Winds of change

Transfer Pricing Perspectives

A collection of articles that discuss some of the significant policy and legislative changes taking place in Transfer Pricing

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Foreword

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In the constantly shifting tax regulatory landscape, post-recessionary pressures have resulted in governments looking for ways to increase tax revenues. This has led to new policies and legislation; new OECD guidelines; increased tax authority enforcement around transfer pricing and additional documentation requirements in certain countries. In addition, wider economic, environmental and technological factors are bringing about organisational transformation, as companies review their strategies in light of today's business challenges. This evolving landscape presents an even greater challenge to company executives who need to keep their finger on the pulse of change and constantly adapt their pricing strategies.

Perspectives: Winds of Change, is a collection of articles evolving from the PwC Global Transfer Pricing Conference 2010, that review some of the significant policy and legislative changes taking place and the challenges these present, along with some transfer pricing challenges from selected industries.

To keep up to date with the latest transfer pricing developments around the world, sign up to our PKN alerts by visiting www.pwc.com/pkn. We have a number of events taking place in 2011 including the PwC Annual Global Transfer Pricing Conference in Singapore from 19 - 21 October. Further event details will be available shortly and also via your usual transfer pricing or tax contact.

I look forward to seeing you there and hope you enjoy this edition of Transfer Pricing Perspectives.

Garry Stone
PwC US

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Transfer pricing litigation

What should you know about litigating a transfer pricing case in a foreign country and what are the issues you need to consider?

First published in International Transfer Pricing Journal 2 (2011), cited with the permission of IBFD, see www.ibfd.org

Transfer Pricing Litigation: A Comparative Study of Fourteen Countries

Introduction

It has been explained many times why companies can expect to face more challenges to their transfer pricing models in all the countries in which they operate. When such disputes arise, they can be dealt with in various ways, including negotiate and settle; litigate; or apply for a mutual agreement procedure or arbitration under international treaties. Each of these ways has its own advantages and disadvantages. During the PwC[1] Global Transfer Pricing Conference in Budapest in October 2010, PwC practitioners debated with the tax directors and other leading tax specialists of international companies on litigation as a possible way of settling disputes with tax authorities. It soon appeared that there are quite some differences among the countries represented, and that some of these differences were unexpected.

This article summarises what you should know about litigating a transfer pricing case in a foreign country, as well as looking at the overseas issues which you will have to consider, over and above the issues you already face from litigation in your home country. Our review covers 14 countries, with representation from all trading continents: Australia, Belgium, Brazil, Canada, France, Germany, India, Japan, Korea (Rep.), Malaysia, Mexico, the Netherlands, Poland and the United States.

[1] 'PwC' refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network.

'PwC practitioners debated with the tax directors and other leading tax specialists of international companies on litigation as a possible way of settling disputes with tax authorities'

Administrative appeal

As a first step, a multinational corporation may have to file for administrative appeal against the transfer pricing adjustment with the local tax authorities. If the company wants to litigate its case in court, this step is mandatory in some countries, but not in all countries, as indicated in Table 1.

In India, which has more complex rules in this area, the taxpayer can choose to start the administrative appeal at two different institutes of the government, namely the Dispute Resolution Panel or the Commissioner for Appeals. The existence of two options means that you have to develop a strategy which enables you to make the best choice for your case. All countries where an administrative appeal is a mandatory step prior to litigation, reported that they have rules allowing the taxpayer to go to court if the government fails to take a decision on the administrative appeal within a certain time period.

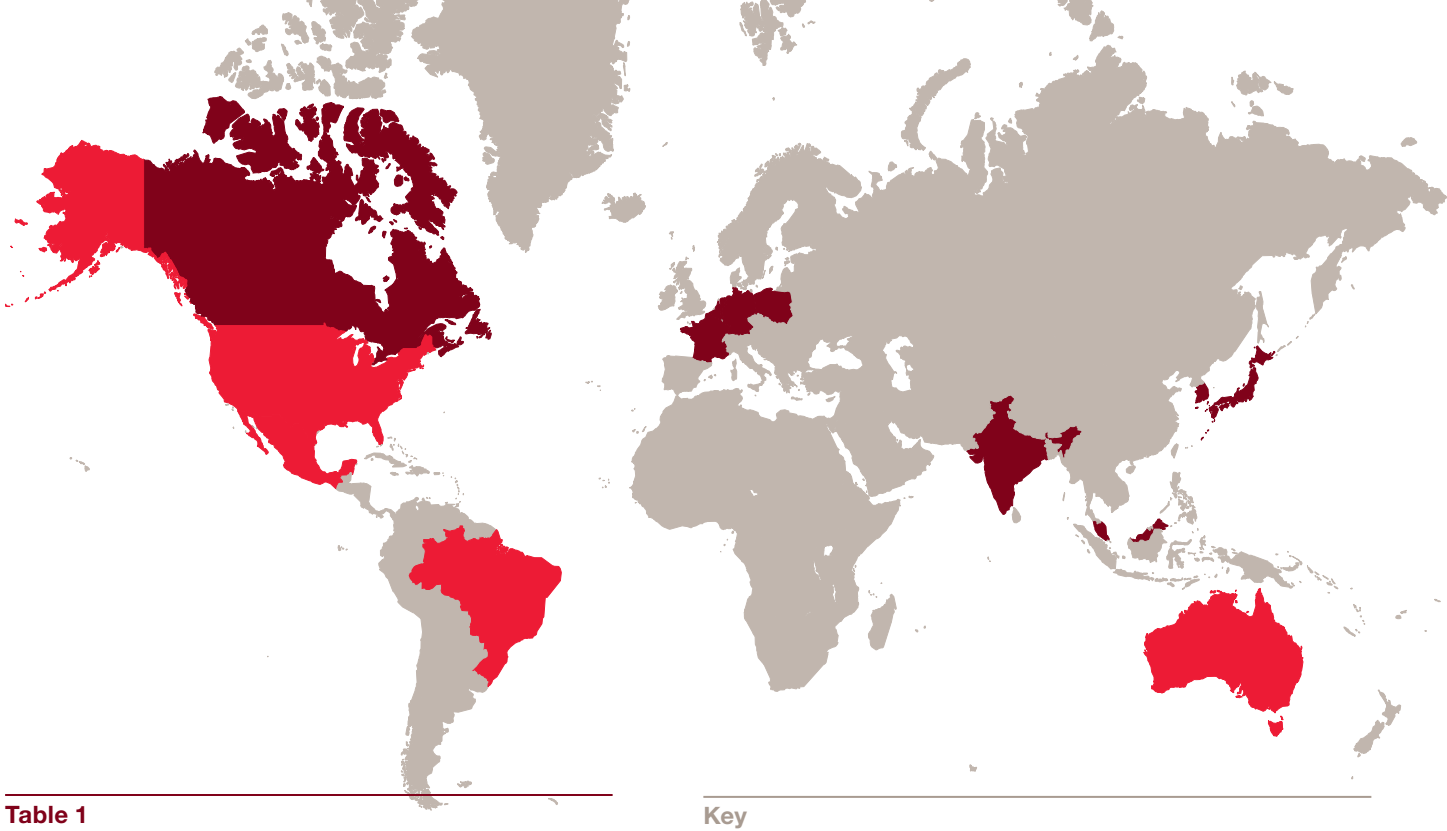


Table 1

Administrative appeal is a mandatory step for litigation	Belgium, Canada, France, Germany, India, Japan, Korea, Malaysia, Netherlands, Poland
Administrative appeal is not a mandatory step for litigation	Australia, Brazil, Mexico, United States

Key

- Administrative appeal is a mandatory step for litigation
- Administrative appeal is not a mandatory step for litigation

All countries have a system in place in which the administrative appeal is handled by a different person than the one who has issued the tax assessment with the transfer pricing adjustment. The purpose of this procedure is to ensure that the issue is reviewed within the tax authority by an independent tax inspector with a fresh view. In Poland and the United States, the administrative appeal is even handled by a separate part of the government. In most countries, however, the administrative appeal is handled by a different individual within the same tax office. As transfer pricing adjustments in practice are decisions by a team within a tax authority, you may be concerned at how fresh the view in administrative appeal is in reality, as the internal reviewer may already know of the case and the sentiments surrounding the case, e.g., within the framework of internal technical meetings.

With these issues in mind, the question arises as to why taxpayers would bother to file an administrative appeal in those countries where it is not a mandatory step prior to litigation. The answer is that, despite the said issues, a large number of disputes are resolved on administrative appeal in favour of the taxpayer, especially in the United States. In addition, it is less costly and less time consuming than litigation. Finally, none of the countries require that the administrative appeal be filed by a lawyer who is admitted to the bar.

Reputational aspects of tax litigation

Most multinational corporations consider corporate responsibility as a cornerstone of their reputational strategy. Corporate responsibility is about corporate self-regulation, support to law enforcement and ethical standards. It is about the deliberate inclusion of the public interest into corporate decision making. The question therefore arises as to how tax litigation relates to the company's corporate responsibility strategy and to its reputation, especially if the issue may be described in a newspaper article as "aggressive tax planning". As an anecdote, you may recall that, when GlaxoSmithKline settled its US transfer pricing dispute with the IRS in 2006, a reputable newspaper commented that "the IRS accused GSK of transfer pricing". Apparently misunderstandings easily arise. Some companies have a strict policy not to litigate their tax issues because the government is also an important customer of the group. The company therefore may want to balance possible benefits of litigation against the possible impact of litigation on its reputation with financial markets and customers. Table 2 shows in which countries it can become public knowledge that a multinational corporation has serious tax issues.

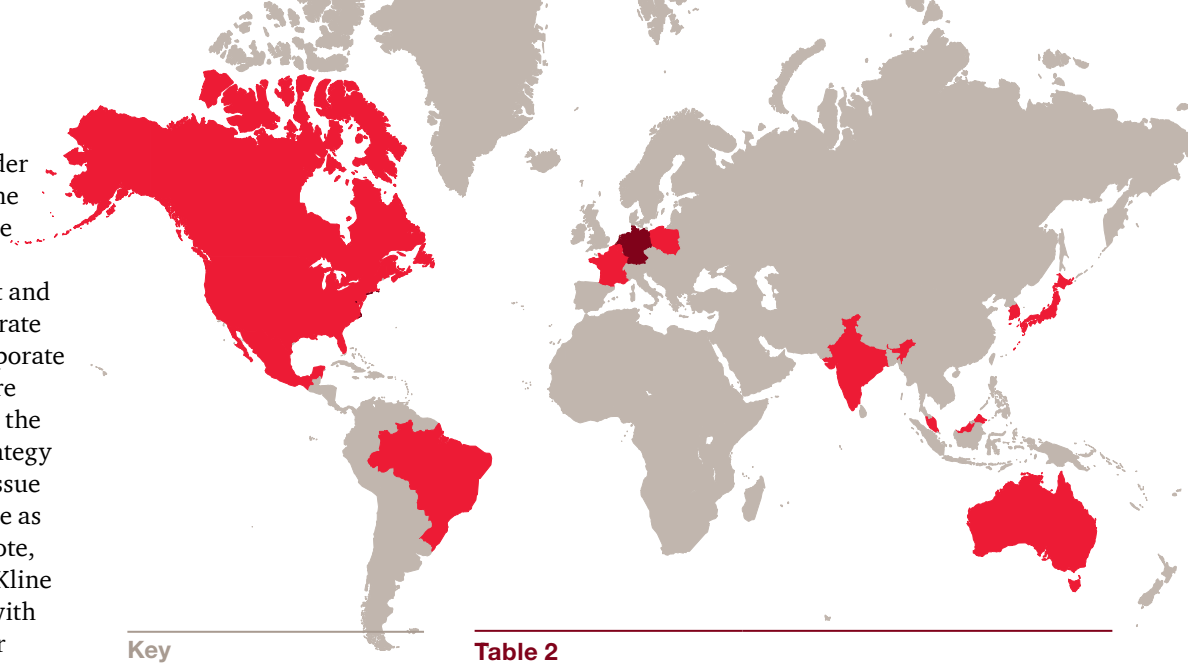
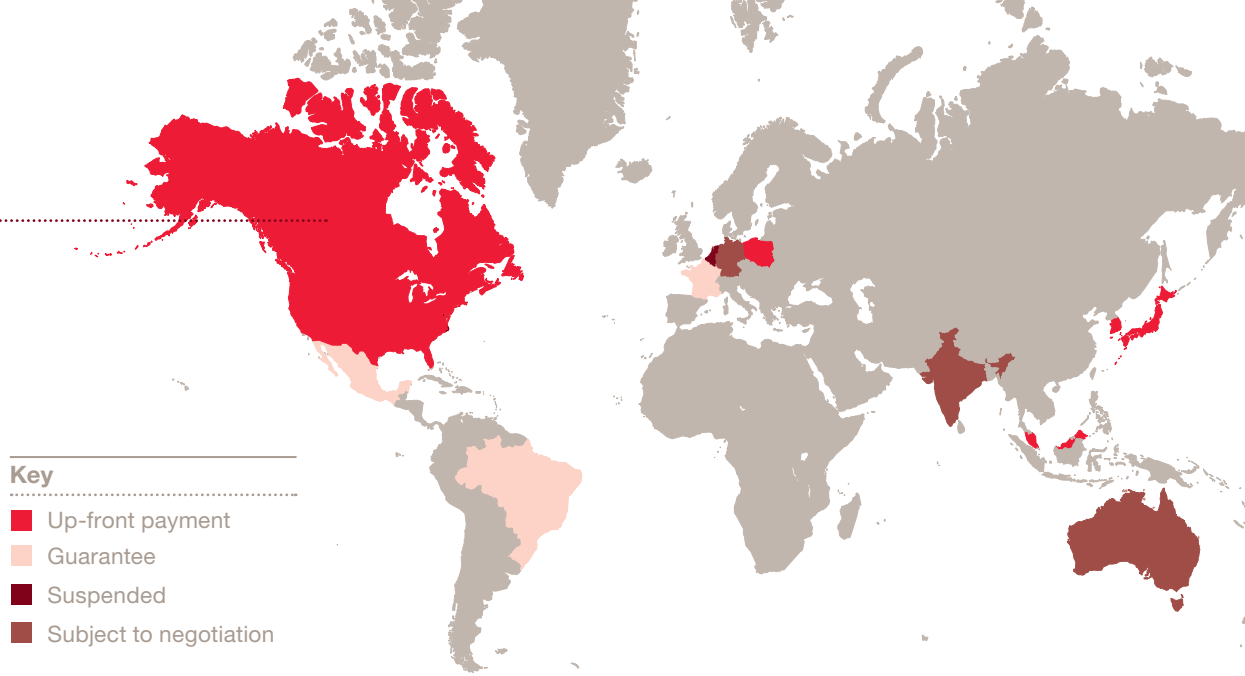


Table 2

Taxpayers named in litigation	Australia (but petition for anonymity), Belgium, Brazil, Canada, France, India, Japan, Korea, Malaysia, Mexico, Poland, United States
Taxpayers not named in litigation	Germany, Netherlands

'In Canada, 50 percent of the disputed tax must be paid upfront or else be guaranteed'



Cash is king

An important consideration for the group will be whether it has to pay the disputed tax upfront, especially in view of the long time frame of litigation. All countries reported that the full cycle of litigation lasts between five and ten years. India is the exception to this rule, where litigation is anticipated to take more than ten years.

There were a number of variations in response to the question of whether the disputed tax must be paid up-front. In the United States, the answer depends on the tax tribunal at which the taxpayer litigates the transfer pricing adjustment. In India, the payment of disputed tax is subject to negotiation, but both UK and US multinational corporations may invoke certain arrangements based on their tax treaties with India.

In Brazil, taxpayers can choose to bring their case before an administrative court or directly before a judicial court. Disputed tax is suspended while the litigation is in the administrative court. Before the judicial court, taxpayers must proceed with a deposit of the disputed tax or offer assets in guarantee. Alternatively, they can plead for a preliminary injunction in order to suspend the disputed tax, although such preliminary injunction is unlikely to be granted. In Canada, 50 percent of the disputed tax must be paid upfront or else be guaranteed. In some cases, it may be possible to ask the court for a suspension of the entire amount of the disputed tax. Table 3 indicates whether tax must be paid up-front in the countries considered in this survey.

Table 3

Up-front payment	Canada (50%), Japan, Korea, Malaysia, Poland, United States (federal district court; court of federal claims)
Guarantee	Brazil (judicial court), Canada, France (but not in MAP), Japan (only in MAP), Mexico
Suspended	Belgium, Brazil (administrative court), Netherlands, United States (tax court)
Subject to negotiation	Australia, Germany, India

How strong is the case in court?

When considering litigating a transfer pricing dispute, several factors should be addressed to evaluate the strength of the case. Not only does such evaluation require an analysis of the economic rationale of the transfer pricing system, but it also requires additional analyses such as of the division of the burden of proof and the strength of the available transfer pricing documentation. Table 4 considers the burden of proof in transfer pricing cases in the countries analysed in this comparative survey. Quite often multinational corporations are convinced of the robustness of their transfer pricing documentation. However, the question as to whether the documentation would convince a foreign court, i.e., outsiders trained in legal analysis and not in economics or business administration, is often overlooked. Important questions for litigation include whether the documentation has been reviewed against local laws, and whether it is necessary to prepare the documentation in the local language. When it comes to the strength of the transfer pricing documentation, the company may want to consider preparing additional documentation to remedy possible deficiencies.

