Year-round success

Transfer Pricing Firm of the Year:  
North America, Dallas/Houston, Los Angeles, New York, Venezuela

Tax Firm of the Year:  
Washington D.C., Colombia, Uruguay

Americas Tax Policy Firm of the Year  
Latin America Indirect Tax Firm of the Year

Americas Tax Innovator of the Year

To learn how you can win in a changing world, visit www.deloitte.com/transferpricing
Introduction

FSI trends
Recent international transfer pricing developments in the financial services industry
Deloitte’s UK transfer pricing practice recently held a seminar for its clients in the financial services sector. As part of this event, representatives from Deloitte’s financial services transfer pricing practices provided updates on key events in their respective markets. Below is a summary of each of the presentations from the London event, by Bill Yohana of Deloitte in the US.

OECD approach
Application of the AOA for PEs of banks and insurance companies in Germany
Oliver Busch and Jobst Wilmanns, of Deloitte Germany, take a look at the authorised OECD approach for PEs of banks and insurance companies in Germany.

Risk & recharacterisation
Risk and recharacterisation – Does it make sense in a financial services context?
Robert Plunkett, Bill Yohana, and Brian Green of Deloitte Tax in the US, focus on the aspects of risk and recharacterisation and explain how taxpayers can take measure to protect themselves as global legislation realigns.

Offshore
New powers to tax offshore booking of Australian customer sales
Geoff Gill and Priscilla Ratilal, of Deloitte Australia, discuss the Australian government’s increased focus on anti-avoidance measures to tax offshore bookings of Australian customer sales, particularly in relation to marketing operations.

China
How BEPS and and Bulletin 16 could impact outbound payments from China
Patrick Cheung and Johnny Foun, of Deloitte China, go through the significant aspects of the BEPS action plan and local legislation to explore how these policies could affect multinationals’ outbound payments from China.

India
Unfolding the transfer pricing complexities in Indian financial services
Anis Chakravarty, Vineet Chhabra and Neha Bang of Deloitte India discuss how the transfer pricing aspects of the financial services industry have developed and what taxpayers can expect next.

PE issues
PE issues in global insurance distribution
Sebastian Ma’ilei & Jeremy Brown, of Deloitte UK, describe how permanent establishment issues can arise from global insurance distribution models and explain how taxpayers can prepare and defend themselves.
The Global Transfer Pricing practice of Deloitte Touche Tohmatsu Limited is pleased to present International Tax Review’s guide to transfer pricing in the financial services industry, a collection of articles on different aspects of transfer pricing specifically geared to this industry.

For the past two years, since the OECD issued its report on Addressing Base Erosion and Profit Shifting, BEPS – which quickly became part of the tax lexicon – has permeated discussions of international taxation. For better or for worse, today most transfer pricing conversations take place in the context of BEPS. This is true for all sectors, and the financial services industry is no different. But multinational corporations engaged in financial services also face other transfer pricing issues, and different countries have developed different approaches to these issues, rendering the global environment for FSI companies a complicated one.

In this guide, we provide valuable insights into some of the most significant challenges that financial institutions are likely to come across in connection with international taxation, as well as updates on the status of some transfer pricing initiatives that will affect FSI multinationals.

Our first article addresses the OECD’s draft guidance on risk and recharacterisation. One of the open questions in the draft was whether the guidance should apply to financial services firms. As Robert Plunkett explains in this guide, for entities with significant levels of regulatory capital, risk management on a cross-border basis can constitute a vital component of their business. In that light, complying with some aspects of the risk and recharacterisation draft may give rise to tensions between regulatory requirement and tax requirements.

The BEPS initiative is also looking at “preventing the artificial avoidance of PE status,” an issue that affects insurance companies in particular. The act of negotiating and concluding insurance contracts by mobile underwriters, senior executives, and MGAs risks creating a taxable presence or permanent establishment (PE) of the primary insurer or reinsurer in the jurisdiction where these activities take place. When a PE is created, profits must be attributed to the PE for tax purposes, and the insurer will be required to file a corporation tax return in that jurisdiction. Sebastian Ma’ilei and Jeremy Brown’s article identifies those circumstances under which a PE is created in the insurance sector, and most usefully, answer two questions: “So what if you have a PE?” and “What should you do about it?”

In the first of our country-specific articles, Anis Chakravarty, Vineet Chhabra, and Neha Bang of Deloitte India examine the transfer pricing...
issues faced by financial services taxpayers, which they believe have recently increased in significance and scope. As they explain, “[T]his may be attributable to the experience gained by field officers in scrutinizing financial services transactions, the near absence of guidance in the Indian regulations, and limited judicial precedents on the application of transfer pricing methodology to complex financial services transactions.”

In China, many multinational financial institutions have had their intragroup service fees and royalties scrutinised by the Chinese tax authorities in the past few years. Most of the tax authorities’ reviews of these institutions’ outbound payments have focused on the concept of “benefits,” and in particular what “benefits” were provided by the services or intangibles to the Chinese entity in question. China recently issued Bulletin 16 to formalise its position on some of these issues, and as Patrick Cheung and Johnny Foun explain, the benefit tests introduced by Bulletin 16 are consistent with the OECD’s historical approach to analyse the reasonableness of service fees, and also with the discussion draft issued under the BEPS initiative regarding low-value-adding intragroup services.

In Australia, a very recent move by the tax authorities – the release in May 2015 of exposure draft legislation – the Tax Integrity Multinational Anti-avoidance Law – poses a new challenge for FSI taxpayers. Geoff Gill and Priscilla Ratilal of Deloitte Australia provide a review of the basic mechanics of the new law, identify a number of important features, and discuss the implications of the new law and associated ATO compliance activity for the financial services and financial technology sectors.

At the end of last year, the Upper Chamber of the German Parliament adopted the final version of the German Regulation on the Application of the Arm’s Length Principle to Permanent Establishments. The regulation provides detailed guidance regarding the application of the authorised OECD approach (AOA) in Germany, and binds the taxpayer, the tax authorities and the tax courts. The Branch Profit Attribution Regulation governs, in particular, the principles of asset attribution, the branch capital allocation, and the recognition of internal dealings (so-called “assumed contractual relationships” in German tax law). Oliver Busch and Jobst Wilmanns of Deloitte Germany explain the operation of the new regulation, and summarise the special German rules for permanent establishments of financial institutions.

Deloitte’s UK transfer pricing practice recently held a seminar for its clients in the financial services sector. As part of this event, representatives from Deloitte’s financial services transfer pricing practices provided updates on key events in their respective markets. Bill Yohana of Deloitte Tax LLP has summarised the presentations from the London event.

Navigating the world of financial services transfer pricing is not easy. For assistance in this endeavour, please contact your local Deloitte transfer pricing specialist.

Robert Plunkett
Global Leader, FSI Transfer Pricing

Todd Wolosoff
Global Managing Partner, Transfer Pricing Service Line
Recent international transfer pricing developments in the financial services industry

Deloitte’s UK transfer pricing practice recently held a seminar for its clients in the financial services sector. As part of this event, representatives from Deloitte’s financial services transfer pricing practices provided updates on key events in their respective markets. Below is a summary of each of the presentations from the London event, by Bill Yohana of Deloitte in the US.

**Australia – Geoff Gill, Deloitte Australia**

Australia recently introduced a new transfer pricing law incorporating a requirement for arm’s-length conditions (beyond price) and self-assessment of reconstruction.

This law is effective for taxpayers for income years commencing after 1 July 2013. The law also explicitly requires preparation of contemporaneous documentation to specific requirements for the taxpayer to obtain penalty reductions in the event of an ATO-initiated transfer pricing adjustment.

Recent announcements by the Australian government involve introduction of a new multinational anti-avoidance law (MAAL) that targets aggressive use of low-tax jurisdictions as booking locations for Australian customer sales. The measure targets both the business profits that could be attributable to a deemed Australian permanent establishment (PE) and the obligations arising under royalty and interest withholding tax.

Such business profits will be taxed at an effective tax rate that could be as high as 60%. In financial services, offshore booking of sales and trading revenue when the ultimate customer is in Australia therefore carries current and emerging tax risks. For a more in-depth discussion of the new law, see the related article in this issue.

Additional announcements by the government in the 2015-16 budget include early adoption of Action 13 of the OECD’s Base Erosion and Profit Shifting (BEPS) Action Plan regarding country-by-country reporting and master file/local file documentation requirements. These documentation requirements are expected to be effective for income years commencing after January 1 2016.

In the courts, the pending outcome of recent litigation is expected to be pivotal on many transfer pricing issues related to intragroup funding.

In terms of ATO activity relevant to the financial services sector, the following areas are receiving significant scrutiny:

- Business restructures, including transfers of businesses, financial assets, or “books”.
- Marketing/origination activities, including particularly when trades are placed electronically
- Offshore hubs, including marketing hubs in low-tax jurisdictions and service hubs in low-cost jurisdictions.

In addition, the ATO has challenged Inbound funding pricing and liquidity charges. More recently, ATO focus has also turned to understanding positions regarding outbound funding and liquidity charges.
The ATO’s International Structuring and Profit Shifting (ISAPS) audit programme continues – many reviews have been completed, and many more are expected to be completed in 2015/16.

Belgium – Mourad Chatar, Deloitte Belgium

In 2006, the Belgian tax authorities set up a specific team dedicated to transfer pricing matters. Since its inception, the transfer pricing squad has grown significantly, from eight to around 30 full-time personnel focusing exclusively on transfer pricing audits. Today, the transfer pricing squad is composed of a mix of highly skilled senior transfer pricing professionals and relatively junior auditors. Although the transfer pricing squad has limited resources available, it has been very active and very efficient over the last years.

Since 2013, the TP squad has significantly changed the way in which audits are structured. First, the core team is now assisted on an ad-hoc basis by local tax inspectors. Further, a broad wave of transfer pricing audits is launched every year. Specifically, 250 questionnaires are sent each January to taxpayers selected for review. This selection is based on objective and consistent criteria, including whether the taxpayer is in a loss-making position, whether it has recently undergone a restructuring, and the like. The questionnaire aims to gather qualitative as well as quantitative information about the controlled entity. The transfer pricing squad seems to have adjusted in 2015 the initial standard questionnaire to focus on potential BEPS pressure points such as intragroup financial charges and captive insurance arrangements.

