

Transfer Pricing Perspectives: A selection of articles tackling the issues of the transfer pricing lifecycle.

The Middle East within the transfer pricing lifecycle ^{p4} / *Africa's changing landscape* ^{p10} / *Documentation* ^{p14} / *VCT in the BRICs* ^{p20} / *New tax pitfalls for acquisitions and restructuring* ^{p26} / *Economic substance* ^{p28} / *How much is corporate America worth?* ^{p36} / *Intercompany pricing* ^{p44} / *Our global network* ^{p42}

Old challenges, new approaches.



Contents

Where is the Middle East within the transfer pricing lifecycle?	4
Spotlight on Africa's changing transfer pricing landscape	10
Documentation	14
Value chain transformation in the BRICs: What works in evolving economies?	20
New tax pitfalls for multinational acquisitions and restructuring in the age of fiscal shortfall	26
Economic substance: myth or reality?	28
How much is corporate America worth?: Corporate tax reform and firm valuation premia	36
The perils and potential of intercompany pricing – on mergers and acquisitions in a multinational environment	44
Our global network – Country leaders	49



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Design Services 27897 (10/12).



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Today's transfer pricing rules are extremely complex. Multinational organisations are navigating operations in an ever-expanding globalised world, and the stringent, diverse transfer pricing requirements they face are daunting. As companies align their business supply chains, tax, and legal operating models to deliver sustainable financial benefits, the pressure is on to achieve these goals within a strict and divergent transfer pricing environment.

The articles in this October 2012 edition of *Transfer Pricing Perspectives* take a broad look at the different transfer pricing requirements and unique challenges companies are facing all over the world. Topics covered include:

- Tax pitfalls for multinational acquisitions and restructuring in times of fiscal shortfall
- Africa's increased focus on transfer pricing issues in the region
- Intercompany pricing: The challenges and potential benefits
- The Middle East: Where it stands with transfer pricing
- Emerging BRICS companies and their approach to transfer pricing
- The principle of economic substance and how it has become an issue for transfer pricing practitioners
- Challenges in keeping transfer pricing documentation up to date
- The continuing importance of corporate tax reform

Transfer pricing specialists address these issues in detail and set out best practices for preparing and maintaining consistent and defensible transfer pricing documentation in widely varying situations.

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I hope you enjoy this edition of *Transfer Pricing Perspectives*.

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

Garry Stone

Transfer pricing in the Middle East: *Our experts Dan Axelsen and Jochem Rossel of PwC UAE discuss the transfer pricing landscape in the region.*

Where is the Middle East within the transfer pricing lifecycle?

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Transfer pricing in the Middle East: An introduction

The Middle East region represents a group of countries with important developing economies for many multinational companies (MNCs). As an illustration, in 2011, several key economies forming part of the Gulf Cooperation Council (GCC) grew at relatively high real GDP growth rates – 18.8% for Qatar, 6.8% for Saudi Arabia, 8.2% for Kuwait, 5.5% for Oman, and 4.9% for the UAE.¹ What's more, the economies of the GCC, despite political uncertainty and unrest, and the broader Middle East in general, continue to be areas of real growth for MNCs, who regularly experience double digit growth in turnover, year-over-year. As such, the Middle East continues to evolve as an important region, and is also evolving with respect to general tax administration, including the application and formation of transfer pricing laws and associated guidelines.

Given many MNCs' movement into the Middle East region – and their growth aspirations in the region – many are now facing the question of how to structure their operations and business in light of the expected business growth and opportunity. Tax and transfer pricing are important

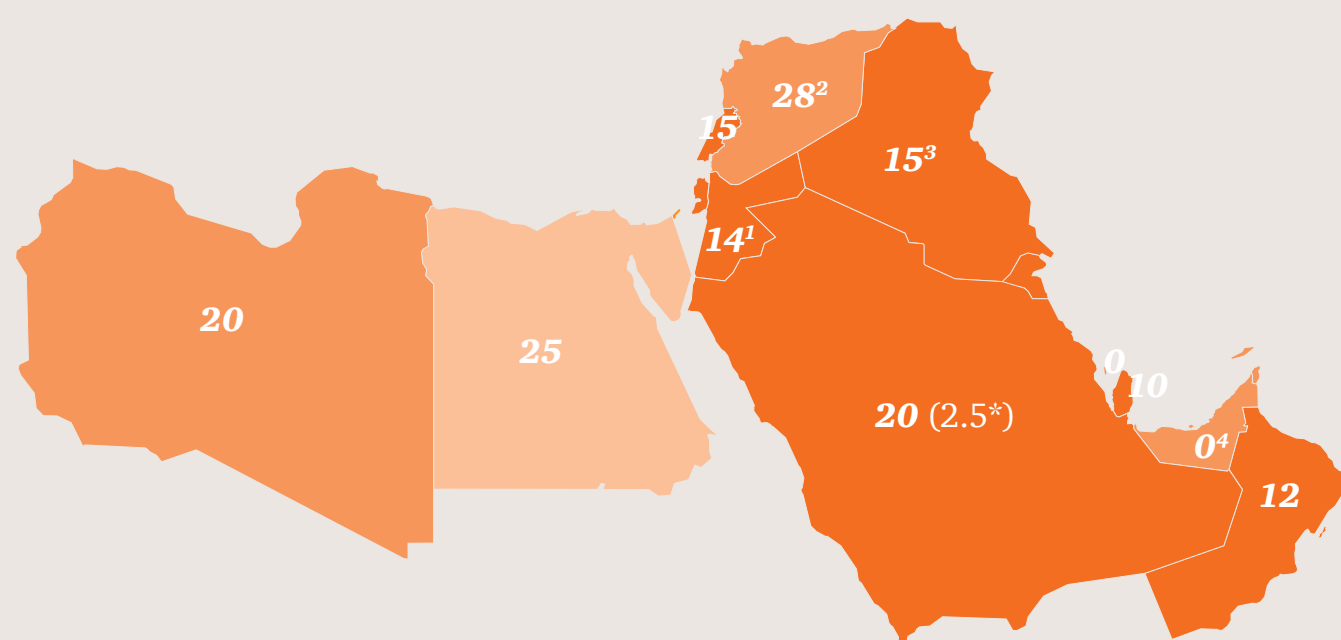
considerations for them when deciding how to best organise their operations within the region.

The Middle East region's positioning within the transfer pricing lifecycle is interesting and potentially unique relative to many MNCs operating in more developed transfer pricing regions, like North America and Europe. Specifically, the Middle East region is at the initial stages of the transfer pricing lifecycle, with transfer pricing and international tax regimes being developed. This, coupled with certain favourable taxing jurisdictions in the region (in some cases with no resident and non-resident corporate taxation), offers a unique opportunity for taxpayers to consider how to restructure their operations (for tax purposes) in response to this growing, evolving and important market for MNCs. This article focuses on the general tax planning environment across the broader Middle East region, with emphasis on transfer pricing planning.

Before we start, let's first consider the Middle Eastern territories covered in this article (see Figure 1 overleaf). A brief illustration of both the current transfer pricing rules in place and the level of corporate taxation by country is included.

¹ Other countries, including Egypt and Bahrain, endured substantial political uncertainty, yet still had positive real growth in GDP. In fact, Egypt's real GDP grew at 1.8% while Bahrain's real GDP also grew at 1.8%, for 2011. For more information www.cia.gov.



Figure 1: Transfer pricing environment in the Middle East**Notes**

- ¹ CIT rate is 30% for banks, 24% for telecommunication, insurance, financial intermediation companies (including exchange and finance leasing companies).
- ² Represents highest rate of CIT. The tax rates for various categories of taxable profit (in Syrian Pounds) are: up to 200,000 (10%); 200,000 - 500,000 (15%); 500,001 - 1,000,000 (20%); 1,000,000 - 3,000,000 (24%) and over 3,000,000 (28%).
- ³ Represents general CIT rate. Applicable rate for companies in the oil and gas production sector and related industries is 35%.
- ⁴ In practice, tax is levied on branches of foreign banks (20%) and oil and gas companies (55%).
Represents Zakat rates for Saudi/Kuwaiti based companies, who are not subject to corporate taxation.

Key

Country has transfer pricing guidelines
Country has transfer pricing provisions in its laws
Country with no transfer pricing

² The arm's length principle and the transfer pricing law is described by Income Tax Law no. 91 of 2005, Article (30) and its Executive Regulations, Articles (38), (39), and (40). The Egyptian Transfer Pricing Guidelines: A Practical Guide to the Application of Article (30) of the Income Tax Law no 91 of 2005 were published in November of 2010 as an application to the 2005 law.

³ In addition to most companies in Bahrain and the UAE not being subjected to corporate income tax, most locally owned companies operating in Qatar, Kuwait, and Saudi Arabia, do not pay corporate income tax.

⁴ The corporate tax rate in Egypt is 20% for earnings of EGP 10 million and less and 25% for earnings of greater than EGP 10 million.

Figure 1 illustrates the transfer pricing environment for certain Middle Eastern countries, of which only Egypt currently has detailed transfer pricing guidelines that address the application of its 2005 transfer pricing law.² Most of the other territories depicted in Figure 1 have either a specific law regarding transfer pricing and some level of recognition of the arm's length principle (which includes Qatar, Saudi Arabia, and Oman), or include general transfer pricing only by way of practical application of the tax authority's interpretation of the arm's length principle. Figure 1 also indicates levels of corporate taxation are relatively low, ranging from 0% for most UAE and Bahrain companies, to 28% in Syria. Countries like Oman and Qatar, which are at 12% and 10%, respectively, are considered relatively low by global standards.³ The Middle East region's largest economies, outside of the UAE, are Saudi Arabia, with a corporate tax rate of 20%, and Egypt, with a corporate tax rate of 25%.⁴ So, how should a MNC consider its transfer pricing positions and policies within the Middle East in light of the fact that (1) tax regimes are largely in the process of designing their transfer pricing and international tax rules and (2) levels of corporate taxation are relatively low in most territories? This question is addressed next.

Transfer pricing planning landscape in the Middle East

Certain territories in the Middle East – the UAE and Bahrain in particular – do not apply corporate taxation, with the exception of upstream oil and gas companies in the UAE and Bahrain, and branches of foreign banks in the UAE. While both jurisdictions possess unique operational challenges, e.g., requiring a local partner if operating outside a Free Trade Zone in the UAE, the UAE (and to a lesser extent, Bahrain) is often used by MNCs as a regional hub or alternative base for performing centralised activities including procurement, financing, leasing, etc. Many MNCs see both jurisdictions as being business friendly environments, but less so for Bahrain as a result of recent political unrest and uncertainty – and the UAE is seen as a key port for much of the Middle East region more generally. What's more, both countries, especially the UAE, have a wide and growing double tax treaty network. As a result, the transfer pricing lifecycle in the Middle East region, as it pertains to the UAE and Bahrain, is really at the planning and structuring phase with emphasis on outbound business and general management being provided from these two jurisdictions. The trend here has been to put substance and regionally based management in the UAE in particular, and some in Bahrain.

As for overall structure, there are many challenges to consider when establishing a presence in the region. In particular, relatively high domestic withholding tax rates compared to domestic rates of corporate taxation, and lack of a treaty network within the Middle East region may mean certain standard related party transactions will attract high levels of taxation at source and scrutiny under audit. For instance, if an MNC's operating companies are set-up as full risk, or fully fledged, and therefore subject to various outbound transactions within the country of operation (including services, royalties, leasing of equipment, cost sharing, etc.), all such transactions are likely to be subject to relatively high domestic withholding tax rates, which in many instances will not be eligible for treaty relief. On the other hand, for MNCs with a regional presence and economic substance in a regional hub/headquarter, much of the tax compliance, potential for dispute, and cost can be reduced if the operations are run out of the hub, and the operating companies have more limited risk in nature. Of course, like all operationally based transfer pricing models, the facts, substance, and form of the intercompany relationships need to support the limited risk type models if they are to be considered.

Another consideration for MNCs establishing operations in the Middle East is general tax authority acceptance of the arm's length principle as understood by Article 9 of the *OECD Model Tax Convention on Income and on Capital*, and thus, general acceptance of many of their standard and global transfer pricing policies. The reality is that tax authority acceptance of the arm's length principle throughout the region is mixed, and as a general rule "form" over "substance" tends to prevail. As such, presence of a legal contract and documentation supporting the charges and illustrating that the legal contract and policy has been administered as intended are often more important than trying to explain the substance of a transaction.⁵ As an example, it can be challenging to explain that a limited risk distributor should earn an arm's length operating margin, and cost of goods sold is valued accordingly in an effort to target such a margin, as opposed to being able to tie the transaction back to a schedule of actual costs and profits earned by the seller of the goods. More simply, the legal contract alone, if interpreted by a tax authority as a "reasonable" and "arm's length" agreement may suffice.

⁵ Tax authorities across the Middle East, and many of the laws in various jurisdictions, refer to the term "documentation" which is not the same as typical transfer pricing documentation as many MNCs understand it to be in places like North America and Europe, but instead supporting schedules and other evidence supporting the amount and nature of charges.



‘Unlike many regions and specific countries throughout the world who are well established within the transfer pricing lifecycle, the Middle East region is very much at the beginning. While this does provide some uncertainty about where and how transfer pricing might develop throughout the region, it also provides MNCs with an opportunity to consider what their transfer pricing policies should look like and how they might evolve as their businesses grow throughout the region.’