The experience of the foreign judicial system

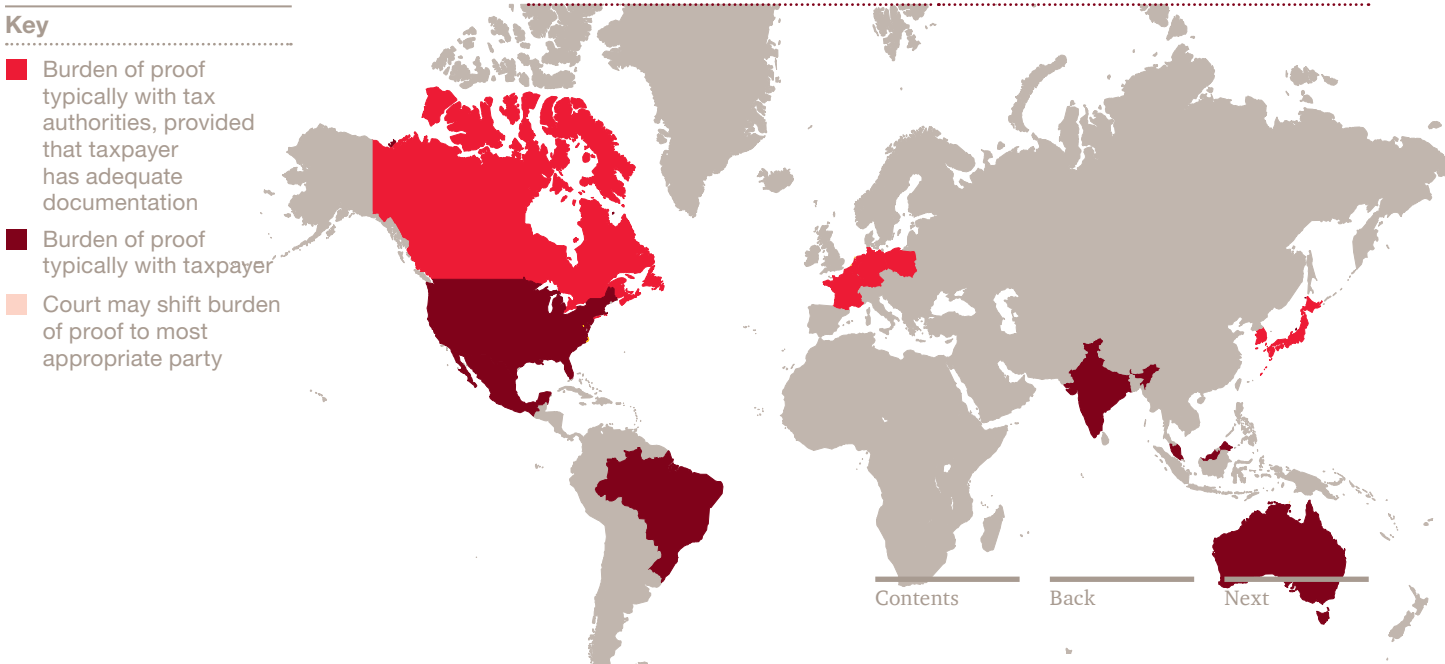
A multinational corporation may also want to consider the experience of the foreign judicial system in transfer pricing cases. In all countries, the number of transfer pricing cases is very low. India is the exception, and accounts for more than half of the total number of transfer pricing cases around the world. In addition, although most countries provide for a system of expert witnesses, it appears that they are only called upon on a frequent basis in Australia, Canada, Mexico and the United States. Finally, in many countries, practitioners on both sides have developed a common, economic approach to transfer pricing issues, and the question arises as to whether a court will follow this common approach or whether it will apply a totally different one. These issues require careful consideration by the multinational corporation.

In court

Most countries have a judicial system that follows a generic model of a district court, a court of appeal and a Supreme Court. However, we found some interesting variations on the generic model. When considering litigating a case in one of the EU Member States, you should be aware that the local Supreme Court is obliged to refer the case to the European Court of Justice if the interpretation of EU law in respect of the transfer pricing legislation in the concrete case is unclear. Also, EU taxpayers may lodge a complaint with the European Commission if the local transfer pricing legislation, administrative guidelines or conduct of the tax authorities runs counter to EU law.

Table 4

Burden of proof typically with tax authorities, provided that taxpayer has adequate documentation	Belgium, Canada, France, Germany, Japan, Korea, Netherlands, Poland
Burden of proof typically with taxpayer	Australia, Brazil, India, Malaysia, Mexico, United States
Court may shift burden of proof to most appropriate party	Canada, India, Mexico, Netherlands



In Brazil, the taxpayer can choose to bring its case directly before a judicial court or before an administrative court. Taxpayers generally prefer the administrative court as a first step, as there are an equal number of representatives from the administration and from taxpayer organisations. In India, it appears that taxpayers have been quite successful in litigating transfer pricing adjustments. In the Netherlands, the court can invite the taxpayer and the tax authorities to restart settlement negotiations, but now under the guidance of an independent mediator. In the United States, the taxpayer can choose to commence its litigation before one of three different tax tribunals, each having its own rules for appeal, upfront payment of tax, relevance of earlier case law, etc.

As to what kind of ruling to expect from the judicial system, we also found some unexpected differences. In almost all countries included in this review, the lower courts may either decide in favour of a particular party or may decide anything in between the positions of the two parties, while the Supreme Court only considers whether the decision of the lower courts is lawful. In Brazil, Korea and Norway, however, the situation in the lower courts resembles final-offering arbitration. The lower courts in these countries have very little authority (if any at all) to develop an independent view on whether the transfer pricing adjustment can differ from the adjustment proposed by the tax authorities or from the zero adjustment defended by the taxpayer.

Finally, we found quite a number of different answers to the question as to whether litigation requires the services of a lawyer admitted to the bar, as indicated in Table 5. It is interesting to note that some countries like Germany and the Netherlands answered that the litigation system has been designed in such a way that the taxpayer can represent himself.

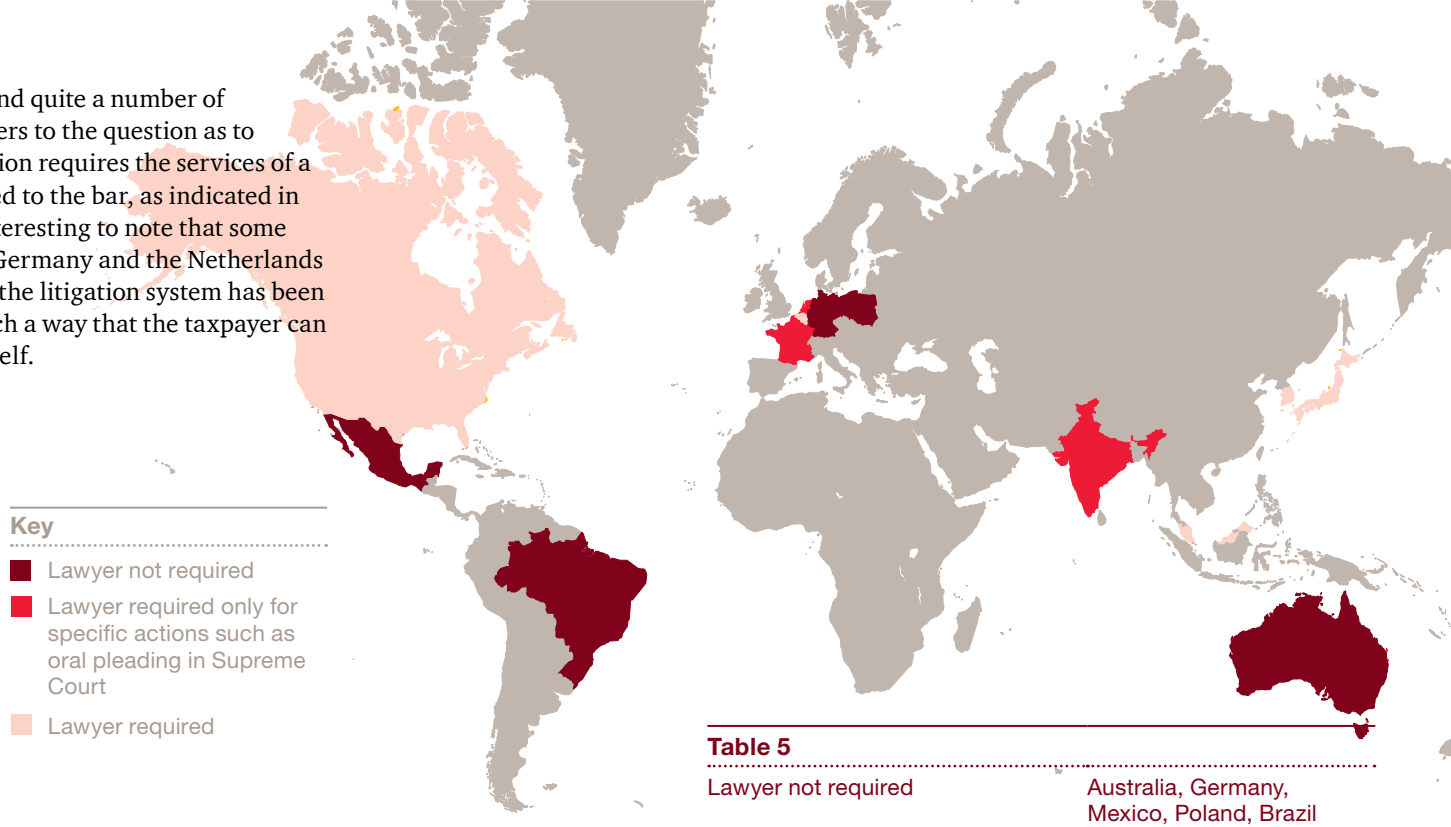


Table 5

Lawyer not required	Australia, Germany, Mexico, Poland, Brazil
Lawyer required only for specific actions such as oral pleading in Supreme Court	France, India, Netherlands
Lawyer required	Belgium, Canada, Japan, Korea, Malaysia, US

It may be a great advantage over litigation for the tax director to resolve all disputes in one effort, through negotiations.

Conclusion

The foreign tax director is often faced with the decision to accept the final settlement offer of the local tax authorities or to litigate the transfer pricing adjustment. From earlier disputes in the foreign tax director's home country, he or she is familiar with the hazards of litigation. This article has summarised additional topics to be taken into account when considering transfer pricing litigation in a foreign country.

In the preparation for our global transfer pricing conference, we found a number of significant procedural differences between countries that require tax directors to develop a country-specific strategy before bringing their cases to a foreign court.

Moreover, in the discussions between tax directors and PwC practitioners during the conference, attention was drawn to important aspects of other dispute resolution mechanisms. All those who put forward views expressed concerns that litigation may hinder company-driven change to the transfer pricing system, as it may be seen as a sign of weakness during litigation. A multinational corporation may therefore be locked into its current transfer pricing system as long as the litigation lasts.

In Australia and the Netherlands, the tax authorities recognise that if there is a contentious issue in the audit period, it is also likely to exist in later years. Therefore, in these countries, settlement negotiations also offer the opportunity to resolve the issue for more recent years, in addition to the years under audit. It may be a great advantage over litigation for the tax director to resolve all disputes in one effort, through negotiations.

Belgium, Mexico and the Netherlands reported that if a company is willing to consider a change of its transfer pricing system for future years, such behaviour is greatly appreciated by tax authorities and may help in reaching a settlement for the years under dispute in a more amicable way.

Germany, the Netherlands and the United Kingdom all offer enhanced relations programmes, and consideration must be given to how litigation fits into these programmes.

When considering how to resolve a dispute, it is important to bear in mind that there are also differences in the extent to which mutual agreement procedures are effective. Brazil, for example, does not have any system for mutual agreement procedures in place. In France, on the other hand, a mutual agreement procedure will result in the payment of the disputed tax being suspended without guarantees, while such guarantees are required during litigation. Likewise in Japan, payment of tax may also be suspended during a mutual agreement procedure, subject to a guarantee being provided (although no such suspension is possible for litigation). Japan and Germany have over 350 and 500 pending mutual agreement procedures, respectively, with some 100 being resolved each year for both countries. The Netherlands claims to resolve more than 90 percent of its mutual agreement procedures within two years.

The conclusion from the debate was that the decision of a tax director to settle, to litigate or to start a mutual agreement or arbitration procedure for a transfer pricing dispute in a foreign country must take into account many factors that differ from one country to another and even from one industry to another. Thus, it is important to keep an open mind to all possibilities and options when such a situation arises.

Pending mutual agreement procedures

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OECD – Transfer Pricing Guidelines

The 2010 update represents the most significant revision to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Guidelines) in over a decade. Although not binding upon taxing authorities, the principles set forth in the new Guidelines constitute the consensus view of the OECD member countries as to how the arm's length principle is to be applied. Since the updated principles are now in force for the many countries that apply the Guidelines, taxpayers will need to review the changes and consider what impact these have.

On 22 July 2010 the Organisation for Economic Co-operation and Development (OECD) approved changes to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Guidelines).
The main changes made to the 1995 Guidelines by the 2010 revisions are as follows:

- The replacement of the hierarchy of the transfer pricing methods and the adoption of the "most appropriate method" rule for the selection of the transfer pricing method (Chapter II);
- A detailed discussion of the importance of comparability standards (Chapter I);
- The nine-step process which the OECD sees as good practice in performing the transfer pricing analysis (Chapter III);
- The extension and refinement of the guidance provided on the application of the profit split method and the Transaction Net Margin Method (TNMM) (Chapter II); and
- The new principles on disregarding or re-characterising certain restructuring transactions, reallocation of risk and compensation for the restructuring itself (Chapter IX).

As a result of the changes, taxpayers should expect to see the following from taxing authorities:

1. increased challenges on the comparability of data used to support the application of one-sided methods (i.e. the TNMM, the resale price method, and cost plus method);
2. additional pressure to use, or at least to consider, the profit split method;
3. closer examination of the processes followed to establish or document their transfer prices;
4. requests to explain the options realistically available to the parties to a transaction;
5. examination of capability to control risks by the party which has been assigned the risks in the restructuring; and
6. more focus on intangibles.

'The new Guidelines emphasise the importance of a comparability analysis'

Priority of methods (Chapter II)
The basis for choosing one method over the others is now expressed as "finding the most appropriate method for a particular case." Considerations to be taken into account in determining the most appropriate method include:

1. the strengths and weaknesses of various methods;
2. the nature of the controlled transaction;
3. functional analysis;
4. the availability of reliable information needed to apply the method - in particular, data on comparables;
5. the degree of comparability; and
6. the reliability of any comparability adjustments that may be required or reasonable in the circumstances.

A degree of hierarchy is still maintained in that the CUP method is to be preferred to the other methods, and traditional transactional-based methods are to be preferred to profit based methods when they are "equally reliable".

Standards of comparability (Chapter I)
The new Guidelines emphasise the importance of a comparability analysis. The OECD expanded the guidance on the five comparability factors and linked it with the search for the most reliable comparables defined in Chapter III. The OECD sees the comparability analysis as an important step now that the TNMM method ranks equally with the traditional methods. Taxpayers should expect tax authorities to focus on the quality of comparability analysis in particular when the TNMM method is used and probably also when other one-sided methods (cost plus and resale price) are used. The Guidelines are also explicit in that the process of the comparability analysis should be methodological, consistent and finally transparent (i.e. one that tax authorities can examine, follow, and test when necessary).

The new nine-step process (Chapter III)
In addition to the five comparability factors, a new nine-step process for performing a comparability analysis has been added. This is as an example of how the stipulations and recommendations of the revised Guidelines can be applied in combination, in practice. While the nine-step process is not mandatory under the Guidelines, taxpayers should document their application of the comparability process based on the facts of the case. The revised text is explicit that merely following these nine steps in a formalistic way will not necessarily lead to an arm's length result and, conversely, that following a different process will not preclude an arm's length result. However, the inclusion of a process in the Guidelines will lead tax authorities to compare the OECD process with that which a taxpayer actually applies, and perhaps to challenge any differences or omissions. In many cases this will have the practical consequence that it would be advisable to follow the OECD process to ease the tax audit process.

The profit split method (Chapter II)

The revised text contains more detailed analysis on when the profit split method is likely to be the most appropriate method and, importantly, what its limitations and disadvantages are in practice, and how it should be applied.

The profit split method is appropriate where parties have highly integrated operations for which a one-sided method is not appropriate, or where more than one entity makes a valuable, unique contribution to the operation of a business. The profit split method is not ordinarily used in transactions when one party performs only simple functions and does not make any significant unique contribution. The revised text is explicit in expressing a preference for objective profit split factors (e.g., costs, assets, or other relevant contributions).

Taken together with the tighter approach to comparability that is likely to affect the TNMM more than the profit split method, the result of the elevation of the profit split method may be an increased use of it by taxpayers, or at least, more pressure from taxing authorities for taxpayers to do so. While the OECD stated that it did not intend to encourage broader use of the profit split method either as a primary method or as a form of confirming analysis, there is no such statement in the revised Guidelines. This is likely to encourage tax authorities pursuing a profit split approach during a tax audit.