In terms of timing, taxpayers have an obligation to respond to information requests within one month. However, as collecting this information may be time- and resource-intensive, the transfer pricing squad generally grants extensions for reasonable reasons (such as force majeure). A pre-audit meeting may also be arranged with tax inspectors during which taxpayers, assisted by their tax advisers if necessary, have the opportunity to go over the scope of the audit.

Taxpayers may submit a ruling request to the tax authorities to secure their tax positions for five years on their operations in Belgium (permanent establishment status, transfer pricing, head office to branch capital allocation, etcetera). Requests to the Ruling Commission are free of charge, offering taxpayers an efficient and transparent process.

Taxpayers may request a pre-filing meeting before submitting their ruling request, which may be conducted on a no-name basis. During the pre-filing meeting, the Ruling Commission provides initial feedback and seeks clarification on certain points. This feedback will be useful to fine-tune the request before filing.

Belgium currently follows the OECD transfer pricing guidelines closely. Therefore, Belgium is also likely to follow, strictly, any OECD guidance issued under the BEPS initiative. In Belgium, soft law issued by the OECD and other bodies such as the EU Joint Transfer Pricing Forum (EU JTPF) are the main benchmarks for the Belgian tax authorities. Thus, Belgian circular letters providing guidance on transfer pricing matters refer to OECD and EU JTPF guidelines.

Canada – Muris Dujsic, Deloitte Canada

Officials from Canada’s Department of Finance have confirmed the Canadian government’s commitment to introducing any necessary legislative measures for the implementation of country-by-country reporting starting in 2016. However, because Canada is in a federal election year, there is some risk that the change will not happen when anticipated, as a legislative change will be required.

The Canada Revenue Agency (CRA) has recently increased its transfer pricing audit activity. Specifically, it has proposed and made adjustments in a number of cases and the overall transfer pricing environment has become very litigious.

Issues that attract particular scrutiny from the CRA include intercompany reinsurance, captive insurance, financial transactions, royalties, attribution of profits, and inbound intra-group services charges with a profit mark-up.

France – Gregoire De Vogue – Taj

The French taxation authorities recently published a list of 17 structures they consider to be abusive. This list notably includes aggressive transfer pricing, restructuring/business optimization, dividend or interest double-dip structures, and transactions they consider give rise to treaty abuse. Although this list does not prescribe any specific penalties, it is likely that those structures will be closely scrutinised during tax audits, and bad faith penalties of up to 40% may be applied, which would also prevent the taxpayer from benefiting from the opening of a competent authority procedure.

The taxation authorities also have extended the penalty regime for taxpayers that lack transfer pricing documentation (Article 1735 of the French Tax Code), so that taxpayers can be fined up to 0.5% of the amount of the non-documented transactions, meaning that a taxpayer can be penalised for a lack of documentation even if its transfer pricing policies are at arm’s-length.

As a general observation, France is a strong advocate of the current BEPS initiative, and most of the BEPS final guidance will be quickly translated into domestic legislation. For instance, hybrids are already banned in France, and country-by-country reporting should be enacted by the end of 2015.

Ireland – Gerard Feeney, Deloitte Ireland

Ireland introduced a formal transfer pricing regime with effect from January 1, 2011. Companies that are trading in Ireland and subject to the 12.5% corporate tax rate are within in the scope of Ireland’s transfer pricing regime.

The key developments in Ireland over the last 12 months are the OECD’s BEPS project and internal developments
within the Irish Revenue regarding resources dealing with transfer pricing matters.

To assure international investors of Ireland’s commitment to and focus on tax competitiveness, the Irish government in May 2014 announced a BEPS consultation process aimed at gathering views on how Ireland’s tax system may need to change in response to the rapidly changing international tax landscape. The consultation process focused on three key elements: rate, regime, and reputation. The Irish government took on board the feedback provided by various groups and the BEPS discussion drafts released, and have outlined a roadmap on tax policy and measures to enhance Ireland’s intellectual property regime and underpin the government’s commitment to making Ireland a destination for successful global companies.

Over the last year, the Irish Revenue increased their internal resources to deal with transfer pricing matters, with a number of experienced hires from practice in the areas of competent authority and audits. The first transfer pricing audits are now taking place in Ireland.

Italy – Marco Mazzetti – Deloitte Italy

The transfer pricing landscape in Italy has been evolving in recent years in light of a significant number of transfer pricing audits. These audits, in turn, have led to several court cases, especially in the last two years. Most of these cases have affirmed the use of OECD principles, for instance on the importance of comparability factors, as well as on companies in a loss position that cannot be excluded without a functional analysis. Two Supreme Court decisions are particularly noteworthy, including one that applied the lender market principle in assessing whether an interest rate applied on intercompany loans is in line with arm’s-length principle, and another one that considered an interest-free loan from an Italian parent company to a subsidiary not subject to the transfer pricing rules.

Moreover, it is worth mentioning the decree on international tax issues, which is still in draft form, and which includes several transfer pricing changes such as those to the black list regime, exit taxes and advance pricing agreements.

Finally, it is important to remember that, according to Italian regulation, transfer pricing documentation for branches consists of not only the country file but may also include the master file, depending on the qualification of the head office of the branch.

Germany – Christian Jacob, Deloitte Germany

Global measures in response to the OECD’s BEPS initiative also have an impact on the regulatory framework in Germany, in particular for the financial services industry. The German government supports the BEPS initiative, particularly Action 7 (Prevent the artificial avoidance of PE status) and Action 8 (Intangibles), both of which are expected to have an impact on the transfer pricing rules for the financial services industry in Germany.

Regarding German laws, regulations, and case law, the following three developments should be highlighted:

First, in 2014, Germany implemented the Authorised OECD Approach (AOA) in domestic law (Sec. 1 para. 5 Foreign Tax Act (FTA)), followed by the introduction of the decree-law on the profit allocation to permanent establishments (BsGaV), which substantiates the AOA and provides detailed rules especially for banking and insurance companies. Germany generally follows the guidance provided by the 2010 OECD Attribution of Profits to Permanent Establishments Report. However, for some fact patterns, the decree-law provides more detailed rules than discussed by the OECD, and reduces the range of alternative approaches available to the taxpayer. This is especially true for branch capital allocation methods and – deviating from the standards set by the OECD – the refundable presumptions set forth in the decree-law, for example, regarding the concept of the “general representative” in the context of insurance.

Second, the German tax authorities are paying increasing attention to business restructurings and the transfer of functions, including in the financial services industry. This is related to the concept of the hypothetical arm’s-length test, which has been introduced by the amendment of the FTA as of January 1 2008 and the decree-law on the relocation of business functions (FVerlV).

Finally, with its judgment in the case Verder LabTec GmbH & Co. KG (Case C-657/13; judgment dated May 21, 2015) the European Court of Justice has confirmed that Germany’s exit taxation regime complies with EU law. This judgment also clarifies that the adjustment rules based on the AOA, which explicitly allow an adjustment item in the balance sheet (see Sec. 1 para. 5 FTA, in conjunction with Sec. 16 para. 1 no. 1 and para. 2 BsGaV) does not violate EU law.

Netherlands – Pim Gerritsen van der Hoop, Deloitte Netherlands

The Dutch state secretary of finance on June 12, 2014, published decrees updating and replacing, among others, previous guidance on the substance requirements for holding companies and intragroup financing, licensing, and leasing companies. The decrees provide guidance and clarifications by the Ministry of Finance regarding its views on the minimum substance required for intragroup financing, licensing, and leasing companies to successfully claim application of the Dutch treaty network or the EU Interest and Royalty Directive, and to claim withholding tax credits.

In February 2015, the remuneration legislation for companies in the financial services sector (known as Wbfo) officially entered into force. In addition to a 20% bonus cap, whereby variable remuneration cannot account for more than 20% of fixed remuneration, the Wbfo introduces a broad set of rules
to ensure that financial services companies carry out a sound remuneration policy and avoid payment of excessive variable remuneration.

**New Zealand – Bart de Gouw, Deloitte New Zealand**

Although there have been few development in New Zealand transfer pricing legislation and limited publication by the New Zealand Inland Revenue regarding transfer pricing in the financial services sector, the Inland Revenue supports the OECD’s BEPS initiative, with New Zealand following the OECD transfer pricing guidelines closely. Any OECD guidance issued as a result of the BEPS initiative will have an impact on the development of New Zealand domestic legislation and practice going forward.

Despite the lack of formal changes to the New Zealand transfer pricing compliance landscape, Inland Revenue has intensified its transfer pricing review and audit activities in the past 12–18 months, and is recruiting additional resources to assist with this initiative. The following observations apply to clients operating in New Zealand in the financial services industry.

The Inland Revenue has demonstrated an increased focus on debt pricing, particularly since the change in its “small value loan guidance” in 2014, which raised the threshold to NZD 10 million ($6.6 million) and thus increased its focus on loans in excess of this amount. Inland Revenue now has a dedicated debt pricing team, which comprises approximately 50% of its entire transfer pricing team, scrutinising these arrangements in detail.

The Inland Revenue’s 2015-2016 tax policy work programme includes continued work on the BEPS initiative, with particular mention of hybrid instruments and entities in light of the OECD’s recommendations. Inland Revenue has been successful in challenging a number of hybrid instruments in recent years, and the use of these instruments in New Zealand has declined significantly.

Annual basic compliance package (BCP) reviews have become more frequent since their introduction in 2013, with most taxpayers with turnover in excess of NZD 80 million being required to complete an annual BCP information package (of which transfer pricing and financing risk assessment questionnaires are a large part) and attend an interview with the Inland Revenue.

In addition to the BCP process, the Inland Revenue released in June 2015 an International Questionnaire for large multinationals that is designed to collect key information about financing/debt, transfer pricing, and tax management policy matters to assist the tax authorities to measure the impact of BEPS on New Zealand. The questionnaire is a further risk assessment process that supplements the existing BCP and Compliance Management processes already in place; it is expected to feed into key policy decisions for New Zealand as countries move toward implementation measures arising from the BEPS Action Plan.