Some tax authorities in practice do not apply the arm’s length principle, and instead use formulary rules to audit related party transactions. For instance, in Kuwait the tax authority in practice tends to take the view that all inbound MNCs should earn some level of profit, and thus, pay some level of corporate tax. To apply such a standard, the Kuwait tax authority applies formulas to restrict inbound charges, e.g., disallowing costs of goods over between 85% and 93.5% of turnover, or disallowing any form of management fee from a head office that is in excess of between 1% and 1.5% of turnover (percentage depending upon ownership structure), and even specifically denoting that “design and consultancy” costs from the head office or an affiliate be capped at some percentage of turnover.⁶ Iraq also restricts head office expenses to branches as a percentage of turnover and the reality is that the actual percentage changes periodically based upon Ministry of Finance directions.⁷ Jordan restricts management fees from the head office to its branch in Jordan to 5% of turnover, and Lebanon restricts management fees to 3% of turnover or by evaluating the branch’s service charge based upon its pro rata share of group assets. Jordan does provide for additional deductibility if evidence (documentation) can be provided to support the additional charges, but the type and nature of the documentary evidence is not defined by Jordanian law. Interestingly, Oman historically restricted branch service charges to 3% of turnover, and 5% of turnover for banks and other financial institutions in addition to requiring that the current year charges were not greater than the historical average charges. However, it recently released its executive regulations which move away from such formulas and instead now allows deductions up to the caps for such charges if such charges (1) contributed to profits earned by the branch and (2) are not related to the head office’s “supervision” and “control” of the branch.⁸ Even Egypt, which has transfer pricing rules, restricts head office costs charged to branches to 7% of profit for banks for instance, with certain expense categories exempt from the cap.⁹ Needless to say, the mix of rules across the Middle East region is diverse.

Last, a unique consideration in the Middle East and when considering an MNCs transfer pricing policies and structure as part of the transfer pricing lifecycle in the region, as well as how the region fits into an MNCs transfer pricing structure globally, is that having local partners in many jurisdictions across the Middle East region is business reality. Also, in certain Middle Eastern jurisdictions a company (without local ownership) cannot import products into many of the jurisdictions in the Middle East, nor can it generally operate without either an agent or local partner in many instances. This operational reality causes many MNCs in the Middle East region to consider (1) whether their global transfer pricing policies can actually be applied to their operations and (2) whether a unique structure is warranted given the operational realities. From a tax perspective, this is also interesting in that the mere entering into a contract could already trigger a local taxable presence even if the MNC has no operational presence or activities in the respective territory.

So where does the Middle East fit within the transfer pricing lifecycle?

The Middle East region is an important developing economy for many MNCs, and as they move into the region, or prepare for long-term structural growth, the way in which their transfer pricing policies and general tax framework is structured becomes an important consideration. Unlike many regions and specific countries throughout the world who are well established within the transfer pricing lifecycle, the Middle East region is very much at the beginning. While this does provide some uncertainty about where and how transfer pricing might develop throughout the region, it also provides MNCs with an opportunity to consider what their transfer pricing policies should look like and how they might evolve as their businesses grow throughout the region. By the way, constraints such as the OECD Guidelines Chapter 9 do not generally exist in the Middle East region. This provides the MNC an opportunity to perform transfer pricing and general international tax planning, to ensure that a defensible structure driven by their business operations and strategic goals is achieved.

⁶ For instance, design costs from affiliates are allowable up to between 80% and 85% of turnover, while the same design costs from a head office are only allowable up to between 75% and 80% of turnover. The same applies to consultancy costs but the range of allowable costs is between 75% and 80% of turnover for affiliates, and between 70% and 75% of turnover for head office charges.

⁷ There is court precedence, however, that suggests that the rate is 2.5% of turnover.

⁸ Interestingly, control and supervision seem analogous to what the OECD Guidelines might see as being akin to a shareholder activity, thus not allocable. The application of the provisions included within the executive regulations has not yet been tested under audit.

⁹ However, the Egyptian transfer pricing guidelines note explicitly that they are not relevant to branches, and it is anticipated that additional chapters to the Egyptian transfer pricing guidelines will be published specific to branches in the near future.

Anthony Curtis and Ogniana Todorova from PwC US take a look at transfer pricing in Africa

Spotlight on Africa's changing transfer pricing landscape

Despite the recent global recession, Africa averaged annual GDP growth of 5.2% between 2001 and 2010¹ – a fact that underscores why so many investors increasingly see it as a destination for opportunity and growth. In its 3 December 2011, edition, *The Economist* summed up the global sentiment regarding the outlook for Africa's economy in its cover story, "Africa Rising."² As that article suggests, Africa's economy is expected to grow considerably in the near future. As that happens, multinational corporations (MNCs) will expand their footprint on the continent. With the prospect of their increased investment, transfer pricing is receiving more focus in the region.

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¹ The Africa Competitiveness Report 2011, World Economic Forum, the World Bank and the African Development Bank.

² The Economist, "Africa Rising," December 3, 2011.





The United Nations (UN), the Organisation for Economic Cooperation and Development (OECD), and the European Commission (EC) - as well as many African governments - are particularly focused on establishing transfer pricing regimes in Africa. International organisations consider transfer pricing a development financing issue, because without adequate tax revenues, a country's ability to mobilise domestic resources for development might be hampered.³ As a result, scrutiny of MNCs' tax footprints in Africa has increased recently.

Over the past few years, there has been much debate about the most appropriate transfer pricing regime for developing countries. Some consider implementation of the arm's length standard (ALS) - the central feature of the transfer pricing regimes of most developed nations as well as the OECD Transfer Pricing Guidelines (OECD Guidelines) - prohibitively resource-intensive and costly for developing countries. Alternative approaches, like formulary apportionment or fixed margins of returns for intercompany transactions, have been suggested, but these approaches, while simpler to administer, do not have international acceptance and still require agreement on the formulae or fixed margin. As a result, no alternatives have been agreed to in practice at the international level and are not yet adequate substitutes for the ALS.⁴ Although the UN historically has been reluctant to recommend the ALS, it recently endorsed the ALS in its Practical Manual on Transfer Pricing for Developing Countries (UN Practical Manual), stating that the ALS is "the accepted guiding principle in establishing an acceptable 'transfer price.'"⁵

Although there are significant challenges associated with the implementation of the transfer pricing regimes based on the ALS in developing countries, the benefits likely outweigh the perceived risks. Stable transfer pricing regimes have the potential to increase much needed tax revenues and attract foreign direct investment (FDI).⁶ In addition, MNCs often perceive operating in countries with comprehensive transfer pricing regulations as presenting less tax risk than operating in countries in which the characterisation and tax treatment of an MNC's intercompany transactions are uncertain.

Several African nations - most notably Kenya, Egypt, Morocco and South Africa - have broad transfer pricing regimes based on the ALS, while several other African countries, such as Uganda, recently passed legislation adopting transfer pricing regulations based on the ALS.⁷ Still other African nations that do not have comprehensive transfer pricing regimes, such as the Democratic



It is anticipated that more African nations will adopt transfer pricing regulations based on the ALS

Republic of Congo and Mozambique, have provisions in their tax code that reference the ALS.

However, while many African nations have transfer pricing regimes or provisions in their tax code based on the ALS, they often also have special tax rules and considerations for particular industries, especially mining, oil and natural gas. Many African governments recently noted that existing contracts allow MNCs to exploit their country's natural resources without providing adequate compensation. As a result, there is speculation that some resource-rich nations, like South Africa and Ghana, may impose a "super tax" on excess profits from mining.⁸ Nigeria, a nation that is expected to pass transfer pricing legislation in the coming year, has claimed that it has lost \$5 billion in tax revenue because of off-shore oil contracts.⁹

As Africa continues to grow and become more integrated into the global economy, it is anticipated that more African nations will adopt transfer pricing regulations based on the ALS. Although transfer pricing regimes in Africa are expected to be based on the OECD Guidelines and the UN Practical Manual, African governments' desire to protect revenues from natural resources will probably influence future transfer pricing legislation. In addition, African nations that have already adopted the ALS will likely move toward legislation that will allow for more Advance Pricing Agreements (APAs), tax treaties, and safe harbours as these nations seek to increase domestic tax revenue and make their countries more attractive to MNCs.

³ Sundarm, Jomo Kwame, "Transfer Pricing is a Financing for Development Issue," February 2012, at 1.

⁴ Id. at 6.

⁵ United Nations, "Practical Manual of Transfer Pricing for Developing Nations" Chapter 1.4. October 2012.

⁶ EuropeAid, Transfer Pricing and Developing Countries, at 1.

⁷ PKN Alert Uganda - "New Transfer Pricing Regulations," (March 8, 2012). <http://www.pwc.com/gx/en/tax/transfer-pricing/pricing-knowledge-network-pkn.jhtml>

⁸ The Economist, "Wish you were mine," February 11, 2012.

⁹ Id.

¹⁰ WB (2011a), "Transfer Pricing Technical Assistance Global Tax Simplification Program," presentation by Rajul Awasthi in Brussels, 24 February 2011.

¹¹ EuropeAid, Transfer Pricing and Developing Countries, at 5.

¹² Id.

¹³ Jeffrey Owens, OECD Conference: Transfer Pricing and Treaties in a Changing World, Opening Speech, Paris, 21-22 September 2009. <http://www.oecd.org/dataoecd/18/25/43744164.pdf>.

¹⁴ 1.482-9(b)

¹⁵ Kevin A. Bell and Rick Mitchell, OECD, 20 Transfer Pricing Report 1199, "Secretary-General Pledges Group To Simplifying Transfer Pricing Provisions."

¹⁶ The necessary preconditions are broken down into three broad categories: economic and political preconditions (e.g., economic growth and diversification, open economy, and FDI); legal preconditions (e.g., comprehensive income tax law, tax treaty network, existing transfer pricing legislation if applicable); and preconditions related to the tax administration (e.g., some level of specialisation within the tax administration). EuropeAid at 2.

Why transfer pricing regimes are important to African countries

Globalisation is causing MNCs to play a significant role in the economy of most nations. It has been estimated that approximately two-thirds of all business transactions worldwide take place between related parties.¹⁰ African nations are no exception. In 2000, the UN developed Millennium Development Goals (MDGs) to tackle extreme poverty and to share the benefits of globalisation more equitably.¹¹ It is generally accepted that to meet the MDGs, developing countries need to strengthen their tax systems and increase domestic revenues.¹² It is for this reason that the development or expansion of transfer pricing regimes in developing nations, including many African nations, has become a priority.

In terms of tax policy generally, and, more specifically, transfer pricing policy, one of the main considerations for nations is how to protect their domestic tax base without disincentivising international trade and FDI. Jeffrey Owens, Director of the Centre for Tax Policy and Administration at the OECD, identifies the issue in the context of developing countries:

“Developing economies in particular are increasingly aware of the importance of establishing a robust legislative and administrative framework to deal with transfer pricing issues. The challenge for these countries is in essence the same as for OECD countries: protecting their tax base while not hampering foreign direct investment and cross-border trade.”¹³

Although protectionist transfer pricing policies can impede FDI and cross-border trade, it is likely that the adoption and development of reasonable transfer pricing regimes in African countries, especially in countries that historically did not have transfer pricing rules, will attract FDI and increase cross-border trade by creating certainty and legitimacy. International consistency in transfer pricing regimes is beneficial in creating a basic worldwide structure and facilitating international trade.

As African nations adopt transfer pricing standards that are consistent with international norms, MNCs likely will perceive less tax risk associated with operating in those countries, allowing for increasing FDI. Concurrently, transfer pricing rules will allow African nations to protect their domestic tax base by collecting appropriate revenues from MNCs operating within their borders.

As more African countries adopt the ALS, MNCs will be able to determine where to invest based on differing comparative advantages, rather than being deterred from certain markets because of uncertainties in the tax regime.

The future of transfer pricing in Africa

To continue integrating into the global economy, African nations that have implemented comprehensive transfer pricing regimes will likely begin to consider programmes that allow for APAs.

To ease compliance and capacity issues, strategic safe harbours can also be employed. Safe harbours do not have to be based on profits. An example of a simplifying safe harbour that is consistent with the ALS is the Services Cost Method (SCM) in the US transfer pricing regulations.

The SCM provides that for covered services, taxpayers may elect to treat the arm's length compensation for such services as the total services cost with no mark-up.¹⁴ Balancing compliance costs with protection of the public fisc, the SCM was meant to simplify compliance for certain services that otherwise would generate little additional revenue.

Maybe as a response to the UN's growing influence, the OECD pledged to simplify transfer pricing worldwide, including a possible update to the OECD's existing guidance on safe harbours.¹⁵

African nations seeking transfer pricing legislation should assess the preconditions identified in the EuropeAid report and work towards bolstering those preconditions to the extent they are lacking.¹⁶ Institutional capacity, including economic, political, and legal preconditions are a necessary first step for developing countries lacking transfer pricing rules but interested in developing transfer pricing expertise. After institutional capacity is achieved, developing countries can build a sustainable transfer pricing regime. Although transfer pricing regimes in Africa are expected to be based on the OECD Guidelines and the UN Practical Manual, the desire of African governments to protect revenues from natural resources probably will influence future transfer pricing legislation. Also, African nations that already have adopted the ALS likely will move toward legislation that will allow for APAs, tax treaties, and safe harbours as these nations seek to increase domestic tax revenue and make their countries more attractive to MNCs.