'The revised text contains more detailed analysis on when the profit split method is likely to be the most appropriate method and, importantly, what its limitations and disadvantages are in practice, and how it should be applied'

Disregarding or re-characterising the restructuring transactions (Chapter IX)

The final text of the Guidelines states that the circumstances when a transaction would be disregarded are exceptional. It goes on to define exceptional as similar in meaning to “rare” or “unusual”, specifying that in most cases arrangements should stand as structured. Chapter IX uses the two tests regarding the recognition of transactions mentioned in paragraphs 1.64-1.69 of the Guidelines and applies them to the restructuring with the notion of options realistically available to the parties playing an important role.

The allocation of risks (Chapter IX)

The position of the Guidelines is that risk allocation should first be analysed against comparable evidence (to be searched for e.g., as part of the comparability analysis), showing how third parties actually divide risk in comparable transactions. If no such evidence is available (which is very likely), then it is necessary to determine how third parties might allocate risk. This determination is to be based on factors such as the location of control over risk and the financial capacity to assume the risk.

The compensation for the restructuring itself (Chapter IX)

The Guidelines state that:

1. an independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction of its profit potential; the question is whether there is a transfer of something of value, or a termination, or substantial renegotiation, and that would be compensated between independents in comparable circumstances;
2. if there is a transfer of something of value, then profit potential should not be interpreted as the profit or loss that would occur if the pre-restructuring arrangement would continue indefinitely; and
3. there is no presumption that a termination should give rise to an indemnification. All these things depend on the facts and circumstances of the case including the relevant rights and other assets together with the options realistically available to the parties.

So what does all of this mean?

The impact of the changes is likely to be felt in planning and implementation of transfer pricing policies because the OECD has now specifically addressed the treatment of a number of aspects for the first time. The change in the hierarchy of methods is unlikely to have a dramatic impact on taxpayers – the most immediate effect is likely to be found in terms of the focus on the quality of comparables analysis and the comparability of the data used. In the longer term there is likely to be more emphasis on two-sided analysis and pressure from tax authorities for some sort of profit split analysis in all but the simplest cases, in many cases to corroborate or even "disprove" the results of the controlled transaction.

‘The change in the hierarchy of methods is unlikely to have a dramatic impact on taxpayers’

As a result of the changes of the Guidelines, taxpayers should be more careful with the comparability process, documentation and justification of pricing policies.

Conclusion

As a result of the changes of the Guidelines, taxpayers should be more careful with the comparability process, documentation and justification of pricing policies. In addition, in case of a business restructuring, taxpayers should:

- thoroughly understand and document (qualitative and quantitative analysis) the business restructuring;
- manage uncertainty around the definition of intangibles in their particular circumstances; and
- implement control over risk and commercial substance.

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Documentation in a Changing World

Historically, the late ‘90s and early 2000s can be seen as the first wave of transfer pricing activity as many countries introduced specific transfer pricing rules and documentation requirements. Now, we are going through the second wave of transfer pricing activity– the enforcement of those rules, and an increase in transfer pricing audit activities.

At the same time, the economic downturn has led to lower tax revenues in multiple countries around the world, motivating tax authorities to maintain or to even expand tax bases.

Following the changing transfer pricing environment, three main areas around documentation now have to be considered by multinationals:

Compliance

A significant number of countries around the world now have formal transfer pricing requirements, such as information returns or special transfer pricing forms, and other disclosure requirements (typically prepared or filed by a third party). In many instances, such requirements are very stringent with respect to content and deadlines.

Proper documentation

Taxpayers should not only focus on having robust documentation in place ("TP reports"), but also on producing (or collecting) background documentation such as intercompany agreements, invoices and additional support for services.

Consistency

The increased coordination between tax authorities around the world means that, where appropriate, taxpayers have to ensure consistency in their methodology (i.e., the same transfer pricing method applied to similar transactions), and approach (i.e., the content of TP reports). Most importantly, this consistency should be reflected in the actual behaviour of the parties.

Regional Review

Companies today face increasing demands in most parts of the world around transfer pricing documentation. However we summarise below the current differences, pitfalls and best practices for specific regions.

Western Europe

Most Western European countries have already introduced transfer pricing regulations and have documentation requirements, with the exception of Belgium, Ireland (until the end of 2010), Norway and Switzerland. All of these countries accept the transfer pricing methods included in the OECD Guidelines and almost none of these countries use safe harbours, with the exception of Germany, Spain and the Netherlands (relating to thin capitalisation rules).

Transfer pricing audits were already on the rise before the current economic downturn and are now intensifying. In countries with long-standing transfer pricing regimes like the UK, Germany or the Netherlands, taxpayers must expect a greater degree of specialisation from tax inspectors. Tax inspectors now carefully screen corporate tax returns, as well as information obtained during the pre-audit meetings, to compare these with publicly available information including press releases, websites, and statistical data, among others. Tax audits very often focus on business restructurings, net operating loss positions, management charges and license agreements.

Documentation has become a very important starting point for a tax audit, and is generally considered to be the basis of further tax audit work. In general, tax authorities request detailed country-specific documentation, addressing issues like the necessity for compensation payments, the actual local functions and risk allocation, the reasons for net operating losses and the calculation scheme or benefit test for management and license fees.

The most common pitfalls around transfer pricing documentation are:

- excessive leveraging from existing foreign documentation without detailed local customisation;
- inconsistencies around the actual local function and risk profiles and the ones described in the foreign documentation, regarding the terms of agreements and the actual behaviour of the related parties; and
- inconsistencies between other sources of information (such as corporate income tax returns, financial statements, websites and company brochures).

One best practice around documentation is to provide a clear overview of the value chain, including the functional profile of the parties involved. Regional benchmarking studies with supporting local subsets are recommended, as well as the verification of the transfer pricing documentation for inconsistencies.

Central and Eastern Europe

The Central and Eastern European (CEE) region is truly heterogeneous, extending from the Czech Republic to Kazakhstan. However, formal documentation requirements are becoming more of a rule than an exception in CEE, with Poland as a pioneer back in 2001 and the long-awaited Russian regulations to be published in the near future.

Historically, tax inspectors in CEE countries assessed transactions based solely on the contractual framework, and not on the actual behaviour of the taxpayers. Tax inspectors today have moved away from this approach and focus more on local circumstances and actual dealings between related parties. In line with this trend, there are now greater expectations around the documentation. Although there are diverse documentation requirements across CEE countries, tax authorities all expect specific local documentation to reflect the actual behaviour of the related parties and in some cases even to provide local benchmarks. Furthermore, some countries are requiring a translation into the local language.

'In Western Europe, one best practice around documentation is to provide a clear overview of the value chain'

There are certain intercompany transactions and other transfer pricing-related issues that are typically investigated by CEE tax inspectors: provision of intercompany management services, benchmarking studies, net operating losses of routine companies, as well as year-end transfer pricing adjustments. In terms of the provision of management services, tax inspectors focus on the substance of the service and the benefit test rather than on the actual pricing. To successfully defend benchmarking studies, a detailed analysis of the search strategy and the selection of comparables is necessary. Net operating losses for routine companies must be justified in detail and year-end transfer pricing adjustments are rather difficult to defend as most countries don't have any provisions on their acceptability.

Furthermore, we have observed lately that tax authorities are collaborating more often and are using the exchange of information tools embedded in the double tax treaties and now the EU directives.

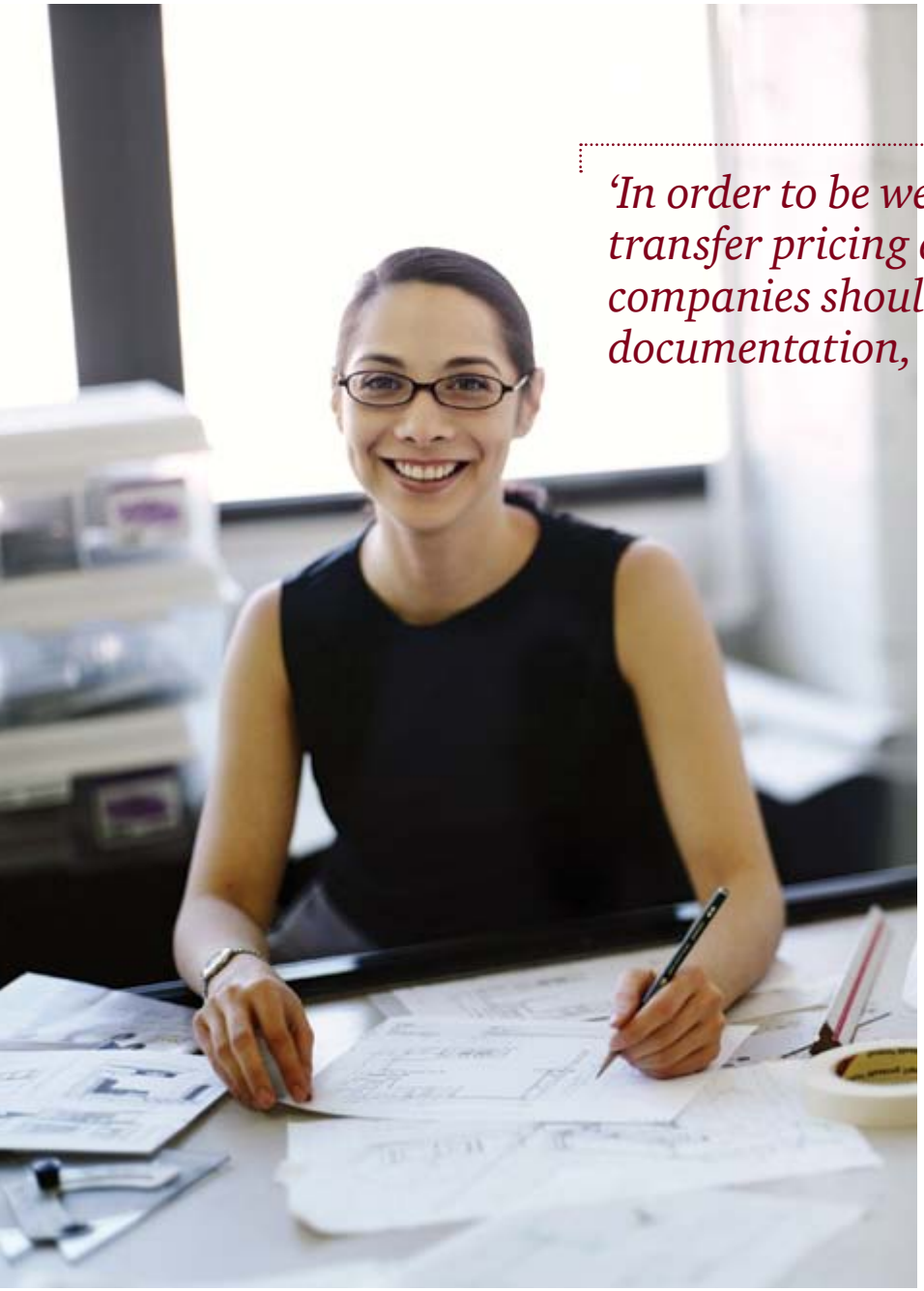
In some countries, rules may deviate from the OECD guidelines, e.g., in Russia and in Kazakhstan, where transfer pricing rules also apply to dealings with independent parties. However, in countries like Poland, Hungary, Romania, Czech Republic and Kazakhstan, applying for APAs could be one way to obtain more certainty around intercompany transactions.

Latin America

Transfer pricing regulations in Latin America are very formalistic and are primarily based on OECD guidelines, except in Brazil. Strict deadlines for transfer pricing compliance, especially regarding special information returns and submission of transfer pricing reports, have to be kept to avoid certain penalties. In addition, in countries like Mexico and Peru, domestic intercompany transactions must also comply with the arm's length principle. In Mexico, taxpayers should consider that the deductibility of intercompany service costs (e.g., management fees), based exclusively on a pro rata basis, will be challenged and considered as a non deductible item.

There has recently been a significant increase in tax audit activities. Tax authorities are sharing information both internally, with other local government authorities, such as Customs or the Central bank, as well as externally, with foreign tax authorities.

'Transfer pricing regulations in Latin America are very formalistic and are primarily based on OECD guidelines except in Brazil'



'In order to be well prepared for the changing transfer pricing environment in Latin America, companies should prepare robust and thorough documentation, on a timely basis'

In addition to the common pitfalls already highlighted in Western Europe the use of US GAAP over local GAAP often creates difficulties in tax audits, because local GAAP is required for tax filing purposes.

In order to be well prepared for the changing transfer pricing environment in Latin America, companies should prepare robust and thorough documentation, on a timely basis. Documentation needs to be consistent with the specific transfer pricing policy, filed tax returns and publicly available information, and should reflect local GAAP financials.

USA & Canada

Transfer pricing documentation should be available in Canada and USA at a certain date after the fiscal year end. Such documentation should demonstrate that pricing policies and intercompany agreements have been followed. In Canada, the documentation must contain functional analysis that appropriately reflects the Canadian business activities, and comparables that consider relevant comparability factors and follow a selection process in accordance with Chapter III of the OECD revised guidelines. In the US, upon request, taxpayers must provide within 30 days sufficient transfer pricing documentation demonstrating to the IRS that the method applied provides the most reliable measure of an arm's length result.

A significant number of APAs in multiple industries have already been submitted in both countries. The average duration for completion of a bilateral APA takes more than 3 years in USA, and approximately 4 years in Canada, due to lack of resources and increased APA filings during the economic crisis. Not surprisingly, the most common type of transaction is the import of finished product for resale in local markets (i.e., distribution), with the most common transfer pricing methodology being the Comparable Profit Method ("CPM") or Transactional Net Margin Method ("TNMM"). The typical profit level indicators are the operating margin (or return on sales - ROS) and berry ratio.

'In China & Asia Pacific, documentation requirements are rather extensive, and very prescriptive'

In December 2010, pursuant to the recent Canada/US Income Tax protocol, companies are now eligible for arbitration for cases that have been unresolved for 2 years.

Transfer pricing is an area of high interest for the tax authorities in both Canada and USA, and this has been reflected in a number of recent court cases. In Canada, GlaxoSmithKline addressed objections raised by the tax authorities against the pricing of a blockbuster drug. GE Capital prevailed with the tax authorities on an issue regarding guarantee fees. In the US, the Veritas case was a big win for a US taxpayer as the tax court challenged the IRS valuation of certain intangibles. And it was finally decided in the Xilinx case that stock options do not need to be included in the pool of costs shared in a cost-sharing agreement.

China & Asia Pacific

New transfer pricing regulations have been introduced recently in China, Japan, Hong Kong, Malaysia and Korea. In certain cases, however, the requirements are not mandatory (for example, Hong Kong). The documentation requirements are rather extensive, and very prescriptive, and often have to be followed line-by-line. Additionally, local language requirements need to be considered as non-compliance leads to significant consequences. What is worth a mention is that the Chinese tax authorities stipulated that single function/routine entities should not have losses (Circular 363). Currently, the most controversial transfer pricing area in Australia is a nearly finalised taxation ruling from the ATO on the interaction between thin capitalisation and transfer pricing. In New Zealand, tax authorities focus on intra-group financing and the "importation" of losses through non-arm's length pricing considering the overall profitability of the controlled entity.

Regarding tax audit approaches, tax inspectors have become more aggressive and they often challenge benchmarking studies or raise permanent establishment issues. In addition, local tax authorities have become more sophisticated around issues such as location savings and market premiums. As a result, tax authorities are moving more and more away from the use of TNMM. From their perspective, market benefit should be factored in and, therefore, be part of the transfer pricing methodology.

Another factor to consider is that, contrary to the situation of other regions, China, as well as other Asian countries, has recently been experiencing strong growth despite the worldwide economic crisis. Thus, there is also a strong resistance to accept losses for controlled companies operating in this region.

Pitfalls that could discourage taxpayers include the filing of the documentation in local language, the necessity for local comparables and the reluctance in accepting at least some losses for routine companies.

APAs are becoming more popular in countries with more experienced local authorities, such as Australia, China, Japan and Korea, both as a way of protection and also as a good way to achieve certainties.

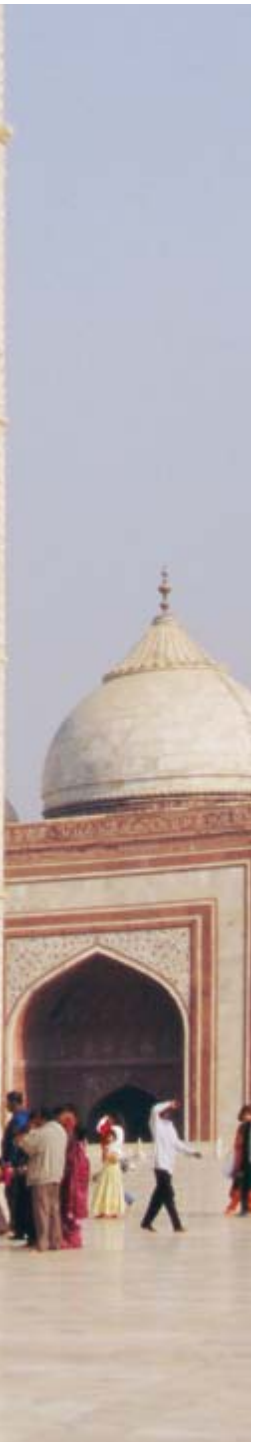
In addition, it is worth bearing in mind that the OECD guidelines are not always followed, or interpreted, in the same way as in the rest of the world, as domestic law is preferred (and prevails) where there is a conflict.