**United Kingdom – Peter Johns, Deloitte UK**

Transfer pricing has been a particularly hot topic in the UK over the last 12 to 18 months, with increased public interest in the area encouraged by the Public Accounts Committee hearings during late 2013/early 2014, which attracted signif-
icant media attention and led to an upscaling in HMRC’s transfer pricing resources, a development that has already translated into more inquiries within certain sectors, including insurance.

The UK is an enthusiastic participant in the OECD’s BEPS programme and has committed to early adoption of the country-by-country reporting requirements recommended by the OECD in Action 13 (Transfer Pricing Documentation) releases. A significant domestic law development has been the introduction of the diverted profits tax legislation effective April 1 2015, which involves the application of a penal tax rate of 25% to profits viewed as being diverted away from the UK, either as a result of transactions lacking economic substance or the avoidance of a UK PE. This is closely connected with the BEPS programme, in that the stated intention of this legislation is to encourage multinational groups to adjust their UK tax position in line with the government’s expected outcomes from BEPS.
At the end of last year, the Upper Chamber of the German Parliament adopted the final version of the German Regulation on the Application of the Arm’s Length Principle to Permanent Establishments (the Branch Profit Attribution Regulation).

The Branch Profit Attribution Regulation provides detailed guidance regarding the application of the authorised OECD approach (AOA) in Germany, and binds the taxpayer, the tax authorities and the tax courts. The Branch Profit Attribution Regulation confirms the cliché regarding the German affinity for tax law: while the pertinent passages on the AOA in the German Foreign Tax Code include 8 sentences, the related regulation, including the reasoning, includes 142 pages.

The basic idea of the AOA is to treat a permanent establishment as a (nearly) fully independent and separate entity for tax purposes. This implies the consistent application of the arm’s-length principle to internal dealings between the permanent establishment (PE) and its head office and between permanent establishments of the same company, based on a function-and-risk analysis. The Branch Profit Attribution Regulation governs, in particular, the principles of asset attribution, the branch capital allocation, and the recognition of internal dealings (so-called assumed contractual relationships in German tax law).

The AOA’s general two-step approach for profit attribution has already been introduced in 2013 into Sec. 1 para. 5 German Foreign Tax Code, and is applicable for all financial years that have started after December 31 2012. This is not true for the specific application rules of the Branch Profit Attribution Regulation, which apply only for financial years starting after December 31 2014 (Sec. 40 Branch Profit Attribution Regulation). In addition to the new regulation, the German Ministry of Finance (MoF) is working on Administration Principles for the Audit of Profit Attribution to Permanent Establishments, which will be published later this year and will bind only tax auditors, not taxpayers.

The new tax rules are highly relevant, especially for financial services institutions because banks and insurance companies often operate in a branch structure within the EU.

One advantage of this structure is that the company must deal with only one supervisory authority (the so-called EU passport or single license). Like the OECD Report on the Attribution of Profits to Permanent Establishments (OECD PE Report), the German Branch Profit Attribution Regulation includes special sections on permanent establishments of banks and insurance companies that deal with the specifics of these industries.
This article summarises the special German rules for permanent establishments of financial institutions, and analyses whether they are in accordance with the OECD PE Report.

**The AOA’s two-step approach and the specifics of the financial services sector**

Usually, arm’s-length transfer prices are determined taking into account the functions performed, the risks assumed, and the assets used by the related parties involved in the intercompany transaction. In the context of PEs, however, the assets are owned and the risks are borne by the company as a whole, and cannot be legally assigned to a specific part of the enterprise. The AOA solves this dilemma by adopting a strict activity-based focus. In the first step, the significant people functions performed by the PE are identified based on the activities of locally employed personnel. Next, the assets used and risks assumed that are associated with these people functions are attributed to the different parts of the enterprise. Finally, the branch capital is attributed to the PE in relation to the attributed functions and risks. On the basis of this attribution, the internal dealings between the head office and its permanent establishment(s) and between PEs of the same company are identified and an arm’s-length remuneration is determined. For this, the guidance of the OECD Transfer Pricing Guidelines can be applied analogously.

The central business activity of banks and insurance companies is the assumption of risks, manifested in the conclusion of loan agreements and insurance contracts respectively. The OECD PE Report attributes the core financial assets of financial services companies (the loans and insurance contracts) and, therewith, the associated opportunities and risks to the permanent establishment that has performed the key entrepreneurial risk-taking (KERT) function, the most important function in the process of risk assumption. All other PEs involved in the business must be remunerated at arm’s length for their contribution, based on internal dealings.

Moreover, the international profit attribution with respect to banks and insurance companies must take into account regulatory requirements. In particular, the regulatory law is focused on the capitalisation of financial services institutions, because capital is needed to back the risks assumed. Therefore, capital is a key value driver in the financial services sector and the branch capital allocation has a significant impact on taxable income.

**Permanent establishments of banks**

**Attribution of loans**

For financial assets resulting from the traditional banking business (loans), the German Branch Profit Attribution Regulation defines the KERT function as that people function responsible for the creation of the associated opportunities and risks (Sec.19 para. 1 Branch Profit Attribution Regulation).

If PEs located in different jurisdictions are involved in this process, the loan must be attributed to the PE that has performed the most important function up to the point in time when the financial asset has been created. The German regulation does not provide any guidance as to which people function should be generally regarded as the most important one up to the conclusion of the loan. According to the OECD PE Report, the sales/trading function will usually be regarded as the KERT function. (OECD PE Report (part II), para. 6 lit. b). This function comprises a bundle of work steps and includes, for example, the establishment of the client’s credit-worthiness and the bank’s overall credit exposure to the client, the decision whether any collateral is needed, the pricing of the loan, the negotiation of contractual terms, and finally the bank’s commitment of its capital to the loan. Therefore, the asset attribution decision should be based on a detailed functional analysis that should take into account the bank’s organisational structure, the decision-making process, and the decision-making power of the people involved.

In addition, the risk guidelines issued by the German Financial Supervisory Authority (BaFin) should be taken into account in the functional analysis. For the process of issuing a loan, these guidelines require a strict functional segregation between the trading office (so-called Markt) and the middle/back office that performs an upfront risk evaluation (Marktfolge). Both offices must agree independently on the conclusion of the loan. In any credit committee, the Marktfolge must not be in the minority based on the guidelines (Circular dated 14 December 2013, Minimum Requirements for Risk Management, BTO 1.1. No 2). If the company doing the risk control is significantly involved in, or completely prepares Marktfolge vote, an argument could be made for attributing the financial asset upon its creation to the permanent establishment of the bank that performs the risk controlling and management.

If the functional analysis does not lead to a clear-cut result, regarding which people function is the most important one for the creation of the financial asset, the loan agreement must be attributed to the PE that has the customer relationship (this is the rule of last resort). The taxpayer can deviate from this attribution of last resort only if it can demonstrate that attribution to another permanent establishment better reflects the arm’s-length principle.

Any reattribution to another PE of the same bank is possible only in two cases. Sec. 19 para. 4 Branch Profit Attribution Regulation. In the first alternative, reattribution is possible if the PE to which the financial asset has been attributed to no longer performs any people functions at all regarding this asset, and the financial asset will be attributed in the future to the PE that maintains that customer relationship. In the second alternative, reattribution is possible if it better reflects the arm’s-length principle. The reasoning of the regulation clarifies that reattribution to the risk management
function should be possible under the second alternative if risk management plays a central role after the conclusion of the loan agreement. Specifically, if a loan or portfolio of loans becomes non-performing and is therefore managed by a special task force, this condition (central role) seems to be fulfilled.

Diagram 1 summarises the rules for the attribution of loans.

In sum, the Branch Profit Attribution Regulation follows the guidance provided by the OECD PE Report regarding the attribution of loans. In particular, it allows attributing the financial asset to both KERT functions identified by the OECD, namely, the sales/trading function and the ongoing risk management. In comparison to the current rules for the attribution of a loan, the new regulation brings more clarity to asset attribution and avoids the attribution of a loan to several PEs (splitting of assets).

**Profit attribution and internal dealings**

The attribution of the loan also determines the attribution of the associated opportunities and risks (the debtor’s interest payments and any defaults). The PEs that have performed preparatory functions in connection with the creation of the loan or that administer the loan agreement or perform any other auxiliary functions should be remunerated for those services at arm’s length. To determine the amount of that remuneration, the cost plus method is usually appropriate. In case of re-attribution, the transfer of the loan would constitute an “assumed contractual relationship” within the meaning of Sec. 16 para. 1 No. 1 Branch Profit Attribution Regulation, and the actual market value of the loan should be determined.

As a deviation from the general provisions of the Branch Profit Attribution Regulation, an internal dealing regarding the provision of liquidity is possible for PEs of banks if the taxpayer can demonstrate that such long-term financing of one PE by the rest of the enterprise is in line with the bank’s business strategy and with the people functions performed in the other PEs, and better reflects the arm’s length principle than allocating the overall external financing of the bank on an annual basis to the PEs according to their liquidity needs. Sec. 19 para. 6 Branch Profit Attribution Regulation.

**Branch capital allocation**

The rules for the branch capital allocation of banks remain nearly unchanged in comparison to the respective Administrative Principles, which have been in force for 10 years.

---

**Diagram 1: Attribution of financial assets (loans) according to the German Branch Profit Attribution Regulation**

Key entrepreneurial risk-taking (KERT) function, i.e. the most important people function for the creation of the chances and risks resulting from the financial asset (loan), can be unambiguously identified.

Yes (normal case)

Attribution of the financial asset (loan) to the permanent establishment which performs the KERT function.