To read the full report in our Perspectives Special Edition, please visit www.pwc.com/tpperspectives. Here you will also find a listing of our PwC Africa country leaders who contributed to this article.

Matias Pedevilla, Ogniana Todorova and Aoife Murphy from our US practice examine the challenges facing MNCs in keeping their transfer pricing documentation up to date.

Documentation

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The current transfer pricing environment is increasingly more challenging. As multinational companies operate in an ever globalised world, they're facing more stringent transfer pricing documentation requirements and scrutiny by tax authorities. Here, we take a look at some common pitfalls associated with transfer pricing documentation and set out best practices for preparing and maintaining consistent and defensible transfer pricing documentation.



Multinational companies have seen a significant increase of transfer pricing rules and documentation requirements in recent years because many jurisdictions are changing or introducing more stringent requirements in relation to intercompany transactions. For the most part, the transfer pricing regulations adhere to those set out by the Organisation for Economic Cooperation and Development (OECD). Notable exceptions though are Brazil, which has a different set of local requirements, and a number of African countries that are struggling to decide which transfer pricing model to adopt. Some consider the implementation of the arm's length standard - the central feature of the transfer pricing guidelines set out by the OECD - to be extremely resource-intensive and costly for developing countries. But alternative approaches come with risks and still require international acceptance. The vast majority of these new rules allows for specific transfer pricing penalties, making transfer pricing a more time-consuming consideration for the taxpayer.

This consistent expansion of the transfer pricing regulations is a direct result of the increased sophistication of local tax authorities throughout the world and their need for local tax funds. This has led to both positive and negative consequences. On the plus side, Advance Pricing Agreement (APA) programmes are constantly expanding, allowing for greater certainty and less burdensome reporting. There has been a significant increase in APA activity in the recent years, with a 75% increase in APAs filed globally. On the other hand, APAs can take a long time to process and gain approval. The IRS, for example, has committed more government resources to their legacy APA programme over the past several years. However, they incurred a ten-year record

low productivity, completing only 43 APAs in 2011, down from 69 in 2010. At the same time, pending APAs have increased from 350 in 2010 to 445 in 2011.

Approach to documentation

In broad terms, there are three ways in which companies can approach transfer pricing documentation: companies prepare the documentation internally; companies engage a third party advisor to prepare the documentation, or a mixture of the two. In all cases, there are common pitfalls which can be avoided and these are discussed below.

(i) Documentation prepared internally

One of the main issues that face companies who prepare their documentation internally is the lack of dedicated staff to the documentation process, leading to inconsistencies in the approach taken. For example, the use of multiple short term tax or finance staff can lead to differing decision making processes with no explanation or paper trail for the next preparer. The absence of dedicated staff can also result in documentation which has not been fully vetted and reviewed. What's more, if only one person is involved in the process, there will be a lack of appreciation for the local facts and perspectives. This may lead to a transfer pricing documentation that focuses on or emphasises areas that may raise queries or open the door to further scrutiny in an audit.

Often transfer pricing documentation prepared internally is prepared by someone with transfer pricing technical limitations. This can mean a lack of awareness of local rules and deadlines, the inability to meet local language requirements, and the absence of current transfer pricing knowledge in an ever changing environment.

75%

There has been a significant increase in APA activity in the recent years, with a 75% increase in APAs filed globally

Another common feature is that the transfer pricing documentation process is often combined with other requirements, such as local policy documents. This can lead to an over-emphasis on certain areas which can falsely characterise local entities, and once again, open a company to further scrutiny by tax authorities.

Finally, when companies prepare documentation internally, they are often balancing these requirements with other tax filing obligations – and time is scarce. Furthermore, for larger companies, multiple local documents are due for preparation and filing at the same time. With limited resources, companies are often forced to cut corners, a prime example being the reluctance to undertake regular comparable analysis updates.

(ii) Documentation prepared by advisors

When a company engages a third party to prepare the transfer pricing documentation, the company often disconnects from the process. This disconnect could impair the ability of the transfer pricing preparer to develop complete and accurate factual and financial analyses on which the validity of the transfer pricing documentation relies. It is imperative that the company and service provider maintain communication and knowledge sharing to ensure that the facts and circumstances of each transaction are delivered accurately. This communication and coordination is of utmost importance when multiple advisors are used so that a consistent message in the analyses undertaken can be maintained.

‘Some consider the implementation of the arm’s length standard – the central feature of the transfer pricing guidelines set out by the OECD – to be extremely resource-intensive and costly for developing countries. But alternative approaches come with risks and still require international acceptance.’



The level of company centralisation driving the documentation process and transfer pricing experience can determine the level of “scope creep” and the risk of a disconnect on the process and purpose of the final deliverable. A third party advisor is only helpful if they have a good understanding of the facts and circumstances surrounding each transaction. If more transactions come to light as the documentation process progresses, scope creep issues arise and the ability to provide full documentation may be compromised.

In our experience, budget constraints often determine whether a centralised or localised approach is taken to transfer pricing documentation. A happy medium between the two is the optimal solution, but this can be difficult to achieve. By localising, that is, tailoring the centralised approach to local specifications and limitations, a streamlined, consistent and defensible approach can be achieved.

(iii) Documentation prepared internally and by external advisors

One of the most critical pitfalls of a combined approach to transfer pricing documentation is that it is unclear who takes ownership of the process and final deliverable which could lead to confusion, frustration and delays. This can endanger the entire project. Obviously, depending on the level of internal and external involvement

in the documentation process, the various pitfalls identified above can apply.

The key area to focus on is to maximise the strengths of internal and external resources. External advisors can most effectively deliver when they can glean from the vast knowledge of company background, financial data and product flows from these internal resources.

How to get transfer pricing documentation right

Regardless of whether the transfer pricing documentation process is carried out internally or by third party advisors, it is imperative that three steps are carried out in order to address the prevailing challenges in today’s transfer pricing environment.

- 1. Identification:** Identification of all known and unknown intercompany transactions and any recent changes to intercompany transactions.
- 2. Documentation:** As discussed in the previous section, transfer pricing documentation must meet the local country rules, whether this relates to language, tax filing requirements, or local comparables. A way of ensuring that all transactions are covered by a documentation report is to create and maintain an entity – by entity inventory of intercompany transactions. This can prove invaluable to a company.



Every company should be able to evaluate the risk of each intercompany transaction from a transfer pricing perspective, and a matrix should be created and maintained. Finally, each company should decide whether the documentation should be managed centrally or locally.

- 3. Implementation:** A global transfer pricing policy ensures consistency among the various countries and enhances the company's transfer pricing position in front of increasingly aggressive tax authorities. Support should be provided from the global and/or regional headquarters, and all results should be tracked and monitored on a periodic basis.

As mentioned previously, there is a fine balance between thinking globally and acting locally. Global involvement is critical but local buy-in to the process is also necessary. Therefore the identification of central and local transfer pricing risk management roles and responsibilities are crucial to the success of transfer pricing documentation. It is imperative that all local requirements are considered and adhered to. One way of achieving this is to converge all local requirements to the extent possible, such as using a uniform "generic" functional analysis across all regions and pan-regional comparable searches.

Arguably, a way to eliminate the onerous documentation requirements and to gain certainty on the transfer pricing policy with the local tax authority is to partake in an APA. A tax authority will not make transfer pricing adjustments if the taxpayer complies with the APA's transfer pricing method, thereby eliminating the need to book reserves or report uncertain tax positions.

Conclusion

Companies must now deal with increased sophistication and knowledge sharing among tax authorities which leads to increasing scrutiny on intercompany transactions and their documentation. It is therefore imperative that all companies have an in-depth understanding of the transactions, the characterisation of the entities and pricing approaches taken. Companies must focus on concentrating their resources on transfer pricing and anticipate any controversial situations and documentation weaknesses. Transfer pricing positions can be strengthened by having quarterly reviews of local transfer pricing documentation requirements and pricing.



Value chain transformation in the BRICs: What works in evolving economies?

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What lies beneath the overall growth story for BRIC (Brazil, Russia, India, China) countries? Not only have BRIC countries made strides as manufacturing and services countries, they are now developing into significant end markets for multinationals. What's more, they frequently represent the fastest growing (as with Apple) or biggest (as with General Motors) markets. Large multinationals now find large portions of their supply chains focused on the BRIC countries. Not surprisingly, this will add extra strains on existing operational and tax structures.

Meanwhile, tax authorities from emerging countries are also establishing themselves as among the most aggressive in the world, so that tax and customs issues have become a priority for even the highest corporate leadership when it comes to BRIC countries. Falling on the wrong side of these issues can lead to significant competitive disadvantages or challenges from tax authorities. As a result, multinationals in BRICs are forced to take a more proactive approach, including direct engagement with local tax authorities, to ensure they employ sustainable operating models.

Implementing new models is hard work. It involves considerable change and requires strong support from all levels of the organisation. But there are major benefits to be gained – especially when tax, financial, and operational considerations are aligned to provide benefits in all three areas. A holistic, systematic approach is essential, in particular the need to map out potential models so that each can be analysed from key perspectives, as illustrated in the country specific sections below.

Brazil

Brazil and Latin America present special opportunities, but also challenges. Brazil is now the sixth largest economy in the world, with the fifth largest population. In recent years, Brazil has made important strides in providing economic opportunities to its expanding middle class of consumers. Domestic and foreign investment is strong, especially with the upcoming 2014 World Cup and the 2016 Olympics.

Brazil has a complex tax structure, with a high tax burden, complex layers of taxation, frequent changes in laws and regulations, and a lack of incentives for foreign investment. Nevertheless several value chain transformation (VCT) solutions have been developed for companies to adapt to Brazil's challenges and to make use of growth opportunities. There are special regimes for relief of customs duties and other indirect taxes for products manufactured for export, or for targeted industries (including automotive, aerospace, and information technology). There

are also incentives available for infrastructure projects and for manufacturing in the Manaus Free Trade Zone.

Companies may also utilise “in-country principal” entities in Brazil with proper substance, which can benefit from a lower rate of taxation (presumed profit method) and can remit dividends free of withholding taxes. These entities could effectively serve as a Brazilian affiliate of a regional principal company in a more traditional VCT structure. Brazil's transfer pricing regime has recently (2012) been modified to improve the application of the resale price method for importation, and to recognise a commodity price method.

Apart from Brazil, other countries in Latin America generally have transfer pricing regimes that are more OECD-compliant, however their sometimes spotty Double Taxation Treaty (DTT) network and incomplete Permanent Establishment (PE) definitions add complexity. Companies in Mexico have utilised its maquiladora (toll manufacturing for export) regime and DTT network to align Mexican manufacturing with a global principal structure. Other companies have utilised regional headquarter companies in Panama, Uruguay, and Costa Rica as shared service centers or procurement hubs, often as a branch of an EU principal company.

Russia

Despite the impact of the global financial crisis, the Russian economy has recovered at a satisfactory pace in 2011-2012, as demonstrated by stable GDP growth (4.3% in 2011), a falling inflation rate and a year-on-year rise in real disposable income. Together with the overall size of its market, these positive indicators continue to make Russia one of the top-tier countries for many multinational corporations (MNCs).

In 2012, Russia finally became a member of the World Trade Organisation (WTO). As a result, customs rules will eventually be brought into line with those of other WTO members while the remaining preferences available to local

50%

The percentage of tax disputes won by taxpayers through litigation still remains comfortably above 50%.

manufacturers will gradually be removed, yet some will remain. This may significantly impact the business case for setting up local production in Russia. Also in 2012, Russia introduced new transfer pricing (TP) rules. Compared to the previous rules, the new TP regime is considerably more sophisticated and better aligned with OECD principles. This should help multinationals to apply VCT solutions in Russia that have been proven in other OECD territories. Although Advance Pricing Agreements (APAs) are allowed under the new TP legislation, actual practice is still in its infancy. In fact, no APAs had been obtained as of the time of writing.

With all that, however, the Russian tax authorities continue to see maximising collections as their primary task. In 2011, more than 90% of field tax audits resulted in additional tax assessments, which was largely due to the numerous, and at times rather rigid compliance and documentation requirements. The percentage of tax disputes won by taxpayers through litigation still remains comfortably above 50%. But, this figure has been declining from year to year due to the increasing complexity of disputes. While taxation in Russia has traditionally been a form-based system (which requires a different approach and mindset than at home), it is clear that substance is becoming increasingly important. Thus, it is critical to make sure that operating models encompass both form and substance.

In summary, MNCs now enjoy significant opportunities to build efficient value chains for the Russian market. However, these must be robust and defensible, both in form and substance, in view of the Russian tax authorities' traditional focus on maximising collections and their increasing sophistication in pursuing that goal.

Incredible, (Un)certain India!

Despite short-term reverses, India's GDP growth continues to be robust at a little over 6% per annum and is expected to continue that way for the foreseeable future. For multinationals, this means opportunities for resource deployment as more sectors open up to enhanced investment, including multi-brand retail, aviation, pharmaceuticals and insurance.

Foreign Direct Investment (FDI) is for the most part liberalised; however, there are exceptions such as retail, and while political change may be coming, so far there are very few success stories in large-format retail for several reasons. In short, partnerships and alliances may be the way to go in this sector, just as in the case of insurance – MNC retailers will have to place a long term bet on India.

