfer pricing decisions in this area are not straightforward. Coupled with a lower level of understanding from tax authorities, this will place heavy demands on both transfer pricing policy and documentation to establish and support a pricing model. In an uncertain area, the certainty offered by advance pricing agreements might be advantageous for many companies.

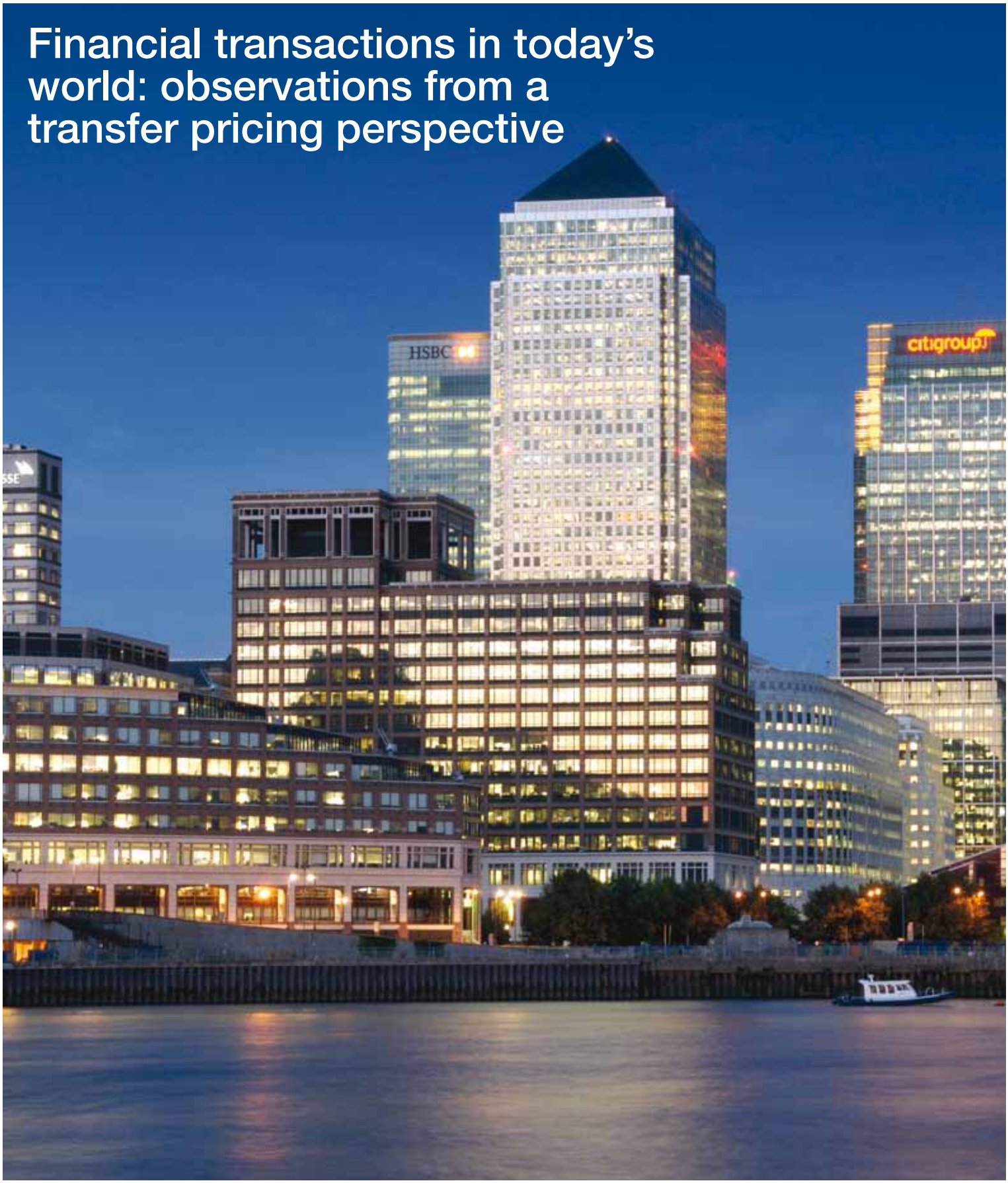
A key challenge for tax departments will be to ensure they are linked into their business’s environmental strategy. The survey interviewed the most senior person in the organisation responsible for setting strategy and managing environmental impact. Of these, only 37% also have the responsibility for managing environmental taxes in the organisation.

This suggests that in many cases, those responsible for transfer pricing will need to reach out to the relevant parts of the business, not only to ensure they are aware of changes to operations, but to bring transfer pricing considerations into any business change early to allow for effective planning and compliance.

Conclusion

Businesses have been clear that the sustainability agenda has already brought change and this process will intensify. This is changing how value and cost are created and distributed within groups, and both transfer pricing policies and the tax model for the supply chain must keep pace with this to meet compliance requirements and to identify planning opportunities. The impacts of sustainability are complex, with a range of drivers and little international consistency, and responses are often highly specific to the business model, facts and circumstances of each group, which might be in flux. Tax departments will need to understand both the changes and their impacts and take action to optimise their transfer pricing policy going forward. In our experience, the earlier transfer pricing is considered in this process, the more effective and robust the results.

Financial transactions in today's world: observations from a transfer pricing perspective



Financial transactions in today's world: observations from a transfer pricing perspective

By **David Ledure** (PwC Belgium),
Paul Bertrand (PwC Belgium),
Michel van der Breggen (PwC Netherlands)
and **Matthew Hardy** (PwC Netherlands)

After almost two years, the economic crisis continues to affect financial markets around the world. The staggering speed of events and severity of their impact, especially after the summer of 2008, has surprised even the most seasoned experts. Contrary to other historic market events, the current crisis has shaken the foundations of our financial system. Treasurers are now reconsidering generally accepted industry practices that were prevalent before the crisis took hold. As a result of major shifts in the underlying principles of financial markets, it might be wise to also consider the impact of these drastic changes in the "real world" on intercompany financing policies and practices. This article contains some "food for thought" on what groups might want to consider in this respect.

'The current crisis has shaken the foundations of our financial system'

Some characteristics of current financial market conditions

Reference rates at historically low levels

During the first half of 2008, financial markets realised that the US subprime crisis had contaminated the world's banking system. Mutual trust between banks was eroded and, despite several interventions by major central banks, the interbank lending market dried up and interbank interest rates increased significantly.

From the second half of 2008, most central banks gradually reduced their reference rates to record lows and continued to inject more cash into the banking system with the aim of encouraging ailing economies and stimulating financial markets. At the same time, several governments intervened in various ways to support their local banks. The combination of these measures severely impacted so-called "low-risk" interest rates. For example, the Euribor one-month rate tumbled from more than 5% to approximately 1% in fewer than eight months. Today, this reference rate is lower than 0.5% (see Figure 3).

Figure 3:
Euribor rates

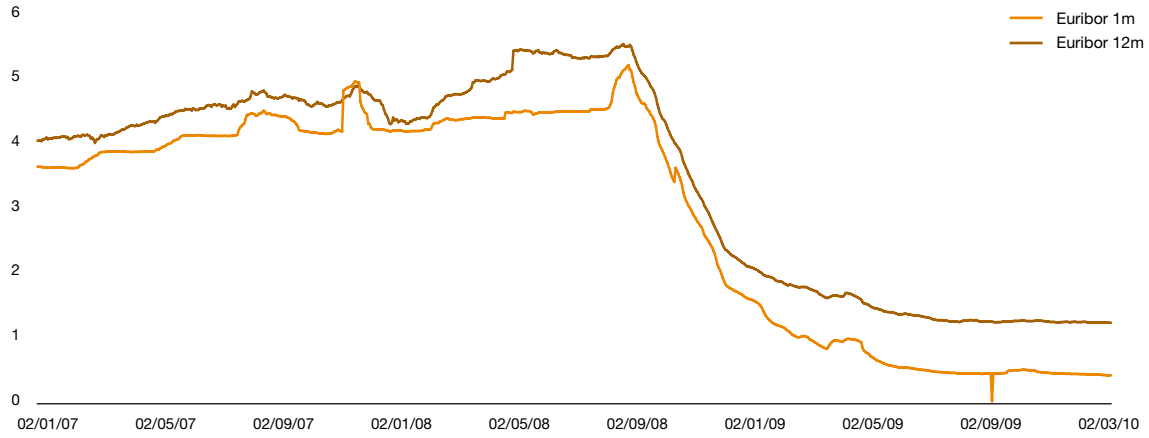


Figure 4:

BBB credit rating - 31 December 09

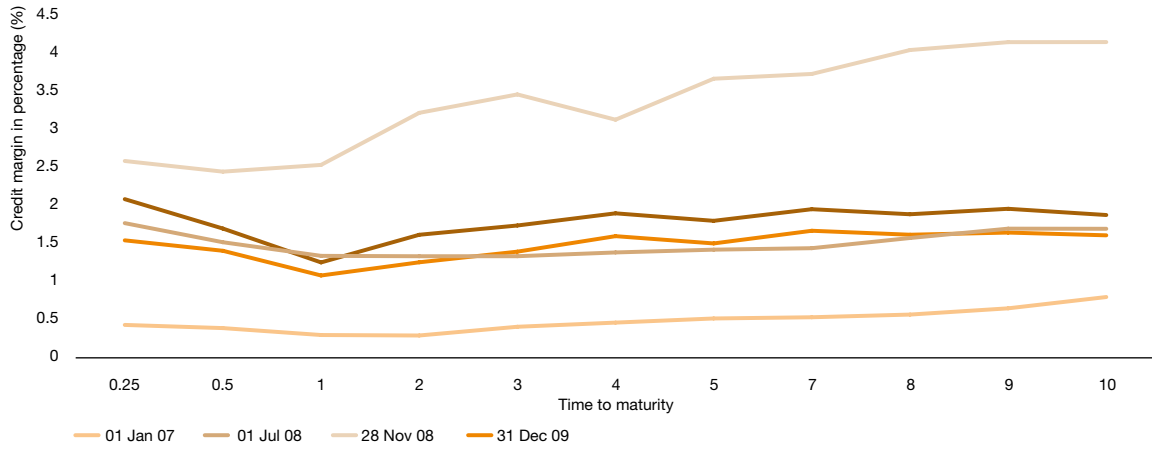
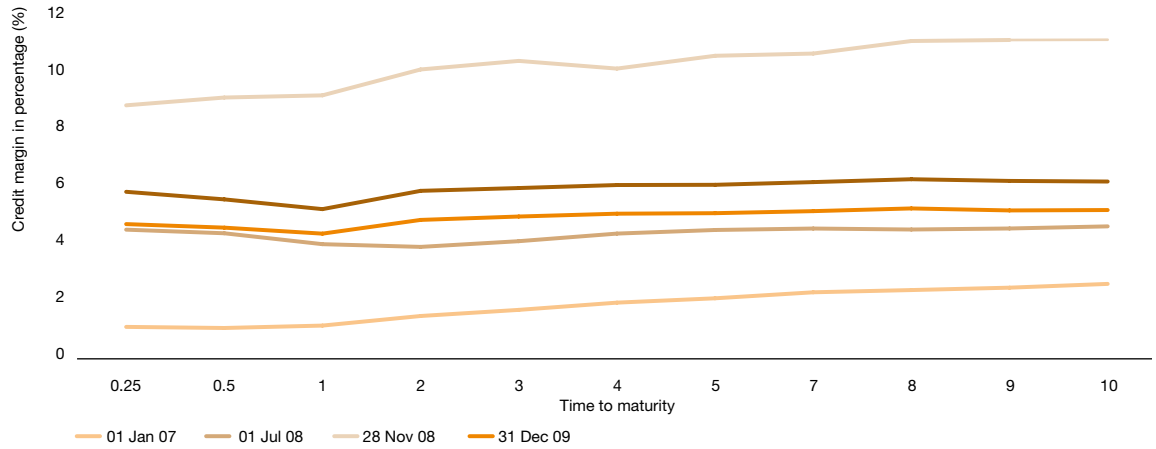


Figure 5:

B credit rating - 31 December 09



Risk premiums remain at a relatively high level

Due to the uncertainty surrounding the economic crisis, various market participants have become more risk averse. At the same time, the turmoil within financial markets has severely impacted the real economy, resulting in higher risks of defaults. The combination of these factors resulted in a significant increase in risk premiums that continued until the fourth quarter of financial year 2008.

In the fourth quarter of 2008, for example, the credit spreads for long-term BBB (investment grade) quoted bonds were more than five times higher than the credit spreads at the beginning of 2007. It is only as of the second quarter of 2009 that significant reductions in risk premiums have been recorded.

Figures 4 and 5 present an overview of the evolution of credit spreads on quoted bonds for both BBB and B credit ratings between January 2007 and December 2009.

‘Should intercompany financing reflect funding conditions at a group level and, as such, mirror the risk profile of the group as a whole, or, should the individual risk profile of the borrowing entity be considered?’

More stringent conditions to obtain external funding

Despite the efforts of various governments to instigate a recovery of financial markets and to encourage confidence, financial institutions are still facing a mix of challenges. While they have to restore their capital buffers, the default risk of their clients has increased. Consequently, financial institutions remain cautious when granting funding. Therefore, borrowers now typically have to pass more rigorous screening processes and are faced with much more stringent terms and conditions (ie, formal guarantees and covenants that impose more severe earnings before interest and taxes — EBIT — or debt-equity conditions, etc).