<table>
<thead>
<tr>
<th>Yes (normal case)</th>
<th>No (rule of last resort)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attribution of the financial asset (loan) to the permanent establishment which has the customer relationship (unless it can be demonstrated in the individual case that another attribution better reflects the arm’s length principle.</td>
<td></td>
</tr>
<tr>
<td>Attribution of the financial asset (loan) to the permanent establishment which performs the KERT function.</td>
<td></td>
</tr>
</tbody>
</table>

Any re-attribution of the financial asset (loan) can only be performed

1. If the loan is now attributed to the permanent establishment which has the customer relationship and the permanent establishment to which the loan was attributed before does not any longer perform any people function with respect to the loan, or
2. If there-attribution leads in the individual case to a result which better reflects the arm’s length principle.
The capital allocation method is the preferred method for the determination of the capital attributable to domestic PEs of foreign banks. Sec. 20 para. 1 Branch Profit Attribution Regulation. See also the OECD PE Report (part II), para. 98-105 for a discussion of this method. The preferred method for the determination of the branch capital of foreign PEs of domestic banks is the regulatory minimum capital approach. This asymmetric treatment of domestic and foreign banks raises the question whether the new German rules are in accordance with EU law. Under this method, the bank’s equity (free capital) must be attributed to the German branch using as allocation key the risk-weighted exposure amounts determined according to the regulatory law of the bank’s home country of the bank. According to the reasoning of the regulation, the term “risk-weighted exposure amounts” directly refers to EU-Regulation No. 575/2013 (the so-called Capital Requirements Regulation, or CRR). Based on the language of the CRR, the risk-weighted exposure amounts relate only to the credit and dilution risk and the counterparty risk for certain transaction types. Art. 92 para 3 lit. a and f of the CRR.

With respect to operational and market risk (Art. 312 ff. and 325 ff. CRR), the regulation does not use the phrase “risk-weighted exposure amount”, so it seems these risks should not be considered for the branch capital allocation. The German branch must be attributed a share in the equity that equals the bank’s total equity – determined according to German tax accounting rules – times the risk-weighted exposure amounts attributable to the German branch, divided by the risk-weighted exposure amounts of the whole bank. If the bank makes use of the solo-waiver according to Art. 7 CRR and the own funds requirements are fulfilled only on a consolidated basis, the bank must provide evidence that the entity to which the German branch belongs is endowed with sufficient capital on a solo basis. Alternatively, the equity and the risk-weighted exposure amounts of the consolidated group should be used for the capital allocation.

For purposes of this calculation, the risk-weighted exposure amounts resulting from internal dealings should not be taken into account. For the sake of simplicity, the taxpayer can use, as the amount of equity, the paid-in capital plus the reserves and retained earnings minus the accumulated deficit – all taken from the foreign balance sheet – if it can demonstrate that it is plausible that the equity amount does not significantly deviate from the equity determined under German tax law. Sec. 12 para. 2 sent. 2 in connection with Sec. 20 para. 5 sent 2 Branch Profit Attribution Regulation.

The taxpayer can apply another method for the capital allocation and attribute less capital to the German branch, if it can demonstrate that this result better reflects the arm’s-length principle. Sec. 20 para. 2 Branch Profit Attribution Regulation. If the taxpayer applies this escape clause, the German branch must be attributed at least capital in the amount that would result from applying the regulatory minimum capital approach. This means that the PE must be attributed core capital at least in the amount the branch would be required to hold based on the regulatory law if it operated as a legally separate entity in the German market. This method corresponds to the safe harbour approach (quasi-thin capitalisation/regulatory minimum capital approach in the OECD PE Report (part II), para. 112-115. In addition to this, the German legislation assumes that the branch holds a buffer of 0.5 percentage points of the sum of its risk-weighted exposure.
amounts to be able to expand the business at any moment. A similar provision is already included in the actual public ruling on the branch capital allocation. In the new regulation, the taxpayer is given the right to demonstrate that a smaller buffer is more appropriate for his business.

The simplification rule for small banks has been extended to domestic permanent establishments of foreign banks with a balance sheet total in their Auxiliary Calculation (discussed in Section 4 of this article) below €1 billion ($1.1 billion) (before that, the threshold was only €500 million).

The simplification rule to apply this simplification rule and instead use the standard method if, for example, the capital allocation method leads to a capital of less than 3% of the branch’s total assets or to a lower amount than the minimum amount of €5 million.

The Branch Profit Attribution Regulation does not allow the application of one of the methods described above to result in an attribution of free capital to the German PE that is less than the capital that has been recorded in the statutory accounts of the German branch, if such statutory accounts have been prepared. Sec. 20 para. 5 sent. 2 in connection with Sec. 12 para. 5 Branch Profit Attribution Regulation.

After having determined the assets and the branch capital in the Auxiliary Calculation, liabilities must be attributed to the German branch to equalise the balance sheet. If feasible, a direct attribution of liabilities and their associated refinancing expenses must be performed. If a direct attribution is not feasible or causes a disproportionate burden, an indirect attribution of liabilities must be performed and the average refinancing expenses of the indirectly attributable liabilities must be attributed to the German branch. In comparison to the actual public ruling on the branch capital allocation, the simplification rule to apply the average 12-month EURIBOR for any correction of the non-deductible refinancing expenses associated with the free capital did not find its way into the new regulation.

Global trading
Financial instruments traded globally 24/7 must be attributed primarily like assets resulting from the traditional banking business to the PE that performs the KERT function, that is, the people function that is most important for the creation of the associated chances and risks. See Sec. 22 Branch Profit Attribution Regulation. The German regulation defines global trading as – including but not limited to – (i) the global issuance and the global distribution of financial instruments; (ii) acting as market maker for physical securities; (iii) acting on stock and commodities exchanges; and (iv) the development of new financial products.

If global trading is performed via a global book, and if no clear attribution is feasible at all, or only with disproportionate effort, the profits resulting from these financial instruments must be attributed to all PEs involved based on a reasonable allocation key. Because it is often impossible to distinguish between profits that have been realised for tax purposes and unrealised ones, the allocation must be made for both at the same time. Another attribution of the financial instruments is possible (for example, to a central booking location), if the associated opportunities and risks inherent in the global trading are nevertheless attributed to all PEs involved and are taken into account for the determination of their branch capital. In addition, this (central booking) approach must be recorded in the Auxiliary Calculation and the taxable income of the branches involved must remain unchanged by this booking procedure.

If the KERT function in the global trading is performed in different jurisdictions, the transactional residual profit split method must be applied if no other method better reflects the arm’s-length principle in the individual case.

PEs of insurance companies
 Attribution of insurance contracts
In contrast to banks and all non-financial services companies, the attribution of insurance contracts has a direct impact on the liability side of the insurance company’s balance sheet. This is because the attribution of all technical reserves follows the attribution of the insurance contracts. Moreover, the attribution of the technical reserves has a direct impact on the attribution of investment assets; thus, the attribution of insurance contracts is crucial for insurance companies.

According to the OECD, underwriting is typically the KERT function in the insurance sector, that is, it is the most important active decision-making function relevant to the assumption of risks. See OECD PE Report (part IV), para. 50, para. 68-69, para. 73, para. 93-94, para. 103, para. 127 and para. 193. In line with this view, the Branch Profit Attribution Regulation defines underwriting as the (only) KERT function. The German regulation defines underwriting as setting the underwriting policy, risk classification and risk selection, pricing, risk retention analysis, and the acceptance of insured risk. OECD PE Report (part IV), para. 34. Contrary to the OECD PE Report, the German regulation rebuttably presumes that for the reinsurance business, risk classification and risk selection is the KERT function.

If PEs located in different tax jurisdictions are involved in the underwriting process, the insurance contract must be attributed to the PE that performs the most important function in this process. Thus, in those cases, the attribution decision must be based on a detailed functional analysis in
particular of the underwriting process that takes into account the characteristics of the specific line of business and the allocation of decision-making powers within the approval chain.

The regulation includes a rebuttable presumption that if a foreign insurance company operates in Germany via a registered branch, the underwriting is performed in the German branch. Sec. 24 para. 5 Branch Profit Attribution Regulation. This presumption is based on the argument that by regulatory law the branch’s appointed general representative is authorised to conclude binding insurance contracts with insureds in Germany. Sec. 106 para. 3 sent. 3 Insurance Regulation Act. However, this reasoning stands in clear contradiction to the OECD consensus in cases in which the underwriting is actually not performed by the German branch. As a result, this rule has been heavily criticised in the literature. The only resulting change the German MoF made in the final regulation (compared to the draft version published 5 August 2013), was to allow taxpayers to rebut this presumption. For this, the foreign insurance company must demonstrate to the German tax authorities:

- That the domestic insurance branch indeed does not perform the most significant role in the underwriting process;
- That the general branch manager has not outsourced the underwriting function by active decision-making and does not control the underwriting performed abroad; and
- Where the KERT function is actually performed.

In addition, the foreign insurance company must inform the supervisory authorities in Germany and in its home country about these facts. If the taxpayer does not prepare such documentation, the insurance contracts and all associated opportunities and risk are attributed to the German branch. Diagram 2 summarises the attribution of insurance contracts.

**Profit attribution and internal dealings**

The attribution of insurance contracts also determines the attribution of associated opportunities (the premium income) and risks (in particular the claims). All other PEs that contribute to the insurance business (for example, those that perform asset management, claims management, administration of the contracts, and any support functions) must be remu-
nerated at arm’s length based on internal dealings. For asset management activities, arm’s-length (sub)advisory fees (in basis points of total assets under management) are usually observed in the market. For claims management and other support functions, a cost-based approach seems appropriate. With respect to the recognition of internal dealings, it must be noted that the German regulation explicitly and categorically excludes internal reinsurance dealings. Sec. 28 Branch Profit Attribution Regulation.

Branch capital allocation
The new rules regarding the branch capital allocation for insurance companies represent uncharted waters, given that the actual public ruling on branch capital allocation is rather vague with respect to insurance companies.

According to the Branch Profit Attribution Regulation, the “modified capital allocation method for permanent establishments of insurance companies” is the preferred method for the branch capital allocation to domestic permanent establishments of foreign insurance companies. Conversely, for foreign permanent establishments of domestic insurance companies the minimum capital approach is the preferred method. This method is applied in two steps. First, a share in the (investment) assets of the foreign insurance company that cover the technical reserves and the surplus is attributed to the domestic branch using the technical reserves – determined according to the foreign GAAP – as allocation key. Subtracting from these attributable (investment) assets the technical reserves, other liabilities and deferred items resulting from the insurance business – all determined according to German GAAP – yields the capital attributable to the German branch.