India

Indian transfer pricing regulations prescribe mandatory maintenance of information and documents ('documentation') for all entities entering into international transactions. The robust documentation must exist by the due date of filing the tax return and must be updated annually. Next to the documentation of strategies, group policies and assumptions made while arriving at the transaction price, a separate documentation of the roles and responsibility of each associated entity per transaction is mandatory ('transactional approach'). Other common pitfalls in India include the lack of availability and maintenance of transfer pricing data, and the wrong choice of tested parties as well as the absence of intercompany agreements.

The main tax audit issues in India are: marketing intangibles, management service fees and losses made by start-up companies. In the course of transfer pricing audits, it is also very important to have robust documentation around topics such as the provision of a benefit test or transfer pricing calculation method, as well as reasons for any change of the transfer pricing method or the cost allocation method.

'The main tax audit issues in India are: marketing intangibles, management service fees and losses made by start-up companies'



...transfer pricing documentation is becoming increasingly important...

Conclusion

Tax authorities are increasingly coordinating their approaches worldwide and are specialising in transfer pricing by sharing information and by focusing on the analysis of the economic substance and purpose of intercompany transactions. As a result, transfer pricing documentation is becoming increasingly important, not only for compliance purposes, but also for supporting taxpayers' positions under transfer pricing audits. There are a number of transfer pricing best practices to observe in the current environment, which include having an in-depth understanding of related-party transactions, being aware of the local environment, anticipating deadlines and controversial situations and employing written intercompany arrangements.

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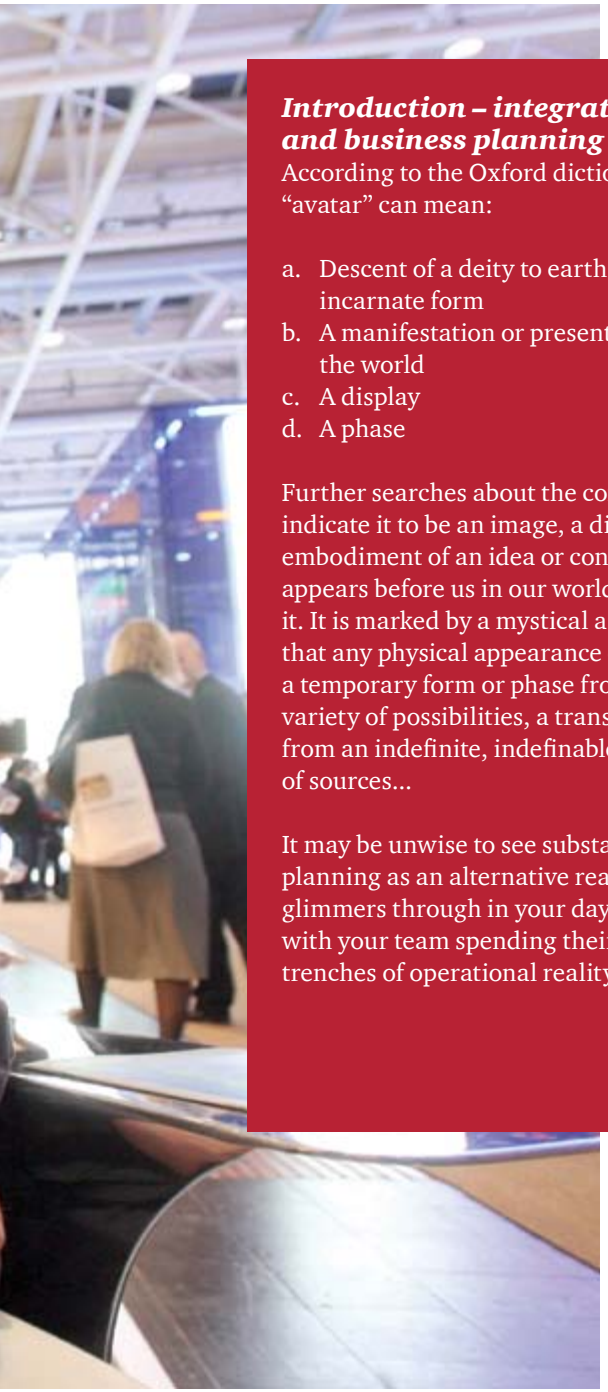
Value chain transformation – avatar or reality?



Introduction – integrated tax and business planning

According to the Oxford dictionary, "avatar" can mean:

a. Descent of a deity to earth in an incarnate form
b. A manifestation or presentation to the world
c. A display
d. A phase

Further searches about the concept indicate it to be an image, a display, or the embodiment of an idea or concept that appears before us in our world as we know it. It is marked by a mystical aspect meaning that any physical appearance of an avatar is a temporary form or phase from an infinite variety of possibilities, a transient form from an indefinite, indefinable number of sources...

It may be unwise to see substance-based planning as an alternative reality as it glimmers through in your day-to-day life, with your team spending their time in the trenches of operational reality.

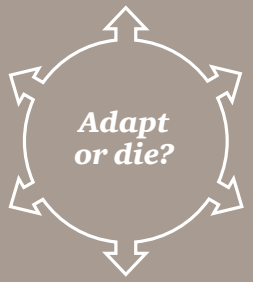
Tax directors are becoming increasingly concerned with the international footprint of their company and are seeking to ensure and sustain a competitive edge. One way this competitive edge can be sustained is through *Value Chain Transformation (VCT)*. This is a process which includes organisational, business and process system changes and aligns the legal structure, tax planning and transfer pricing with a new organisation, marked by consolidation of entrepreneurial oversight in one or more key entities. VCT can assist companies with an international footprint as they unwind and re-assemble their value chains in order to maintain a competitive edge.

'Tax directors are becoming increasingly concerned with the international footprint of their company'

Why MNCs are focusing on VCT business models now

Responding to "Globalisation"
- Competitive pressure on tax rate
- Cost pressure
- Product harmonisation
- Risks inherent in divisional centralisation/local profit
- Need for common/single focus
- Tax rate pressures doing business in "difficult" markets
- Partial reversal of centralisation?

Responding to OECD directive of arm's length directive
- Significant people functions
- Business restructuring



Responding to simplification agenda
- Increased I/C transactions
- Treasury complexity
- Complex legal structures
- Multiple tiers of decision making

(In Europe) responding to EU opportunities
- Cross border asset transfers
- CFC / reform
- Societas Europaea
- Mergers Directive

Responding to downturn
- Margin / EPS pressure
- Lower multiples de-risk exit

Responding to technical challenges/aggressive tax authorities
- Debt pushdown attacks
- Double dip attacks
- Running to stand still

Key tax fundamentals are aligning ...transfer pricing / PE profit attribution / controlled foreign company rules ...& its all about SUBSTANCE

'An increasing number of tax authorities are paying attention to the topic of Business Restructuring and its related cousin "substance"'

As tax practitioners, we will focus in this article on a number of tax themes that are increasingly dominating your agenda, particularly those issues affecting VCT. Typical examples are Permanent Establishments (PEs); the allocation of (entrepreneurial) risk among the various affiliates; and the transfers of such risks, all the while ensuring that the "functional profiles" of the respective group entities are fully aligned with the desired tax structure. The functional profile of a "principal entity" in an entrepreneurial structure shares some attributes with what is better known in common parlance as the "substance" debate.

An increasing number of tax authorities are paying attention to the topic of Business Restructuring and its related cousin "substance". As we discussed in our previous artice, OECD - Transfer Pricing Guidelines, the OECD is one of the key bodies to "set the rules of the game" and issued guidance in July 2010 through a new Chapter IX on "Business Restructurings" in its Transfer Pricing Guidelines.

This article provides some commentary on (i) new concepts that must be considered in the context of the OECD guidelines on business restructuring; (ii) Permanent Establishments in a business restructuring context, and (iii) recent actions and practices of tax authorities.

A Changing world – New concepts to deal with in the context of the latest OECD developments on business restructurings

Introduction: What can tax authorities do?

The new guidance on business restructurings, as laid down in the new Chapter IX, contains significant language that will cause taxpayers to think thoroughly through the drivers, processes and ultimate aims of a contemplated restructuring and to develop a substantial amount of qualitative information.

Tax authorities, when analysing business restructurings, may take the opportunity to revisit or even attempt to unwind a transaction, and will need to be carefully convinced of the business purpose of a restructuring. Indeed, the new guidelines specify that tax authorities are not allowed to question why the taxpayer engages in a certain transaction. However, through the introduction of new concepts such as "commercially rational behaviour", the tax authorities risk becoming fairly judgmental of the way a taxpayer has structured their business operations.

The current debate on business restructurings started in 2005 with a plea from tax authorities to obtain more legal and/or administrative ammunition to combat (deemed) "abusive restructurings".

When confronted with a business restructuring where an enterprise in its jurisdiction is "stripped" from risk and/or functions, a tax authority can probably consider three approaches to audit or challenge the transaction. Firstly, it can simply try to ignore the business restructuring. Paragraph 1.65 of the OECD guidelines specifically states that tax authorities can only disregard the transaction in "exceptional circumstances". Another route that authorities might explore is to accept the restructuring itself, but to challenge it based on arguments that the taxpayer has disposed of "something of value" so as to levy what is called in common parlance a capital gains tax or an "exit tax". A very good example of this approach can be found in the German so-called "transfer package" legislation. A third option for tax authorities is once again to accept the restructuring but challenge specific aspects of the transaction based on transfer pricing arguments, i.e., purely on pricing and/or even argue that a taxable presence of the transferee is created further to the conversion via a Permanent Establishment (PE).

The transfer of "something of value" vs. the transfer of Profit Potential[1]

One of the most pressing issues to address is whether an enterprise, upon restructuring is transferring "something of value" for which a third party would be willing to pay. You may indeed expect a third party to be only willing to pay provided a sufficiently identifiable asset was transferred that would have value to an unrelated party. The new guidance in the OECD Chapter IX provides several positive statements:

"An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction of its profit potential or expected future profits. The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits. The question is whether there is a transfer of something of value (rights or other assets) or a termination or substantial renegotiation and that would be compensated between independents in comparable circumstances."[2]

"[If] there is a transfer of rights or other assets or of a going concern then "profit potential" should not be interpreted as the profit or loss that would occur if the pre-restructuring arrangement would continue indefinitely."[3]

[There is to be] "no presumption that a termination should give rise to an indemnification. This depends on rights and other assets and options realistically available." Moreover, "the arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits."[4]

'One of the most pressing issues to address is whether an enterprise, upon restructuring is transferring "something of value"'

These candid statements are highly welcomed, but the concept of the transfer of "something of value" looks deliberately vague. Most likely, the reason for this lies in the fact that in the autumn of 2010, the OECD embarked on a project on the Transfer Pricing aspects of intangibles which may include on its ambitious agenda the definition (or at least the characterisation) of what is meant by "intangibles". The term "something of value" is probably deliberately intended to be broader than just transfers of property interests. This potential broadening of the commonly-accepted definition of intangibles may raise concerns as this may open the door to legislators to codify mere "value drivers" as intangibles, such as a skilled workforce in place, first-mover advantage etc.

The Guidelines also provide relevant guidance given for the transfer of an activity, where an issue of "going concern" may arise. The guidance states that it is necessary to have transferred a "functioning, integrated business unit," which is further defined as a "transfer of assets bundled with the ability to perform certain functions and bear certain risks". Some examples are given, but this is also likely to be an area where uncertainty may arise.

While analysing whether sufficiently identifiable assets have been transferred, it is necessary to consider assets that are relevant and significant in the business and not just which ones are legally protected. The Guidelines recommend considering "soft intangibles" or what are often considered as "value drivers". The OECD did include some helpful statements in the guidelines about how MNCs can have sound reasons to transfer intangibles whilst also advising that the effect of the transfer be considered both from a transferor and transferee's perspective.

The topic of transfer of entire activity addresses the key attributes of a "going concern", of which the valuations tend to be done in the aggregate. There is an increasing threat of "package valuations" that risk resulting in over-apportionment of taxable profit to those countries with the most rigid legislation. An illustration can be found in the aforementioned German rules on the transfer of functions.

[1] Adapted with permission from BNA Transfer Pricing Report, Vol 19, Copyright 2010, The Bureau of National Affairs, Inc. (800-372-1033) "http:// www.bna.com", from the article "Final OECD Guidance on Restructurings: A Precious Balance" by Isabel Verlinden and Ian Dykes.
[2] OECD guidelines, par. 9.65. [3] OECD guidelines, par. 9.67. [4] OECD guidelines, par. 9.65.

The discussion above also implies that attention should be paid to "indemnification", as characterisation changes from e.g., a full risk entity to one with a more limited profile. A careful analysis of the contractual obligations is an important starting point. Actual conduct of the respective parties is, however, also an element which tax inspectors may scrutinise thoroughly. Long term contracts among unrelated parties do not necessarily require compensation upon termination. The "relative bargaining position" of the parties will be an important element in considering the need for an indemnification. For example, if it is easy to find alternative providers as the sector of activity is marked by excess capacity and/or rather routine technical competence, then an indemnification may not be warranted. Under the concept of "relative bargaining position" tax authorities may want to question what the real strength is in terms of negotiation and bargaining power amongst affiliates and then decide whether or not the restructuring should be challenged. In this respect, the 2009 case of DSG Retail vs. HMRC gives more insight. The relative bargaining position of the parties, and particularly the value attached to the "point of sales advantage" of the local affiliate, formed the basis of a tax assessment based on imposing a profit split to the detriment of a unilateral transfer pricing method.

The concept of "options realistically available"

The question about the "options realistically available" to the converted entity comes into play. Unfortunately the OECD guidelines do not accept that a restructuring simply makes sense at the level of the group. Instead, an analysis at the level of the restructured entity is required. As the very essence of a MNC is to reap the benefits of vertical integration, the question "what are the merits of considering purely hypothetical options?" may be asked. The concept of "options realistically available" seems to build on the economic theory of opportunity cost and rational decision making. You may assume a decision to be rational from a MNC's perspective, if it increases its value on an aggregated basis. The decision to streamline is probably rational as it is expected to have a positive net present value and makes sense from an opportunity cost perspective (referring to the value of the next-best alternative, which was the option not to engage in the restructuring). The new Chapter IX requires that both parties engaging in a business restructuring, i.e., the transferor and the transferee should both assess their realistically available options. This would imply that both would need to value the restructuring on a net present value basis and then engage in a transaction but only if they are both not worse off compared to their respective next-best alternative.

In this case, what is the "next best alternative" for a "full-fledged" entity which is converted to an entity with reduced functions and risks? The "next best alternative" may be "not to engage in the restructuring" which then may even mean that one is forced to ultimately cease operations in a competitive environment, unless there are strong contractual protections against any change of operations.

The threat of non-recognition

Some have perceived an increased risk of tax authorities using the latest OECD developments to actually try to challenge standard tax planning structures. One particular paragraph which has been in the OECD guidelines since 1995 (paragraph 1.65 in the July 2010 version) states that in "exceptional cases" tax authorities can actually disregard a transaction: when the actual conduct of the parties is not in line with the form, or alternatively where actual conduct and form do coincide but are believed to be non-arm's length. The increased focus on this paragraph is a rather troublesome development and risks to being used in a rather "abusive way" by aggressive tax authorities to maximise the collection of taxes.

'A careful analysis of the contractual obligations is an important starting point'

'MNCs can organise business operations as they see fit without having tax administrations dictate how to design and structure their operations'

The new Chapter IX states that in the context of the arm's length principle (as embedded in Article 9 of the OECD Model treaty), the analysis should start from the transaction actually undertaken by associated enterprises. MNCs can organise business operations as they see fit without having tax administrations dictate how to design and structure their operations. Also, it is acknowledged that tax considerations may be a factor in MNCs acting in their own best commercial and economic interest, subject to the above limitations that could come into play in "exceptional circumstances".

"Exceptional" means "rare" or "unusual" and the guidelines state that in most cases it is expected that the arm's length principle can be satisfied by determining an arm's length price for arrangements actually undertaken and structured.

Simultaneously, the OECD recognises that related parties should behave as would be expected from unrelated parties when negotiating and agreeing to the terms of a particular arrangement.

This paragraph may lead to further analysis and even controversy, as the lack of a uniform approach to the application of the "exceptional circumstances" has been a growing concern. This issue is addressed in Part Four of the new Chapter IX with a view to providing more guidance on what is meant by "exceptional circumstances". The OECD seeks to strike a fair balance between the unique features of MNCs on the one hand and the need to safeguard consistency with what independent enterprises in similar circumstances (though without synergy benefits), would do on the other.

The mere fact that an associated enterprise arrangement is not seen between independent parties does not imply that it is not arm's length. The determination of what independent parties might have been expected to do should be based on their "realistically available" options – that is, on the notion that independent enterprises will not enter into the transaction if they see an alternative that is clearly more attractive, taking into account all the relevant conditions of the restructuring. Unfortunately, this concept is accompanied by another new concept, the expectation of "normal commercial behaviour" which may also pave the way for controversy.

Risk allocation and transfer of risk

When setting up principal operations, taxpayers usually take the view that the risk has been transferred from a local entity to the principal while the former becomes a limited risk entity.