Unique market conditions trigger different transfer pricing questions

Establishing the credit rating of an intercompany borrower

Various tax authorities around the world are currently struggling with the question “Should intercompany financing reflect funding conditions at a group level and, as such, mirror the risk profile of the group as a whole, or, should the individual risk profile of the borrowing entity be considered?”

If we consider the tax authorities that adhere to an individual risk profile (separate entity or stand-alone) approach, different methodologies can be observed when determining an entity’s individual risk profile. These alternative approaches could result in significantly different outcomes. As the risk profile of an entity is one of the most important factors when establishing an arm’s-length interest rate, one can imagine that these discussions are not merely academic. The theoretical arguments in favour or against the various possible approaches should not be influenced by the current crisis. However, given the increased risk premiums, the financial impact of these discussions has become much more important.

The General Electric Tax Court Case (TCC) in Canada dated 4 December 2009, regarding the payment of guarantee fees, contains an interesting debate on how to determine the credit risk profile of a subsidiary. This case relates to the level of guarantee fee payable by a Canadian subsidiary in return for a formal guarantee granted by its AAA rated US parent. The Canadian tax authorities fully disallowed the payment of the guarantee fee based on the assertion that the Canadian subsidiary did not receive any benefit from this guarantee. The Canadian tax authorities further defended their position by arguing that the Canadian subsidiary

would benefit from the group's rating solely by virtue of affiliation (an implicit guarantee or passive association). The tax payer's position was that a subsidiary's rating should be assessed on a stand-alone basis and, as such, affiliation should be disregarded. In the case at hand, the tax payer estimated the stand-alone rating of the subsidiary to be BB-/B+.

In its decision, the TCC disagreed with the tax authority's position that the subsidiary's rating should be equal to the parent's rating since the Canadian subsidiary benefited from better financing conditions thanks to the explicit guarantee. As such, the guarantee fee was determined to be priced in accordance with the arm's-length principle. However, the TCC did also recognise that, to a certain extent, the subsidiary would have benefited from implicit group support even in the absence of a formal guarantee. Such implicit support is based on the fact that multinational groups might be incentivised to support their subsidiaries due to reputational risk, for example. For the case at hand, implicit group support resulted in an uplift of three notches on the stand-alone credit rating of the subsidiary. Implicit group support is the result of what the OECD defines "as passive association".

Before the crisis, the discussion of subsidiary credit ratings was mostly based on hypothetical arguments. Due to the current crisis, some real-life cases now exist on groups' behaviour. There are examples where groups have intervened to avoid the bankruptcy of a subsidiary, however, in other cases, sub-groups or subsidiaries have been allowed to fail.

'Moreover, while in the past, banks rarely enforced covenants, nowadays, more and more banks are withdrawing or renegotiating existing credit facilities if these covenants are not met.'

Arm's-length terms and conditions

Traditionally, a transfer pricing analysis of intercompany loans was typically limited to an analysis of the level of the interest rates applied. However, tax authorities are increasingly questioning whether the other terms and conditions of an intercompany loan reflect arms's-length behaviour. This might especially be the case where tax authorities adhere to a "substance-over-form" approach. Recent examples of relevant questions relate to where entities have financed long-term needs via short-term facilities and where guarantees have been provided that do not provide a real economic benefit. As a high level test to understand whether a transaction might reflect arm's-length dealings, it could be worth asking whether the transaction makes sense for all parties involved from an economic perspective and also whether unrelated parties enter into this transaction on comparable terms and conditions.

Recently, there has been extensive press coverage with respect to banks imposing more stringent and comprehensive covenants for new funding. Moreover, while in the past, banks rarely enforced covenants, nowadays, more and more banks are withdrawing or renegotiating existing credit facilities if these covenants are not met. One may argue that for intragroup funding, such covenants are less important as one could reasonably assume that a group would protect the financial health and interests of its subsidiaries. Consequently, such covenants would have a rather theoretical impact. At the same time, as covenants are applied in third-party funding, tax authorities could argue that comparable terms and conditions should also be reflected in intercompany loan agreements. Even if such covenants are not included within intercompany contracts, it is recommended that groups maintain an awareness of the financial health of their subsidiaries. This might be particularly relevant should a subsidiary's activities be reorganised resulting in, for example, significantly different debt coverage ratios.

Capital structure

Various countries have thin capitalisation rules based on simple financial tests, for example, debt to equity ratios. Recently, some countries, including Germany and Italy, have tightened their thin capitalisation rules, for instance by introducing limits specifically addressing the level of (intercompany) interest that can be deducted (not only focusing on the level of debt).

When looking at third-party dealings, banks have become much stricter when it comes to granting funding. This fact, combined with higher interest rates, might result in groups having to reduce the amount of third-party debt that they hold. When scrutinising intercompany financing transactions, in addition to questioning interest rates and terms and conditions, some tax authorities are also interested in whether an intercompany borrower would have been able to attract the same volume of external funding. In other words, this comes down to the question of whether the decision to grant or accept an intercompany loan is an arm's-length decision. If not, the loan might, from a tax perspective, be re-qualified as non-interest bearing equity for example. In other words, thin capitalisation is more and more being considered to be a transfer pricing issue. According to paragraph 1.37 of the OECD Transfer Pricing Guidelines this indeed seems to be the case.

Existing loans

Existing loans that were concluded prior to the financial crisis should reflect the market conditions (and information reasonably available) at the time that the transaction (and loan agreement) was established. Changing market conditions do not automatically impact existing loans. Nevertheless, for these transactions, it should be considered whether any of the parties are entitled to renegotiate existing loans and if so, whether that party would have an interest in doing so. Particular attention should be paid to the economics of each transaction to assess whether the parties are behaving in an arm's-length manner. Potential areas for consideration include contracts with lender or borrower call and put options, contracts that are automatically extended or penalty clauses where the cost of the penalty does not outweigh the advantage of early termination, etc.

Particular care should be taken when making amendments to existing transactions, especially at a time when tax authorities are becoming increasing sophisticated in their approach to the transfer pricing of financial transactions.

Safe harbour rules

Several countries have adopted domestic safe-harbour rules. In certain cases, if pre-determined interest rate thresholds are respected, interest expenses are, in such cases, deemed to be at arm's length. However, most of these safe harbour regimes allow for the application of higher interest rates if the tax payer can demonstrate that the higher rates satisfy the arm's-length principle. Such safe harbour rules appear to be a cost-effective way to avoid transfer pricing scrutiny. A well-known example is the US safe harbour rules, whereby safe harbour interest rates are determined by reference to the Applicable Federal Rates. The latter is determined on the basis of US Treasury rates.

Most of these safe harbour rules are based on local reference rates, which are updated from time to time. However, these reference rates are often "low risk" rates derived from government bonds for example. Consequently, given the fact that low risk rates are at historically low levels, the safe harbour rates are typically also rather low. At the same time, credit margins are higher than they were in recent years. This means that there are an increasing number of cases where conflict arises between safe harbour rules and arm's-length interest rates.

Cash pooling

As a result of the financial crisis, companies in need of cash increasingly rely on their internal cash pool(s) for the management of the cash available within the company. Taxpayers need to address specific transfer pricing issues that arise from cash pool arrangements, such as how the appropriate debit and credit interest rates to be applied to intragroup balances are set; how the underlying (cross) guarantee structure is priced; and how the cash pool leader is remunerated. With the increased usage of cash pools and the volumes handled by these cash pools, the attention of taxation authorities on these types of transfer pricing issues has increased significantly.

Recent examples of discussions with tax authorities include that, in practice, positions in a cash pool often end up in being long-term positions, on which – given the nature of a cash pool – short-term debit and credit interest rates are applied. Furthermore, traditionally the benefit for the group of using a cash pool (ie, the "cash pool advantage") ends up being allocated to the cash pool leader, which might actually be a thinly capitalised company that cannot "substantiate" the return on equity that it earns. At the same time, the depositing participants, who in many cases are effectively incurring the credit risk associated with the cash pool, might receive only a credit interest rate similar to what they would have received if they had made a deposit at a major commercial bank, with a much lower risk profile.

Intercompany guarantees

Many local subsidiaries that attract funding from third-parties are increasingly confronted with the fact that financial institutions are requesting additional collateral in the form of guarantees from parent companies. This raises the question; if and to what extent guarantee fees should be charged by those parent companies.

Charging a guarantee fee can be contentious in some countries, but is a requirement in others. Where a benefit is conferred, the taxpayer should consider charging for this benefit. However, care should be taken when establishing whether a guarantee fee is due. From a transfer pricing perspective, there are certain circumstances where a guarantee fee is not due on the basis that the provision of a guarantee is a shareholder service. This might be the case if the subsidiary could not have secured funding of any kind without a parental guarantee. On the other hand, if a subsidiary could have secured funding, but a better rate or better conditions were achieved by virtue of a parental guarantee, a guarantee fee might be due.

The different approaches taken by various tax authorities should be considered when establishing whether a guarantee fee is due, and what an arm's-length guarantee fee is.

As the GE case demonstrates, discussions on how to assess a subsidiary's credit rating might impact the benefit derived from an intercompany guarantee and thus, the level of guarantee fee due.

The importance of having a loan pricing policy

Following the above, it might appear that the transfer pricing requirements to substantiate and document each and every inter-company financial transaction can be quite cumbersome and inflexible, especially in today's world. However, in practice this does not necessarily need to be the case. In our experience, the starting point to address these transfer pricing requirements can be to develop a loan pricing policy that sets out which processes and tools are being used to substantiate and price intercompany financial transactions. In developing such a policy, theoretical requirements versus practical needs can be balanced in a way that best suits the needs and the transfer pricing risk profile of the company.

A loan pricing policy can include a specific methodology to substantiate and document the arm's-length nature of each type of intercompany financial transaction taking place within the group. It can also specify which departments are involved in the process of implementing and monitoring financial transactions (ie, treasury, tax, legal), which specific financial information systems are being used and where and how documentation is kept to support specific transactions. The policy can be tailored towards the information systems used within your organisation and, as such, it can accommodate the day-to-day operations while at the same time, as much as possible, addressing the transfer pricing requirements that must be satisfied.

In principle, a loan pricing policy should be capable of being rolled out to all finance and treasury centres within the company. Together with robust, written agreements addressing all the key terms and conditions third parties would also address, it can help companies to significantly increase their level of documentation and strengthen their line of defence towards tax authorities.

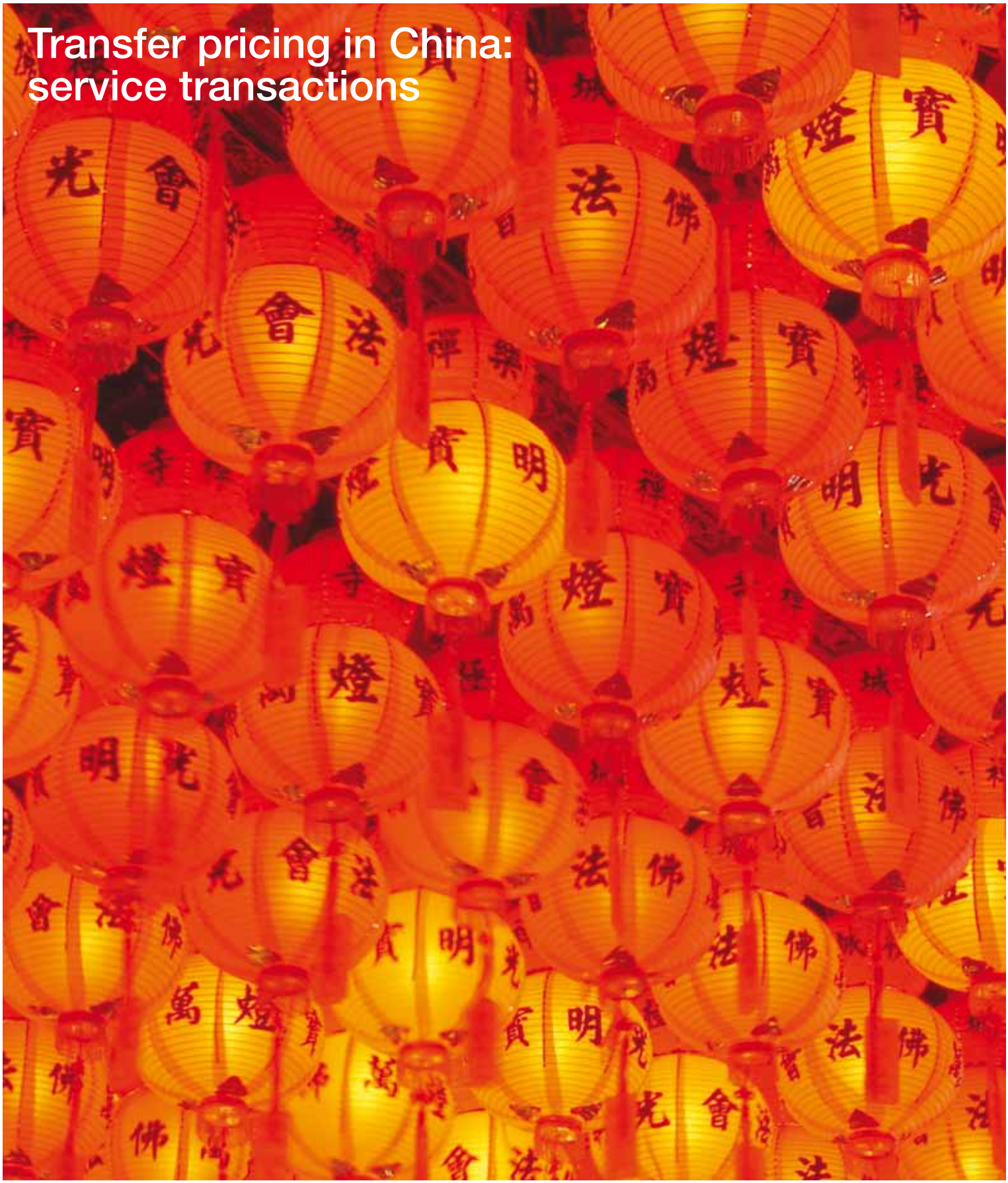
All doom and gloom?