A method other than the capital allocation method can be used if it better reflects the arm’s-length principle (Sec. 25 para. 3 Branch Profit Attribution Regulation). An example of such other method (if the taxpayer provides reasons why it better suits the fact pattern) might be the thin capitalisation/adjusted regulatory minimum approach. If the taxpayer uses another method, the German branch must at least be attributed that amount of capital that would result from the application of the regulatory minimum approach.

The reasoning of the regulation explicitly denies that the escape clause can be used to apply another allocation key than the technical reserves for the capital allocation method. This contradicts the OECD’s view, which regards several alternative allocation keys as appropriate (for example, premiums, solvency margin, and hybrid approaches). OECD PE Report (part IV), para. 150. Although the reasoning of the regulation does not represent binding law for taxpayers, it can be expected that German tax auditors will refer to the reasoning if an allocation key other than technical reserves is used.

Regardless of the capital allocation approach applied, the German branch must not be attributed an amount of capital less than the capital that has been recorded in a domestic statutory balance sheet for the domestic branch. Therefore, it is highly recommended that foreign insurance companies check whether the approach used for the capital allocation in the statutory accounts is in line with the new tax regulation before the statutory balance sheet of the German branch is prepared for any financial year starting after December 31 2014.

The German branch must be attributed (net) investment returns associated with the attributable assets if the assets back either the technical reserves, the liabilities and deferred items resulting from the insurance business, or the branch capital of the German branch. Preferably, the net returns are directly attributed to the assets. If this is not feasible (for example, because the German branch does not directly hold any or sufficient assets), the “average net return from invested assets” must be applied. This value must be disclosed by every insurance company in the annual report. It takes into account both the returns from investments and the associated expenses and indirect costs.
New documentation requirements: Auxiliary Calculation

The Branch Profit Attribution Regulation also introduces an obligation for taxpayers to prepare a separate balance sheet and profit and loss statement for the German permanent establishment in accordance with the principles of the AOA (the Auxiliary Calculation). Sec. 3 Branch Profit Attribution Regulation.

The Auxiliary Calculation comprises the assets attributable to the PE, the opportunities and risks, the branch capital, and the liabilities. For this, it seems recommendable going through the tax balance sheet of the bank or the insurance company line by line and checking whether the asset attribution applied so far is in line with the Branch Profit Attribution Regulation. In addition, the fictitious revenues and expenses resulting from internal dealings have to be recorded in the Auxiliary Calculation.

The Auxiliary Calculation must be prepared by the filing date of the PE’s tax return for the pertinent fiscal year. This requirement has given rise to the fear that a contemporaneous documentation requirement has been introduced into German tax law through the backdoor. It is appreciated, therefore, that the final version of the regulation states that the reasoning for the asset attribution and the identification of internal dealings must be documented in writing based on the general transfer pricing documentation requirements (Sec. 90 para. 3 General Tax Code). These general rules require only that the taxpayer be able to submit its transfer pricing documentation for its routine intercompany transactions within 60 days upon a tax auditor’s request to avoid late submission penalties. Extraordinary business transactions (any relocation of a business function from the German PE to the foreign head office) must be documented within six months after the end of the fiscal year in which they have occurred, and the respective documentation must be submitted within 30 days upon request. The above rules notwithstanding, it is advisable for taxpayers to appropriately document the reasons for the asset attribution when preparing the tax return to ensure consistency between the submitted tax return and the subsequent transfer pricing documentation.

Profit Attribution Health Check recommendable for financial institutions with PEs in Germany

In light of the detailed rules regarding application of the AOA, and the various refutable presumptions found in the Branch Profit Attribution Regulation, it seems highly recommendable for financial institutions with PEs in Germany to perform a health check as to whether their currently applied approach for profit attribution is in line with the new German regulation.

The health check should focus on the specific rules regarding the attribution of loans and insurance contracts to the German branch respectively, and the branch capital allocation methodology. This is particularly true if the bank or the insurance company applies an escape clause. If, for example, the bank deviates from a standard approach because another approach better reflects the arm’s-length principle, the reasons for this deviation should be documented in writing. If the German branch of a foreign insurance company does not perform the underwriting, special documentation must be prepared for submission to the tax authorities and disclosure to the supervisory authorities.
Risk and recharacterisation – Does it make sense in a financial services context?

Robert Plunkett, Bill Yohana, and Brian Green of Deloitte Tax in the US, focus on the aspects of risk and recharacterisation and explain how taxpayers can take measure to protect themselves as global legislation realigns.

As part of its broader base erosion and profit shifting (BEPS) initiative, the OECD issued a non-consensus discussion draft in December 2014 on “Risk, Recharacterisation and Special Measures”. That document delineated proposed changes to the OECD’s transfer pricing guidelines that affect how tax authorities might evaluate risk allocation among members of multinational groups, along with instances when tax authorities could recharacterise a given transaction or set of transactions. Subsequent guidance from the OECD noted that “special measures” would not be required.

Significantly, the OECD leaves open the question whether the risk and recharacterisation discussion draft’s precepts should apply to financial institutions, including commercial banks and other entities that deal in securities, loans, and commodities. For regulated financial services companies, cross-border risk management can constitute a significant component of their business. The role of capital, even if separated from functions, is important in these types of businesses, particularly in light of the introduction of the Bank for International Settlement’s Basel III capital requirements. Basel capital requirements have been adopted in some form or fashion by most OECD members.

This analysis considers an important aspect of the risk and recharacterisation discussion draft – its views on the treatment of capital – and concludes that applying a key aspect of the thinking underlying the discussion draft to financial institutions would not be appropriate, given the role of capital in this sector. In particular, an objective of the discussion draft is “to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital”. It is unclear how the OECD might apply this approach to the banking sector.

In broad terms, the risk and recharacterisation discussion draft proposes that returns associated with risk bearing should be allocated to entities that perform value-creating people functions, rather than to entities that merely provide capital. In a financial services context, this guidance could be interpreted to imply that if a derivatives trader in New York entered into a transaction and recorded (or booked) that transaction in the bank’s London affiliate, the return associated with that transaction would be reattributed to the US entity, notwithstanding the fact that the UK affiliate would be required to hold regulatory capital, and the possibility that the UK affiliate might bear the economic losses from the trade. To the extent that the risk and recharacterisation discussion draft allows for a return to capital for the assumption of risk, the quantum of return may not be large,
as noted in the discussion draft’s section on inappropriate returns for providing capital:

“Transfer pricing rules, including the guidance in Part I of this discussion draft, focus on the functions actually performed in relation to those assets, including the management of risks, and may determine that little or no return is due to the capital-rich, asset-owning company, and in some circumstances may determine that the resulting intra-group transactions relating to that company’s assets should not be recognised”

To the extent that an entity providing capital earns a return, the risk and recharacterisation discussion draft argues that it should receive only a “normal” return. This is perhaps best articulated at the end of the discussion draft, where the OECD states that “excess returns would need to be defined in accordance with design considerations but could target returns associated with intangibles and risk and equal all of the CFC’s income, less an allowance for corporate equity, which may provide an exemption for normal returns on capital invested in real activities within a jurisdiction”.

There is a broad body of academic literature that asserts that returns to equity capital are inherently volatile. Hence, when ascribing a fixed rate of return to risk-bearing functions, the very real possibility exists that the actual return to capital providers could deviate from a modeled, long-run return; this possibility increases as the risk of the underlying asset increases. Moreover, when contemplating the return to capital in a financial services business, it is important to note that regulators such as the Federal Reserve and its foreign counterparts view net income and retained earnings as a source of capital, and hence could be expected to have views about the legal entities to which net income is attributed and the extent to which such income is subject to tax (or double tax).

To illustrate the impact of ascribing a routine (fixed) return to capital and attributing residual returns to “people functions”, we looked at publicly available data from Bloomberg and the Osiris database on the net income of approximately 20 large, regulated banks with significant multinational operations for the period from 2010 to 2014. While the primary regulator of these banks differs depending on the institution’s parent country, all the banks in our set were subject to a regulatory regime based on the Basel Accords and had regulatory capital amounts that were supported by Tier 1 and Tier 2 capital.

It is a simplistic but useful shorthand to conceptualise Tier 1 capital as “equity-like” and Tier 2 capital as “debt-like”. Applying this intuition, we looked at both book value estimates of the after-tax return on equity and market estimates (Bloomberg CAPM derived) of the after-tax return on equity. A 10% return on equity fell into both ranges, and hence appears to be a reasonable proxy for the average rate of return that one would expect regulatory capital to earn.

For approximately 70% of the banks in our sample of large, regulated banks with significant multinational operations, the risk and recharacterisation discussion draft argues that it should receive only a “normal” return.
routine return to Tier 1 capital was greater than or equal to the net income actually earned by the bank. For the other 30% of banks, the routine return to Tier 1 capital accounted for 80% of the bank’s total net income, on average. Moreover, if one were to ascribe some return to the Tier 2 capital or to other routine functions, the amount of residual profit that could be attributed to value-creating people functions would be lower still.

In the risk and recharacterisation discussion draft, the OECD asks whether this guidance should apply to financial services firms:

“Is the discussion of risk of a general nature such that the concepts apply to financial services activities notwithstanding the fact that for financial services activities risk is stock in trade and risk transfer is a core component of its business? If not, what distinctions should be made in the proposed guidance?”

The analysis above also suggests that the risk and recharacterisation guidance may be difficult to apply in the financial services industry – or at least that portion of the industry involving the use of significant amounts of regulatory capital – because the attribution of routine returns to regulatory capital may not leave sufficient levels of residual profit to attribute value to any function other than the provision of capital and the assumption of risk.
Global Transfer Pricing
Proactively addressing global tax planning and tax compliance

Multinational organizations are operating in an environment of unprecedented complexity. Rising volume and variety of intercompany transactions and transfer pricing regulations, accompanied by increased enforcement activities worldwide, have made transfer pricing a leading risk management issue for global businesses.