The guidelines advise tax authorities to pay proper attention to what is risk and how it can be managed and valued. The key question is whether the principal has control over the risk. It should have the capabilities and authority to actually take the respective decisions. The second element is the financial capacity, i.e., whether the principal has the financial capacity to assume the consequences of a risk materialising. An example could be product liability where, after converting a manufacturer into a contract manufacturer, the principal assumes product liability risk.

The guidelines also make the point that the day to day management of risk can be outsourced and provides good illustrations. Two examples are given, i.e., related to a fund manager and a contract R&D provider respectively.

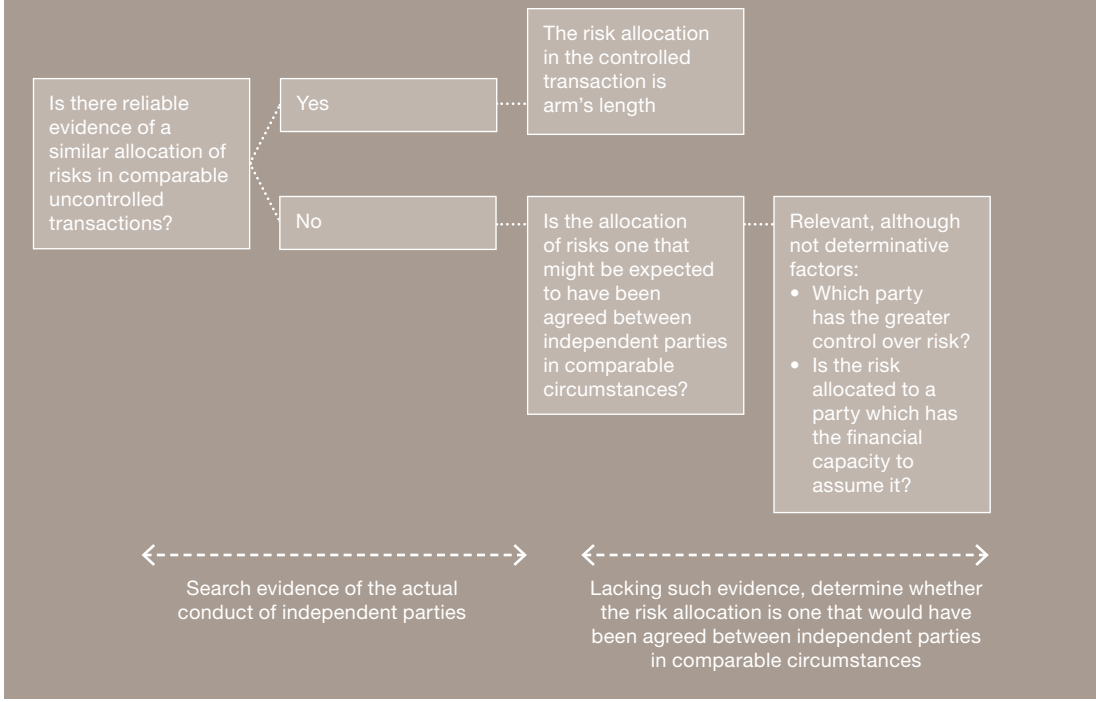
The examples provide three key criteria for the principal being respected as a risk bearing enterprise in such circumstances: if the principal (1) takes the original decision to hire or fire the manager or the contract R&D contractor, (2) provides guidelines for the services provider, and (3) allocates funds to put at risk in the market. In both cases there is an implication that reports would be fed back to the principal as a risk taker.

The other issue is whether the risks being transferred are really economically significant, i.e., whether those risks really carry profit potential in the particular enterprise/industry. For example, when inventory risk is transferred from a distributor to a principal, the question should be raised whether there has been a past history of inventory obsolescence, whether there is a possibility to insure those risks and what the corresponding cost of insuring the risk is etc.

Another point to consider is a potential tension between specific risks attributed to local entities and global risks that affect the whole company and cannot be assigned to particular entities. The example may be supply risk, where the supply chain is disrupted if there are many entities in the supply chain. This question basically touches on how realistic it is to assume that risk is not diversified throughout the MNC entities and is instead concentrated in one legal entity, i.e., the principal. This question requires in-depth analysis, as arguments can potentially be made depending on the actual level of risk diversification, to impose a profit split approach. We expect these topics to be one of the main areas of discussion with tax authorities in the not too distant future, if not already the case.

Figure 1

OECD Paragraph 9.33 - Determining whether the allocation of risks in a controlled transaction is arm's length



Permanent Establishments in a business restructuring context

As already mentioned, one of the practical routes for tax authorities challenging the tax effects of the restructuring is through the assertion that a Permanent Establishment (PE) of a foreign transferee has been created in the local jurisdiction after the conversion. The tax authorities' approach to the PE aspects of the restructuring varies country-by-country and different aspects or scenarios may expose a given structure to a PE risk in particular jurisdictions. It is of utmost importance to understand these risks, in particular when operating in "emerging markets" where the approach to more complex structures or concepts may not yet be well established.

Asian emerging economies

The PE concept has been used as a tool by tax authorities who are concerned about the shifting of profits out of their local jurisdictions to principal structures which tend to be located in low tax jurisdictions. India is a prime example of a jurisdiction which is already focusing on PE as a tool to verify substance and the movement of functions, risks and assets abroad. With this in mind, it should be noted that the Indian tax authorities do not present a coherent approach to the PE concept. This concept is changing as illustrated in the following cases.

The above example shows how the concept of PE has evolved in order to attack the centralised models. The Seagate example is one of the recent cases in India. Seagate International, the principal located in Singapore has a business and transfers products into India where it sells to third party customers. Physically, the products are sent to a third party warehouse, where a specific space is kept aside by the third party in order for Seagate to keep its products there, manage its inventory, package and ensure quality. In this case the Indian advanced ruling regime recognised Seagate's PE in India taking into account separation of the storage area dedicated to Seagate and the scope of activities that Seagate was performing.

With the broadening understanding of the PE, this ruling is a surprise and causes concern because typically, having product stored in a third party warehouse, is not considered to create a PE. On the other hand, a slightly contradictory point of view was presented by the Mumbai tax tribunal in a similar case. Rotables UK sent spare parts to one of its customers' warehouses in India. The set of facts that differentiates Rotables UK from the Seagate case is that in the former, the foreign entity has no right to use the place, nor was it carrying out business there and had no distinct right to enter the warehouse. Taking these circumstances into consideration, the tribunal ruled that holding inventory in the warehouse did not constitute a PE for Indian PE purposes.

Comparing both cases, contradictory positions of the Indian authorities can be seen. Therefore, the lesson to be learned is that when performing business restructurings in India (but also other locations) you need to be very careful and aware of the changes to understanding a PE and its role as a tool by tax authorities to verify substance in centralised models.

Figure 2

Contradicting positions on whether warehousing in India will create a PE

Seagate Singapore International (Authority for Advance Rulings)

- Fixed place of business though owned by a 3rd party is a distinct, earmarked and identified place
- Applicant's representative had right to enter the warehouse for physical inspection, audit, repackaging, etc
- Revenue contested that applicant has a fixed place PE in India

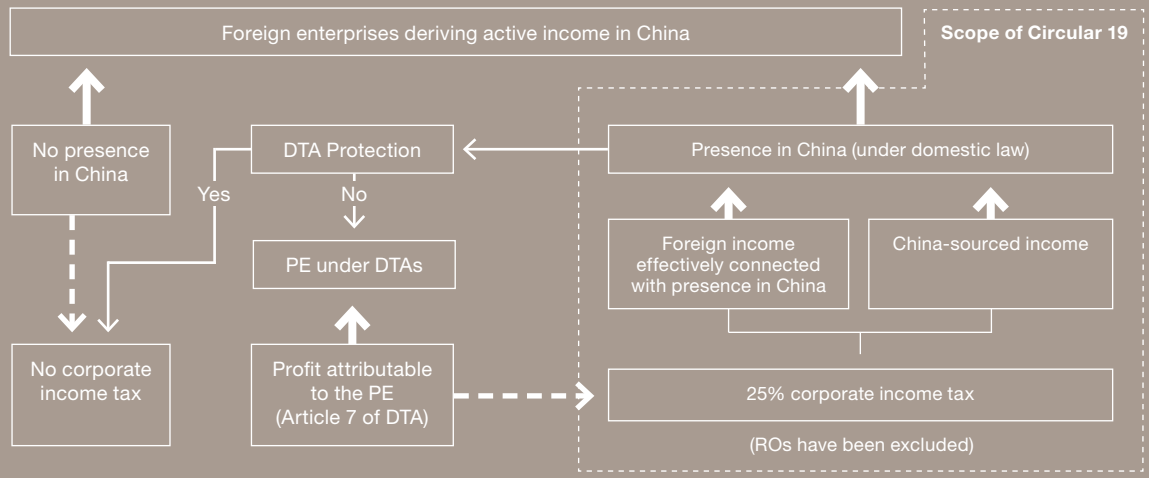
Airlines Rotables Ltd, UK (Mumbai Tribunal)

- Mere existence of physical location is not enough
- The location should be at the disposal of and use of the taxpayer
- Simple maintenance of stock at customer's location for standby use does not constitute a PE in India

Similarly, China presents us with a growing and changing role of PE. Recently, the Chinese Tax Authority issued a new Circular 19 specifically looking at enterprise tax on service companies which may or may not have a presence in China but which are providing services where the source of income is located in China. In this regard, Circular 19 ensures that these types of construction, engineering or management companies keep specific constructive accounts of income and expenses incurred in China. Where specific accounts are not kept, Circular 19 provides for a deemed profit method to be used by the SAT to actually construct a taxable income for these types of service companies, either using the gross income method, the cost plus method or the expenditure plus method. The Circular notes that the profit rates on these methods can be very substantial, reaching 15% to 30% in the case of construction projects, 30% to 50% for management services and 15% or more for any other service or business activity.

Figure 3

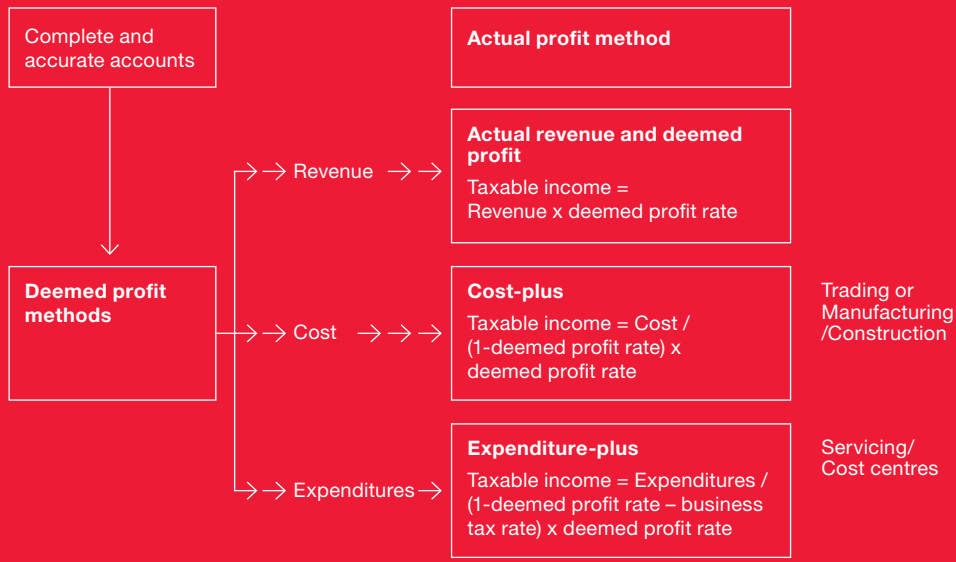
New Taxation Rules for foreign companies deriving income through establishments or places (presence) in China issued via a circular



Note: Methods for determination of the attributable profits of presence is in line with Article 7 of DTAs

Figure 4

Approach for calculation of corporate income tax



Central and Eastern Europe (CEE)

Operating in CEE, significant differences between local PE concepts and the situations or structures typically triggering the creation of the PE, need to be recognised. The below table summarises major PE concepts to be met in the CEE region.

It is also worth noting that tax authorities' expertise and sophistication in tax audits has been increasing significantly, compared to recent years when the PE issue was rarely identified or recognised by the local tax authorities. One recent case in Poland concerned a branch of a Danish entity which deemed to create a PE. According to the tax authorities, since the branch had the authority to conclude contracts on behalf of the head office, it created a PE regardless of whether or not the branch actually executed this right in practice. In their view, by having the authority to legally bind the head office, the branch influenced its business significantly. This conclusion was further confirmed by the administrative court. To this end both the authorities and judges disregarded the facts that the branch actually only issued proposals to its clients, while the clients put in orders directly at the head office in Denmark and then concluded respective agreements with the Danish head office.

Another real-life example concerns two Polish entities – a commissionaire and a contract toller - operating under a Swiss principal. Surprisingly, the tax authorities concentrated on the toll manufacturing part in order to analyse the potential existence of the Swiss company's PE. While the tax authorities were comfortable with the toll manufacturing agreement itself and owning the stock locally – in respect of both they confirmed that such operations do not create a PE – at the same time they concentrated strongly on the Polish entity's participation in negotiations of purchase contracts on behalf of its principal which, in their view, created a taxable presence of the Swiss entity in Poland. In conclusion, they stated that the PE is created by the toll manufacturer (taking part in negotiations of purchases) and in consequence, sought to attribute to this PE the full profit associated with the manufacturing activity conducted in Poland.

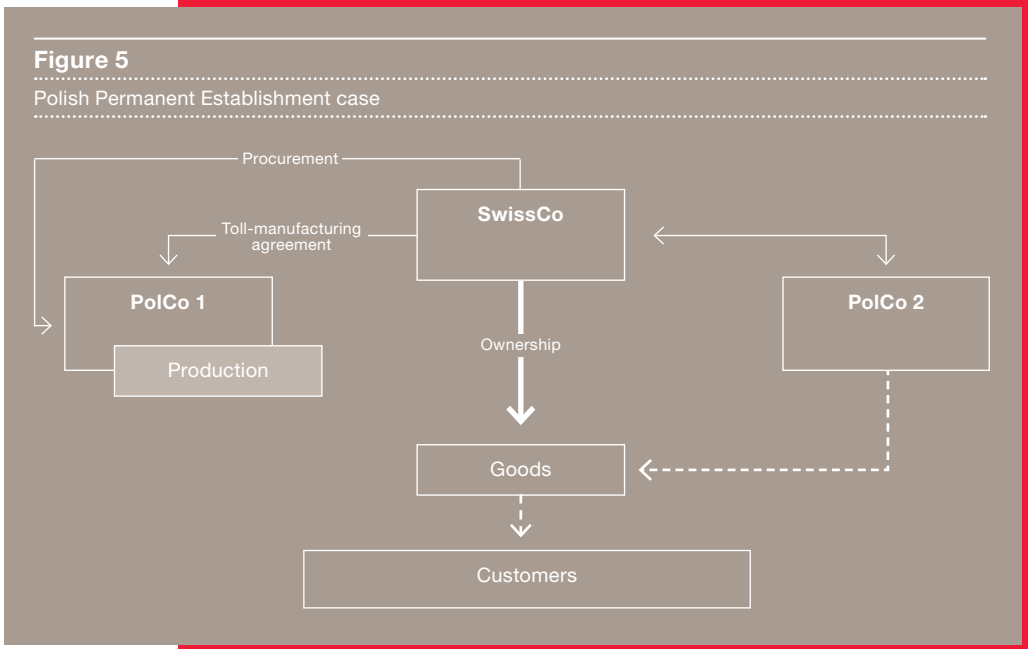
Major PE concepts to be met in the CEE region.

Concepts	Countries
Construction PE	Romania, Slovakia, Macedonia, Czech Republic (6 months), Estonia, Latvia, Russia, Poland, Lithuania (not specified), Hungary (3 months), Slovenia (12 months)
Supervisory activities related to construction/installation	Hungary, Latvia, Macedonia, Romania, Slovenia
Detailed / Specific agency PE clause	Russia, Slovakia, Slovenia, Latvia
Agency PE – delivery of goods from stock	Macedonia, Romania, Russia, Hungary
Service PE	Czech Republic (6 months in any 12 months period), Latvia (30 days in any 6 months), Macedonia (longer than 90 days in any 12 months), Russia (not specified)
Insurance PE	Hungary
One-off activity performed for a defined period of time	Slovakia
PE related to cross-border reorganisation	Romania
Offshore activities PE	Latvia, Lithuania

Source: PwC survey of PE concepts in 11 countries of the CEE region: Czech Republic, Estonia, Lithuania, Latvia, Hungary, Macedonia, Poland, Slovakia, Slovenia, Romania and Russia. The survey was completed September – November 2009.

Figure 5

Polish Permanent Establishment case



Recent tax authorities practice

It's all about substance

Experiences in Asia show that "substance based planning" is becoming increasingly important. Tax authorities want to see evidence of substance in a sense that they look at what has actually changed in terms of movement of certain functions, assets and risks associated with e.g. marketing and R&D from a local entity to a principal. Companies need to demonstrate to tax authorities in an audit context that "the control over certain functions" associated with R&D and marketing, and the decision making around product mix, marketing materials, go-to-market strategy, the schedule of R&D and the processes have effectively been moved. This requirement may go beyond what tax practitioners tend to include in transfer pricing documentation and inter-company agreements. Recently, the tax authorities' focus is down in the detail of the organisation design and often the processes themselves. Some of the documents we have seen tax authorities ask for recently, in terms of trying to establish whether transfer pricing substance exists or not, include:

1. RACI Charts – describes the participation by various roles in completing tasks or deliverables for a project business process;
2. Position descriptions;
3. Reporting flows;
4. Board and senior management papers;
5. Organisational charts; and
6. IT process maps.