India continues to provide new developments on the tax front, including introduction of a “negative list” of tax exempt services and place of





performance rules which mean that companies will have to consider input credits for services and their linkage in the supply chain to goods or services for local consumption or export. By introducing the APA to India, certainty on transactions which are typically vulnerable to adjustment in India is now more likely. Such transactions include royalties, compensation for sourcing, imports of goods and export of services. APA rules, recently notified, are consistent with the practices in other jurisdictions and contemplate, among other things, pre-filing meetings and the possibility to obtain bilateral and multilateral APAs. PE issues also consume tax directors' mind-space and a possibility now exists to structure more complex transaction models (toll manufacturing or commission structures through profit attribution).

Although India's tax rate is relatively high at approximately 32.5%, India offers the opportunity to achieve lower effective rates through investment linked incentives - including Special Economic Zones, Free Trade and Warehousing Zones and priority sector projects. The possibility of entering into cost sharing arrangements for research and development (R&D) also entitles companies to get a weighted deduction.

The demographic advantage that India offers, coupled with rising income levels coming from sustained GDP growth over the last two

decades, has resulted in the country emerging as a major market of products and services such as telecommunications, automobiles, consumer goods and healthcare. Multinationals therefore have to deal with domestic production and consumption, which requires development of India-oriented products. This in turn, often calls for a transfer of platform technology for upscale improvisation. In addition, there is a fine balance to be maintained between gravitating towards indigenous production, and retaining import content, which has to be evaluated in the context of capital investments and operating efficiencies. It is acknowledged over time that India is a sub-continent by itself with its unique preferences and modus operandi. Therefore, even as regional headquarter structures thrive in places such as Singapore or Hong Kong, from which strategic decisions can be taken, it is imperative for there to be a strong local operating and management connect at the Indian sub-continent level. In many cases, Indian MNC executives are tasked with overseeing the South Asian Association for Regional Cooperation (SAARC) region that includes Bangladesh and Sri Lanka, given their proximity and similarity to India, making India a sub-regional South Asian territory.

In summary, with changing landscapes, multinationals with operations in India should proactively and continually consider various alternatives to build efficiency and certainty in their tax structures and business models.

32.5%
*At approximately
 32.5%, India's
 tax rate is
 relatively high*



China

China has undergone dramatic change over the past years. Where multinationals once viewed China as a low-cost producer of exports, they are rapidly shifting their focus. They now see China as a consuming nation with a growing middle class and increasing cost of doing business. Changing economic pressures and the regulatory landscape are prompting some businesses to move their production out of China, while others are expanding existing operations or moving production to different locations within China.

A particular challenge to multinationals is in regards to China's foreign exchange and other financial controls, which have the potential to cause trapped cash or otherwise prevent the proper allocation of capital through outbound remittance, an issue that has grown in importance as China's growth begins to slow and change focus. As achieving appropriate levels of outbound remittance can require significant time and effort for each case, and at the same time multinationals have developed quite complex cross-border flows, PwC is helping them to simplify these flows to develop a more streamlined process for achieving outbound remittance. As China does not have consolidation on an intra-China level, some form of "virtual consolidation" as well as tax authority engagement may be necessary to achieve the desired results.

However, even as new ways to simplify transactional flows in China are developed, new complexities emerge. For example, the large numbers of companies expanding R&D and services activities in China has heightened the importance of the valuation of intangibles, an area where opinions differ, especially when it comes to the concept of local intangibles. Developing understandings of valuation techniques in China can lead to different conclusions on the allocation of profit in comparison with tax authorities of other countries. At the same time, proactive engagement with the tax authorities at the local and national level within China - as well as with those of the counterparty country - may be necessary to produce sustainable results.

Conclusion

Given the complex economic and regulatory environment multinationals face in BRIC countries, multinationals will likely face a variety of challenges and opportunities as outlined above. PwC has established a network of VCT specialists and practitioners (international tax, transfer pricing and consulting) in all key BRIC and Latin American countries and we have a strong history of successful teaming with clients to align their emerging markets footprint with their global structure.

Garry Stone, PwC USA and Ajith Choradia, PwC India, comment on strategies being reviewed by both multinationals and governments to sustain economic growth and fiscal stability.

New tax pitfalls for multinational acquisitions and restructuring in the age of fiscal shortfall.

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The persistent negative economic environment has led both multinationals and governments to review strategies to sustain economic growth and fiscal stability. As part of the response to this situation multinational corporations are pursuing acquisitions due to relatively lower valuations of potential targets, and are also spinning-off existing operations for various reasons like to better focus on their core competencies or improving profits going forward. Shareholding and legal structures are also being reorganized within these companies to both integrate acquired businesses and to align with new global financial and operational strategies.

Concurrently, governments around the world are looking at these restructuring and acquisition activities as a potential source of much needed tax revenues. Nearly all governments are facing large and increasing fiscal deficits which have led them to propose or enact aggressive tax regulations in the M&A area. For instance, China has enacted regulations to tax indirect transfer of shares of Chinese companies.



1961

New law in India was amended retrospectively with effect from 1961 with an intention to reverse the Apex Court's judgement in case of Vodafone,

Indian Government has not only enacted similar regulations to tax indirect transfer of shares of Indian companies in the hands of the seller, but also has cast withholding tax obligations in the hands of the buyer. Even more alarming in India is the new law in India was amended retrospectively with effect from 1961 with an intention to reverse the Apex Court's judgement in case of Vodafone, a recent court case which points out many of the issues multinationals may face regarding the potential tax implications resulting from corporate restructuring and acquisition activity.

With enactment of laws related to the indirect transfer of shares, tax authorities in China and India are also increasingly focused on intercompany pricing audits related to intercompany transfer of shares as may occur in an internal corporate reorganization. In the past these transactions would have been valued at current basis levels and therefore result in no gains and none or little tax would have been due.

Under the new approach, corporations may need to value the shares at something similar to a "fair market value". Although the transfer of equity needs to be valued at "fair market value" instead of current basis level in China, the equity transfer transaction is allowed to seek Special Tax Treatment (essentially a tax deferral treatment) when certain requirements in Caishui [2009] No. 59 are met. Multinational corporations should be mindful of this and assess where they are qualified to apply Special Tax Treatment in China before business restructuring.

It is important to note that the valuation approaches are evolving in these countries so care must be taken when evaluating the potential gain and associated tax liabilities resulting from internal share transfers. For instance, China is considering the use of the traditional Income, Market or Cost approaches to valuation, but the specific regulatory applications of these methods is still being developed.

Alexis De Méyère and Karl Abelshausen meet with PwC specialists to debate key substance topics affecting businesses today.

Economic substance: myth or reality?

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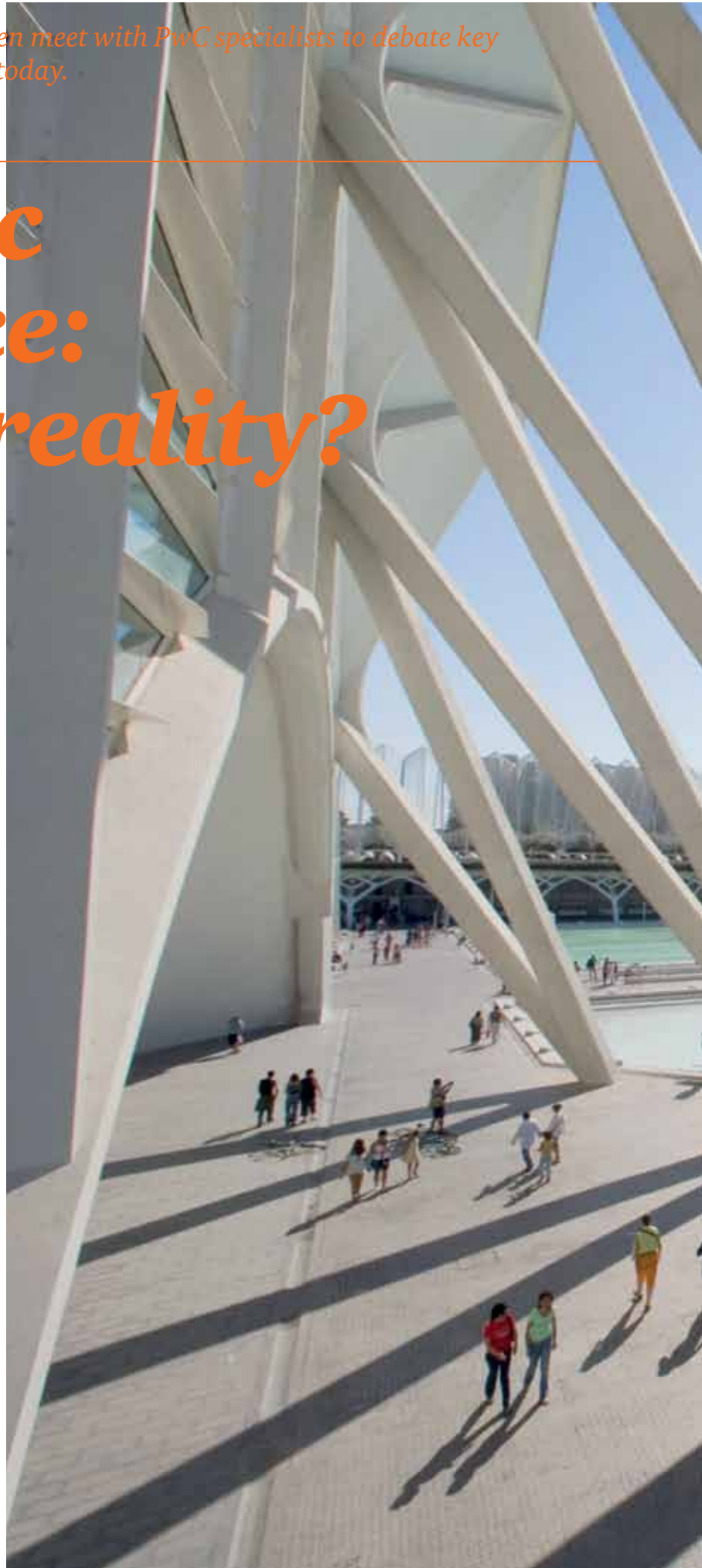
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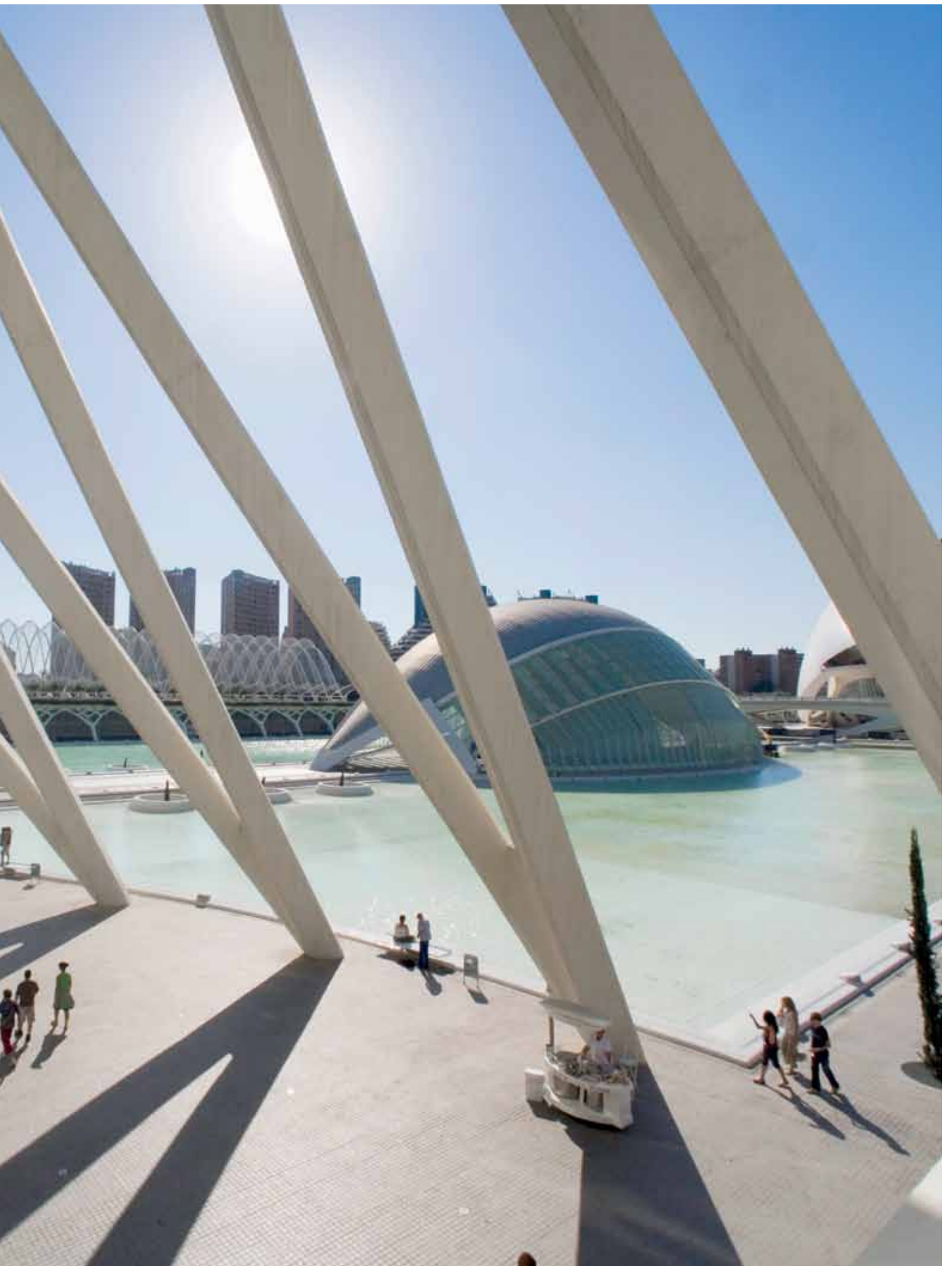
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“What kind of substance do I need?” is a question international tax advisers often hear. It would be somewhat simplistic to think the answer can be found in a standard country checklist as part of the administrative formalities you go through when starting up a new business in a given jurisdiction. The economic substance issue is complex and requires a tailored approach. It has been on the agenda of international tax structuring experts for decades, but has recently also become an issue for transfer pricing practitioners. To better understand the relevance of the substance debate and address the key substance topics, we met Isabel Verlinden, PwC EMEIA Transfer Pricing Leader; Sanjay Tolia, PwC India’s western region Transfer Pricing Leader; Nicole Fung, PwC Singapore Transfer Pricing Leader; Sonia Watson, PwC Transfer Pricing Director in the UK; and Jeff Barnett, PwC Transfer Pricing Director in the US.