The current financial and economic environment presents many challenges for most taxpayers. Transfer pricing of intercompany financial transactions might be one of those challenges, with policies having to be fine-tuned and long established intercompany practices having to be changed or updated. However, current market conditions could also create opportunities that can be realised by the pro-active taxpayer with the right planning, implementation and monitoring processes.

Once financial markets stabilise, governments might reduce or withdraw their market intervention and stimulus packages. Such future changes are likely to change drastically the dynamics of open-market pricing. The increased attention tax authorities are giving to intercompany financial transactions is unlikely to change in the near future and, as a result, transfer pricing should continuously mirror the market and transactions between third parties and group transfer pricing practitioners should remain vigilant and avoid rigid rules when updating their intercompany financing policies.

Transfer pricing perspectives
May 2010

Transfer pricing in China: service transactions



Transfer pricing in China: service transactions

By **Cecilia Lee** (PwC China)
and **Thomas To** (PwC China)

Until recently, the majority of foreign investment in China was in the form of manufacturing activities. Cross-border intercompany services consisted mainly of support or auxiliary services to the manufacturing companies and, to a lesser extent, of certain services outsourced to China. To the Chinese tax authorities, their transfer pricing focus has, in the past, been on the sale and purchase of tangible goods. Today, with China's opening market economy, there is an increasing number and variety of cross-border intercompany services. Likewise, the tax authorities are becoming more and more interested in transfer pricing matters related to cross-border services.

Challenges in China

To many multinational corporations, dealing with cross-border intercompany services with China could be a challenge. While China is not a member of the OECD, its transfer pricing law and regulations are generally consistent with the OECD principles. What makes China challenging is the way in which the law and regulations are implemented by the different levels of the tax authorities – State Administration of Taxation (SAT), provincial, municipal, district, etc. It is important to note that most transfer pricing audits are initiated and conducted by tax bureaus at the municipal level. Although they are supervised by the SAT and their respective provincial tax authorities, the level of technical knowledge and experience across different localities varies significantly, often with differences in interpretation of law and regulation and local practices. While the SAT is stepping up its transfer pricing enforcement and is striving to improve the technical competency of its tax officials across the country, it will still take some time before consistent practices can be achieved. This is particularly true with respect to intercompany services, a somewhat newer area of transfer pricing compared with tangible goods transactions. Therefore, while the view of the SAT and new developments on China's bilateral cases are critical, it is of equal importance for taxpayers to consider the local views and practices when implementing cross-border services transactions.

Practical considerations

With the increased transfer pricing enforcement by the Chinese tax authorities, it will be important for taxpayers to implement intercompany services transactions in the most defensible arm's-length manner. To support service charges from overseas headquarters or affiliates, taxpayers are strongly recommended to develop documentaton that demonstrates the benefits the Chinese affiliates receive, including

providing tangible evidence on how those services are received. It is also important to provide evidence that such services are indeed performed by the overseas affiliates and that the charging method and allocation bases are arm's length. Any globally adopted methodology that supports a consistent transfer pricing policy would be very helpful evidence.

Transfer pricing contemporaneous documentation requirements have been in place in China since 1 January 2008. The threshold of RMB 40 million applies collectively to intercompany services, royalties and interest. Compliance with the documentation rules grants the taxpayer the exemption from the penalty interest rate of 5%, which would otherwise be added to the base interest rate. Transfer pricing documentation in China should be kept on file for 10 years, which is also the statute of limitation for transfer pricing audits. When preparing TP documentation for intercompany services, information disclosure might become an issue, particularly if the overseas affiliate is to be chosen as the tested party. Excessive disclosure of overseas affiliates' services information could attract the attention of the tax authorities and raise alarm in areas such as permanent establishment and individual income tax matters.

Often, the provision of intercompany services in China involves more than just setting the arm's-length transfer price. A successfully implemented intercompany services structure should address all of the following:

- **Income tax deductibility** - particularly for inbound service charges from overseas affiliates, this could be a greater issue than transfer pricing remuneration itself. For the local tax authorities, disallowing a service fee deduction might, from both a technical and administrative perspective, be easier than arguing the merits of the arm's-length nature of the transaction. Characterisation of the deduction is also critical. In China, any payment termed "management fee" is automatically disallowed as a deduction. It is crucial to have service agreements with a proper description of the services performed, and support to show that the fee relates to actual services performed.

- **Foreign exchange controls** – remittance of service fees to overseas affiliates requires tax clearance and proper documentation. This is not always a straight forward process, the results of which often are dependent upon the treatment by the local office of State Administration of Foreign Exchange.

- **Permanent establishment (PE)** – the payer of a service fee often needs to prove that the foreign payee does not have a PE in China.

- **Withholding income tax** - while not technically "correct" for service payments, withholding taxes have been imposed by some local tax authorities in the past.

- **Business tax** – please refer to the following for further elaboration.

Business tax and cost-sharing arrangements

Apart from corporate income tax, China has a turnover tax on services – business tax (BT). This tax is levied on both inbound and outbound services, generally being 5% on the fee amount. For outbound service fees, BT is payable as a withholding tax even if the overseas service provider performs all the services outside China. BT is deductible for corporate income tax, but BT is not an income tax item itself and therefore is not covered by tax treaties. Hence foreign tax credit relief is not available for BT. This could result in a significant tax cost, usually non-recoverable, for many companies that perform service transactions with China. In most areas in China, corporate income tax is administered by the State Tax Bureau, while BT is administered by the Local Tax Bureau, a separate body from the State Tax Bureau. Taxpayers could therefore be challenged on the same intercompany service transaction by the different tax authorities. With the introduction of cost-sharing arrangements (CSA) provisions in the new corporate income tax law effective 1 January 2008, certain types of services might qualify to be covered by CSA, including group procurement and group marketing strategies. It is yet to be seen whether such CSAs are required to address the shared development of intangibles related to these services, or whether this could potentially be an opportunity to avoid the associated BT altogether. It would be important to keep abreast of any progress on this issue.

Conclusion

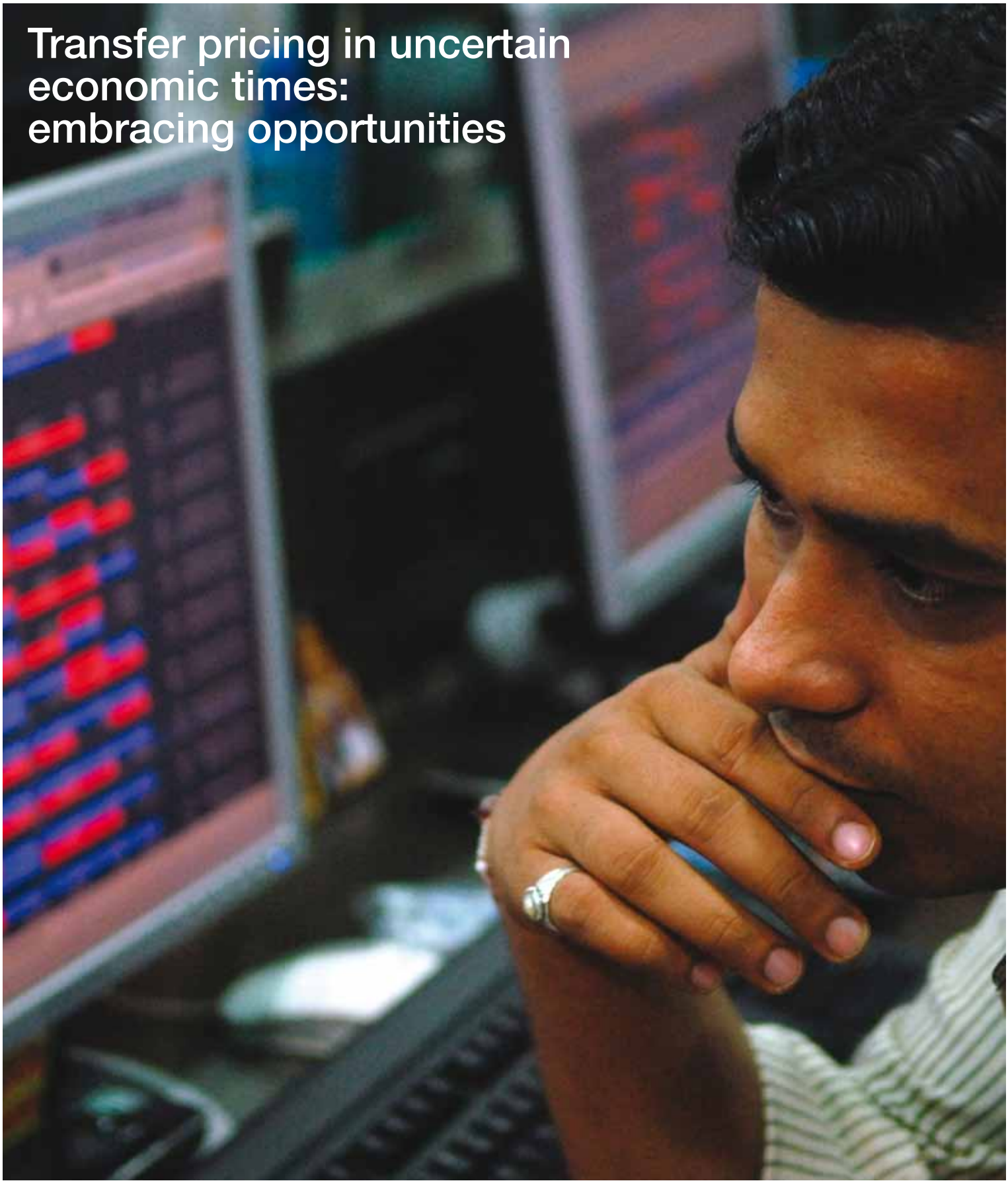
As tax authorities around the world increase enforcement of tax regimes, China has followed suit and toughened its tax laws, particularly in transfer pricing regulations. Transfer pricing of service transactions is an area in which the Chinese tax authorities are gaining increased interest. As a result, companies with intercompany services operating in China will need to:

- understand the trends and practice of tax authorities at both the state and local levels in transfer pricing enforcement and other issues;
- assess the costs and risk level of their current operational model;
- implement and maintain robust documentation; and
- evaluate their risks and where needed take appropriate actions

‘China has followed suit and toughened its tax laws, particularly in transfer pricing regulations’

Transfer pricing perspectives
May 2010

Transfer pricing in uncertain economic times: embracing opportunities



Transfer pricing in uncertain economic times: embracing opportunities

By **Anthony Curtis** (PwC US),
J. Bradford Anwyll (PwC US),
Henry An (PwC Korea),
Lorenz Bernhardt (PwC Germany) and
Brandee Sanders (PwC US)

With continued pressure on the global economy comes the pressure on global governments to fill their tax coffers. Although many economies are beginning what is likely to be slow progress towards recovery, tax authorities around the world are focusing on transfer pricing enforcement as a source of additional revenue. Globally, there has been a proliferation of legislation and regulation intended to limit the movement of income out of tax jurisdictions. In addition, tax authorities have increased their capacity to enforce compliance with such legislation as each jurisdiction looks for ways to collect its perceived fair share of taxes.

But it is not all gloom and doom. Focus on transfer pricing in today's economic environment also offers opportunities for companies to better position themselves in the present and for when the recovery finally arrives. Transfer pricing policies that embed flexibility, align with business needs, and improve cash flow can be achieved with the proper planning and documentation.

Supporting losses/reduced profits

In the current economic climate, many multinational companies are experiencing losses or reduced profitability within the group or in particular group entities. Juxtaposed with the current transfer pricing audit environment, it is critical for companies to develop supporting documentation explaining the underlying reasons for their reduced returns and the interplay with transfer pricing policies.

Successfully defending losses or reduced profitability of companies engaged in intercompany transactions will be dependent on demonstrating that unrelated parties engaged in similar transactions have incurred or would incur similar fates under the same or similar conditions. That is, having compared and cross-referenced the terms of the intercompany relationship, such as the functions performed and risks assumed, with the terms of similar relationships between unrelated parties, it might be shown that a downward pressure on profits is reasonable and expected. In certain circumstances — such as in the case of a limited risk related party where it is more difficult to locate comparable companies for which there is public data available — economic modelling to apply adjustments to the economic returns of comparable companies should be employed.