These types of documents allow us to show that during the restructuring, decision making and control, these particular "value added functions" actually moved from the local country to the principal location. In summary, substance as a concept is critical, substance in evidence may be hard to document and can be quite time consuming upon field tax audits.

'Experiences in Asia show that "substance based planning" is becoming increasingly important'

Change management challenges and critical success factors

Structuring

- Right balance between operational, functional and specialist consulting resources
- Constant and consistent communication flow to all involved parties, management and stakeholders about the progress of the VCT project

Tax and Legal

- Hard link of tax and legal staff into the project from the beginning
- Complete understanding of the facts, objectives, transaction flows, business processes, legal structure by the tax team

Technology

- Early understanding of IT implications and willingness to resolve systems issues

Strategy

- Operational benefits are the key driver for change
- Clear and transparent definition of roles and responsibilities in future operating model

Process

- Adequate resources from all parts of the business that have a stake – at all levels
- Time and senior management effort for key and sensitive steps (e.g., building the detailed final organisation design)

People

- Careful HR management to accomplish headcount targets whilst maintaining critical project resource and motivation

You should also be aware that principal models may not work at all in some jurisdictions. This is an area of particular concern within emerging economies. The BRIC countries can serve as a good example, though this can be extended to places such as Argentina, Indonesia or Vietnam. What all these jurisdictions have in common is they all have foreign exchange controls. In cases where a domestic manufacturer sells to a domestic distributor and where the product never leaves the jurisdiction, it is very difficult to impose a principal structure directly in the supply chain.

In the United States, transfer pricing is also very high on the radar screen of tax authorities and even policy makers. Congress held hearings on transfer pricing, specifically on offshore principal structures in 2010 and the issue is recognised in the president's 2011 budget proposals. In the IRS internal reorganisation of 2010, the role and authority of transfer pricing specialists is growing. Increasing pressure on transfer pricing, especially in relation to outbound transfers of intangibles, is likely.

The famous Veritas case showed a very favourable outcome for the taxpayer. This was because the IRS used an economic theory under a new set of regulations (issued in 2009) and applied it to transactions that were concluded under an old set of regulations. The taxpayer migrated some intangibles to an Irish company for software development and then valued them at USD 124 million. On audit, the IRS changed the amount to USD 2.5 billion and then at trial, issued another valuation of USD 1.7 billion. So the IRS valuation was ten to fifteen times the size of the tax payer's value. The IRS analysis of the valuation was very much consistent with the new (2009) regulations, using "synergy" and other "soft intangibles" to value the transfer much more broadly than what the taxpayer had done.

This case shows the increasing level of tax authorities' behaviour being inspired by budgetary needs. The US administration's fiscal 2011 proposals to broaden the definition of intangibles so as to include "value drivers" such as workforce in place, going concern value and goodwill, is a good example of what can be expected in the near future. Also, the plans to broaden the passive income qualification, so as to include so-called "excessive returns", are very threatening.

For European tax authorities the areas of focus are more traditional, and obviously differences country by country may be observed. These tend to concentrate on the functional analysis from the perspective of what has actually changed and whether the change in the pricing was reasonably supported by the functional change.

Also, European tax authorities are taking a more rigorous approach to verify the benchmarking studies presented by the taxpayers. They also appear to empathise more and more with the use of profit split methods as a secondary approach to verify whether the transfer pricing is at arm's length. Finally, recently enacted domestic legislation and/or administrative guidance such as the German so-called "exit tax rules" on transfer of business activity and profit potential may open the door to copycat behaviour, or at least the appetite for that, by other countries.

Multi national companies face pressure from many directions.

Conclusion

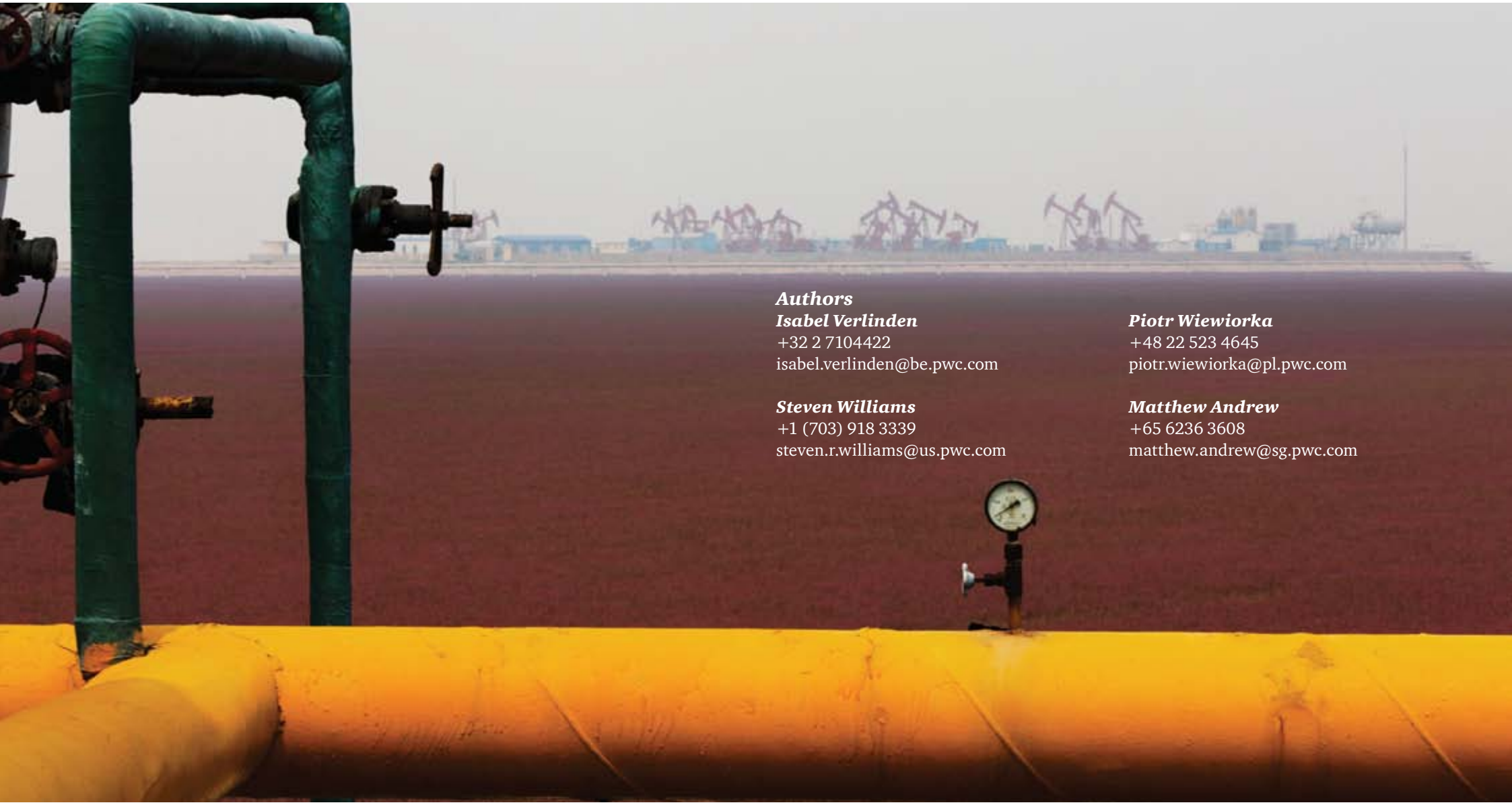
MNCs face pressure from many directions. Countries have a strong need to collect taxes in an attempt to restore budgetary shortages caused by the economic climate. Companies seek to reap the benefits of globalisation in a balanced way, and expanding their geographical footprint is key. Emerging economies also show increasing domestic demand. This means that MNCs need to make sure they capture all opportunities to increase top line revenue whilst ensuring healthy bottom line results through cost effective upstream operations.

For tax directors this means that there has never been a stronger need to align tax optimisation with business realities of consolidating functions and risks into one or more principal locations. VCT is high on every MNC's agenda and the tax angle should be elevated from the mere "after thought status" it was often granted in the not too distant past.

VCT structures are called "business restructurings" in OECD jargon. In its role as a body that sets the rules of the game, the OECD issued final guidance on the topic in the summer of 2010. These guidelines represent a consensus among the OECD countries. Often emerging economies are, however, not (yet) members of the OECD so uncertainty and controversy risks still prevail.

MNCs will continuously rearrange their value chains and tax authorities will be resistant to any movement of profits away from their jurisdiction.

Battles will unavoidably have to be fought and the message is clear. Careful substantiation of "what actually changed" upon a pan-regional streamlining of business operations is the sole key factor to success. Those who do spare the time to meticulously go through such an exercise will be the ultimate winners.



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Back to the future – Automotive Industry

"Those who cannot remember the past are condemned to repeat it"

George Santayana

The years of 2008 and 2009 were certainly memorable for the automotive industry, marking the dramatic trough of a long industry cycle. In an industry noted for its global value chain and substantial global footprint, this downturn caused havoc with transfer pricing policies that were logically designed with profitable value chains in mind. Whether you believe that 2010 signalled the beginning of the industry recovery or was the year of a paradigm shift into a new automotive industry, the challenge will be to remember the lessons learned and incorporate those lessons into new transfer pricing policies.

A typical automotive value chain

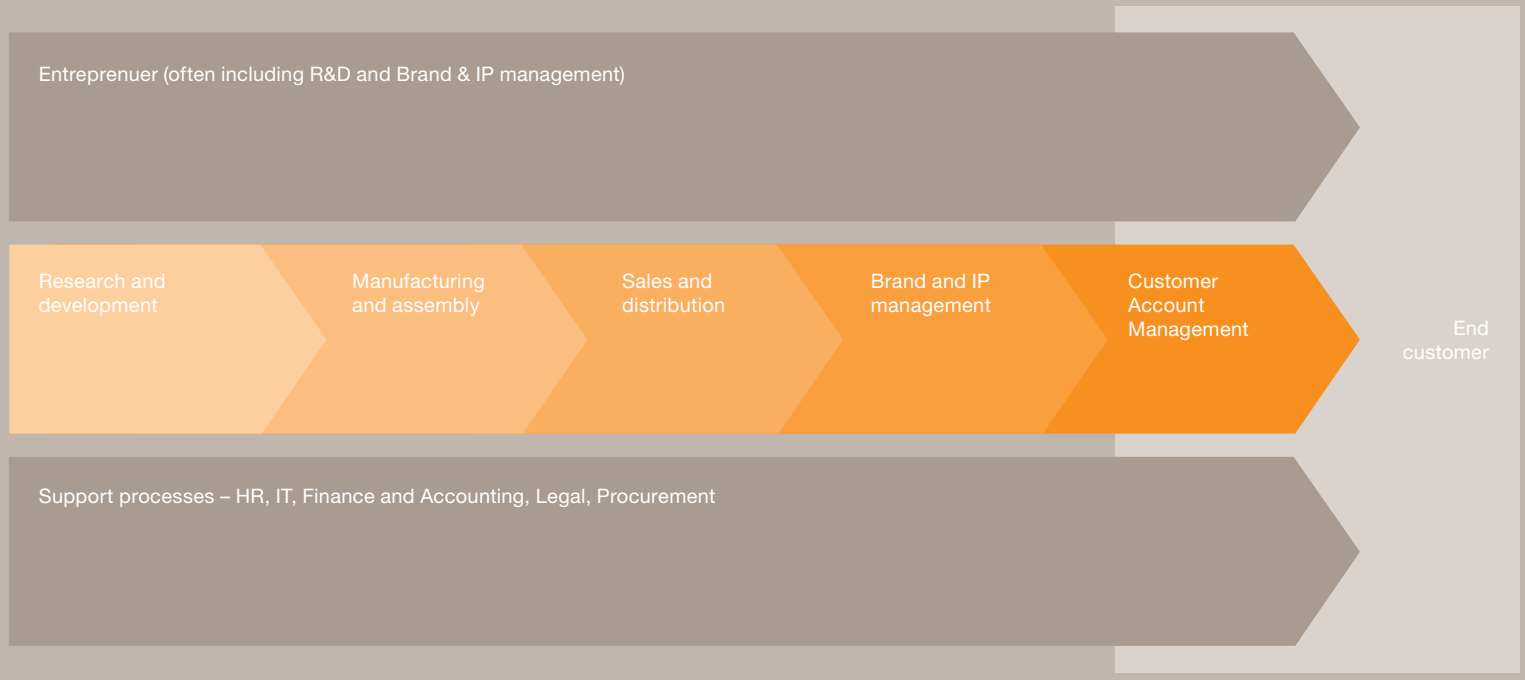
The automotive value chain, described in transfer pricing terms has become the standard for many manufacturing companies. In its simplest form it comprises an Entrepreneur, a series of limited risk manufacturers, a number of limited risk distributors and service providers. Figure 1 provides an illustration of a simplified value chain and the entities involved.

The non-Entrepreneurial elements of the value chain receive a fixed return while the Entrepreneur receives all residual profits. Because the non-entrepreneurial elements are typically viewed as limited risk, for transfer pricing purposes, their arm's length prices or returns are computed first, while the Entrepreneur claims all remaining profits. The returns for the limited risk entities are fixed, in the sense that they are calculated first. The actual profits of these entities (and prices) may vary as the profits and prices of the comparable companies vary, though with a long-standing view that limited risk entities are not fully exposed to market volatility and do not have the financial or management capacity to lose money, these entities are nearly universally expected to earn profits. And as long as the total value chain is sufficiently profitable, the system works well.

However, when the Entrepreneur consistently earns losses, as has occurred recently, a tremendous amount of pressure is placed on the transfer pricing model.

Figure 1

Automotive Transfer Pricing Value Chain

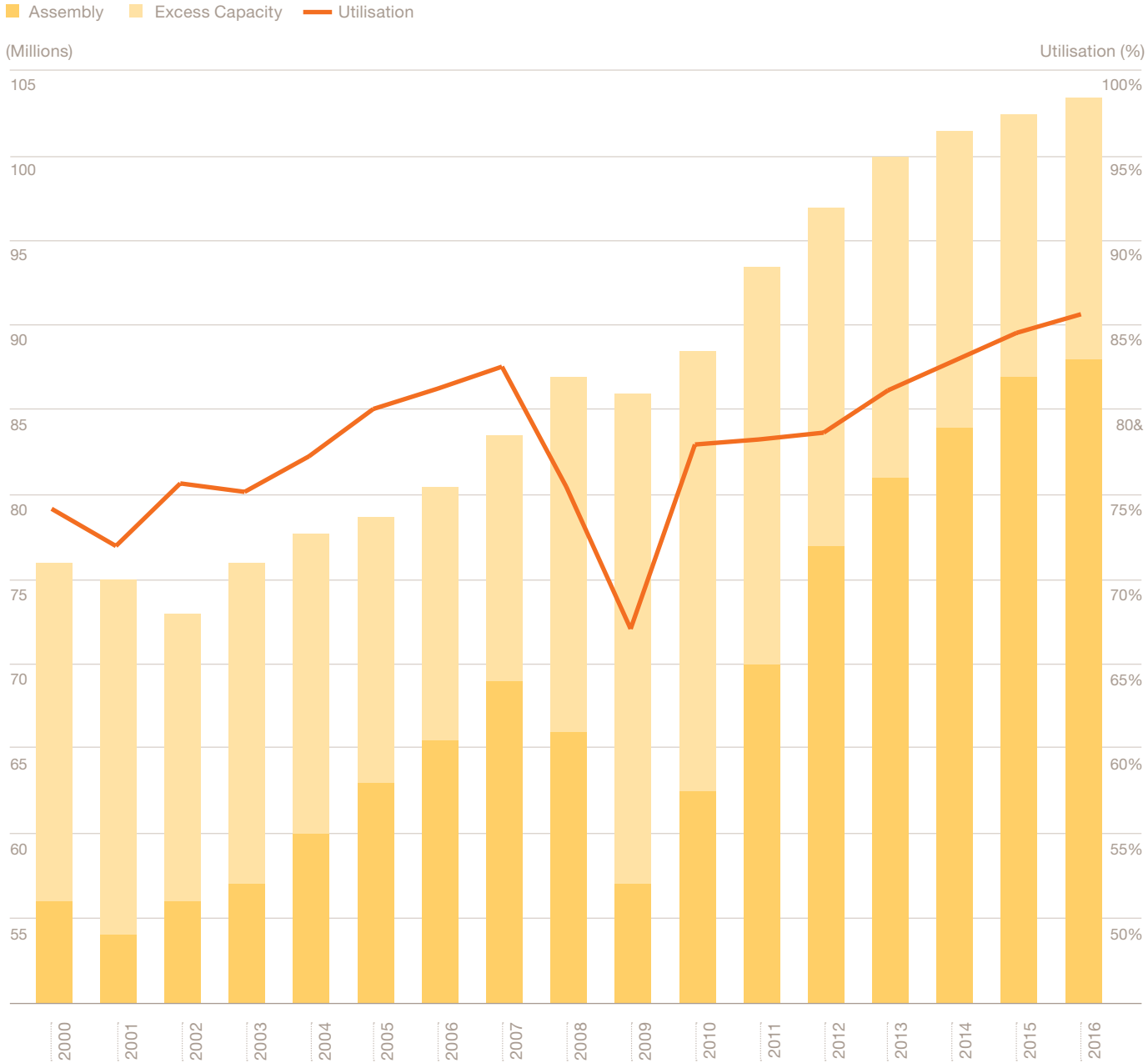


Industry history

In 2000 and 2001 the industry saw global production drop, and at that time, those in the industry felt the resulting pains. However, the ensuing years showed all the promise of a usual recovery and most in the industry were happy for the relatively soft landing and subsequent strong recovery. Figure 2 below, from PwC AutoFacts in late 2009 shows the production trends from 2000-2009. During the years 2001-2007 production was increasing, capacity utilisations were increasing and excess capacity was decreasing. All of these were excellent circumstances for automotive transfer pricing models. However, beginning in 2007 and dramatically illustrated in 2008 and 2009, profits disappeared from nearly all global automotive industry value chains.