For a decade, substance has clearly been a hot topic. What are your views on how tax substance has changed?

Isabel – The substance debate illustrates how the various “transfer pricing stakeholders” are converging these days. First, there are the company’s shareholders who prefer seeing a story focus on the top line in the current challenging economic climate. Simultaneously, cost containment is on the radar screen. The market continuously requires a careful monitoring of the Effective Tax Rate. However, it is very clear that one should at the same time mitigate the risk of tax adjustments, or worse being negatively exposed for tax planning in the (social) media.

Second, consumers are focusing more on the corporate governance of the companies from which they buy. The rapid proliferation of social networks implies that customers are becoming more vocal on the perceived good – but also bad – things a company does, and this increasingly includes a company’s tax affairs.

What’s more, the wider community has sharpened its focus on corporate citizenship. Take the many places NGOs seek “capitalist resources” to meet the budgetary needs of emerging, often politically unstable, economies.

Finally, tax authorities step in the arena. Governments need money and the focus lies on “soft targets”. Companies don’t vote, so they can be challenged more easily. Also, transfer pricing is an area often viewed by tax authorities as an easier place to start compared to other tax provisions, as it is not laid down in hard or fast rules.

All this means that international tax structuring and transfer pricing are converging. First, one needs to thoroughly understand the corporate value chain before tax optimisation can be

addressed. With the surge in novel and complex cross-border business models, tax professionals have to deal with a range of substance principles that could conflict with other doctrines, tax authorities and domestic requirements. And tax executives have to take non-tax constraints into account as well. This complexity stems from the intensity of the substance debate, especially regarding “economic substance”.

What do you mean by ‘economic substance’?

Isabel – Economic substance is qualitative substance. Substance has often been perceived as a “necessary evil” in the past, which was taken as justifying a minimalist approach, reducing the exercise to completing a checklist. When qualitative substance comes into play, a more content-based approach is required, aimed at aligning the tax strategy with the corporate business strategy and reality.

Sanjay – A simple illustration might be where a multinational company sets up a foreign financing company whose directors are the group’s chief technology officer and VP marketing for instance, complemented by an accountant – being an employee of the company – to “run the daily business”. From a qualitative substance perspective, there seem to be at least two things wrong with this picture. First, you’d expect the CFO, a treasurer or a risk management officer to be responsible for managing the entity whose business is finance focussed. Second, can you be sure that the management of the foreign entity will be effectively present there or will overcrowded agendas lead to giving orders by e-mail or telephone – all but from the jurisdiction they should stem from? The main focus in looking for qualitative substance should be on questions like “what am I trying to achieve?” or “what kind of management abilities do I need in a certain jurisdiction to achieve my objectives?”

¹ Substance 2.0, Aligning international tax planning with today's business realities is co-authored by Axel Smits and Isabel Verlinden, together with the help of the global network of PwC firms. See www.pwc.com/substance for more information.

Nicole – One of the areas of economic substance that tax authorities can look to is the amount of capitalization in the principal. Key question here is whether the principal has the financial muscle to undertake the risks it is supposed to take. It will be a matter of judgment as to when there is sufficient capitalization.

What's the most appropriate way to tackle economic substance?

Sonia – The qualitative approach is certainly a “best-in-class” methodology in an international tax-planning context: the aim is to achieve an acceptable overall tax rate. To do this you have to make sure (i) the entities are tax-resident in a certain jurisdiction – and don't have a permanent establishment (PE) exposure elsewhere – and (ii) the results allocated to them are fair under arm's length conditions. For substance analysis purposes, both should be reviewed separately given the different rules that apply – especially from country to country. In the end, however, they should be combined to assess the company's overall position. People need to have the expertise, capability and authorisation to be enabled to credibly oversee the entrepreneurial risk that they are responsible for managing.

Isabel, what are the most important changes in Substance 2.0¹ compared to the previous edition?

Isabel – Since 2009, substance has fairly swiftly gained in importance. Economic uncertainty has made tax authorities and policymakers to step up their efforts to challenge artificial forms or deem artificial forms of tax structuring. We are seeing initiatives at individual country level, as well as at the level of the OECD and the EU, with increased questioning of so-called ‘aggressive tax planning’.

In ‘Substance 2.0’, we focus on substance in corporate structures and operating models, but the PE dimension has also been developed more prominently. This is reflected by recent developments on commissionaire structures and the OECD's public discussion draft entitled, “The interpretation and application of Article 5 (permanent establishment) of the OECD Model Tax Convention”, released on 12 October 2011. On top of this, we see that the “place-of-management” criterion is more prominently present in case law.



Is there a contradiction in talking about permanent establishments and substance in operating models?

Jeff – Not at all! A permanent establishment is deemed to constitute the presence of a substantial activity in a state and so justifies shifting the power to tax to that state. Conversely, if economic bonds with a foreign country are loose or non-existent, taxation will be reserved to just the residence state. Hence, having too much or not enough substance in the appropriate jurisdiction will trigger the permanent establishment question, as it's been developed under international and domestic law. From a substance perspective, a structure could be challenged on a triple basis, i.e. having taxable presence in the form of tax residence, in the form of a permanent establishment or by means of a transfer pricing adjustment.

Isabel – European courts are giving conflicting messages on whether a commissionaire structure constitutes a permanent establishment for a foreign principal.

Sonia – It's worth noting that the OECD's October 2011 public discussion draft does comment on the activities of 'dependent agents'. The critical factor in whether there is an agency permanent establishment is to verify what makes the agent's contracts binding on the principal. They bind it when they're entered into 'in the name of the enterprise'; but does 'conclude contracts in the name of the enterprise' only mean where the principal is 'legally bound' to the third party by reason of the relevant agency law, or is it enough if it is 'economically bound'?

Isabel, you say that the court cases conflict on this topic. How do you explain that?

Isabel – The key question is how to interpret 'conclude contracts in the name of the enterprise'. In practice, views differ. For example, in *Zimmer and Dell*, the French and Norwegian supreme courts interpreted it from a legal perspective whereas the Italian and Spanish supreme courts looked at it purely economically in *Philip Morris* and *Roche Vitamins*. The debate on independent agency is in practice addressed by 'many factors', not all of which are consistent: even the commentary on Article 5 OECD Model Tax Convention lacks consistency. The 2011 public discussion draft on the interpretation and application of Article 5 notes this element but does little to further clarify what independent agency actually means. The discussion draft does discuss 'entrepreneurial risk' as a distinguishing feature of independent agency but concludes that this term requires no further clarification.

Sanjay, what do you think about these recent developments, especially economic substance, from the viewpoint of an emerging economy like India?

Sanjay – Taxpayers active in emerging countries have to be prepared to have their traditional business models scrutinised in depth. I think this is the result of two combined elements: one, tax authorities try to argue that intangibles have been developed in limited-risk entities for which arm's length compensation is needed; two, it is fairly likely that the profit-split method will increasingly be applied by taxpayers or required by tax authorities in emerging countries. In this context, economic substance will be a fundamental aspect, say, when applying functional contribution analyses.

Jeff, Sanjay talks about developing intangibles within multinational enterprises. What are the likeliest pitfalls when considering economic substance?

Jeff – Transfer pricing professionals have often considered that, after routine functional returns, residual profits should be allocated to the party entitled to the intangible-related returns. In the future, things may be different. Based on guidance from the 2010 update of Chapters 1-3 of the OECD Guidelines the importance of a number of notions is stressed. For instance, it refers to 'control over functions and risks', entitlement to intangible-related returns that need to stem from performance, and control of the important functions related to the intangibles. Thus, the link to economic substance is clear cut!

Does that mean it won't be possible to allocate residual profits to entrepreneurs after allocating routine returns?

Nicole – It will definitely still be possible to allocate – some or all – premium profits to the entrepreneur but more analysis is required. For instance, if a contract R&D service provider and its personnel have the authority and means to decide on R&D projects, it will be much harder to allocate residual profits to the entrepreneur.

Is bearing costs enough to create economic substance?

Sanjay – Identifying who it is that bears the costs of intangibles is certainly an important comparability factor that needs to be taken into account when allocating profits. Nevertheless, it's not enough of a factor to constitute economic substance. In essence, that's what the OECD discussion draft says. If a party passively bears costs related to intangibles but does not control the relevant risks or critical functions, the returns shouldn't be attributed to it. This is exactly what happens when a group outsources part of its R&D activity to an independent enterprise.



‘The starting point for a transfer pricing analysis remains the underlying contractual arrangements. The OECD transfer pricing guidelines make clear references to the importance of the contractual framework.’

Economic substance seems to focus on functions actually performed and risks actually borne. Do taxpayers still need to pay attention to intra-group agreements?

Sonia – Yes. The starting point for a transfer pricing analysis remains the underlying contractual arrangements. The OECD transfer pricing guidelines make clear references to the importance of the contractual framework. This is also true for the OECD discussion draft on intangibles, where contracts and legal registrations continue to be seen as a valid and necessary starting point for assessing whether there is true entitlement to intangibles-related returns. However, the actual conduct of the parties and the actual substance of the transaction remain the key test in allocating entitlement to returns. This notion clearly stems from Chapter 9 of the OECD transfer pricing guidelines.

Nicole – The authorities may also seek to apply an arms’ length test to the intra group agreement. With this, they will test to see if a third party would also have agreed to the terms and conditions of the intra group agreement. For example, would a third party have agreed to an early termination of a long-term distributorship agreement without compensation? It is important for taxpayers to have a clear reason to accept and document these conditions in addition to having the intra group agreement.

Sanjay – This is why it is key for taxpayers to align contracts and other corporate policies to their business reality. If there’s a mismatch, this gives tax authorities an easy opportunity to make transfer pricing adjustments.

Can you give an example?

Sanjay – Actually, each time a party fails to abide by the terms of its inter-company agreements, a mismatch occurs. In terms of risk, a straightforward example might be that a distributor should not – contractually – face the foreign exchange risk and would actually incur any FX gain or losses. To a certain extent, this reconfirms that assessing the arm’s length principle should start out from the transaction actually undertaken by associated enterprises, especially in the context of Chapter 9 of the OECD guidelines. In exceptional cases, tax authorities may even completely disregard the structure adopted by a taxpayer in entering into an intra-group transaction (i) where the transaction’s economic substance differs from its form and (ii) where form and substance are the same but the transaction or arrangement differs from what would have been agreed by independent enterprises.

And how far can a discrepancy like that also impact decision-making processes?

Sonia – Well, it’s quite clear that taxpayers should also align business reality with their

corporate governance policies. A common fault we often see with multinationals is inter-company agreements where both parties are represented by the same person signing within the group. So one of the biggest challenges multinationals will face is integrating aspects of substance into corporate governance policies. How will top management delegate responsibilities? Are powers of attorney still relevant? How do you make sure that management has the right power to take decisions? These questions need to be on tax executives' agendas.

Nicole – This is something that was not thoroughly addressed during the OECD proceedings on Chapter 9 as it was key to reach consensus under a tight time schedule.

Sanjay – And the aforementioned alignment should be reflected throughout the entire decision-chain of the company. In other words, the story must be consistent. For example, the websites of the local company and public statements from the local senior management should be compatible with the rationale behind the company.

Is there a clear distinction between 'place of management' and 'place of effective management'?

Isabel – Not really. Consider them both as alternatives for the tax authorities to scrutinise a group's tax strategy. Of course, the two terms serve different purposes in the OECD Model Tax Convention. 'Place of effective management' acts as a tie-breaker in double-residence conflicts ('resident of a Contracting State'); whereas 'place of management' is do with whether or not a permanent establishment is deemed to exist. Despite this theoretical difference, they have a similar consequence in practice, and both are criteria on the basis of which tax authorities can claim a 'tax base'.

Jeff – In addition, it is very difficult to draw a distinction between the interpretations of both concepts. No clear standpoint on 'place of effective management' or 'place of management' can be found in either the OECD MTC or its Commentaries. We know they both refer to 'management'. The question is, to what type of management? In practice, these inherent limitations in terms of interpretation may pose a real danger for the unsuspecting taxpayer.