Surely, demonstrating the cause of a taxpayer's poor returns as independent from transfer pricing could be more complicated in the context of a widespread economic downturn (compared with a single isolated event such as a natural disaster that cripples a company's supply chain and ability to serve its market). Thus, considerations should be given to identifying and documenting the following potential external issues that might be impacting profits:

- the negative impact on sales resulting from the current credit crunch's impact on the taxpayer's ability to provide ample or affordable credit to its customers;
- customer demands for price concessions in order to conclude sales;
- lower sales volumes and values as customers substitute cheaper goods for more expensive goods;
- excess capacity in manufacturing locations;
- increased inventory holdings and related costs; and
- foreign exchange losses as the relative values of currencies vary.

In supporting a taxpayer's position, consider ways to illustrate the "unusual" variations in key financial ratios being experienced relative to comparable company data (data that will most likely depict rosier financial results relative to the taxpayer's current financial results given the lag in publicly available data on comparable companies). For example, analyze several years of taxpayer data with respect to key ratios such as receivables turnover and expenses to sales. Also, a comparison should be made of the taxpayer sales growth to that of the industry. Having identified the unusual variances, then adjust the comparable companies' results to simulate what their results would have been under the current "unusual" economic conditions.

Other considerations when attempting to develop proper factual and economic analyses to support losses and reduced profitability might include:

- treatment and allocation of restructuring costs (eg, termination costs and severance payments) in proportion to the expected benefits of the restructuring;
- treatment of write-off of assets proportionate to the ownership rights of such assets; and
- longer periods for start-ups to move into break even/profitability.

In addition to defending results, taxpayers should be taking stock of their current position and planning for the future. Certainly, if there were an ideal time to consider the appropriateness of current transfer pricing policies — that time is now.

Transfer pricing opportunities and business restructuring

In response to the economic downturn, many businesses are restructuring to gain operational efficiencies, reducing costs in their supply chains and improving cash management. Although business needs drive the direction of such restructuring, overlaying transfer pricing planning will further increase the benefit.

'Certainly, if there were an ideal time to consider the appropriateness of current transfer pricing policies — that time is now'

As part of a restructuring plan, transfer pricing planning could amplify benefits in effecting a strategy to develop a centralised service entity within multinational companies. Various types of services can be centralised in a cost-efficient manner including, for example, research and development services, information technology services, financial support services, marketing research services and logistics management centres. Of course, the location of the centralised service entity must be somewhere where the talent exists to provide the services required.

Other planning strategies include forming companies that capture risks of the group. For instance, captive insurance companies located in low-tax jurisdictions are paid premiums by companies in higher tax jurisdictions (which deduct premium expenses locally). Another strategy is capturing default risks related to accounts receivable via factoring companies. Factoring companies purchase accounts receivable from related parties with the expectation to earn a reasonable yield on these purchased assets based on the assets' maturities and estimated risk of default. Multinational companies could also consider centralised treasury centres where foreign exchange risks are managed via hedging and are pooled in one place; where intercompany loans are managed, and where overall borrowing costs may be reduced.

For multinational with valuable intellectual property (IP), gaining greater tax efficiencies through restructuring could include conversions and the optimisation of IP. Conversion relates to converting full risk (possibly currently loss-

‘Companies that focus their attention on performing the necessary analyses and developing proper support for their current transfer pricing policies, as well as those that identify and implement beneficial transfer pricing strategies for the future, will fare best.’

making entities) into limited-risk entities or vice versa (ie, increasing the functions and risks of current limited risk entities). Under this model, principal entities own and manage group intangible property (ie are the group entrepreneurs), perform valuable functions, and bear certain key business risks of the group. Principal entities also typically provide strategic oversight and managerial direction to limited risk/service entities (eg, marketing service providers, commissionaires, limited risk distributors, and contract or toll manufacturers) and in turn expect to earn profits in the long term that are above the routine returns earned by the limited risk entities and other routine group services operators. It is critical that the principal entity has the economic substance to warrant the return it keeps. Economic slowdowns often bring reductions in the value of IP. Higher discount rates and lower profit estimates reduce the net present value of cash flow projections, with a direct impact on IP valuation estimates. Now could therefore be the best time to consider whether business needs justify the movement of such IP.

Of course, with business restructuring as a top-tier issue for tax authorities around the world, it is critically important that contemporaneous documentation supporting the restructuring exist and that such documentation be thorough and well reasoned. It should also include a detailed discussion of the business purpose for the economic substance of the restructuring. Elements of the transfer pricing documentation for restructurings should thus include the following:

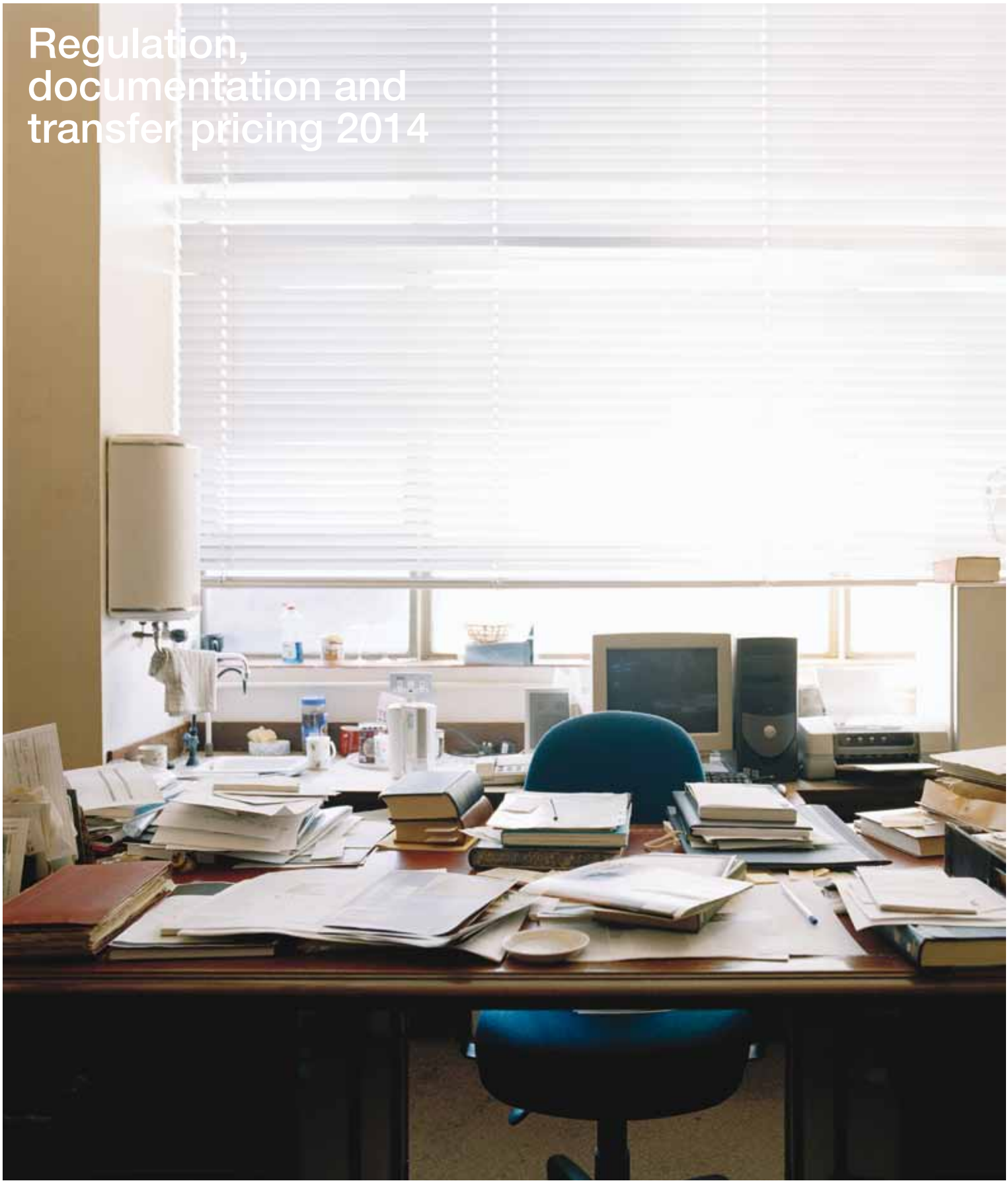
- functional analyses detailing the functions performed, risks assumes, and assets owned/employed by group entities relevant to the restructuring (eg principals employing managers who can perform the strategic and entrepreneurial functions of the group);
- written agreements to support the terms of the intercompany transactions (eg delineating key functions performed and risks assumed, agreed compensation/pricing);
- supporting documentation detailing the business rational behind the restructuring (eg business planning meeting presentations depicting centralisation/reorganisation of certain group functions/services would provide greater control, consistency and cost efficiencies);
- documentation/analyses depicting the economic substance of the restructurings (eg showing the restructuring has economic purpose aside from a reduction of tax liability);
- valuations of IP migrated or other transfer pricing analyses; and
- any other elements specifically required by local regulations.

Conclusion

Authorities from most jurisdictions are increasingly active in developing and enforcing additional transfer pricing related regulations, and also in enhancing their enforcement capabilities. As transfer pricing continues to be high on tax authorities’ list of priorities, the amount and severity of disputes undoubtedly will increase. Opportunities, however, do exist to make needed business restructurings more tax efficient. Companies that focus their attention on performing the necessary analyses and developing proper support for their current transfer pricing policies, as well as those that identify and implement beneficial transfer pricing strategies for the future, will fare best.

Transfer pricing perspectives
May 2010

Regulation, documentation and transfer pricing 2014



Regulation, documentation and transfer pricing 2014

By **Isabel Verlinden** (PwC Belgium), **Diego Muro** (PwC US/Argentina), **Sanjay Tolia** (PwC India) and **Javier Gonzalez Carcedo** (PwC Spain)

The current economic climate strongly affects corporate profitability. Unavoidably, when results are unstable, companies can have an interest in reviewing their intercompany pricing policies. Exploiting rate arbitration opportunities, planning for tax-effective loss recovery, for example preventing losses from expiring and tax-effective accommodation of the unbundling and re-assembling of (parts of) the value chain for a slimmer go-to-market, are all on the agenda of the tax and/or finance director these days.

The question is, though, what lies ahead when groups will no longer be in mere "survival mode" and tax authorities might or might not have scaled back their enforcement initiatives that reined in the fiscal crunch.

Tax directors have an interest in raising some necessary questions:

- What are your organisation's transfer pricing objectives and priorities over the next three to five years?
- What is the process your organisation operates for ensuring cross-border transactions are carried out at arm's length?
- How regularly is your organisation's transfer pricing policy reviewed? How is this policy communicated to all group companies? Are the guidelines clear?
- How are transfer prices applied within your organisation?
- What processes are in place to monitor the quality and accuracy of transfer pricing documentation?
- Is your organisation meeting the legal and statutory transfer pricing obligations in each country in which it operates?
- What are your organisation's procedures for dealing with any transfer pricing disputes that arise around the world?

Figure 6:
The likely transfer pricing landscape in 2014

Tax authorities

- Fiscal deficits
- Expanded tax base
- Substance – challenged in most parts of the world
- Global co-ordinated action
- Analytical sophistication
- Intellectual property focus
- Embrace OECD revised Chapters I-III
- Challenge international principles to meet local objectives
- Preference for profit split
- Customs convergence

Taxpayers

- Develop flexible transfer pricing policy
- Management and tax function – one unified team
- Tax planning ideas aligned to business plans
- Leveraging on EU master file concept
- Settlements with tax authorities not unilateral but a consensus approach

OECD/United Nations/WCO

- Continue to promote mutual agreement procedure (MAP) and mandatory arbitration process to resolve global tax disputes.
- Discourage unilateral advance planning agreements (APA) that restricts MAP
- UN developing transfer pricing practice protection guidelines for least developed countries
- OECD/WCO (World Customs Organization) efforts for customs convergence

Tax authorities

Fiscal deficits do cause more than unilateral action by tax authorities. Indeed they are exchanging sensitive information about taxpayers and all this happens in an increasingly organised way. We see even first attempts crystallising where tax authorities within several countries are joining forces to challenge the way a multinational enterprise has opted to organise its business on a regional basis across local boundaries. It all boils down to "substance" issues, where one could simply say that having too much substance in a so-called entrepreneur entity risks attacks on taxable presences or permanent establishments in other countries. Whereas if the entrepreneur takes too little piece of the action, transfer pricing attacks are provoked as countries might feel that the entrepreneur gets too much reward for its interventions. Interesting to note is that such initiatives tend to happen in countries that are not necessarily known as "the hub of transfer pricing universe". Possibly they are looking for precedents either in the administrative stage or before court to set the scene as some kind of warning to taxpayers that transfer pricing is to be taken seriously, despite the fact that local legislation might appear to be less harsh from the outset. Such situations can appear paradoxical as tax authorities in most countries are stepping up their efforts to collect additional revenue so that in essence they are looking at taxpayers from different geographical perspectives.

The effect of the current surge in disputes is somewhat lessened thanks to more sophisticated tools that are open to multinationals to deal with double taxation. Indeed, the OECD model treaty now includes a fifth paragraph in Article 25 offering the possibility for supplementary arbitration also better known as "mandatory arbitration". Whereas competent authority negotiations are traditionally inspired by a "best endeavour" commitment, the idea is now to make sure double taxation is alleviated. What is known in common parlance as the "EU Arbitration Convention" has served as a source of inspiration and it is probably fair to say that this is one of the biggest merits of the said convention despite the fact that only a couple of cases have been concluded under its application.