Deloitte’s transfer pricing professionals apply in-depth knowledge and experience to help develop, refine and maintain an effective transfer pricing program. We understand the current focus of tax authorities, and we have the technical and practical experience and tools necessary to help you navigate the transfer pricing environment in the U.S. and globally.

Deloitte’s global transfer pricing practice specializes in 15 industries, our services include:

- Advance Pricing Agreement Inbound
- Global Documentation
- Controversy Inbound
- Strategic Transfer Pricing Review
- Controversy Outbound
- U.S. & India Advance Pricing Agreement
- Business Model Optimization (BMO) Intellectual
- Property Tax Planning and BMO Supply Chain

To learn how you can win in a changing world, visit www.deloitte.com/transferpricing.
New powers to tax offshore booking of Australian customer sales

Geoff Gill and Priscilla Ratilal, of Deloitte Australia, discuss the Australian government’s increased focus on anti-avoidance measures to tax offshore bookings of Australian customer sales, particularly in relation to marketing operations.

Multinational corporations operating in Australia with marketing operations and customer sales booked offshore have been on notice for some time that these operations will come under close scrutiny by the Australian Taxation Office from a transfer pricing and permanent establishment (PE) perspective.

However, a new focus is emerging with the Australian government’s release of draft legislation extending anti-avoidance provisions to those situations.

In May 2015, an integrity measure specifically aimed at addressing multinational tax avoidance was announced as part of the 2015-16 Australian federal budget. Simultaneously, Treasury released exposure draft legislation on this topic:- draft Tax Laws Amendment (Tax Integrity Multinational Anti-avoidance Law) Bill 2015 (MAAL).

The Australian government’s primary focus is to target the technology sector, which the government believes aggressively uses low-tax jurisdictions as booking locations for Australian customer sales. However, the law, when enacted, could also significantly affect the financial services and financial technology (fintech) sectors.

This article provides a review of the basic mechanics of the new law, identifies a number of important features, and discusses the implications of the new law and associated ATO compliance activity for the financial services and fintech sectors.

The proposed law

The explanatory memorandum (EM) released with the exposure draft legislation indicates that the new provisions are intended to target only “the most egregious tax structuring by multinational entities, while limiting the impact on legitimate international business activities”.

The EM explains that the draft legislation will introduce changes to Australia’s general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936) to “negate certain tax avoidance schemes used by multinational entities to artificially avoid the attribution of business profits to a permanent establishment in Australia”. The significance of including the MAAL in Part IVA is that Part IVA generally overrides Australia’s tax treaties. As a result, the intention is to allow a PE to be deemed to exist under Part IVA, even though no such PE would exist under the relevant treaty.

The draft legislation targets both the business profits that could be attributable to a deemed Australian permanent establishment and obligations arising under royalty and interest withholding tax.
Effectively, the tax rate on such profits could be as high as 60% (that is, the statutory Australian corporate tax rate of 30% plus a 100% penalty).

The measure will apply when:
• A nonresident of Australia makes a supply to an unrelated Australian resident;
• The income derived by the nonresident is not attributable to an Australian permanent establishment of that nonresident;
• Activities are undertaken in Australia in connection with the supply;
• Some or all of those activities are undertaken by an Australian resident (or an Australian permanent establishment of an entity) which is an associate of, or commercially dependent on, the nonresident;
• It is reasonable to conclude the scheme is designed to avoid the nonresident deriving income attributable to an Australian permanent establishment of the nonresident;
• A principal purpose is to enable a taxpayer (the nonresident or another entity) to obtain a tax benefit, irrespective of whether the scheme also reduces foreign taxes or other Australian non-income taxes (such as the goods & services tax (GST)); and
• The foreign resident is connected with a no-tax or low-tax jurisdiction (see below).

A global revenue threshold of AUD 1 billion ($700 million) will be applied – multinationals must have global sales exceeding that figure for the measure to apply to them.

The measures will apply to tax benefits arising on or after January 1 2016, irrespective of the date the scheme was entered into or commenced.

Broad scope of dealings
The measure potentially will apply to nonresidents with a broad range of dealings with Australians, including but, importantly, not limited to, “the supply of electronic material, advertising services, downloads, the provision of data, intellectual property rights, and the right to priority in search functions”.

The legislation will apply only when the nonresident deals with an Australian resident who is not an associate. Therefore, supplies made by nonresidents to or through an Australian subsidiary should not be caught.

Foreign taxes are relevant to purpose test
The Australian government has recognised that focusing only on Australian tax benefits could be problematic for this measure. The EM provides an example of a group that uses an identical structure throughout the region and that has been designed to avoid the creation of permanent establishments in a number of countries in the region. The Australian operations are a relatively small part of the group’s regional operations.

Ordinarily, it would be possible to argue in such a case that any purpose of obtaining an Australian tax benefit was only a minor purpose of the overall structure, given the relatively small size of the Australian operations. The draft legislation seeks to counteract this argument by testing purpose with regard not only to the Australian tax benefit but also to foreign income tax benefits and Australian non-income tax benefits (such as GST).

It should be noted that while purpose is tested with regard to all of these taxes, only the Australian tax benefit (as determined under the Part IVA rules) can be attacked under this measure – in other words, the measure does not seek to prevent avoidance of foreign taxes or Australian taxes other than income tax.

Profits “channelled” to tax havens
While the Treasurer’s announcement referred to profits channelled to tax havens, the draft legislation includes what is arguably a much broader category of profits. The measure will apply when a nonresident is “connected with” a no-tax/low-tax jurisdiction. This will be the case when the nonresident or any other member of its global group conducts any activities that give rise to income that falls within either of the following categories:
• Income subject to no tax or a low rate of tax by virtue of either a law of a foreign country or an arrangement with the government or an authority of a foreign country. It is important to note that a “low rate of tax” is not defined either in the legislation or the EM.
• “Stateless income” – income that is not subject to tax in any country.

Many multinationals could potentially come within this aspect of the test, because multinationals need to look beyond the particular nonresident entity making the supply, and consider if the income further up the value chain is subject to no tax or low tax. However, there are two carve-outs:
1) When the activities generating the no-tax or low-taxed income are not related directly or indirectly to the Australian dealings, or
2) When the entity undertaking the activities undertakes “substantial economic activity” in the no-tax or low-tax country.
It is important to note that the key terms “substantial economic activity” and “low tax” are not defined.

The onus of proof for these two carve-outs will be on the taxpayer.

Implications for financial services
Origination activities whereby the ultimate supply is made by a separate legal entity to the marketer/originator are very common in financial services. Consider the situation whereby trades, loans, or leases are introduced by one part of a group to another offshore booking entity, which has the capital and/or trade risk management capabilities. The trades, loans, or leases may be introduced by a subsidiary that is responsible
for the local client liaison function, or potentially by a representative office whose activities are arguably preparatory or auxiliary and therefore the representative office has not reached the threshold of creating a permanent establishment under the current law. While banking enterprises, such arrangements are often commercially dependent on capital efficiency and location of expertise. However, it may be the case that these booking entities are located in low-tax jurisdictions, or have received reduced tax rates from local fiscal authorities to encourage economic activity. It is also potentially the case that there may be a separation of functional activity from the booking entity, and the remote booking may be enabled by technology platforms. In those situations, when the product supply is to/with an Australian customer, the potential applicability of the new MAAL should be considered.

Digital disruption continues apace in financial services, particularly in mature markets such as Australia. There is a significant amount of innovation in financial services around payments, online brokerage, currency exchange, small business and peer-to-peer lending, and wealth management. There are also many software companies focused on solutions for the financial services sector. In some situations, the new MAAL could apply to those companies when offshore residents sell product to Australian customers that is enabled by local marketing and origination activity.

Managing risk in the current environment
The ATO is actively testing whether, under current laws, Australian marketing operations perform sufficient activity regarding negotiation of sales to result in the creation of a PE in Australia of the offshore resident sales booking entity. Similarly, the appropriateness of transfer pricing policies to reward the originating entity is being tested in the field, with approaches that may vary from cost plus/transactional net margin method (TNMM) using a cost-based profit level indicator, to commissions on sales and profit splits.

For example, in 2013 the ATO sent a questionnaire to all inbound banks regarding online banking platforms and local marketing activity.

The new MAAL is a significant measure that multinationals in the financial services space will need to consider carefully. Given the level of activity regarding sales/marketing/origination activities, multinationals should review their current arrangements to consider their risk from a transfer pricing, PE, and (now) MAAL perspective.

In terms of risk management with regard to the proposed MAAL and associated compliance activity, some options available to MNCs include:

- Preparation of analysis and a defensive paper rebutting the potential applicability of the MAAL, having regard to the fact that the new law places the onus of proof on the taxpayer to prove the law would not apply (for example, a substance test).
- Reviewing the pertinent facts as to whether, under existing law, a permanent establishment is likely to exist, and preparing defensive documentation.
- If the risk of application of the MAAL is high enough, consider more proactive measures, such as:
  - Recognition of a deemed permanent establishment, and attribution of profits to that PE under OECD principles.
  - Booking of the sales revenue in the subsidiary entity, subject to systems capacity and other commercial and tax impacts.
  - Reviewing the transfer pricing method to reward the subsidiary, which could be modified to a sales-based profit allocation, or profit split.

In some situations, it may be appropriate to manage risk through a proactive approach to the ATO in the form of an advance pricing arrangement, which could achieve certainty on the attribution of profits to the subsidiary and any deemed permanent establishment.

Conclusion
Offshore booking of sales and trading revenue when the ultimate customer is in Australia carries current and emerging tax risks. Because those models are reasonably common in the financial services and fintech sectors, such risks need to be evaluated and managed.
Priscilla Ratilal is an account director with Deloitte’s transfer pricing group in Sydney, Australia. Priscilla has advised multinational clients on a wide range of transfer pricing matters including audits and risk reviews by the Australian Taxation Office (ATO), the negotiation of unilateral and bilateral advance pricing arrangements (APAs), planning strategies and transfer pricing documentation to support tax return filing positions.

Priscilla was based in an investment bank in New York for two years as the transfer pricing manager for the Americas. Her role included oversight of transfer pricing compliance in the US, Canada, Mexico, Brazil and Argentina, advising on transaction structuring from a transfer pricing perspective and management of transfer pricing audits by the US Internal Revenue Service and Canada Revenue Agency.