If a permanent establishment is deemed to exist, is it critical to allocate a fair profit to it?

Jeff – By 'fair', I assume you mean 'arm's length'. First, profits have to be allocated between the permanent establishment and its head office. For this, the permanent establishment has to be considered a distinct separate enterprise subject to the arm's length principle.

So there are no differences when allocating profits to permanent establishments?

Jeff – Oh yes, indeed there are! For non-financial service sectors and as laid down in the OECD Profit Attribution Report to Permanent Establishments released in 2010, the OECD has introduced an authorised approach consisting of the notion of 'significant people functions' in relation to the management of each risk and asset. The 'significant people functions' concept means that assets and risks need to be allocated between the permanent establishment and the head office according to where those functions are carried out. Outside the financial sector, however, this rule does not apply to tangible assets, as they have to be allocated on the basis of use or location. The allocation of people functions only applies to risks and intangibles. This authorised approach requires reliance on the significant-people-functions approach to determine the allocation of intangibles, on the one hand, and risks, on the other.

'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.'



It appears that there's a clear link between people, functions and substance. In a dynamic environment where people change, how can you be sure that substance requirements are constantly met?

Isabel – This is a rather complex issue, where operating and daily management constraints have to be taken into account. It raises the question of how economic substance is monitored. When a tax effective model is implemented, the substance question is addressed at the same time. The next question is, who will take ownership of the monitoring going forward in the years to come? Who will see that proper substance remains in place and who will police the eventuality of a challenge because certain rules might have changed in a given country? It's clear that when something goes wrong and the tax authorities conclude that, say, profits cannot be predominantly allocated to a certain jurisdiction because of a lack of economic substance, it is often the tax department that is blamed. We therefore feel it's important to have a policy on substance in place and to organise substance reviews on a regular basis. As we say, taxpayers may also integrate substance requirements into a broader context like corporate governance. How do the internal governance policies, procedures and processes look, what are the delegation of authority protocols, how do performance metrics work...these are all so crucial and so powerful to counter tax authorities' challenges without wasting valuable management time in addressing these questions.

How would you sum up the main take-aways on the substance debate and what are your key recommendations?

Isabel – 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's no reason to assume that effective tax strategies shouldn't be sustainable for years to come.

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Nicola Lostumbo and Garry Stone from our US firm discuss the continued importance of corporate tax reform

How much is corporate America worth?: Corporate tax reform and firm valuation premia

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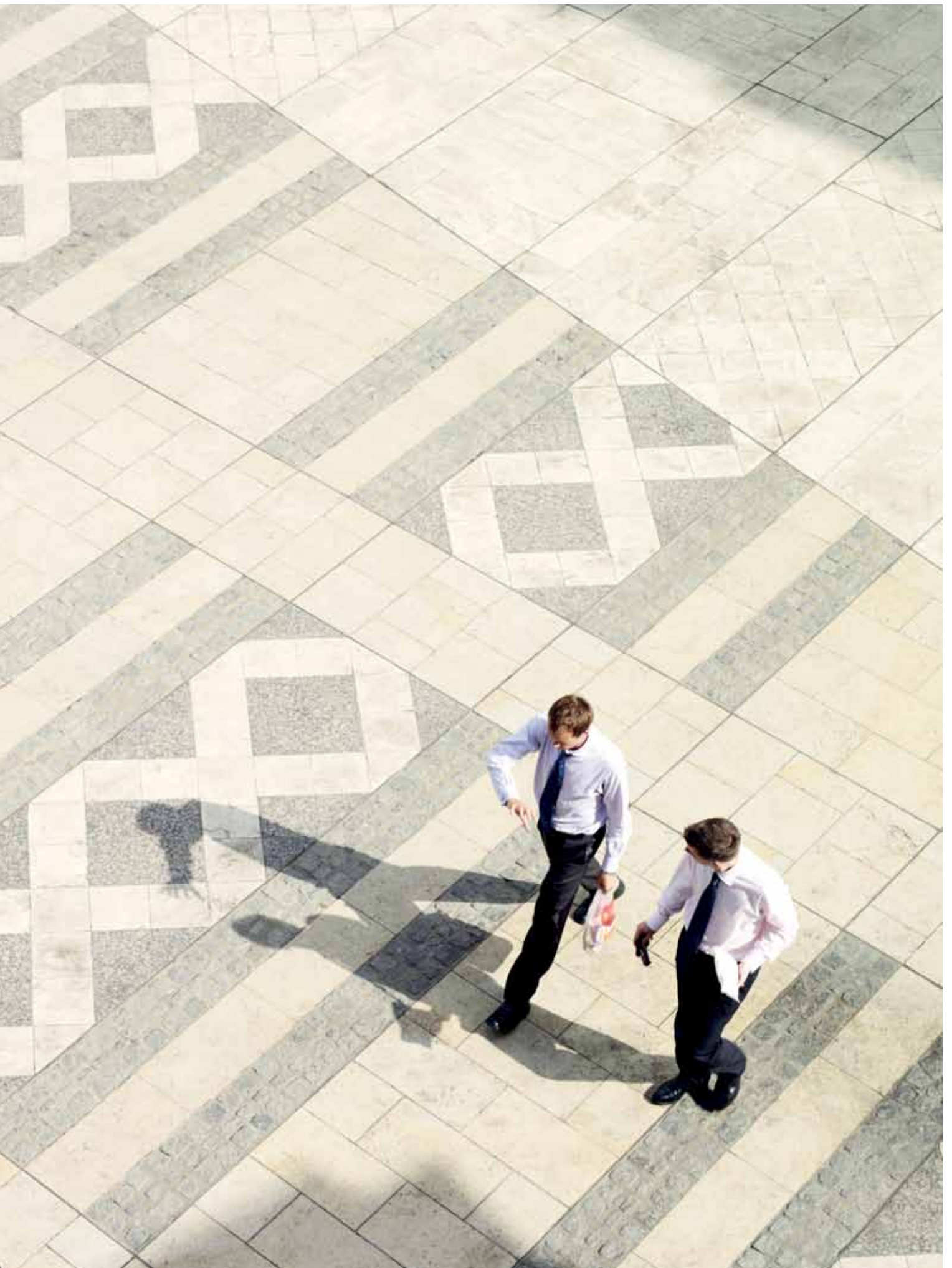
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Corporate tax reform has been a recurring theme in the news lately, with simplification of the tax code and lowering of the top corporate tax rate often listed as main priorities by some, while eliminating deferral and taxing foreign income of US multinationals as priorities of others.¹ Perhaps due to recent economic volatility, one consideration in the debate is that all potential reforms need to ensure the US remains a competitive locale to attract both capital and jobs creation. The Obama Administration's recent fiscal year 2013 budget proposal reads:

“Because our corporate tax system is so riddled with special interest loopholes, our system has one of the highest statutory tax rates among developed countries to generate about the same amount of corporate tax revenue as our developed country partners as a share of our economy; this, in turn, hurts our competitiveness in the world economy.”²

In this statement, the Obama Administration stresses the existence of a correlation between high statutory tax rates and decreased competitiveness for US-based firms and labour. This acknowledgement is a step in the right direction in the tax reform debate.

In this article, we examine via a simple model, the interplay between current proposed tax reforms and the multinational firm valuation for foreign-incorporated firms subjected to lower tax rates on non-US income (foreign source income) compared

to the effective tax rates faced by US firms on foreign source income.

Hybrid tax system

The US system of corporate taxes has been called a hybrid tax system, whereby both US-incorporated and foreign-incorporated firms are taxed at a 35% statutory rate on US source income; with foreign-based firms taxed at their prevailing foreign statutory rates and US-based firms taxed at a 35% rate on foreign source income, respectively.³ The US-based firm is essentially under a worldwide tax system as it is taxed on its worldwide income at the same 35% rate, regardless of where the income is sourced. Foreign source income is exempted from immediate taxation at the 35% rate only if the income qualifies for deferral.⁴

Most countries in the world, including a large majority of high-income OECD (Organisation for Economic Development) countries, impose a tax only on income sourced in their country. Over 80% of OECD countries follow this arrangement, which is up from approximately 50% a decade ago.⁵ This system has been labelled a territorial tax system. To the extent that the foreign tax rate is lower than 35%, the different territorial versus worldwide tax systems produce a tax advantage for foreign-based firms over US-based firms with respect to non-US source income assuming non-deferral of the non-US source income. An illustration is presented in Table 1 below.

Valuation Premia

If the current US hybrid system continues in its present form (or if deferral were to be eliminated without a significant decrease in the US corporate tax rate), valuation implications across foreign-based and US-based firms will result over time due to the differential treatment of foreign source income. More specifically, foreign-based firms will be valued at a premium to their US-based counterparts.

¹ *Tangled Tax Code Primed for Pruning*, John D. McKinnon, Wall Street Journal, 27 February 2012.

² *Budget of the United States Government, Fiscal Year 2013*, 13 February 2012, page 38.

³ Income taxes paid abroad by US-based firms receive a credit toward the total 35% tax liability. The US-based firm would be responsible for paying the balance on the foreign source income tax. The payment is “deferred” as long as: (a.) the income does not qualify as subpart F income; and (b.) the income is not repatriated to the US (i.e. it remains offshore).

⁴ Some commentators have referred to the ability of multinationals to defer foreign source income as a loophole and have called for a repeal of deferral. See *The President's Speech: Right about Stopping Offshore Tax Dodgers, Wrong about Cutting Taxes for Other Corporations*, Citizens for Tax Justice, 26 January 2012.

⁵ *The Importance of Tax Deferral and a Lower Corporate Tax Rate*, Robert Carroll, The Tax Foundation, February 2010.

Table 1: Statutory tax rates for US-based and foreign-based firms^{6, 7}

	US source income	Foreign source income
US-based firms	35%	35%
Foreign-based firms	35%	25%
Foreign-based firm tax advantage	N/A	35% - 25% = 10%

⁶ Table 1 is presented under a 35% US federal corporate tax rate and a 25% foreign corporate tax rate. As of 2011, the average corporate tax rate among OECD countries (US excluded) is 25.1%, compared to 39.2% for the US. The 39.2% rate is a sum of the US federal corporate income tax rate (35%) and the weighted average corporate marginal income tax rate of all US states, accounting for the deduction of state corporate income taxes at the federal level. The 25.1% OECD average is based on a similar federal and state tax rate calculation. Source: OECD <http://www.oecd.org/dataoecd/26/56/33717459.xls> (last accessed 23 March 2012).

⁷ As of 1 April 2012, Japan has lowered its combined corporate tax rate to 38.0%. As a result, the US currently has the highest corporate tax rate among the OECD countries. Source: *The Countdown is Over. We're #1*. Scott A. Hodge, The Tax Foundation, 1 April 2012.

Table 2: Foreign-incorporated firm valuation premium calculation

(amounts in millions USD)	Notation	2012	2013	2014	2015	2016	Terminal Period
Earnings Before Taxes (EBT)	a	100.0	103.0	106.1	109.3	112.6	1,656.1
Present value factor (based on a 10% discount rate)	b	0.95	0.87	0.79	0.72	0.65	0.65
US-incorporated firm							
Post-tax earnings	c = a x (1 - 35%)	65.0	67.0	69.0	71.0	73.2	1,076.5
Present value of post-tax earnings	d = b x c	62.0	58.0	54.3	50.9	47.6	701.0
US-incorporated firm valuation	e = sum(d)	973.9					
Foreign-incorporated firm							
Foreign source income	f = a x 67%	66.7	68.7	70.7	72.8	75.0	1,104.1
US source income	g = a x 33%	33.3	34.3	35.4	36.4	37.5	552.0
Post-tax earnings (foreign source income)	h = f x (1 - 25%)	50.0	51.5	53.0	54.6	56.3	828.1
Post-tax earnings (US source income)	i = g x (1 - 35%)	21.7	22.3	23.0	23.7	24.4	358.8
Post-tax earnings	j = h + i	71.7	73.8	76.0	78.3	80.7	1,186.9
Present value of post-tax earnings	k = b x j	68.3	64.0	59.9	56.1	52.5	772.9
Foreign-incorporated firm valuation	l = sum(k)	1,073.8					
Foreign-incorporated firm valuation premium	m = l / e - 1	10.3%					

ending deferral without an accompanying reduction in the US corporate tax rate will create an environment ripe for acquisitions of US-based companies by foreign-based firms.¹⁰

⁸ Note that US source income would be taxed at 35% for both US-based firms and foreign-based firms, producing no foreign-based firm valuation premium due to US-sourced income. A foreign-based firm valuation premium on US-sourced income does not materialise under a US worldwide tax system regardless of the US tax rate in place, although high tax rates may create other issues.

⁹ This calculation is made under the assumption that sales growth is the same for both US- and foreign-incorporated firms. However, the presence of a valuation premium for the foreign-incorporated firm may give rise to higher future growth relative to the US-incorporated firm as the foreign-based firm would have additional funds to make growth-creating investments.