Certainty versus uncertainty is another paradoxical situation and the US standard around uncertain tax positions, called "FIN48", could serve as a good example. US public companies are required to assess whether the way in which they organise their business from a tax perspective will stand the test before Court in the hypothesis of full disclosure of all relevant facts and figures to the taxman. What we start to see is that FIN48 reports serve as an open invitation for transfer pricing audits in several countries as local tax inspectors want to know more about why companies are accounting for liabilities. Transfer pricing is again a favourite topic in this area.

'What is known in common parlance as the "EU Arbitration Convention" has served as a source of inspiration'

Also noteworthy is the fairly new trend of "enhanced relation" between tax authorities and multinational companies to cover tax audits jointly with the taxpayer. The Netherlands and the UK are pioneering in this sense. Also other countries, such as Spain are moving in this direction despite the fact that transfer pricing audit activity in Spain is pretty intense.

A key question these days is also whether some macro-economic trends might serve as a basis to predict whether and if so at what pace the global economy is beginning to pull out of recession so as to assess the impact on tax authorities' approaches. We see that some countries in Asia appear to come faster out of the recession, mainly because some of them were in a better shape prior to coming into recession while others grasp the benefits of being more exposed to commodities markets. Western Europe and the US seem to be somewhat behind on the recovery front, but expectations are moderately optimistic. Fiscal spend programmes were initiated in several countries to provide support and stimulus during the financial crisis. These fiscal programmes present a challenge to various governments as to how to finance them on the one hand; as well as how to scale them down in the future once the economies are back on track. This creates a stress on public finances resulting in substantial deficits. For example, countries such as the US and the UK present fiscal deficits in excess of 10% of Gross Domestic Product (GDP) and this creates additional debt problems for highly leveraged countries such as Italy whose public net debt ratio is in excess of 100% of GDP.[2] The combination of fiscal deficits and high debt ratios in a recovering world economy could present a challenge to public finances in the coming years.

The search for additional income to support all fiscal spending and mounting debt, makes countries reflect on enforcing rules in terms of documentation and compliance. Latin America serves as a good example, where countries such as Colombia have initiated a broad-based audit programme. In addition, Uruguay recently joined the majority group of countries with contemporaneous transfer pricing documentation requirements; while Chile's recent invitation to become a member of the OECD will likely strengthen the trend to align local rules and requirements to those of the other OECD member states.

Taxpayers have an interest in preparing quality-type documentation in a consistent and coherent way while carefully addressing local differences in what tax authorities want to see. India has formed a coalition with Brazil and South Africa and these three countries actually share information on how transfer pricing audits are to be conducted. In the summer of 2009, the Brazil and the South African revenue officials were invited to India where the domestic tax authorities shared their experience on how transfer pricing audits are conducted.

We are also seeing an increasing level of analytical sophistication on the tax authorities' side. Brazil has, for example implemented a system to develop a comprehensive database with key information about taxpayers' intercompany transactions. Through this system, tax authorities would be able to efficiently identify whether transactions carried out between related parties are implemented in accordance with the Brazilian distinct transfer pricing regulations.

[2] World Economic Outlook, International Monetary Fund, October 2009.

Also “intangibles” (IP) will continue to be the focus of tax authorities and issues on economic or beneficial ownership will continue to govern a predominant part of the tax authorities’ transfer pricing agenda. In old-fashioned economies the IP owners were merely located in the US or other well-known traditional countries, although there is an apparent change in gravity.

Multinationals were traditionally setting up R&D centres, design centres, marketing centres, etc, in countries such as India or Ireland, mostly for cost and/or tax arbitration purposes. However, the continuous increase in domestic consumption in high-growth, emerging countries creates an upward local demand on higher end goods. This trend can create a delayed effect where existing local R&D and/or marketing teams in place are likely to be increasing added value to the worth of the group’s crown jewel intangibles. The expectations are that the IP value will stem from traditional countries going through Eastern countries. These “new kids on the IP block” are stepping up their efforts which is leading to a more balanced global IP creation. This could result in tax authorities preferring an increased use of the profit split method in their transfer pricing analysis.

‘Also “intangibles” will continue to be the focus of tax authorities and issues on economic or beneficial ownership will continue to govern a predominant part of the tax authorities’ transfer pricing agenda’

Those setting the rules of the game: OECD/UN/others

On 9 September 2009 the OECD released a proposed revision of chapters I-III of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Transfer Pricing Guidelines). The proposed changes represent the final step in implementing the OECD projects on comparability and transactional profit methods, two areas considered to be a priority by the OECD Committee on Fiscal Affairs. In particular, the proposed revision reflects the outcome of extensive consultation by the OECD with the business community. Given that the existing guidance on these aspects is dated 1995, the proposed update represents an effort by the OECD to better align the principles laid out in the Transfer Pricing Guidelines with the practical considerations of tax administrations and the business community.

This important update focuses on fundamental aspects of the existing guidance, including:

- **Hierarchy of transfer pricing methods:** According to the proposed revision, all the methods are now on the same footing and the method selection judgement should be made on the basis of the “most appropriate method to the circumstances of the case”. This is an important development.

- **Comparability analysis:** Among other changes, the proposed guidance lays out a 10-step process for performing a comparability analysis, which is recommended as a “good practice”. Specifically, the guidance provides that internal comparables “may have a more direct and closer relationship to the transaction under review than external ones”, but also recognises that internal comparables “are not always more reliable”.

- **Application of the transactional profit methods:** The revised chapters provide additional guidance on the application of the transactional profit methods, including additional guidance on the comparability standard to be applied to the transactional net-margin method and on the application of the profit-split method.

The proposed revision also addresses the issues concerning the need for capital adjustments and provides practical formulae for performing these adjustments in an appendix.

Expectations are that around 2014 most of the tax authorities in the world will have embraced these new guidelines and probably will be following this on a consistent basis, but obviously one is likely to continually see that international principles will be challenged in the domestic market. This would be done to meet objectives of gathering tax revenues to cover fiscal deficits so tax authorities need to engage in balancing acts to address those two perspectives properly to avoid "short-lived victories" of local adjustments that are eventually solved under multilateral dispute mechanisms.

Further, Chapter IV of OECD Transfer Pricing Guidelines was updated in July, 2009 and released to the public in the first week of September, 2009. The updated guidelines emphasise the usage of Mutual Agreement Procedure (MAP) to resolve tax disputes and also that of arbitration process to supplement MAP. These guidelines have been modified, primarily to reflect the adoption, in the 2008 update of the OECD Model Tax Convention — of a new paragraph (5) in Article 25 — dealing with arbitration, and of changes to the Commentary on Article 25 on MAPs to resolve cross-border tax disputes.

Broadly, the updated chapter focuses on where a particular bilateral treaty does not contain an arbitration clause, the MAP does not compel the Competent Authorities (CAs) to reach an agreement and resolve their tax disputes and the CAs are obliged only to endeavour to reach an agreement. Even in the absence of an arbitration clause, the CAs of the contracting states may by mutual agreement, establish a similar binding arbitration procedure.

Further, the revised guidelines state that countries should not conclude any unilateral APA with a taxpayer with a requirement that the taxpayer waives access to the MAP if a transfer pricing dispute arises.

The updated guidelines re-emphasise the need to improve the effectiveness of the tax administration in resolving cross-border tax disputes.

Finally, the long-awaited convergence of customs and transfer pricing appears to remain a long-term exercise. Back in 2007 there were interesting initiatives in which the World Customs Organisation (WCO) and the OECD were playing a pivotal role. The aforementioned new draft chapters I-III, unfortunately, do not get much further than acknowledging that divergences continue to exist.

Besides the OECD, it seems now like if the United Nations also wants to play a role in the TP arena and have announced the development of a Transfer Pricing Model for Developing Countries. This instrument, to be constructed on the foundations of the OECD work, and oriented with a very practical approach, should be already finished by 2014 and could be used by important emerging countries not directly linked with the OECD. Attention should be paid to the developments at this level.

Taxpayers

The question is whether the transfer pricing function should remain a topic for the CFO or the tax manager only. Indeed, as there is an increasing need for quality documentation addressing operational reality, management teams and business teams will need to join hands with the tax teams to develop “good” documentation.

Take management fees as an example. More often than not one might have proper documentation from the service providers’ perspective (including benchmarking analysis and the maths of how those numbers have been computed). However, when one addresses things from the service receiver’s perspective, one can grasp why the tax authorities’ perspective is to understand how these services benefit the local operations. Interestingly, it is generally observed that the tax manager or the CFO of the service receiver company might not be able to provide the necessary supporting evidence unlike the business teams in their company who are the actual beneficiaries. Hence the importance of working together.

By 2014 there will probably be very few countries that have no documentation rules. It will be cumbersome for a corporate taxpayer to collect documentation for each and every country without being able to leverage on core documentation that could be prepared by the group. Simultaneously, one should carefully follow the particularities of local regulations or, as mentioned before, the UN developments that may make some countries to embrace positions that are not completely aligned with the OECD ones. The consequence will be that documentation has to be really carefully constructed from a core perspective, while also taking into account local particularities.

The master file concept within the EU could offer a good source of inspiration for being extended more globally.

A key component of documentation will be the “transfer pricing policy”. Indeed, very often the comparability analysis is conducted to start with, which is actually little more than a post-mortem analysis. Companies need to address how the policy works in situations of economic volatility and it will have to be flexible enough to show the tax authorities how margins, risks and/or losses are actually shared within the group. So-called “reverse business restructurings” could serve as a good example. When groups decide to unwind entrepreneur structures it will be of paramount importance to carefully address all the operational angles thereof because tax authorities need to understand how a group actually gets back to its original position. Careful documentation of the transfer pricing policy in a holistic way will be a key success factor. Moreover, proactivity is important because tax authorities will find it hard to believe that such substantial changes in the way a group conducts its business is only evidenced ex post. The importance cannot be emphasised enough. The aforementioned multilateral audits imply that if a taxpayer is ready to settle in one country, other countries might hear about it and could knock on the door too. In other words, companies should build up that policy, make it flexible and make it fit with business reality.

Tax planning should be the cherry on the cake and not the other way around. Exploiting tax efficiencies by setting up principal structures could indeed be a noble course to pursue, although one must address upfront the consequences of the economy turning sour. The rationale must be readily available in a very robust policy throughout the organisation and not only at the parent company level because everyone has an interest in speaking a common language.

Conclusions

Legislators, authoritative sources and scholars all seek ways to make “transfer pricing life” easier, but the apparent flipside is that countries need money and they will need more and more of it because the fiscal deficits might still be present by 2014.

Tax authorities around the globe are specialising and sharing information. Taxpayers have a particular interest in addressing transfer pricing priorities in a global, integrated and co-ordinated way.

A holistic approach to documentation and settlements is needed. The days of “fighting fires” on a country-by-country basis are gone. Tax authorities do communicate with each other and sometimes the taxpayer is metaphorically seen as the “deep-pocketed, common enemy”.

It is vital to have a coherent and defensible transfer pricing policy, responsive to the climate of change in which companies are currently operating. It is understandable that groups tend to be less rigorous in revisiting internal contractual arrangements compared with dealing in the outside world with suppliers, clients, joint-venture partners, etc. However, putting extra efforts into compliance might spare companies from wasting valuable management time in dealing with tax authorities’ queries on the “degree of arm’s-length attributes” an intercompany arrangement might have.