Figure 2

Global Light Vehicle Assembly Outlook

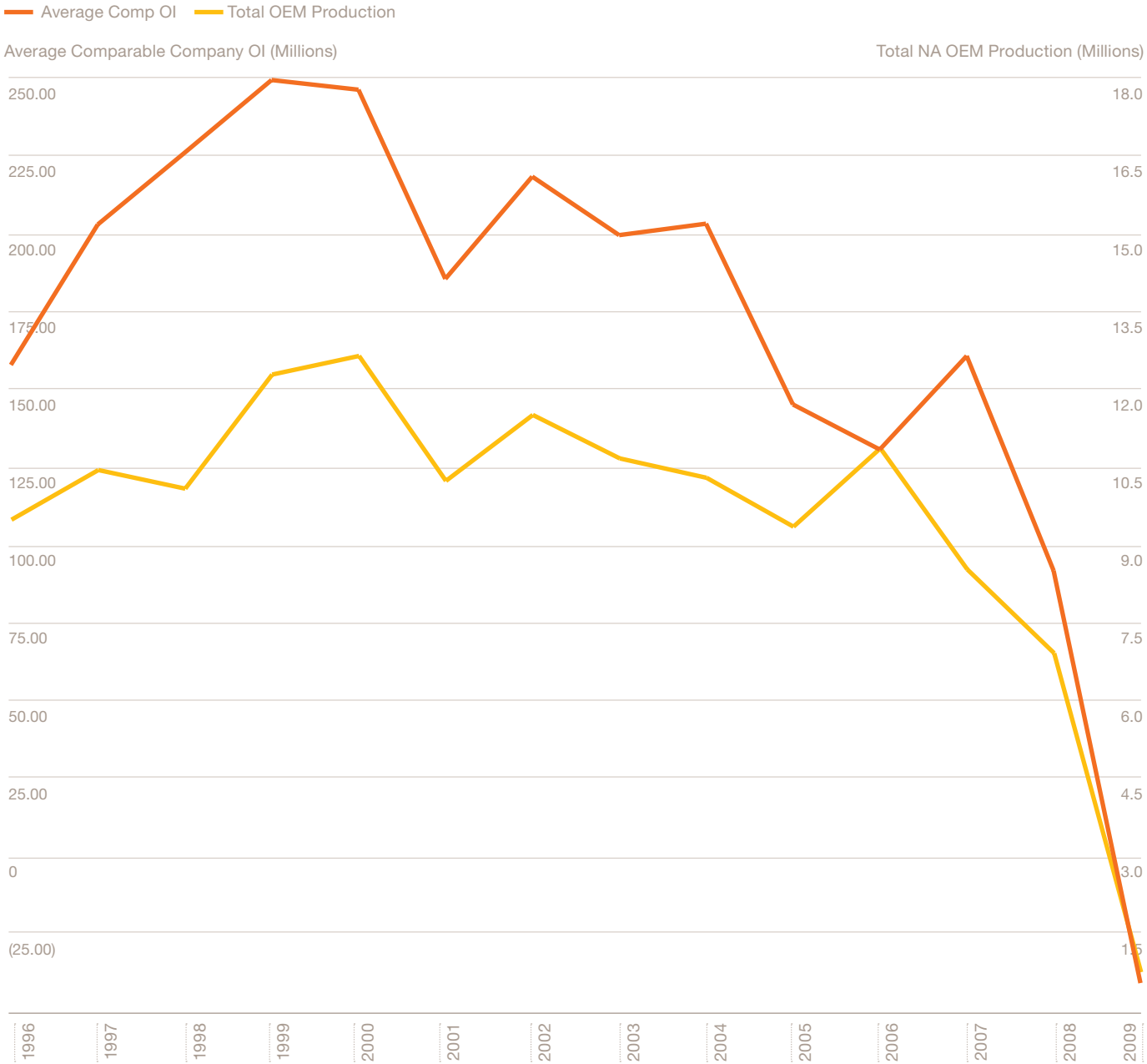


When original contract manufacturer (OEM) production levels plummeted, so did their profits. Given the typical industry analyst view that if the factories can keep running, profits will come, a number of industry and government programs around the world were implemented to buoy production, with at least short term success. Given the capital intensive nature of the industry, there is at least some intuitive appeal to the link between asset utilization and profits. Among the more notable programs were factory incentives designed to draw customers to the market more quickly and government scrappage programs designed for the same purpose but funded by taxpayers. Both types of programs ultimately created throughput for OEM plants. Unfortunately, none of the implemented programs could address harsh industry fundamentals, such as an inflexible cost structure, rapidly changing customer preferences (some environmentally driven) and real price deflation for automobiles. From 1998-2008, the consumer price index for new cars and trucks decreased 6.2 percent according to the US Bureau of Labor Statistics July 2008. To be fair, consumers were faced with a weak economy, a sharply lower stock market, a housing squeeze, high credit costs and limited credit availability, elevated gas prices, and "upside-down" loans, where the outstanding balance on the loan was more than the car's trade-in value.

Further, while it may seem obvious, when OEM production and profits fall, the entire value chain suffers in the same way. Consider Figure 3 below which for ease of analysis shows the total North American OEM production from 1996-2009 and the average operating income for the top 20 largest Tier 1 suppliers in North America.

Figure 3

OEM Production and Tier One Supplier Operating Income



Both GM and Chrysler LLC ("Old Chrysler") filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy code and the businesses emerged with dramatic differences. Long-time vehicle brands, including GM's Pontiac, Saturn, and Hummer, and Ford's Volvo, were discontinued or sold. The Old Chrysler business that was purchased by CGLLC in 2009 came to be managed by Fiat, a new owner of CGLLC.

In Europe many companies reduced or eliminated flexible workforces and some (like Opel) faced the threat of going out of business which initiated intensive political involvement. Many suppliers did not survive and a successful integration of Continental and Schaeffler (initiated under different future expectations) became less certain under dark economic skies.

Through all of this, many limited risk entities continued to earn profits even though the total value chain did not contain profits, and in fact, more than one Entrepreneur went bankrupt or virtually disappeared. This caused many companies to question whether the term "limited risk" meant "no risk" as then current transfer pricing models implied.

Lessons learned

Reactions in the automotive industry to the static nature of the traditional transfer pricing models were as varied as the companies themselves. Some companies rightfully reacted to the overall economic circumstances and forced limited risk entities to accept break even terms or even losses. Other companies correctly maintained their static models and sought to decrease the fixed returns as much as possible, though still earning profits. Likewise, tax authorities around the world also adopted a variety of reactions ranging from pragmatic to seemingly incomprehensible. The at arm's length principle does however, by no means justify to impose additional tax on enterprises that are less successful than average.

'The automotive companies that revise their transfer pricing policies to reflect old and new economic relationships will be best positioned with a model that assigns profits – and losses – in their value chain that are consistent with the operational view of the consolidated business'

Many companies are recognising that the limited/no risk entity model does not sufficiently reflect how the real world operates nor the variety of circumstances a global manufacturing company faces. First, consider that some markets such as Europe will likely have little growth in the coming years, North America will have low growth and China and other Asian markets will likely have very high growth in the coming years. Then consider the end-consumer prices associated with those markets-- European and North American markets with lower volume growth rates, tend to have vehicles with very high content and higher prices especially relative to the high volume growth market of Asia. Further consider that for a variety of reasons from public perception to the high cost of freight, automotive companies tend to assemble vehicles in the same market in which they sell vehicles.

Given the variety of the cost of labor and structural costs across the three major markets of the world, the economics of each market can vary wildly based on costs alone. Finally, with the significantly different economic circumstances of each market, it is highly likely that the performance of each market may vary independently from another.

In the end, the reaction of industry players to their circumstances and the resulting reactions of tax authorities should cause industry players to re-examine whether the traditional, limited risk static transfer pricing models are appropriate for the coming decade.

Conclusion

The future of automotive transfer pricing

In general transfer prices need to change when the relationship of the related parties change, when the industry itself changes, or when the comparable companies change. For some in the industry, the static model will remain in place. Whether it be due to a willingness to pay income tax in some jurisdictions while losing money overall, inertia related to the extreme efforts necessary to implement a new policy in a global organisation or some other reason, some companies will forgo the opportunity change. Many companies, however, are using the reorganisations and restructurings- legal and operational- that resulted from this trough to re-examine and revise their transfer pricing policies.

There are some common themes to how transfer pricing policies are being viewed. The underlying principles of the automotive business were over-looked in the static models and companies are analysing how to ensure that transfer pricing policies reflect the commercial measures of the business. Tying the transfer pricing policy of each element of the value chain to the appropriate key performance indicators can provide a more accurate economic picture for the value chain. For instance, consider a manufacturing element of the value chain that was previously compensated on a cost plus basis and therefore virtually guaranteed a profit.

Going forward, these entities may also incorporate volume throughput into their transfer pricing to modify the cost plus in both good and poor economic times. In another example, a formerly limited risk distributor that was guaranteed a return on sales may be modified to reflect its ability to manage and adjust selling expenses. These two simple examples show how automotive companies are tying transfer pricing to key performance indicators and exposure to market volatility.

Other companies are analysing a complete overhaul of their transfer pricing systems, with more than one discussing the idea of a global or regional profit split. Clearly, the mechanics, administration, and predictability of such a transfer pricing policy have to be weighed against the benefits of high flexibility in reflecting the economic contributions (and taxable income) of the entities. Even so, automotive players are at least considering whether this is a viable option on a regional or global basis and whether such principles can be incorporated into more traditional policies.

The recent extreme swings in the Automotive Industry landscape, put pressure to the choice of the traditional transactional TP models and it remains to be seen whether they are still the most appropriate method for the particular case. Furthermore, the assumption that limited risk entities cannot suffer losses is breaking down. Profit levels are frequently benchmarked against those of comparable independent entities, which can only be useful if the economically relevant characteristics are sufficiently comparable (OECD Transfer Pricing Guidelines). Clearly, when obtaining (financial) data on comparables, such data will always be historical and thus the challenge is how to set the prices for the future and whether or not an ex post review and adjustment would be required. Relative contribution to the value chain may need to be explored in more detail to determine the appropriate pricing structure independent of a comparability analysis, as such faces limitations in unstable economic periods.

Finally, automotive companies would be wise to also consider the new avenues taxing authorities will pursue when examining transfer pricing policies. In a number of taxing jurisdictions and even Courts, location savings-- a competitive advantage relative to other players in the industry based on location-- has been confused with location rents, extra profits (if any) deriving from location savings.

The result has been that even when many automotive companies are operating in the same lower cost country, fiscal authorities are laying claim to the cost savings relative to their prior locations rather than relative to the competition, and seek to attribute a larger share of profits to the lower cost entities even if there is no location rent. In a similar fashion, especially if automotive industry performance is expected to vary greatly between geographies, we expect that taxing authorities will be seeking to assert that country premia may exist in a particular geography and seek ways to levy additional tax, exacerbating the debate and potential controversies on the relative values of market/marketing versus technology intangibles in transfer pricing.

Whatever the final conclusion of this recent automotive economic trough, the automotive companies that revise their transfer pricing policies to reflect old and new economic relationships will be best positioned with a model that assigns profits - and losses - in their value chain that are consistent with the operational view of the consolidated business.

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Coming out of Recession - Industrial Products

The global economy has experienced unprecedented challenges in recent years and continues to face new challenges along the road to recovery. The global recession has influenced all sectors and industries, although specific outcomes and challenges may differ. In this article we analyse the drivers and trends in some industrial products ("IP") industry sub-sectors, identify strategic changes and opportunities for IP companies beginning to emerge from the recession, and examine the key transfer pricing challenges and opportunities for IP sector companies in the current environment.

Key drivers and trends

Chemicals

Revenues in the chemicals sector totalled USD $705 billion in 2009, an approximate 10.6 percent decrease from 2008 revenues. The U.S. chemicals industry has experienced strong competition as Asian producers have successfully penetrated the market. Strong competition has kept prices low as high production costs continue to limit margin growth potential. The chemicals industry continues to be heavily regulated and is subject to stringent laws at both federal and state levels. Typically, non-speciality chemical companies operate with high-volume and low margin production outcomes. Therefore, the economic crisis particularly affected these chemical companies, as they were limited in their ability to reduce fixed costs in response to a decrease in production volume. Certainly, the current environment of the industry can be described as risky, which has led to an increase in merger and acquisition ("M&A") activity and consolidation in the marketplace.

Industrial Manufacturing

Revenues declined an estimated 21 percent in 2009 due to a reduction in volume as well as lower prices. The increase in M&A activity is necessary for the sector to improve revenues and benefit from economies of scale. Consistent with other industry sectors, globalisation continues to be an important trend, integrating national economies through trade and foreign direct investment. The growth rates in the regions with emerging economies continue to increase rapidly.

Engineering & Construction

This sector has also shown an increase in M&A activity after several quarters of decline. Similarly, globalisation continues to be a focus given growth opportunities, cost efficiencies, and economies of scale. Joint ventures are becoming popular as projects increase in size and complexity. The global construction market is currently valued at more than USD $5 trillion and is expected to be worth more than USD $12 trillion by 2020.

Metals

The capacity utilisation was 52.2 percent in 2009, down from 81.4 percent in 2008. The outlook for the metals end-market is poor, as the fluctuation of raw material prices creates mini-factory competitiveness. In particular, steel producers are facing a concentrated iron ore supplier market, which increases costs.

Most of the industrial product subsectors continue to face significant pressure on volume and margins due to tough market conditions. Additional complications are when tax authorities fail to recognise these industry dynamics, or are simply unwilling to accept low profits in their jurisdiction. Risk management continues to be an important focus from a profitability standpoint. Industrial product companies should break down the functions and properly attribute risks to those activities (e.g., headquarters, manufacturing, distribution, etc.) in detail, and clearly explain in the intercompany agreements the risks that are borne by each entity.

Such risk should also be taken into consideration when identifying benchmark comparables that also have faced similar risks as well as when determining the number of years to evaluate.

'Most of the industrial product subsectors continue to face significant pressure on volume and margins due to tough market conditions'

Global Economic Outlook

The outlook of the overall global economy is mixed and varies by region. The Asia-Pacific region is leading the global recovery and entering a phase of moderate growth, with some countries experiencing significant growth. Growth in gross domestic product ("GDP") in the region exceeds that of advanced economies, and is largely driven by exports and resilient domestic demand. Many countries in the region are already operating at normal levels of capacity utilisation. Private domestic demand is expected to remain strong, but the pace of recovery is likely to be uneven within the Asia-Pacific region.

Europe showed low and uneven growth activity during 2010. The revival of the services sector is slow, and credit growth is slower than GDP growth. The industrial capacity utilisation remains below normal and the economies of some countries continue to be in recession. The economic crises in Greece and Ireland have threatened to spill into other areas of Europe, and have further delayed economic recovery of Europe overall.

The U.S. economic recovery appears slow and protracted. The U.S. has witnessed a high unemployment rate over the last two years, as well as low consumer confidence and spending. The housing market continues to suffer, and the revival in services sector is also lagging.

The recovery in Latin America is advancing faster than expected, with regional GDP growth predicted to be approximately 5.4 percent in 2010. The demand for the region's primary products remains strong, along with rising domestic consumption and increasing commodity exports.

Transfer pricing documentation should be specific in defining the economic environment of the industry in that particular country, because although macroeconomic data of the country may be promising, some sectors may still decline or suffer. Therefore, in order to avoid tax authorities challenging transfer prices, supporting documentation should be highly detailed regarding the performance of the industry and the company. Care should be taken to make sure the industry analysis properly reflects actual issues which are affecting profitability in the appropriate sector.

Transfer Pricing Issues and Opportunities

Along with a challenging economy and tough market conditions, companies are facing stringent and aggressive transfer pricing audits by tax authorities, as governments struggle to collect sufficient revenue to minimise their growing budget deficits. Accordingly, it is extremely important that each company has a robust transfer pricing policy and prepares adequate documentation to support its position.