The example in Table 2 above provides insight into how a valuation premium materialises for foreign-based firms due to the varying tax treatment on foreign and US source income under the assumption that the foreign-incorporated firm earns two-thirds of its income outside the US.⁸

A valuation premium for the foreign-based firm of 10.3% results when the US-incorporated firm is subject to a 35% tax rate compared to the foreign-incorporated firm subject to a 25% rate.⁹ The example in Table 2 illustrates that ending deferral without an accompanying reduction in the US corporate tax rate will create an environment ripe for acquisitions of US-based companies by foreign-based firms.¹⁰

Note that the premium calculated above is insensitive to income, growth rate¹¹, discount rates, time periods, etc. It is simply a function of the difference in tax rates and non-US income shares as described in Equation (1) opposite.

Equation (1)

Foreign-based firm valuation premium =

$$\frac{FI_F \times (1 - FTR_F) + USI_F \times (1 - USTR)}{FI_{US} \times (1 - FTR_{US}) + USI_{US} \times (1 - USTR)} - 1$$

FI = Foreign Income Share;
 USI = US Income Share
 (or $1 - \text{Foreign Income Share}$);
 FTR = Foreign Tax Rate;
 $USTR$ = US Tax Rate;
 and the subscripts "F" and "US" represent the foreign-based and the US-based firms.

Equation (2)

Under a US worldwide tax system (i.e. $FTR_{US} = USTR$), Equation (1) reduces to:

$$\text{Foreign-based firm valuation premium} = \frac{FI_F \times (1 - FTR_F)}{(1 - USTR)} - FI_F$$

Table 3: Foreign-incorporated firm valuation premia and tax rates

Foreign-incorporated firm valuation premium ¹²	Foreign statutory corporate tax rate						
	10.0%	15.0%	20.0%	25.0%	30.0%	35.0%	
Foreign-source income share for foreign-incorporated firm	25.0%	9.6%	7.7%	5.8%	3.8%	1.9%	0%
	33.3%	12.8%	10.2%	7.7%	5.1%	2.6%	0%
	50.0%	19.2%	15.4%	11.5%	7.7%	3.8%	0%
	66.7%	25.7%	20.5%	15.4%	10.3%	5.1%	0%
	75.0%	28.8%	23.1%	17.3%	11.5%	5.8%	0%

¹² Foreign-based firm valuation calculated relative to US-based firm valuation where the US firm is taxed at a 35% rate on all domestic and foreign sourced income (no deferral).

Table 3 above displays the relationship between US and foreign statutory tax rates and the foreign firm valuation premia deriving from foreign source income under the system where all income for US-incorporated multinationals is taxed on a worldwide basis.

Understandably, the foreign-based firm valuation premium increases as the foreign tax rate decreases relative to the US tax rate and the share of foreign source income increases for the foreign-incorporated firm. Over the long-term, consistently higher foreign-based firm valuations can have the effect of putting US-based firms at a disadvantage in terms of having less capital to re-invest in their businesses, which has implications for US employment and capital growth as well as for potential acquisitions of US firms by their foreign competitors.¹³

Deferral

The worldwide income tax system for US-based firms, combined with what has become perpetual deferral of foreign source income (due to the high cost of repatriation), produces a similar result as a territorial system does for foreign-based firms (i.e., reducing the foreign-based firm valuation premium as long as foreign source income is not repatriated to the US). However, it should be noted that from a competitiveness standpoint, with perpetual deferral, none of the foreign source income is available for direct investment in the US (removing the related multiplier effects resulting from increased capital investment, job creation, innovation, etc.).

If a US-based firm was interested in expanding their operations in the US via foreign source income, such a move would trigger significant tax costs when repatriating that income. As a case in point, Apple Inc. has approximately \$64 billion in deferral overseas (as of the second quarter of the 2012 fiscal year) and has no plans to repatriate any of it to the US. Apple's CFO, Peter Oppenheimer has stated:

“Repatriating the cash from offshore would result in significant tax consequences. ...We think that the current tax laws provide a considerable economic disincentive to US companies that might otherwise repatriate.”¹⁴

Absent deferral, the US worldwide tax system, in its current form, can reduce or completely eliminate the foreign-based firm valuation premium via a reduction of the statutory corporate tax rate. This is seen in Equation (2) earlier: the valuation premium decreases only to the extent that the difference in the two tax rates is minimised (i.e. $USTR = FTR_F$) or the foreign source income share is nil. A shift from the current US worldwide tax system to a territorial tax system is another avenue to eliminate the foreign-based firm valuation premium arising from income earned abroad. Note that in a US territorial tax system, Equation (1) above produces no valuation premium when comparing similar US-incorporated and foreign-incorporated firms as $FTR_{US} = FTR_F$.¹⁵

Territorial tax proposals

In the past year, to address certain anti-competitive aspects of the US corporate tax system, a couple of territorial-style tax proposals have been advanced separately by Senator Michael Enzi¹⁶ and Representative Dave Camp.¹⁷ Below are some of the main features of the Camp proposal:¹⁸

- Lower US statutory corporate tax rate from 35% to 25%;
- 95% exemption: US-based multinationals would pay US tax on only 5% of newly-generated foreign source income (translating to a 1.25% tax = 25% x 5%);
- End deferral of foreign earnings situated offshore with a 5.25% tax on such existing earnings, regardless of whether earnings are repatriated to the US; and

¹⁰ Note that President Obama proposed ending deferral without lowering the corporate tax rate in 2009. Source: http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TAX-INCENTIVES-FOR-SHIFTING-JOBS-OVERSEAS (last accessed: 25 April 2012).

¹¹ Tables 2 and 3 are presented under the assumption that US- and foreign-incorporated firms grow at the same rate. See previous footnote that discusses the interplay between a foreign valuation premium and growth rates.

¹³ Pure US-based multinational corporations are the most at-risk, as service sector-oriented companies that primarily earn their revenues in the US will not be valued lower than their peers. This is due to the fact that, the peer companies, whether they are US- or foreign-incorporated, will be taxed at the similar US rate if they are performing similar services and earning income in the US.

¹⁴ *Apple's Move Puts Spotlight on Foreign Cash Holdings*, Maxwell Murphy, Wall Street Journal, 20 March 2012.

¹⁵ Note that, under a territorial tax system, a valuation premium of zero results when comparing similar firms that have equivalent foreign source income shares.



¹⁶ *United States Job Creation and International Tax Reform Act of 2012*, Senator Michael Enzi, 9 February 2012.

¹⁷ *Tax Reform Act of 2011*, House Committee on Ways and Means, US Representative Dave Camp, 26 October 2011.

¹⁸ As the Enzi proposal contains similar features as the Camp proposal (without the provision to lower the US statutory corporate tax rate from the current 35% level), the Camp proposal is summarised in this section.

¹⁹ Draft legislation issued as part of *The President's Plan For Economic Growth and Deficit Reduction*, 23 September 2011. President Obama's excess returns proposal immediately taxes "excess" income associated with the outbound transfer of intangibles. Gross income is considered to be excessive if it is greater than a mark-up of 150% above the costs associated with the gross income in question. The excess returns proposal is essentially a cap on deferral. The proposal also broadens the definition of what constitutes an intangible. Note that we have not modelled the excess returns proposals in this article.

- Proposes an excess returns proposal similar to President Obama's proposal¹⁹ as one alternative to mitigate abuses associated with the outbound migration of intangible property.

Likely in response to the Camp/Enzi proposals, President Obama has recently vowed to lower the US corporate tax rate to 28%.²⁰ However, as this new proposal has not been formally presented, it is not clear what the tax treatment will be regarding foreign source income or existing offshore foreign earnings.

The Camp and Obama proposals have different implications for the competitiveness of US-based corporations. Table 4 below provides a comparison of the foreign firm valuation premium for the Obama and Camp proposals with the current system of taxing US firms on their worldwide income (without deferral) and a pure territorial system for a selected set of the largest US multinationals based on market capitalisation. The US multinationals presented below are compared to hypothetical foreign firms facing a 25% corporate tax rate and equivalent foreign source income shares.

Table 4: Comparison of current tax policy and selected tax proposals

Company	FY 2011 Foreign source income share [1]	Foreign-incorporated firm valuation premium			
		US Worldwide [2]	Obama	Camp	Territorial
Apple Inc [3]	63.5%	9.8%	2.6%	1.1%	0%
Microsoft Corporation	68.0%	10.5%	2.8%	1.2%	0%
Google Inc.	61.9%	9.5%	2.6%	1.0%	0%
Coca-Cola Co.[4]	79.8%	12.3%	3.3%	1.4%	0%
Intel Corp.	17.6%	2.7%	0.7%	0.3%	0%

[1] Source: Company FY 2011 10-Ks and authors' calculations.

[2] Note that US worldwide tax system modelled without deferral.

[3] Excludes retail segment and assigns all Americas income to US. Source: Apple 2011 10-K, page 73.

[4] Assigns all North America income to US and excludes bottling and corporate segments which are not regionally segmented. Source: Coca-Cola Co. 2011 10-K, p. 59.

Absent deferral, produces the highest foreign-based firm valuation premium for the US multinationals. President Obama's proposed 28% tax rate drastically contributes to reducing the foreign-firm valuation premium although, as the proposal has not been formally presented, we have not made any assumptions of an additional tax on foreign source income, which would contribute to increasing the premium. Although the Camp proposal includes a provision to lower the corporate tax rate to 25%, it is not equivalent to a pure territorial system as it produces a slight foreign firm valuation premium due to an additional 1.25% tax on foreign source income that the US multinationals would be subject to.²¹ Note that this feature of the Camp proposal produces a similar outcome from a foreign-incorporated firm valuation premium perspective as under the US worldwide tax system with perpetual deferral.²²

The Camp proposal also includes a 5.25% immediate tax on deferred earnings (whether or not such earnings are repatriated to the US), which is not examined in the calculation above. The Obama Administration has not indicated its support for a tax holiday whereby existing offshore foreign earnings could be repatriated at a reduced rate.²³

Although not explicitly modelled in Table 4, it is clear that firms such as Apple would face a less stiff cost in repatriating their offshore cash under Camp's 5.25% proposal for deferred earnings than under the current 35% or proposed 28% tax regimes. As of 31 December 2011, Apple

had a market capitalisation of \$376.4 billion and deferred cash holdings of \$64 billion.²⁴ The Camp proposal would result in an approximate \$3 billion tax payment for Apple on its existing \$64 billion in offshore cash, whereas a 28% rate on repatriated earnings would result in an \$18 billion tax payment. The Camp and Obama tax proposals have the effect in decreasing Apple's valuation by 0.9% and 4.8%, respectively.²⁵

Conclusion

Tax reform will continue to be an important agenda item for legislators in the coming years. Fostering a climate for employment and capital growth and ensuring that US firms are on competitive footing with their foreign counterparts will continue to be recurring themes where all parties will find commonality in any such debate. Therefore, examining proposals from the perspective of whether they give rise to a foreign firm valuation premium will prove to be an unequivocal determinant for whether the legislators behind the proposals are dedicated to US employment and capital growth and to keeping US firms competitive in the global marketplace. We see positive movement by politicians towards the recognition that ending deferral needs to be accompanied by a reduction in corporate tax rates, which will narrow or eliminate the foreign-based firm valuation premium.

An edited version of this article will appear in a forthcoming issue of *Journal of International Taxation* (Thomson Reuters/WG&L)

²⁰ *Obama Offers to Cut Corporate Tax Rate to 28%*, Jackie Calmes, New York Times, 22 February 2012.

²¹ Both Obama and Camp endorse an excess returns proposal associated with the outbound transfer of intangibles. However, calculating the foreign firm valuation premium associated with the excess returns proposal involves a detailed examination of where US multinationals are earning their revenues and the associated tax rates in those jurisdictions, which is beyond the scope of this article. Clearly, the excess returns proposal would contribute to increasing the foreign-based firm valuation premium via a reduction of foreign source income subjected to lower tax rates.