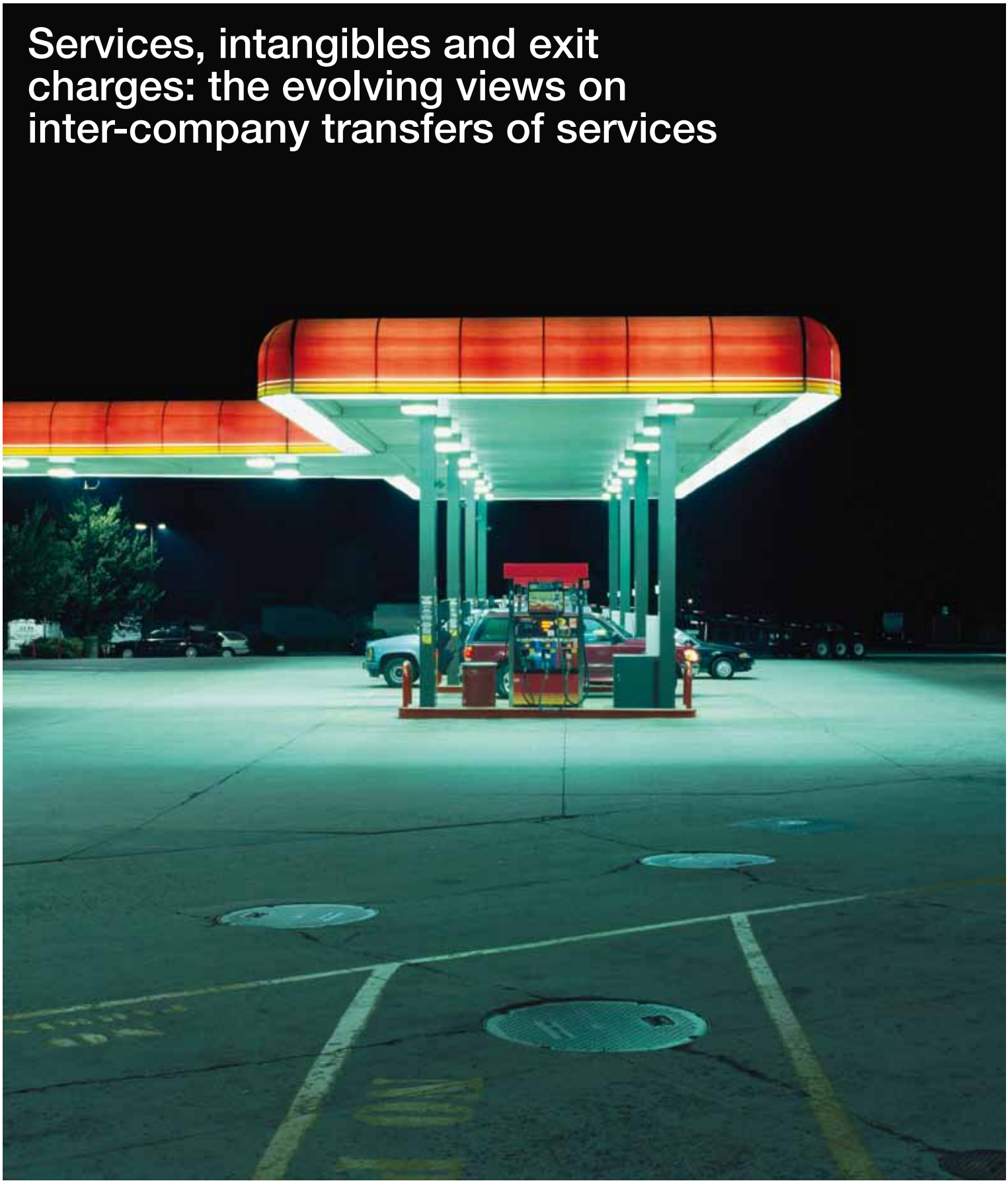
The efficiency of dispute resolution mechanisms, such as the European Arbitration Convention and the supplementary arbitration mechanism provided by the new Article 25(5) OECD Model Convention, will be increasingly tested. Dispute avoidance through – preferably — bi-or multilateral Advance Pricing Agreements might offer even more comfort despite the rather time-consuming nature of such arrangements. Many countries are looking for ways to smooth the process, which can only be welcomed.

‘The future looks bright’

Does all this means that the boundaries of legitimate tax planning are reached much earlier than was common until recently? Not really, because taxes will probably always be seen as a cost of doing business that needs close control or at the very minimum may not be levied more than once on the same income in multiple jurisdictions. The message to the taxpayers is, however, clear in the sense that emphasis is to be put on the analysis of the economic substance and purpose of intercompany transactions. Business should critically reflect upfront the commercial rationale of engaging in transactions.

In other words, the future looks bright because every cloud has its silver lining.

Services, intangibles and exit charges: the evolving views on inter-company transfers of services



Services, intangibles and exit charges: the evolving views on inter-company transfers of services

By **W. Joe Murphy** PwC (US)
and **Kartikeya Singh** PwC (US)

Multinational enterprises (MNEs) that implement business restructure with the aim of optimising their supply chain and improving corporate efficiency and profitability are faced with the following transfer pricing question: do exit charges apply for the transfer of routine or high-value service functions between jurisdictions?[3] A number of different positions are beginning to evolve to address this issue. The Organization for Economic Co-operation and Development (OECD) has issued a discussion draft on business restructurings that does not distinguish between routine and high-value services, but focuses instead on whether rights or assets accompany the transfer of a service function to determine whether an exit charge is triggered. In the United States, an Internal Revenue Service (IRS) examination guideline and the 2008 cost-sharing regulations stop short of applying exit charges for routine services, but are less clear with respect to the treatment of transfers of high-value services.[4] In Germany, newly crafted rules on business restructurings emphasise the need for an exit charge even in the case of transfers of routine functions.[5] This article discusses the uncertainty faced by taxpayers trying to navigate in this evolving area.

OECD view

The OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings (the OECD Draft) presents the preliminary view of the OECD's Committee on Fiscal Affairs regarding transfer pricing aspects of business restructurings.[6] The OECD Draft addresses the issue of whether a transfer of routine or high-value functions should be accompanied by some sort of compensation between the controlled entities involved in the transfer. In particular, Issues Note 2 of the OECD Draft discusses the arm's-length compensation with respect to the transfers of functions, assets, and/or risks with associated profit/loss potential. The discussion paper does not differentiate between routine and high-value services; it focuses instead on whether the transfer encompasses rights or assets. The draft recognises that without a transfer of actual assets, no compensation should be due at arm's length as a result of a restructuring. The OECD Draft states that "[t]he arm's-length principle does not require compensation for the loss of profit/loss potential *per se*. The question arises whether there are rights or other assets transferred that carry

[3] This question can be associated with any of the following three scenarios:
a) transfer of a function (ie, an economic activity such as research and development) from one location to another without the concomitant transfer of personnel previously engaged in the activity;
b) transfer of a function from one location to another accompanied by transfer of associated personnel; or
c) the provision of a specific function (ie, services) by an entity in one jurisdiction on behalf of a controlled entity in another jurisdiction.
Only the first two scenarios are the subject of this article.

[4] See IRS's Coordinated Issue Paper -"Sec. 482 CSA Buy-In Adjustments," LMSB-04-0907-62 (September 27, 2007). See also temporary cost-sharing regulations issued by the Internal Revenue Service pursuant to Treas. Reg. § 1.482-7T.

[5] On 4 July 2008, the German Upper House approved an Ordinance on Business Restructurings (the cross-border transfer of functions (Funktionsverlagerungen)).

[6] See "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment," 19 September 2008 to 19 February 2009, Organization for Economic Cooperation and Development, Centre for Tax Policy and Administration.

profit/loss potential and should be remunerated at arm's length."[7] Such remuneration would be required in the case where the restructured entity that previously performed the said functions (the transferor) had significant profit/loss potential from the rights and/or other assets that were transferred. It is the loss or "sacrifice" of these rights and/or assets for which the transferor should be compensated.

Furthermore, as the OECD Draft emphasises, an evaluation of the rights and obligations of the transferor should go beyond merely the contractual and legal arrangement to which the transferor was party. Such an evaluation should be based on the economic principles that govern comparable relationships between independent parties. For example, the transferor could be party to an "at will" or short-term contractual arrangement.[8] However, the actual conduct of the entity in years prior to the restructuring might be indicative of a longer-term arrangement. In such a case, it could be reasonable to conclude that, at the time of the restructuring, the transferor possesses rights (and assets) to an extent greater than what is indicated by the formal contractual arrangement.

Whether rights or assets accompany the transfer of routine or high-value services is a fact-specific matter. The determination of whether rights exist is complex, but would seem to turn on whether the behaviour of the service provider suggests a reasonable expectation of future benefits. For example, it seems economically consistent that a service provider would make investments (incur short-term losses) only with the expectation (an assumed right) to recoup these losses in the future.

In contrast to the OECD Draft, which focuses on the determination of whether rights or assets have been transferred, the German regulations have a much lower threshold to determine whether an exit charge is required.[9] The German rules look to simply determine whether there has been a transfer of functions (routine or otherwise) between controlled parties. In such cases, the compensation owed to the "transferring enterprise" is equal to the profit potential of the functions transferred. This position cannot be reconciled with the OECD Draft position, unless the German rules assume that the transferring enterprise is inherently entitled to — or "owns" — specific rights to perform the function within the group. If this viewpoint becomes commonplace, taxpayers will need to ponder their current functional footprint carefully and make informed choices as to the placement of future functions.

The US view

The preliminary views expressed in the OECD Draft in the context of transfers resulting from business restructurings are not fundamentally dissimilar to how the issue is treated under relevant US Treasury Regulations (the US Regulations) issued under sections 482 (Section 482) and 367 (Section 367) of the Internal Revenue Code (IRC). Specifically, to the extent that the transfer of a function between affiliated entities across tax jurisdictions is accompanied by a transfer of (tangible and/or intangible) assets, both Section 482 and Section 367 require that the transferor recognises arm's-length compensation for the transfer of intangible assets. However, the IRS stops short of requiring exit charges for the transfer

[7] Id.
[8] This would be the case, for example, where the transferor has been responsible for developing its market without receiving any compensation from any other related entity.
[9] Transfer of Function Regulation (Funktionsverlagerungsverordnung or FVerlV) released on 12 August 2008. The new rules are part of the comprehensive 2008 Enterprise Tax Reform Act, ratified June 7, 2007. The provisions dealing with transfer pricing in the case of a business restructuring amend the 1972 Law Regarding the Taxation of Transactions Involving Foreign Jurisdictions (Foreign TransactionsTax Law).

of routine services as shown by its position in its Coordinated Issue Paper (CIP) on buy-ins pertaining to cost-sharing arrangements (commonly associated with research and development efforts).[10] The CIP concludes that "in the typical initial buy-in scenario an unspecified method known as the income or foregone profits method will generally constitute the most reliable method for measuring the initial buy-in payment. This method determines the buy-in…*after reduction for routine returns*…"[11] This viewpoint was subsequently incorporated into the Temporary Cost Sharing Treasury Regulations issued on 31 December, 2008.[12]

Furthermore, under the US Regulations, a transfer of a business opportunity by itself is not considered the transfer of an asset, and therefore does not seem to require compensation between controlled parties. The leading case in this area is Hospital Corp. of America v. Commissioner, 81 T.C. 520, page 34 (1983), which stated that a business opportunity by itself does not constitute "any legally enforceable contractual or other right" and, therefore, a transfer of the same does not amount to a "transfer [of] any property" that warrants remuneration.[13]

Thus, from the US viewpoint, the existence of an intangible asset is central to the discussion — in particular the question of whether a transfer of a service function entails a transfer of such an asset. It is thus worthwhile to note how intangible assets are defined under IRC Section 936(h)(3)(B). Although including contractual rights and other intellectual property such as patents, trademarks, and franchises, the Section 936(h)(3)(B) definition of intangible property also includes "any similar item, which has substantial value independent of services of any individual" (emphasis added). Furthermore, based on recent developments both in the field and at the administrative level, the IRS has advanced the proposition that workforce in place constitutes intangible property for US federal income tax purposes.[14] In this context, the IRS has asserted that workforce in place is distinguishable from the services of any individual. The IRS's position as presented in the CIP states that the "assembled research team, however, may be expected to have substantial value independent of the services of any individual member of the team attributable to the team's collective contracts and know how, as no one or several individuals may be able to bargain compensation sufficient to eliminate a premium. Thus the value of a research team workforce in place is either derived from the 'contract' or 'know-how' items expressly listed in Section 936(h)(3)(B) and Treas. Reg. § 1.482-4(b), or represents a 'similar item' to such items."[15]

It is important to note that the US Tax Court seemed to reject this position in Veritas Software, Inc. v. Commissioner, 133 T.C. No. 14 (Dec. 10, 2009), a recent case involving a cost sharing buy-in.[16] The court noted that the value, if any, associated with the taxpayer's R&D and marketing teams is primarily based on the services of individuals (ie, the work, knowledge, and skills of team members). Thus, the court concluded that the workforce should be excluded from the buy-in valuation because it is not an item of "intangible property" as defined in Section 936(h)(3)(B), which excludes items that do not have "substantial value independent of the services of any individual".

[10] See U.S. Coordinated Issue Paper on Cost-Sharing Arrangement Buy-In Adjustments, LMSB-04-0907-62, released by IRS 9/27/07.
[11] Id. at Section C (The Income Method Generally Provides the Best Method for Determining the Initial Buy-in).
[12] U.S. Treas. Reg. § 1.482-7T(4)(vii)
[13] The IRS's position regarding workforce in place was articulated in a 2007 IRS Industry Director Directive focusing on US federal income tax implications associated with taxpayer conversions of Section 936 operations into controlled foreign corporations. This issue was revisited early in 2009 in the Obama administration's Fiscal Year 2010 Budget Proposal, which proposed to revise the definition of intangible property explicitly to include workforce in place, as well as goodwill and going concern value.
[14] Id. at Section E.3 (Research Team Intangible Contribution is Part of Buy-in Intangible).

An evolving issue

A key point that the discussion above should make evident is that in order to determine if a transfer of intangible assets has taken place as part of a transfer of a high-value service function, it is important to know what constitutes intangible assets for tax purposes. Although not a straightforward question at the best of times, this issue is further complicated by a provision in the US Regulations that has been the source of significant disagreement between taxpayers and the IRS. This provision is contained in the regulations under Section 367(d) and states that transfers of "foreign goodwill and going concern value" are exempt from an exit charge.[17,18] The disagreement between taxpayers and the IRS has stemmed from differing views on whether the transferred assets/value in such cases are intangible assets or goodwill/going concern value.

In a Technical Advice Memorandum (TAM) issued in February 2009 (TAM 200907024), the IRS attributed the value associated with a foreign business operation to intangibles rather than goodwill and going concern value. The taxpayer in the TAM had transferred to a foreign subsidiary a group of assets (the delivery network), which was essentially a network of contracts with a number of independent agents across numerous countries. Although the taxpayer attributed the bulk of the value of the transferred assets to goodwill and going concern value, the IRS disagreed and determined the delivery network to be an intangible asset as defined under Section 936(h)(3)(B), and thus subject to Section 367(d). The taxpayer adopted a disaggregated view of the multiple contracts and maintained that the sum of the values of these separately valued contracts constituted less than three percent of the business value.