Priscilla specialises in financial services transfer pricing and the pricing of intra-group financial transactions. Her relevant experience includes:

- Pricing of intra-group guarantee fees and lending, including inter-branch funding for multinational banks;
- Analysis to determine arm’s length gearing levels;
- Transfer pricing analysis and attribution of profits in the global dealing of FX, bonds, equity swaps;
- Preparation of transfer pricing documentation and assistance in a revenue authority risk review on the global trading of commodities and commodity derivatives;
- Attribution of profits for lending activities performed in multiple branches;
- Allocation of investment banking fees to remunerate cross-border involvement in M&A advisory, DCM and ECM activities;
- Preparation of transfer pricing documentation and audit defence for management service charges in an equipment leasing business; and
- Transfer pricing due diligence for mergers and acquisitions.

Qualifications

- Bachelor of Arts (Economics and English) – University of Sydney
- Bachelor of Law – University of Sydney
- Masters of Law (Taxation) – University of Sydney

Geoff Gill is a partner and economist with Deloitte’s Global Transfer Pricing group in Sydney. Geoff has over 16 years of experience in transfer pricing, and has worked in both London and Sydney. Geoff leads Deloitte Australia’s transfer pricing practice for the financial services industry. Geoff also specialises in and has extensive experience in the analysis of financial transactions.

Geoff was nominated as a World’s Leading Transfer Pricing Adviser in Euromoney’s 2013 guide and, recently, in its new 2015 guide.

Skills and expertise

Geoff has successfully completed a wide range of bilateral and unilateral advance pricing arrangements and audit defense projects. Geoff advised on the first completed joint transfer pricing audit between the ATO and IRS.

Geoff has published articles on loan guarantees, debt financing and the transfer pricing case law in international journals and speaks regularly at external seminars. Recently, he has been closely involved in working with the Australian Treasury on the reforms to Australia’s transfer pricing rules and on the Inspector General of Taxation’s review of the ATO’s approach to transfer pricing compliance.

Industry specialisation

Geoff’s work covers a wide variety of industries. However his focus areas include:

- Financial services – Transfer pricing advisor to a number of retail and investment banks, property trusts, fund management and brokerage companies
- Telecommunications Media and Technology – including setting global transfer pricing policies and ATO controversy
- Debt pricing – analyses for a wide variety of debt instruments, guarantee fees and determination of arm’s length debt levels.

Professional and academic qualifications

- Master of Philosophy in Economics, University of Oxford
- Bachelor of Economics (Honours), Trinity College, Dublin
- ACCA Diploma in Accounting and Finance
- Affiliate of Institute of Chartered Accountants in Australia
- Member of Tax Institute of Australia

Geoffrey Gill
Partner – Transfer Pricing
Deloitte Touche Tohmatsu
225 George Street
Sydney NSW 2000
Tel: +61 2 9322 5358
gegill@deloitte.com.au

Priscilla Ratilal
Account Director – Transfer Pricing
Deloitte Tax Services
225 George Street
Sydney, NSW 2000
Tel: +61 (2) 9322 5086
pratilal@deloitte.com.au
How BEPS and and Bulletin 16 could impact outbound payments from China

Patrick Cheung and Johnny Foun, of Deloitte China, go through the significant aspects of the BEPS action plan and local legislation to explore how these policies could affect multinationals’ outbound payments from China.

Many multinational financial institutions (FIs) operating in China have had their intragroup service fees and royalties scrutinised by the Chinese tax authorities in the past few years.

This has been part of a broader State Authority of Taxation (SAT) focus on large outbound payments since 2012. Most of the tax authorities’ reviews of FIs’ outbound payments had been focused on the concept of benefits, and in particular, what benefits were provided by the services or intangibles to the Chinese entity in question.

Many of the inquiries by the local tax bureaus resulted in stalemates, because proving benefits provided turned out to be difficult, and the tax bureaus’ concern that some of the services rendered may have been stewardship services, or duplicative in nature, required substantial amounts of evidence as part of the review process.

Another difficult challenge was the lack of an official definition of some of the “benefit tests” in the current Circular 2 – Special Adjustments Implementation Measures issued by the SAT. Circular 2 is China’s primary transfer pricing administrative guidance.

Lastly, the view of financial regulators such as the China Banking Regulatory Commission (CBRC) on what is an allowable service or royalty is also unclear. All these factors led to an uncertain environment for multinationals, which are also under pressure in their home locations to ensure that appropriate costs are charged out to affiliates that have benefited from the services or the intangibles for tax and regulatory purposes.

The SAT stated its views on a number of transfer pricing subjects in the United Nations Practical Manual on Transfer Pricing for Developing Countries, issued in 2012, and in a subsequent comment letter regarding services issued in 2014. Now, after a number of preliminary measures, the SAT has formalised its position with the issuance of Bulletin 16 in 2015 (see Diagram 1).

The benefit tests introduced by Bulletin 16 are consistent with the OECD’s historical approach to analyse the reasonableness of service fees. The language used in Bulletin 16 is consistent with the discussion draft issued by the OECD under its Base Erosion and Profit Shifting (BEPS) initiative regarding low-value-adding intragroup services, which provides that a benefit test will be performed to evaluate whether “the activity provides to a respective group member with economic or commercial value to enhance or maintain its commercial position....”

While the concepts behind some of the SAT’s current “six tests” (the benefits test, necessity test, duplication test, value creation test, remuneration...
test, and authenticity test) sometimes overlap, the clearer language of Bulletin 16 now clarifies the SAT’s view of what factors are important in evaluating the reasonableness of service fees. The tests themselves are broadly consistent with the OECD’s own benefit tests in terms of stewardship and duplicative and other activities that do not provide benefit to the service recipients, although the terms used may be different. It also reflects the SAT’s effort to implement parts of the BEPS Action Plan domestically.

In the context of services fees and royalties paid by FIs to related parties outside China, the various benefit tests now stack up as follows:

Economic value benefit test

Article 4 of Bulletin 16 treats payments for “incidental” benefits as nondeductible. This position is in line with the current OECD view on services as expressed in the BEPS discussion draft.

Article 6 also denies the deductibility of royalty payments to overseas related parties for “incidental benefits” derived from the financing and listing of the holding company – that is, royalty payments to overseas headquarters that claim that the listing of the group enhances the reputation of the PRC subsidiary.

The SAT has stated specifically in Article 2 of Bulletin 16 that there will be no deduction for royalties paid to recipients that are IP box-type companies with no commercial substance. This of course does not mean royalties are never allowed. However, it does mean that to get the royalty deduction, the PRC entity must show that the fees or royalty recipient has provided demonstrable and perhaps quantifiable benefits to the PRC entity through ongoing “DEMPE” functions (developing, enhancing, maintaining, protecting, and exploiting intangibles) and related investments, rather than merely through group association.

In other words, an extensive global network of bank branches with a well-recognised brand cannot be the primary
basis of a royalty charge. The taxpayer now must demonstrate that the legal IP owner charging the royalty has to actively drive the ongoing development, enhancement, or maintenance of the brand, and that the PRC entity can reasonably exploit said brand in the China market because of these ongoing efforts by the IP owner. For example, has the development cycle considered perception of Chinese banking or insurance customers? What China-specific marketing and branding activities were implemented, and what are the expected financial and non-financial benefits specific to China?

Necessity test
The SAT advocates that consideration should also be given to whether the PRC subsidiary needs the services subsidiary, and what are the direct and indirect benefits received. For example, if a multinational insurer allocates product development costs to its global affiliates, but the PRC subsidiary does not have the required regulatory approval or capital to sell some of the products being developed, it may be difficult to demonstrate direct benefits. At the same time, would it be possible to demonstrate indirect benefits if the PRC entity is in the process of seeking approval for selling such products in China?

Value creation test
As noted above, services can create value when they are able to bring in identifiable enhancements of economic and business value — improving the service recipient’s operating performance. Of particular concern to the SAT are service payments to parent companies just for providing authorisation services to the local country management. In those situations, the SAT believes those services are simply management services that serve as a procedure instead of creating identifiable economic or commercial values, and therefore they should not be charged. While this may be viewed as consistent with the OECD’s approach to stewardship or custodial costs, for FIs around the world, substantial and ever-increasing efforts and costs are spent on improving controls and ring-fencing risks. The question of how much of these costs is spent for shareholder protection and how much is for risk mitigation for the specific local entities and their local customers can be a complex one.

Duplication test
This test is consistent with existing OECD guidelines, and it also appears in the discussion draft issued by the OECD on low-value-adding services: “... no intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself, or that is being performed for such other group member by a third party”. Because they are large, complex, and sometimes matrix organisations, multinational FIs

Patrick Cheung
Tax partner – FS tax transfer pricing
Deloitte Touche Tohmatsu
Tel: +852 28521095
Fax: +852 25206205
patcheung@deloitte.com.hk

Patrick is a transfer pricing partner and the financial services transfer pricing leader for Deloitte China. Before joining Deloitte, Patrick was a financial services transfer pricing partner of another Big 4 accounting firm in Hong Kong. Patrick began his Big 4 international tax and transfer pricing consulting career in Canada. Before that, he worked for the Canada Revenue Agency.

Patrick is recognised by LMG’s Expert Guides as a Leading Transfer Pricing Adviser in Hong Kong

Experience
Patrick has deep experience in all kinds of transfer pricing projects, from general compliance to supply chain planning and implementation to dispute resolutions and advance pricing arrangements. His financial institution clients include major international commercial and investment banks, insurance and reinsurance companies as well as asset management firms.

Project experience
Some of Patrick’s project experiences include:
- Developing master and local transfer pricing documentation for Chinese insurers;
- Review of insurance and reinsurance transactions;
- Asia-Pac regional documentation for a number of major investment banks and MNC insurers;
- ECM and DCM transactions;
- Regional cross charge studies for a number of European and North American financial institutions;
- Loan-benchmarking and cash-pooling analyses;
- Bank assurance benchmarking projects;
- Banking and insurance outsourcing centers planning;
- Migration of global trading desks and other KERT activities to Asia-Pac; and
- Explanation of book losses and other related-party transactions to tax authorities and the coordinating financial regulators.