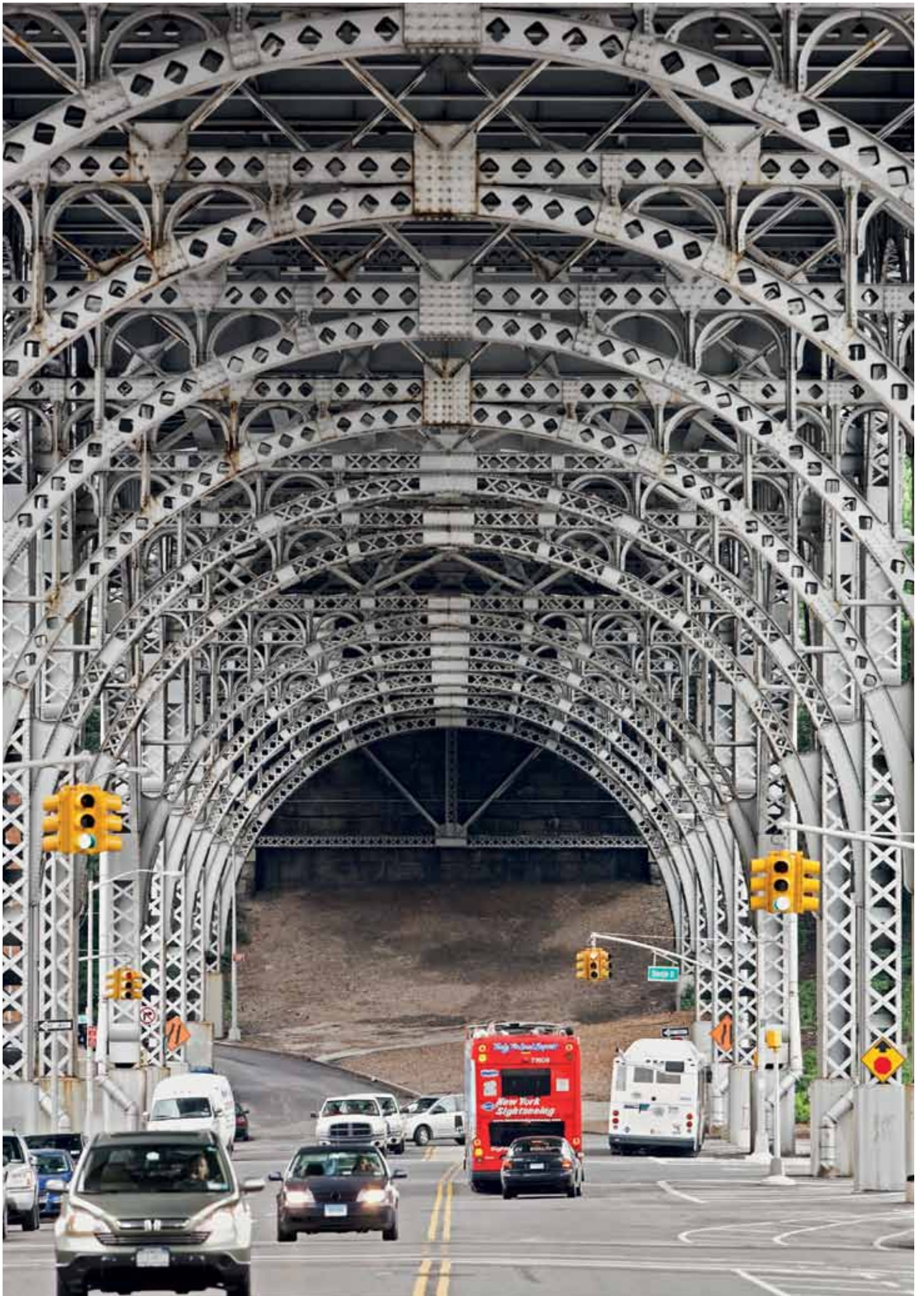
²² The foreign-incorporated firm valuation premium under the US worldwide tax regime was modeled without deferral in our analysis.

²³ *White House Unmoved by Apple's Offshore Cash Problem*, Carl Franzen, Talking Points Memo, 19 March 2012.

²⁴ Sources: Financial Times Global 500 <http://www.ft.com/intl/cms/73f82726-385d-11e1-9f07-00144feabdc0.pdf> (last accessed: 27 March 2012) and Apple FY12 Q1 10-Q.

²⁵ Source: Authors' calculations.





Garry Stone and Paige Hill from our US practice outline some of the key risks and benefits to evaluating the intercompany pricing implications for target and acquired entities.

The perils and potential of intercompany pricing – on mergers and acquisitions in a multinational environment

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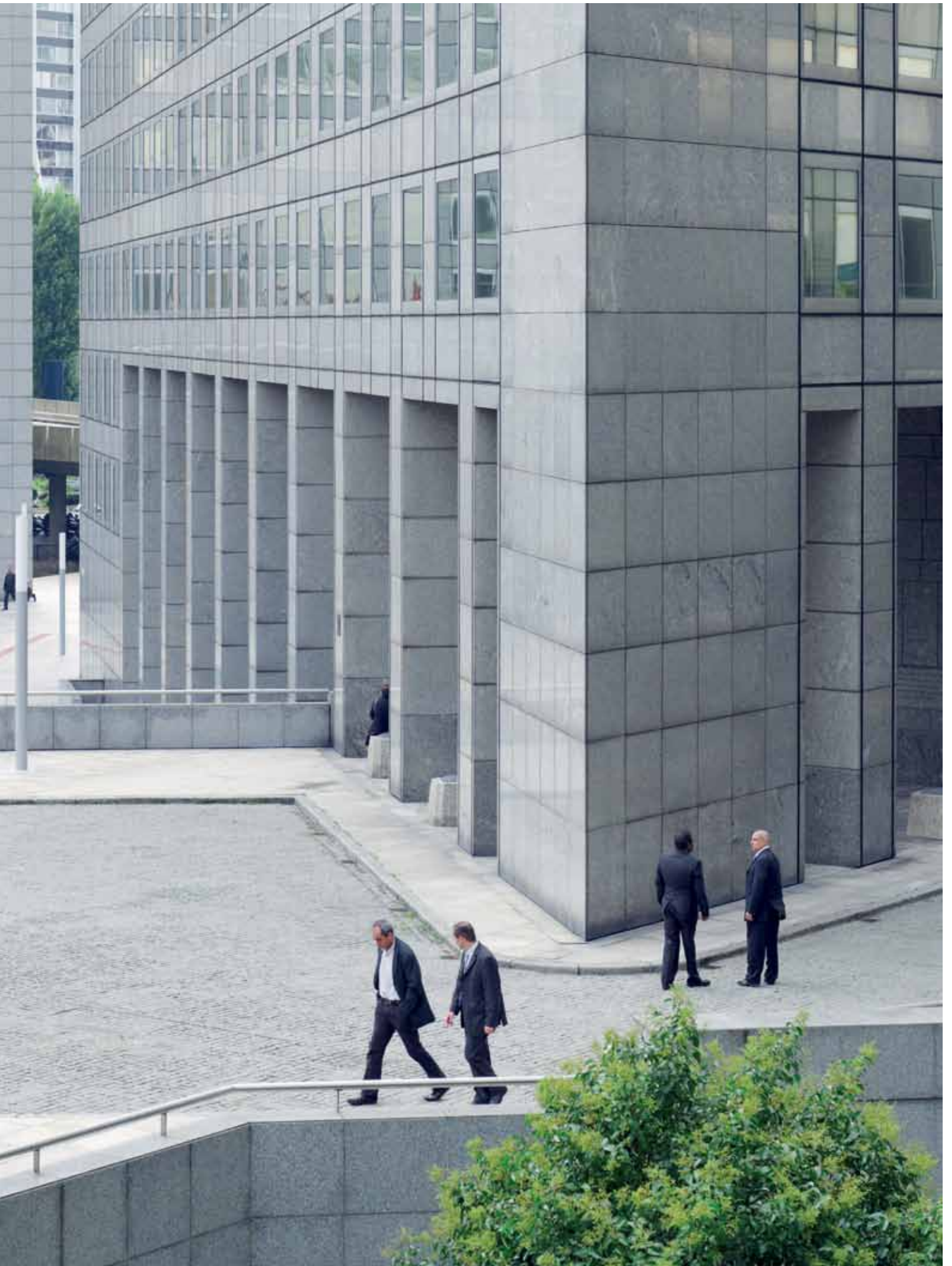
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Intercompany pricing's effect on the valuations of business enterprises and its importance to the risk and opportunity matrix of a deal often pass under the radar screens of deal teams.

However the proper assessment of transfer pricing in the context of a purchase or sale of a multinational enterprise can significantly affect the pricing and success of the deal. The potential issues and opportunities discussed in this paper focus on the need for:

- i. proper treatment of the intercompany pricing in the valuation of businesses which are part of a multinational group
- ii. proper due diligence of the intercompany pricing issues as they relate to existing or future tax liabilities of the target enterprise
- iii. the potential for intercompany pricing tax benefits and associated implementation issues to sustain these benefits (or to avoid adverse results) associated with post-deal integration of these acquired businesses into existing companies.

Early in the due diligence process, it's important to identify and understand the target's significant intercompany transactions. Examples of intercompany transactions include product sales, distribution arrangements, licensing of intellectual property (IP)/royalty payments, management fees, and intercompany financing, among others. Identifying these transactions at the outset lets you assess their potential effects on valuation and historic exposures and determine the extent to which a deeper review in the due diligence process is necessary. We begin with a look at the potential implications of intercompany pricing on business enterprise valuations.

Valuation of a business within a multinational group: the need for arm's length intercompany pricing assumptions

When valuing a business it is standard procedure to obtain and evaluate past financial results (P&L and cash flow data) and balance sheet information.

This data is typically analysed and forecasts of future cash flows are developed from this information base. These cash flow estimates are then discounted at an appropriate risk adjusted discount rate to determine a discounted cash flow (DCF) "fair market value" (assuming for our discussion no deal synergies exist). Alternatively, market multiples of the target companies' current earning (P/E) and or sales revenues (P/S) are also often used to determine a fair value. These methods (in the case of a target company which is a member of a multinational group) are often relying on the correctness of the historic intercompany pricing among the members of the multinational group.

The tax regulations of most countries generally impose an arm's length pricing principle on the intercompany transactions of a multinational enterprise, but the regulations intended to result in arm's length pricing tend to differ somewhat across countries – and the application of the regulations vary widely in practice. Also, the regulations that try to offer guidance on how to apply the arm's length standard in practice often allow for a reasonable range of prices which, in and of itself, can influence valuation substantially even if the enterprise is fully complying with the appropriate tax rules.

P/E
P/S

Market multiples of the target companies' current earning (P/E) and or sales revenues (P/S) are also often used to determine a fair value

Even if small changes are imposed on transactions involving high volume tangible goods transactions, were to be imposed on the intercompany pricing (say for a manufacturing entity which exports products to its foreign affiliates prior to acquisition), the resulting shift in the reported profits and sales revenues could substantially impact the DCF, P/E or P/S valuation results.

Significant deviations from the arm's length standard for intercompany pricing could also result in unanticipated past or future tax liabilities (or possibly benefits) which, if known, may be material enough to disrupt an unadjusted fair market valuation by altering the stand alone cash flow or balance sheet financial projections as presented by the target.

Due diligence in a multinational environment: Potential risks associated with existing intercompany pricing policies

During the due diligence process in evaluating a potential acquisition, tax risks inherent in the target company's profile are carefully examined. When considering a multinational target, it is increasingly important to understand the company's transfer pricing policies, strategies and associated risks. Fundamental to this due diligence process for transfer pricing is the development of the functional profile of the company's key operating entities and a quantification of the magnitude of intercompany transactions between the key operating entities.

The functional profile will normally characterise the operating entity as a manufacturer, distributor, service provider, IP owner, entrepreneur, or some combination thereof. The magnitude of intercompany transactions, including product sales, royalties, service payments, or financing payments, indicate the relative importance of the intercompany transactions to the particular operating entity.

For example, if the company has a German manufacturing operation that sells to the local German market, and its intercompany purchases of inventory amount to less than 5% of total cost of goods sold, transfer pricing is not likely to be a significant issue for this entity, even if it is one of the largest operating entities in the group.

Conversely, if the company has a buy-sell distributor in Japan, where 100% of its product purchases are intercompany, then transfer pricing is a highly significant issue for that entity.

In terms of assessing the risk associated with transfer pricing, it is important to identify certain types of operating models or transactions that are indicative of significant tax planning that often carry a higher-risk profile.

Examples include IP transfers or migrations, cost sharing (or co-development) arrangements, centralised IP companies or regional headquarters and hub models. These arrangements generally attract significant attention under audit and can have material risk associated with them over a



multiyear period. It is helpful to understand the company's tax provision position with respect to these and other material transfer pricing policies as this is often a good indicator of where the company anticipates (or has experienced) tax audit activity. The existence of Advance Pricing Agreements (APAs) which offer pre-approval on covered intercompany transactions may serve to minimise the risk associated with more material or high-profile transactions.

Most major jurisdictions require companies to document the arm's length nature of their material intercompany transactions through annual transfer pricing tax studies. Typically the existence of these studies serves to mitigate tax penalties associated with adjustments to transfer prices, and in the absence of such studies significant penalties can be assessed by local tax authorities.

Intercompany pricing policies and post-deal integration

While risks associated with a target company's transfer pricing policies may be identified during the due diligence process, the savvy investor will look for opportunities that are available through the acquisition and post-deal integration process.

The priorities and opportunities may differ depending on whether the acquirer is a strategic investor or a private equity fund. For the strategic investor, the integration of the operations of the target with existing operations could generate inconsistencies between existing transfer pricing policies and those of the target.

At a minimum, the buyer should consider harmonisation of transfer pricing policies across similar jurisdictions and transaction types. From a more opportunistic standpoint, the acquisition may offer a one-time chance to make significant changes to prevailing transfer pricing policies (for both legacy and acquired operations) in light of operational changes happening as part of the integration.

For example, if the acquired company had a significant procurement business that will now support the larger, integrated company, then there may be an opportunity to consider the best tax structure to support this procurement activity in light of the overall value chain of the business.

For private equity investors, the tax profiles and priorities may differ from strategic investors. In a private equity setting, the existence of significant finance expense associated with the acquisition may give rise to unique and intermediate term cash needs that can in some cases be achieved through transfer pricing planning.



What's more, these planning strategies can in many cases be supplemented with longer-term objectives of effective tax rate minimisation through value chain transformation and other operational tax planning initiatives.

The key in the private equity setting is to ensure that cash needs and cash tax objectives in the intermediate term are married with longer-term objectives of effective tax rate minimisation which serves to maximise the value of the individual portfolio company on a stand-alone basis.

Conclusions

In this short article we attempt to outline some of the key risks and benefits to evaluating the intercompany pricing implications for target and acquired entities. By including these often overlooked intercompany pricing issues and opportunities involving valuation, due diligence and post-deal integration, deal teams can relatively easily improve performance and reduce the risks associated with an already complex set of deal analyses.

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