It further argued that the "delivery network" constituted "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." Finally, as part of this argument, the taxpayer claimed that a vital part of this value is derived from "the ability of a business to continue to function and generate income without interruption as a consequence of a change in ownership" and thus falls under the "traditional" definition of goodwill or going concern value.

In contrast, the IRS argued that the "delivery network" constituted a collection of contracts and as such fell under the list of intangibles in Section 936(h)(3)(B). The IRS further argued that the "delivery network" could alternatively be viewed as a collection of franchises, or could be said to constitute a "method, program, and procedure" and thus fell under the list of intangibles in Section 936(h)(3)(B). The IRS opposed the taxpayer's use of "traditional definitions of goodwill and going concern value" in the context of Section 367(d) on the grounds that that they were "too broad". In particular, the IRS noted that the US Regulations' definition of foreign goodwill and going concern did not depend on the "traditional definitions".[19]

In its arguments set out in the TAM, the IRS cited cases such as Massey-Ferguson, Inc. v. Commissioner, 59 T.C. 220 (1972) ("Massey-Ferguson"), in which the Tax Court treated a distributor network based on multiple contracts as a single intangible asset. The IRS also cited Newark Morning Ledger v. United States, 507 U.S. 546, 555-56 (1993) ("Newark Morning Ledger"), to support its assertion that the traditional definitions of goodwill and going concern value are too broad for Section 367(d).[20]

[16] Section 367(d) governs the transfer of an intangible by a US entity to a foreign corporation in a transaction that would otherwise qualify for tax deferral.
[17] Treas. Reg. §§ 1.367(d)-1T(b), 1.367(a)-1T(d)(5)(i).
[18] Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines foreign goodwill or going concern value as the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued.
[19] The dispute between the taxpayer and the IRS in this case concerned the treatment of a list of "paid subscribers" to a newspaper. Although the taxpayer contended that this list constituted an intangible asset with a limited useful life whose value could be depreciated, the IRS maintained that this was indistinguishable from goodwill and thus was not a depreciable asset.

It is interesting to note that the positions of the taxpayer and the IRS taken in the TAM with respect to Section 367(d) (which are similar to the positions taken by other taxpayers and the IRS in audits) are the reverse of the positions taken by taxpayers and the IRS in previous cases involving the definition of goodwill and going concern value (such as Massey-Ferguson and Newark Morning Ledger). For many years, taxpayers and the IRS were embroiled in numerous disputes involving the amortisation of intangible assets. At that time (before the enactment of IRC Section 197 changed the law on this point), goodwill and going concern value were considered non-amortisable assets, whereas other intangible assets could be amortised over their useful lives. Taxpayers therefore sought a very narrow definition of goodwill and going concern value to maximise their amortisation deductions, while the IRS took the opposite position and broadly defined the scope of goodwill and going concern value. In the context of cases involving the Section 367(d) exit charge, however, the interests of each side are now reversed.

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Conclusion

The question often confronting taxpayers faced with a business restructuring is whether a transfer of routine or high-value service functions warrants an exit charge. A reading of the OECD and IRS views suggests that in order to address this question, the taxpayer needs to make the following determination:

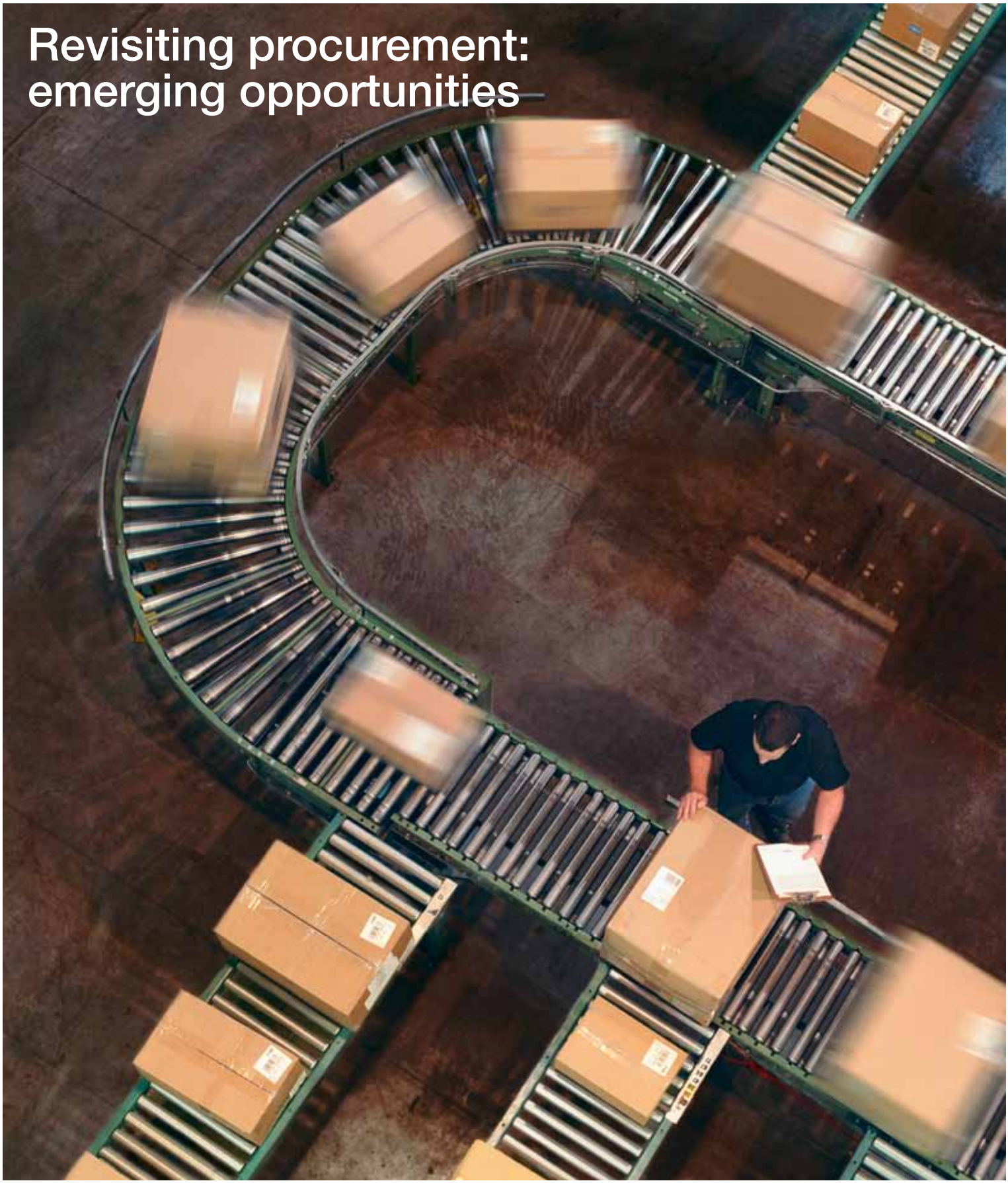
1. Is the service in question associated with any right or valuable intangible asset?; and
2. Does the transfer of the service function necessarily amount to the transfer of the associated intangible assets?

The answers to these questions depend on the facts and circumstances specific to each case. However, it should be disconcerting to taxpayers that the OECD Draft no longer attempts to differentiate between routine and non-routine (high value) services, but simply focuses on the existence of rights or assets. The German regulations take this viewpoint a step further and appear to assume that the current service provider essentially has a “right” to perform the services within the group setting. As such, the German view would suggest that compensation is owed to the “transferring enterprise” regardless of the characterisation of the services being performed.

The IRS view continues to distinguish between routine and non-routine (high-value) services, the latter typically accompanied with some intangible in the form of a valuable workforce in place or know-how. However, once the income associated with the routine services, assets, and intangibles is accounted for, the treatment of the residual income is the source of significant disagreement between the IRS and taxpayers. This is especially true in the context of whether the specific value transferred as part of such restructurings constitutes goodwill or going concern value or in fact can be identified and valued as separate and distinct intangible assets, such as workforce in place.

Transfer pricing perspectives
May 2010

Revisiting procurement: emerging opportunities



Revisiting procurement: emerging opportunities

By **Nick Mühlemann** (PwC UK),
Sonia Watson (PwC UK),
Steve Hasson (PwC UK) and
Victor Abrams (PwC UK)

Procurement has changed. Globalisation of supply chains and increased economic and competitive pressures have driven the management of third-party spend further up the corporate agenda. In response, companies are looking to alternative procurement models that allow a greater level of central control – this presents companies with both a tax opportunity and a risk. One such model is the emerging "centre-led" model. Whichever model is adopted it must be underpinned by the appropriate arm's-length transfer pricing. This can be challenging for some of the more innovative models, but increasingly we are seeing the availability of supporting third-party evidence.

Procurement has changed

Procurement, sourcing, purchasing, buying — there are a multitude of terms used to describe the activity of acquiring goods and services from third parties, each no doubt with a particular nuance in different industries and firms. For the purposes of this article we are defining procurement in its broadest sense, covering:

- **strategic sourcing** — encompassing the strategic decisions governing the development of a sourcing strategy, selection of suppliers and contracting, which identifies and captures the procurement savings;
- **the purchase to pay process** — the operational processes of spending money through the improved terms of the contract and in line with demand strategy, which realises the saving; and
- **the supplier and contract management activity** — the tactical decisions on how to get the most out of the supplier relationships, which sustain the savings.

The savings from procurement are not trivial; when bought-in products and services make up more than 50% of the typical company's cost base, you cannot afford to ignore it. Neither are all the savings based on the aggregation of spend. Leading procurement functions rely on a wide range of levers to reduce costs and manage quality including demand management and the optimisation of specifications; supply performance; relationship and risk management and total ownership cost analysis.

Procurement is now a critical success factor for many firms as they fight to respond to economic and competitive pressures:

- **Globalisation:** Procurement is central to the increased complexity of managing global supply chains, and can drive additional benefit through strategies such as low-cost country sourcing.
- **Economic downturn:** There is now a greater level of involvement from procurement in areas such as marketing and legal spend — which were not previously within the remit of procurement — and an increased role in the management of traditional spend areas (for example involvement in new product development and continuous improvement programmes). The increase in bankruptcies and defaults has led to a corresponding increase in focus on supplier risk management and supply continuity.
- **Sustainability:** Leading firms are incorporating environmental factors into their supplier selection and management criteria.

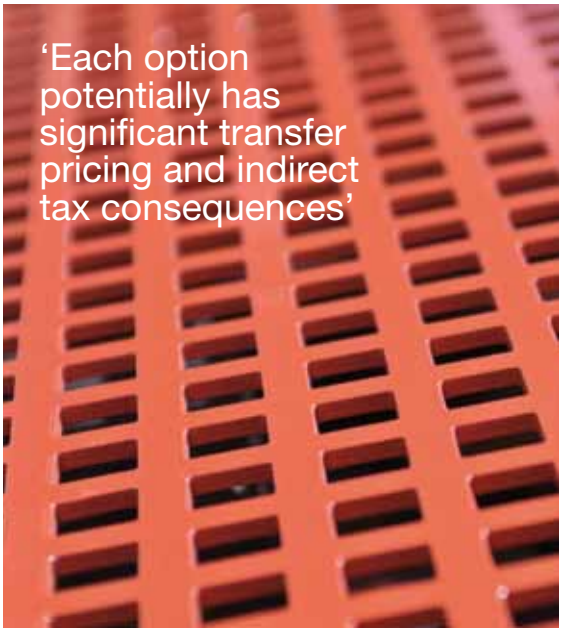
In response companies are looking to alternative procurement models

These pressures are leading companies to reconsider their procurement operating models. This typically covers three dimensions:

- **The level of centralisation:** We have observed a move to more centralised or centre-led structures, regionally and increasingly globally, often around specific spend category teams to drive sourcing best practice, spend leverage and risk management across business units and geographies.
- **Relationships with third parties:** An increased reliance on the skills and expertise of third parties through hybrid models such as co-sourcing agreements, buying groups, outsourcing, or lead supplier relationships.
- **Relationship with the business:** Procurement does not (and should not) always lead the sourcing activity. We have observed three main types of relationship:

    1. Procurement manages the spend — this tends to be for non-contentious, non-strategic spend areas, where there are opportunities to leverage across the business;
    2. Procurement co-ordinates the spend — here it plays a role to bring together the business users across the company and to help drive improvements and a common strategy; or
    3. Procurement supports the process — this tends to be strategic items with complex specifications that require heavy input from the business.

These numerous variables lead to a multitude of possible operating model configurations, with companies further adding to the complexity by introducing different models for different spend categories, geographies and or business units. Each option potentially has significant transfer pricing and indirect tax consequences. These tax issues are not always fully understood or appropriately managed by those leading the procurement operating model design. However leading firms are recognising this risk (and potential) and incorporating tax into the operating model design decisions. The next section of this article will look at some of these hybrid models and the implications for sustainable transfer pricing.



Centre-led model

There are a range of characterisations that might be appropriate for a procurement organisation, from a service provider at the lower end of the value chain through to a supply chain entrepreneur. The most appropriate characterisation will depend on the level of geographic (physical) centralisation, the functions, risks and assets managed and borne by the procurement organisation, and the scope of spend categories managed. Typically, the greater the level of central control the more substantial the operational benefits, and the higher the return to the procurement company that can be justified. However, this needs to be balanced against the operational practicalities and the appetite for disruption within the business.