Going forward, the definition of intangibles and the approaches used to value intangibles is expected to be a significant issue in future transfer pricing disputes. The traditional definition of intangibles includes patents, copyrights, know-how, and trademarks. The Obama administration's proposed extension (or "clarification") to the definition of intangibles includes workforce in place, foreign goodwill, and going concern value. Tax authorities throughout the world are becoming more aggressive in challenging transfer pricing. Some other important audit issues and challenges include aggregation of transactions (versus testing them separately), sharing of losses among related parties, and charging management fees to related parties. Other issues being raised by tax authorities include adjustments for location savings or market premiums. The tax authorities in certain countries have argued that location savings belong to local entities and a substantial market premium should be attributable to entities in certain high growth industries.

'this is an ideal time for companies to re-evaluate their structures and contemplate enhancements'

Despite the challenges of tough economic conditions and aggressive tax audits, this is an ideal time for companies to re-evaluate their structures and contemplate enhancements to their transfer pricing models given anticipated future business plans.

Transfer pricing continues to be a high priority for tax authorities in many countries.

Conclusion

The various IP subsectors are starting to show positive growth trends, with the economic recovery being led by the Asian economies. Transfer pricing continues to be a high priority for tax authorities in many countries, and tax authorities from most jurisdictions are enhancing their enforcement capabilities. However, opportunities still exist to implement robust transfer pricing policies consistent with future business objectives.

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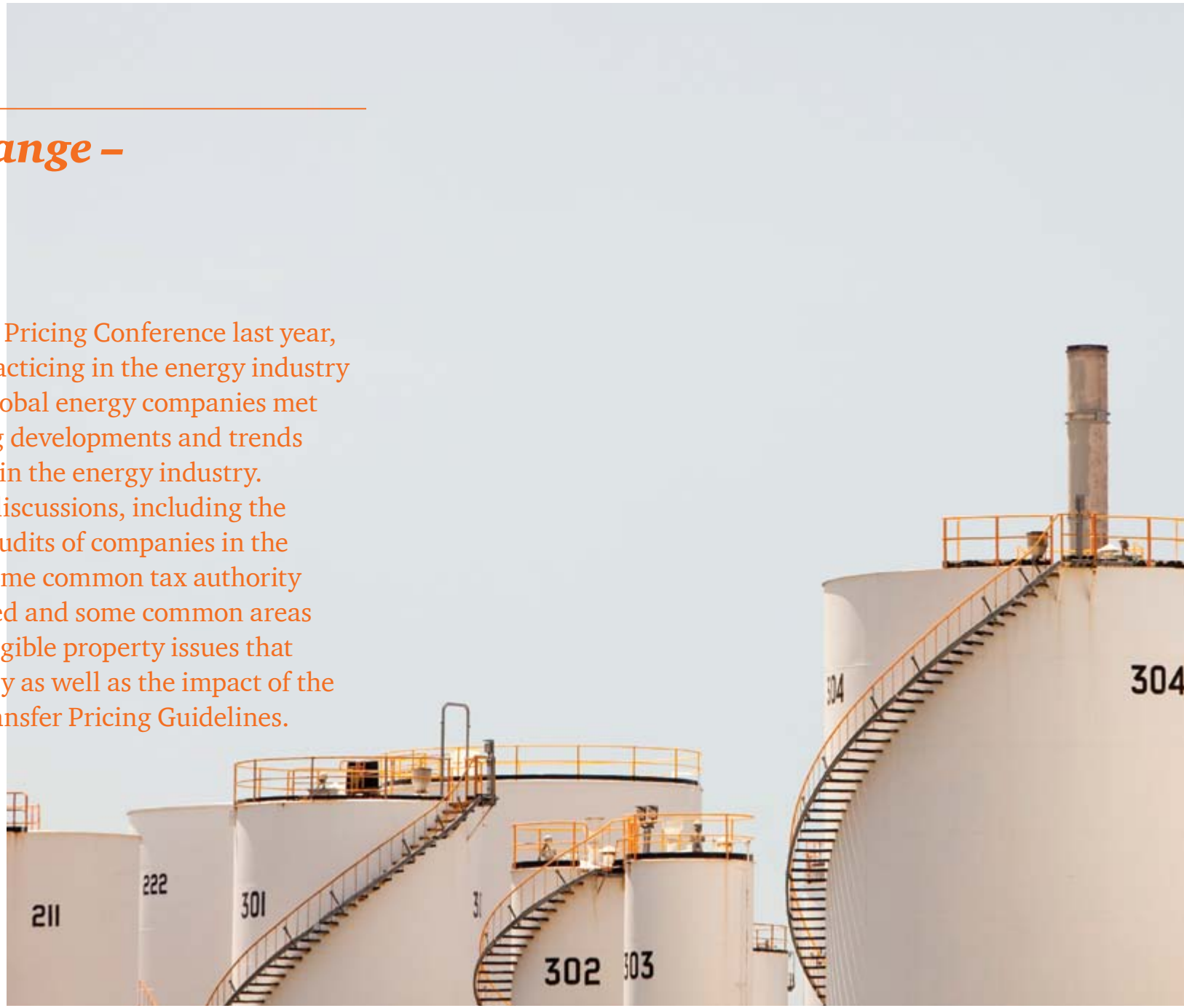
Implementing change – Energy Industry

During the PwC Global Transfer Pricing Conference last year, a group of PwC professionals practicing in the energy industry and representatives of several global energy companies met to discuss recent transfer pricing developments and trends impacting companies operating in the energy industry. This article follows the group's discussions, including the recent tax authority activity in audits of companies in the energy industry, and includes some common tax authority practices that have been observed and some common areas of focus. We also highlight intangible property issues that are unique to the energy industry as well as the impact of the recent revisions to the OECD Transfer Pricing Guidelines.



Tax Authority Activity

Tax authorities around the world are facing significant pressure to generate revenue for governments working through the global fiscal crisis. Companies in the energy industry are perceived as performing well in the challenging economy, which is attracting aggressive challenges from tax authorities trying to raise revenue. Transfer pricing issues are high on the agenda. Over the last few years, some common, and often troublesome, practices and areas of focus have emerged.

Recent Tax Authority Practices

The U.S. Internal Revenue Service ("IRS") has recently completed an initiative to bring its audit cycles more current. The current audit cycles for most U.S. companies now include the most recently filed returns. The U.S. is, however, the exception. Most other jurisdictions are taking advantage of the full time allowed under the local statute of limitations. In many cases, this means that audits with potential transfer pricing issues are beginning near the end of the time limit within which to seek relief under the Mutual Agreement Procedure ("MAP") provisions of applicable treaties. Many energy companies are in the position of having to take steps to preserve their right to the MAP process before they know the magnitude of any issues, or whether there will even be issues eligible for MAP.

In addition to starting audits years after the transactions in question, many tax authorities are requiring taxpayers to produce voluminous detail. Many tax authorities lack the sophistication or experience to conduct a transfer pricing audit in an efficient manner, which is leading to requests for large amounts of data that may or may not be relevant. Such practices are placing a premium on strong contemporaneous documentation and record keeping by taxpayers.

The data requests often include requests for large amounts of foreign data, leaving taxpayers with a dilemma of how to respond. Taxpayers must decide whether to simply provide the data or force the foreign authority to work through exchange of information ("EOI") processes. EOI can sometimes be helpful because it can bring the other government into play with its own tax collections at risk. However, EOI also adds time, complication and expense to the process, and a taxpayer introducing such complications may create an impression of having something at risk.

Another recent trend in transfer pricing audits is tax authorities requesting information about taxpayers' dealings with unrelated parties. The tax authorities are trying to gather information about uncontrolled transactions. Some tax authorities, like Norway, appear to be building databases of contracts, particularly oil and gas contracts. Presumably, they can then use the databases to generate comparable data. It would appear that such information would essentially equate to the use of secret comparables because it is information the tax authorities have gained through audits of taxpayers and is not available to the public.

'Management and other service fees continue to be a common source of contention between taxpayers and authorities'

Areas of Focus

While a transfer pricing audit can go in many directions, it is possible to identify some areas where tax authorities have repeatedly raised issues for energy companies. Some areas of focus include service fees, the remuneration of trading companies, interest rates, and guarantee fees. Another recent trend is tax authorities examining other issues related to transfer pricing, such as permanent establishments and withholding taxes either in lieu of pursuing transfer pricing adjustments or in addition to transfer pricing adjustments.

Service Fees

Management and other service fees continue to be a common source of contention between taxpayers and authorities. Jurisdictions where head offices and technical expertise may be located, like the U.S., are exerting considerable pressure on companies based in those jurisdictions to charge costs out to operating subsidiaries. In addition to the charge out of costs, there is some indication that the tax authorities perceive these services to have value in excess of the cost of providing the services, and taxpayers are seeing more pressure to include a profit element included in their service fees. On the receiving end, tax authorities are aggressively challenging the deductions for management fees.

In many cases, the challenges are pure transfer pricing cases, where the tax authority is challenging the allocation of costs, the benefit provided, or the mark up. More troubling, however, are cases where the tax authorities are challenging deductions based on technicalities in local law regarding the form of invoices, the type of financial support available, or other technicalities in an apparent attempt to turn a transfer pricing dispute, which would be subject to MAP, into a domestic issue. Taxpayers need to be aware of these tactics as they develop and consider bringing them to the attention of the competent authority in their home jurisdiction, which may be successful in getting the other competent authority to recognise them as transfer pricing issues or possibly get them into MAP under anti-discrimination provisions. Competent authorities in the home jurisdiction are often willing to engage because they view their own tax collections at risk.

Trading Companies

Many energy companies have captive trading companies to either procure raw materials or market their production. Many energy companies and other companies dealing in commodities have established centralised trading companies that buy and sell between members of the group and/or between members of the group and third parties. In these structures, other members of the group tend to be remunerated as routine suppliers or routine sales and marketing companies. Some authorities, like the Australian Tax Office, have begun to challenge the economic substance of the central trading companies, questioning whether the trading company truly has the financial and management wherewithal to bear the risk and earn the profits that are being attributed to those risks.

On the other side of the equation, many energy companies have established trading offices that serve simply as procurement or marketing companies. These trading companies typically source raw material, such as crude oil, in amounts and grades as specified by other members of the group, or they may simply sell the output of other members of the group. Such trading companies are typically compensated as routine service providers. However, authorities like the Canada Revenue Agency, have questioned this practice based on the premise that the trading companies provide high value added services. The arguments are based, in part, on the perceived high compensation paid to the individual traders employed by the trading office.

Interest Rates and Guarantee Fees

The energy industry is often characterised by significant investment requiring large amounts of capital or large projects requiring significant resources from vendors. These characteristics make the energy industry sensitive to the issue of arm's length interest rates on intercompany advances and to the more emerging issue of arm's length charges for financial and performance guarantees.

In the current economic environment, safe harbour interest rates like the Applicable Federal Rate in the U.S. may not be particularly meaningful because they may be significantly lower than typically available to a company in the market. Only companies with the best credit ratings are able to obtain funds at those rates. The current yield curves demonstrate high risk premiums, and most companies are facing significantly higher market rates. Challenges from tax authorities are ranging from debt versus equity characterisation to the arm's length rate of interest. Given the size of some loans, even small changes in interest rate can result in significant assessments.

Guarantee fee issues range from whether a benefit beyond the implicit benefit of being a member of the group has been provided, to determining the most appropriate method and comparables for establishing an arm's length charge. Performance guarantees are even more subjective. It is often difficult to demonstrate benefits provided to the guaranteed party and even more difficult to identify comparables. In cases where every significant contract of a subsidiary requires a parent guarantee, the guarantees can even appear to be more like equity than guarantees that would exist in an uncontrolled environment.

Issues related to transfer pricing

Tax authorities are pursuing matters closely related to transfer pricing, such as permanent establishment ("PE") issues and withholding. These issues may be pursued instead of transfer pricing issues or in addition to transfer pricing issues. The PE issue may be particularly sensitive for some oil field service providers. Some jurisdictions, like the U.S., are aggressively pursuing permanent establishment audits against service providers that may bring personnel and resources into an area, like the Gulf of Mexico, without forming a subsidiary or declaring a PE. Aside from the issue of the profit attributable to the PE, the tax authorities are also pursuing related payroll taxes for the employees plus penalties and interest.

'Tax authorities are pursuing matters closely related to transfer pricing'

Tax authorities have also found that withholding related to intercompany payments is often easier to audit and win. Such challenges might include documentation of eligibility for withholding at treaty rates. The difference between the treaty rate and the statutory rate is often 15% to 30% of the gross payment, and the underpayment generally carries a penalty as well. Both the tax adjustment and penalty may be easier to quantify and sustain than a transfer pricing adjustment and penalty. The withholding assessment and penalty may also be beyond the reach of MAP because the withholding assessment is often based on a failure to comply with the local requirements.

Intangible Property

Many aspects of the energy industry require specialised equipment and technical expertise. Oilfield services companies often have proprietary tools and processes that allow them to perform the complicated tasks required by their customers, but the issue of intangible property clearly extends beyond oilfield services companies. Companies operating in most facets of the industry can be expected to bring some kind of technology or expertise to the table.

While tax authorities have long been sensitive to intangible property transfers and the value of intangible property, the issue of intangible property is becoming more convoluted, particularly in an industry like the energy industry that is characterised by specialised equipment and services. The recent trend among tax authorities, including the U.S. IRS, is to attempt to more broadly define intangible property with the intention of identifying more transfers of intangible property of significant value.

Recent developments like the issuance of new U.S. regulations addressing intercompany services transactions and intangible property transfers have caused a new look at intangible property. For example, the intercompany services regulations in the U.S. clearly contemplate that services may include intangible property or effect a transfer of intangible property. While it remains to be seen how the IRS might apply the provisions, it seems likely that companies in the energy industry providing specialised services and technical expertise to related parties could be challenged on the value of the services and possible intangible property.

Similar issues could also arise with respect to intercompany rentals of specialised equipment. While the specifics may vary from jurisdiction to jurisdiction, it is clear that the U.S. IRS is not alone in its concerns over intangible property.

OECD Guidelines

The recent changes to Chapters I-III and Chapter IX of the OECD guidelines have clearly been a topic of discussion within the transfer pricing community. The revisions to Chapter IX may have the most relevance for the energy industry, particularly the revisions related to the allocation of risks and economic substance. The revisions to Chapter IX deal with business restructurings, which could include the centralisation of functions (like a trading office), the centralisation of intangible property, and conversions to limited risk arrangements like commissionaires and contract manufacturers. Included within the discussion are guidelines regarding the allocation of risks among related parties and whether tax administrators should respect the allocation. The audit activity around trading companies is a good illustration of the importance of these concepts in the energy industry.

The guidelines generally provide that tax administrators should respect the related parties' contractual allocation of risks unless it is not consistent with the economic substance of the transaction. The economic substance should be determined based on whether the conduct of the related parties conforms to the contractual allocation of the risks and whether the allocation of risks is arm's length. The guidelines indicate that comparable uncontrolled transactions may provide evidence regarding the arm's length allocation of risks. However, the guidelines are also clear that the absence of comparable arrangements among unrelated parties does not mean the allocation among related parties is not arm's length. In such cases, it is necessary to determine whether the allocation of risks is one that might be expected to have been agreed between independent parties in similar circumstances. Two relevant factors to be considered are which party has relatively more control over the risk and which party has the financial capacity to assume the risk.

The contractual allocation of risks is generally determined by examining the documented contractual arrangements among the parties. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between unrelated parties.

Chapter IX of the OECD guidelines clearly encourages taxpayers to document in writing the contractual arrangements and allocations of risks with respect to intercompany transactions. Chapter IX also provides an indication of efforts taxpayers can undertake to ensure their contractual allocations are respected.

...companies in the energy industry are facing aggressive audits from tax authorities around the world.

Conclusion

Companies in the energy industry are often perceived to be among the few strong performers in the current economic environment. Accordingly, companies in the energy industry are facing aggressive audits from tax authorities around the world. Recent audit activity has been characterised by audits starting late in the statute of limitations, which is creating issues in for energy companies facing time restrictions in their ability to seek correlative adjustments through the MAP process, requests for voluminous amounts of data that may or may not be relevant to the transfer pricing audit, requests for data related to uncontrolled transactions, and requests for foreign data. While these practices can place a significant strain on company resources and present other issues, companies should be aware of the MAP process and other situations in which the competent authority may be helpful.

Some common areas of focus for tax authorities include service fees, trading companies, interest rates and guarantee fees, as well as issues related to transfer pricing such as Permanent Establishments and withholding taxes. These areas tend to be controversial because the industry is characterised by significant technical expertise, large capital investment and high risks associated with commodity prices and other uncertainties.

The energy industry is also facing some unique issues surrounding intangible property. Many facets of the industry require highly specialised equipment and technical expertise. Tax authorities have long been sensitive to intangible property transfers and value, but many authorities have taken a renewed focus on intangible property, often seeking to broaden the definition of intangible property and identify the inclusion of intangible property in transactions once considered by many to be routine.

The revisions to Chapter IX of the OECD Transfer Pricing Guidelines are particularly relevant to companies in the energy industry. Chapter IX deals with business restructurings and discusses factors tax administrators should consider when determining whether the allocation of risks among related parties should be respected. The guidance in Chapter IX encourages taxpayers to document contractual arrangements and risk allocations among related parties in writing and ensure that parties bearing risks have control over the risks and the financial ability to bear the risk.

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Design Services 26140 (02/11).

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