As procurement adds increasing value to a business, a traditional cost plus service model might no longer be appropriate. Some companies have looked to buy-sell models, where the procurement organisation contracts directly with suppliers to buy materials, which can drive further operational benefits (such as facilitating hedging strategies and increasing spend control). However, for other businesses, a buy-sell model could introduce too many operational complexities, particularly in terms of systems complexity.

One emerging model for a centralised procurement activity that has generated a lot of interest from procurement organisations is the centre-led model. Centre-led denotes a model where the sourcing strategy, supplier negotiation and selection is managed centrally (often underpinned by company wide umbrella agreements), while the local businesses still contract directly with the supplier under centrally agreed terms and conditions and all orders are executed locally. Accordingly it does not require substantial changes to the transactional flows or systems, yet still promotes the benefits of greater central control. Under a centre-led model, a value-based service fee might be appropriate, for example a commission-based on spend. Centre-Led has a number of advantages compared with the buy-sell model, in particular fewer systems and indirect tax complexities.

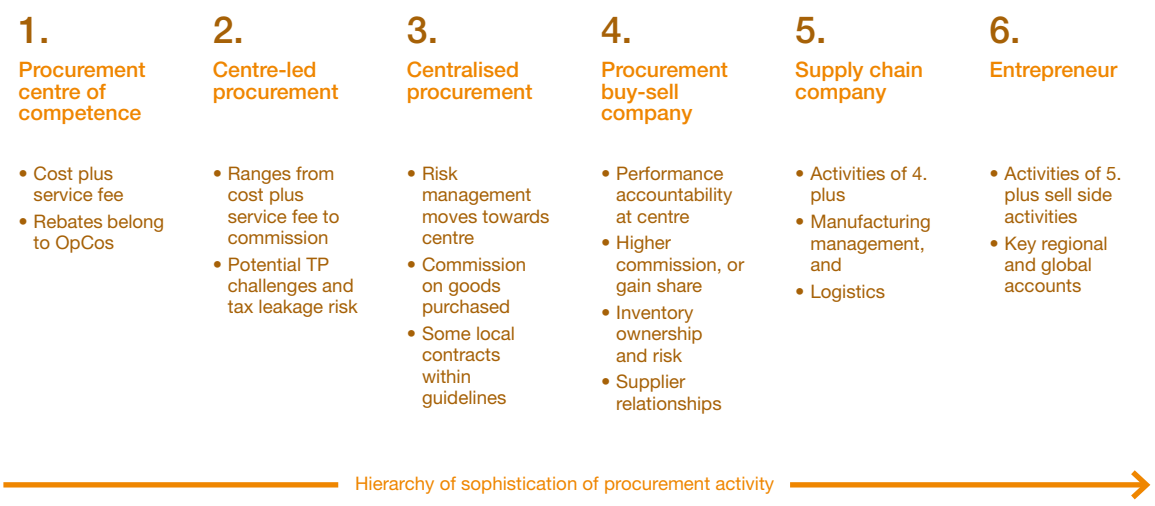
There are a number of tax issues to be assessed and managed on transition to a new procurement business model, including substance, tax leakage issues from permanent establishments of the procurement organisation in other countries, exit costs from moving functions, risks and assets, withholding taxes, indirect taxes, transfer pricing exposure, and ensuring sustainability of the model in the longer term. With careful analysis, implementation and documentation, however, these transition issues can be managed.

Whichever model is adopted, it must be underpinned by the right transfer pricing.

When a company changes its business or operational model it is important that these changes are reflected in its transfer pricing model. There is relatively little guidance from the OECD that is specific to procurement transfer pricing, however, the more recent OECD business restructuring paper includes a specific example of a centralised procurement entity. While the paper reiterates that there is little or no value in "mere purchasing", the scope and impact of leading companies' procurement functions are unlikely to be classified as "mere purchasing". The paper goes on to indicate that a commission or gain-share transfer pricing model might be appropriate for the centralisation of the strategic and tactical procurement activities we are considering here in the centre-led example.

The choice of transfer pricing method for a procurement operation depends on how it is set up to operate. The diagram below sets out the different potential transfer pricing methods against the level of centralised procurement activity:

Figure 7:
Potential transfer pricing methods against the level of centralised procurement activity



It is important that the transfer pricing model is supported by benchmarking data in order to show, under the appropriate business model, that the level of reward for the procurement activity is arm's length. Under a centre-led model, where real economic value is added and risk taken, then it might be appropriate for a procurement company to earn a commission. There is some third-party evidence available that can provide a guide to the level of reward. For example, we have already discussed that third parties (for example, buying agents) operate in the market, but obtaining data on the specific services they are performing and what they charge is not always straight forward. However, it is generally possible to obtain a range of third-party agreements that provide indications about the level of fees that third parties charge for procurement activities. This buying commission data, is useful for benchmarking centre-led fees and/or an appropriate gross margin for buy-sell models.

There are a number of factors that should be considered when reviewing the range of buying commissions and setting an arm's-length commission (or gross margin for the buy-sell model) from within the range. These factors include the type of materials being procured, the relative strength of supplier relationships, whether value added services (such as product design) are being performed, and volumes. One factor which is particularly important and specifically mentioned in the OECD business restructuring paper is the level of procurement savings obtained by the procurement organisation. While savings can be subjective to measure, savings are a very relevant factor in determining an appropriate commission.

Conclusion

As we have shown, various commercial pressures have led many companies to revisit their procurement model. New models, such as centre-led, are emerging, which overcome some of the complexities associated with more traditional centralised models and there is market evidence available to support the transfer pricing for these. As with all aspects of the business, it is critical for the tax department to understand any planned changes to procurement. By keeping up to date with the evolution of the changing procurement operating model, the tax department can ensure its transfer pricing remains appropriate and where possible capitalise on any tax optimisation opportunities while efficiently managing compliance.

'By keeping up to date with the evolution of the changing procurement operating model, the tax department can ensure their transfer pricing remains appropriate and where possible capitalise on any tax optimisation opportunities while efficiently managing compliance'

Transfer pricing country leaders

Global transfer pricing network leader
Garry Stone
garry.stone@us.pwc.com
+1—312—298—2464

Argentina
Juan Carlos Ferreiro
juan.carlos.ferreiro@ar.pwc.com
+54–11–4850–6712

Australia
Helen Fazzino
helen.fazzino@au.pwc.com
+61–3–8603–3673

Austria
Herbert Greinecker
herbert.greinecker@at.pwc.com
+43–1–501–88–3300

Belgium
Isabel Verlinden
isabel.verlinden@pwc.be
+32–2–710–44–22

Bermuda
Peter C. Mitchell
peter.c.mitchell@bm.pwc.com
+1–441–299–7101

Brazil
Cristina Medeiros
nelio.weiss@br.pwc.com
+55–11–3674–3557

Bulgaria
Irina Tsvetkova
irina.tsvetkova@bg.pwc.com
+359–2–9355–126

Canada
Charles Theriault
charles.theriault@ca.pwc.com
+514–205–5144

Chile
Roberto Carlos Rivas
roberto.carlos.rivas@cl.pwc.com
+56–2–9400151

China
Spencer Chong
spencer.chong@cn.pwc.com
+8621–2323–2580

Columbia
Carlos Mario Lafaurie
carlos_mario.lafaurie@co.pwc.com
+57–1–634–0555 (ext 404)

Costa Rica
Emilia Amado
emilia.amado@cr.pwc.com
+506–2224–1555

Croatia
Ivo Bijelic
ivo.bijelic@hr.pwc.com
+385–16328802

Czech Republic
David Borkovec
david.borkovec@cz.pwc.com
+420–251–152–561

Denmark
Erik Todbjerg
erik.todbjerg@dk.pwc.com
+45–39–45–94–33

Estonia
Villi Tõntson
villi.tontson@ee.pwc.com
+37–26–14–19–37

Finland
Ray A Grimes
ray.a.grimes@fi.pwc.com
+358–9–2280–1905

France
Pierre Escaut
pierre.escaut@fr.landwellglobal.com
+33–1–56–57–42–95

Germany
Lorenz Bernhardt
lorenz.bernhardt@de.pwc.com
+49–30–2636–5204

Transfer pricing country leaders

Greece
John Christodoulou
john.christodoulou@gr.pwc.com
+30–1–68–74–540

Hong Kong
Colin Farrell
colin.farrell@hk.pwc.com
+852–2289–3800

Hungary
Zaid Sethi
zaid.sethi@hu.pwc.com
+36–1–461–9289

Iceland
Elin Arnadottir
elin.arnadottir@is.pwc.com
+354–550–5322

India
Rahul Mitra
rahul.k.mitra@in.pwc.com
+91 124 330 6501

Ireland
Gavan Ryle
gavan.ryle@ie.pwc.com
+353–1–792–8704

Israel
Gerry Seligman
gerry.seligman@us.pwc.com
+972–3–795–4476

Italy
Gianni Colucci
gianni.colucci@it.pwc.com
+390–291–605500

Jamaica
Eric Crawford
eric.crawford@jm.pwc.com
+1 876–932–8323

Japan
Akio Miyamoto
akio.miyamoto@jp.pwc.com
+81–3–5251–2337

Kazakhstan
Carmen Cancela
carmen.cancela@ve.pwc.com
+58–212–7006117

Kenya
Rajesh K Shah
rajesh.k.shah@ke.pwc.com
+254–20–285–5000

Korea
Henry An
henryan@samil.com
+82–2–3781–2594

Latvia
Vita Sakne
vita.sakne@lv.pwc.com
+371–67–094–400

Lithuania
Nerijus Nedzinskas
nerijus.nedzinskas@lt.pwc.com
+370–5–2392350

Luxembourg
David Roach
david.roach@lu.pwc.com
+352–49–48–48–3057

Malaysia
Thanneermalai Somasundaram
thanneermalai.somasundaram@my.pwc.com
+60–3–2693–1077 (ext 1852)

Malta
Neville Gatt
neville.gatt@mt.pwc.com
+356–2564–6711

Mexico
Mauricio Hurtado
mauricio.hurtado@mx.pwc.com
+52–55–5263–6045

Namibia
Albe Botha
albe.botha@na.pwc.com
+264 61 284–1081

Transfer pricing country leaders

Netherlands
Arnout van der Rest
arnout.van.der.rest@nl.pwc.com
+31–10–407–53–28

New Zealand
Michael J Bignell
michael.j.bignell@nz.pwc.com
+64–9–355–8051

Norway
Morten Beck
morten.beck@no.pwc.com
+47–95–26–06–50

Peru
Rudolf Röder
rudolf.roeder@pe.pwc.com
+51–1–211–6500 (ext 1906)

Phillipines
Carlos T. Carado
carlos.carado@ph.pwc.com
+63–2–459–2020

Poland
Mike Ahern
mike.ahern@pl.pwc.com
+48–22–523–4985

Portugal
Jaime Esteves
jaime.esteves@pt.pwc.com
+351–22–54–33–000

Romania
Ionut Simion
ionut.simion@ro.pwc.com
+40–21–202–8702

Russia
Evgenia Veter
evgenia.veter@ru.pwc.com
+7–495–232–5438

Serbia & Montenegro
Jelena Djokic
jelena.djokic@rs.pwc.com
+381–11–3302–100

Singapore
Nicole Fung
nicole.fung@sg.pwc.com
+65–6236–03618

Slovakia
Christiana Serugova
christiana.serugova@sk.pwc.com
+421–2–59–350–614

Slovenia, Bosnia/Herzegovina
Janos Kelemen
janos.kelemen@si.pwc.com
+386–1–5836–058

Spain
Javier Gonzalez Carcedo
javier.gonzalez.carcedo@es.landwellglobal.com
+34–91–568–4542

Sri Lanka
Daya Weeraratne
daya.weeraratne@lk.pwc.com
+94–11–4719838

Sweden
Mika Myllynen
magnus.grive@se.pwc.com
+46–8–555–34–157

Switzerland
Norbert Raschle
norbert.raschle@ch.pwc.com
+41–58–792–4306

Taiwan
Wendy Chiu
wendy.chiu@tw.pwc.com
+886–2–27296666

Thailand
Peerapat Poshyanonda
peerapat.poshyanonda@th.pwc.com
+66–2–344–1220

Trinidad and Tobago
Peter Inglefield
peter.inglefield@tt.pwc.com
+1–868–868–623–1361

Transfer pricing country leaders

Turkey
Zeki Gunduz
zeki.gunduz@tr.pwc.com
+90–212–326–6410

United Arab Emirates (Dubai)
David Stevens
david.stevens@ae.pwc.com
+971–4–3043100 (ext 304)

UK
Ian Dykes
ian.dykes@uk.pwc.com
+44-121-265-5968

Ukraine
Ron Barden
ron.j.barden@ua.pwc.com
+38–044–490–6777

Uruguay
Sergio Franco
sergio.franco@uy.pwc.com
+598–2–9160463 (ext 1319)

US
Garry Stone
garry.stone@us.pwc.com
+312–298–2464

Venezuela
Fernando Miranda
fernando.miranda@ve.pwc.com
+58–212–700–6123

pwc.com/transferpricingperspectives

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