Patrick is also a frequent speaker at PRC State Administration of Taxation national training events on the subject of financial services transfer pricing and at other industry forums.

Patrick is a graduate of the University of Toronto and a CPA, CMA.
often have departments and cost items that have similar names and/or descriptions. It is not unusual for such FIs to have information technology or human resources departments at global headquarters, regional headquarters, centres of excellence, and local entities. The challenge is for the organisation to explain (and provide evidence) to the local tax authorities the differences among these similarly named departments, and how different people in different places work together to deliver a combined result.

**Remuneration test**

The SAT points out that when analysing intragroup services, consideration should be given to whether the provision of various services has already been remunerated through other related-party transactions. For example, if a profit split method is already utilised for investment banking activities, then foreign costs related to those activities should not be allocated as part of overall intragroup services. As another example, when a PRC entity is only a limited-scope investment research entity, then its routine return for its limited role in the global value chain should not be reduced by intragroup service costs unless it then forms part of its arm’s-length cost base.

**Authenticity test**

Under Bulletin 16, the in-charge tax authority has the right to request relevant documents to substantiate the authenticity and arm’s length nature of a service transaction. Enterprises can be challenged if they do not have the relevant information and documents prepared and filed in advance. Depending on your viewpoint, this may be an extra hurdle for many taxpayers in China, or from a practical perspective, already an existing hurdle.

**Cost Contribution Arrangements**

On April 29, 2015, the OECD released a non-consensus discussion draft on cost contribution arrangements (CCAs) that contains proposed revisions to Chapter VIII of the OECD’s transfer pricing guidelines in relation to BEPS Action Plan under Action 8 (transfer pricing valuation with respect to transfers of intangibles).

Consistent with the current guidance, the CCA discussion draft applies to both service CCAs, in which participants share the cost of services, and development CCAs, in which participants share the costs and risk of developing property. The CCA discussion draft takes the position that the outcome of operating within the context of a CCA should be the same as if the CCA had not existed. Therefore, both initial contributions to the CCA and ongoing contributions must be measured by value rather than cost. The CCA discussion draft provides one exception to this rule for low-value services, for which valuation of contributions at cost is permitted. The requirement that contributions be based on value rather than costs is more limiting than the current guidance, but aligns with the BEPS Action Plan and the increased emphasis on value splits. Nonetheless, the requirement to use value rather than cost is the change likely to have the greatest impact on existing CCAs.

In China, the current Circular allows for the use of CCAs; however, it does not provide detailed guidance on the implementation. While the OECD CCA discussion draft provides significant updates of the existing global guidance, there remain a number of uncertainties as to how it can be successfully implemented in China. Setting aside some of these issues, such as local valuation principles and potential location-specific advantages in China, the prospect of using CCAs in China brings out two interesting points with respect to intragroup services payments.

It seems possible that the SAT may also apply benefit tests similar to those introduced in Bulletin 16 when reviewing a service CCA involving Chinese participants. For example, the SAT may focus particularly on the review of the determination/classification of the cost pool (for example, whether stewardship and non-beneficial expenses have been inappropriately included), how the participants are determined (whether the participants have made a contribution and benefit from the CCA, especially for those participants located in low-tax jurisdictions), etcetera.

Second, because a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA. This part is consistent with both the overall BEPS Actions on intangibles and value contribution as well as the SAT’s stated positions on the subject.
The SAT’s views have been repeated in the UN Manual (released on 2 October 2012) and Administration Plan for International Taxation Compliance in 2014-2015, by Jiangsu Provincial Office of SAT in April 2014. The SAT put emphasis on functions performed, assets used, and risks incurred at local Chinese entities, and the transfer pricing outcome should be in line with value creation. However, does this also mean that the SAT will accept situations where, for example, significant IT costs are invested globally by a bank or an insurance group and operating losses are driven by current-year CCA-related activities since the relevant China entity will in effect be a local entrepreneurial entity (for CCA-related business lines) and not be subject to loss limitation such as those outlined in Circular 363 assuming the benefit tests are properly addressed?

As a practical matter

Bulletin 16 and its interpretation make it clear that there is no need to obtain preapprovals from the tax authorities for overseas remittances of service charges or royalties. However, upon request by the tax authorities, the domestic payer is required to submit the intercompany agreements and other supporting evidence to substantiate the authenticity and arm’s-length nature of the transaction. As noted above, there is a clear emphasis on being able to prove the authenticity of the service being provided, something that can be particularly difficult for some types of services being provided in a global FI environment. The tax authorities will have the right to perform a tax adjustment on any noncomplying transactions within a period of 10 years, and evidence of services should be maintained contemporaneously.

So while Bulletin 16 provides more common languages between global FIs and the tax authorities than prior rules, it does not resolve many of the practical challenges when the discussion turns to the details. Benefits, measurement issues, and types and amount of required back-up evidence may likely continue to be sources of transfer pricing controversies in China in the near future. The insight into the SAT’s viewpoint from Bulletin 16 does provide some valuable clues for multinational FIs with intragroup services and royalties to design and implement transfer pricing structures and evidence-collection mechanisms that will improve their chance of successfully deducting services costs in China.
Unfolding the transfer pricing complexities in Indian financial services

Anis Chakravarty, Vineet Chhabra and Neha Bang of Deloitte India discuss how the transfer pricing aspects of the financial services industry have developed and what taxpayers can expect next.

Since its introduction, India’s transfer pricing regime has emerged as a key challenge for multinational enterprises doing business in the country. Over the past few years, the Indian transfer pricing litigation environment has been continuously evolving, with the intensity of audits and tax adjustments increasing year after year. It has been estimated that the total value of adjustments for transfer pricing audits undertaken during the financial year (FY) 2013-14 was about $9 billion, resulting in adjustments in almost 53% of the cases audited by field level officers, according to the Indian Ministry of Finance’s Annual Report FY 2013-14.

The effect of aggressive transfer pricing audits has been felt across industries, and the financial services sector is no exception. Transfer pricing issues faced by the financial services firms have increased in significance and scope. This may be attributable to the experience gained by field officers in scrutinising financial services transactions, the near absence of guidance in the Indian regulations, and limited judicial precedents on the application of transfer pricing methodology to complex financial services transactions.

This article provides insights into some of the recent transfer pricing challenges faced by multinational banks, asset managers, and alternative investment firms that have a presence in India.

Origination of banking products – Attribution of high value to local origination activities undertaken by the Indian branches of the foreign banks

Over the last decade, India has witnessed a sizable increase in the number of foreign bank branches dealing in structured finance products, primarily focused on the Indian market. These products include structured derivative products, corporate banking products, commodities trading and foreign currency loans, etcetera.

Before delving into the issues faced by Indian branches, it is important to understand the key activities undertaken by the parties to the transaction and the compensation model generally adopted by the banks. Typically, Indian branches are responsible for dissemination of local market information, opportunity/target identification, liaising with potential customers, origination of the deal, and assistance in structuring and maintaining client relationships. The overseas branch/head office is engaged in product development, approving the structuring performed by the Indian branch, credit approval, pricing and booking the deal on its balance sheet, and subsequent management of the positions.
Anis Chakravarty is a financial services transfer pricing partner in Deloitte India. He brings significant experience in advising companies in the European Union, India and the United States on a number of issues related to economics, finance and transfer pricing.

Anis is the co-leader of Deloitte’s Global Economists Network. He specialises in advance pricing agreements (APA), transfer pricing risk management and implementation of cost allocation systems.

He has assisted a number of financial services institutions including foreign and domestic commercial and investment banks, private equity players and asset management firms with their transfer pricing needs including filing and negotiation of APAs.

Anis is involved with the firm’s practice and knowledge development initiatives in India and the Asia Pacific region. He is a guest faculty at IBFD Asia Pacific, IFA and other forums, lecturing on various transfer pricing issues.

Before joining Deloitte India, Anis was based in Brussels, Belgium, advising European inbound as well as outbound clients on a number of transfer pricing and supply chain issues.

Anis is a regular contributor to the print and electronic media on various macroeconomic issues and trade, monetary and fiscal policies. His views have been quoted by Bloomberg, and the Wall Street Journal amongst others. He is a speaker at seminars on topics related to economics, transfer pricing and business and has appeared in various publications.

With respect to the compensation model, many foreign banks have global policies for determining the compensation for such origination and marketing activities. For such derivative transactions, Indian branches are generally compensated as per the foreign bank’s global policy, using a benchmark that may be a percentage of the client value, a proportion of the value added on a transaction, a percentage of day one profit/loss, or a proportion of the commercial markup of each transaction. This compensation model typically results in a split of the initial dealer spread – the difference between final price quoted to the client by the marketing team of the Indian branch and the price quoted by the trading desk – in a specified ratio between the Indian branch and the foreign bank.

During audit, the Indian Revenue has tended to take a position that the Indian branch should be entitled to the larger initial dealer spread, contending that the spread is earned due to the efforts of the Indian branch’s marketing/sales team. Further, the Indian Revenue has put forth that the default credit risk is also borne by the Indian branches when such branches enter into swaps and options on their own account, effectively resulting in the capital of the Indian branch getting blocked, and warranting additional compensation to be attributed to the Indian branch. As a consequence, we have often seen the Indian Revenue propose adjustments equal to almost 100% of the initial dealer spread.

With respect to other banking products, Indian branches have developed key capabilities over the last few years, resulting in an increase in their level of involvement in origination activities. Because of the enhanced role, there has been a gradual shift in the remuneration model from a cost-plus approach to a more sophisticated profit/fee-split model. The Indian Revenue, during audits, tends to take a position that because the Indian branches are undertaking certain key entrepreneurial risk-taking (KERT) functions, revenue splits should be applied to test the arm’s-length nature of such origination activities undertaken by the Indian branches. To support its case, the Indian Revenue has resorted to the use of outside comparables by finding support in the global transfer pricing policies of other banks and proposing adjustments on that basis. Overall, the Indian Revenue tends to assign a higher weighting to the origination activity undertaken by Indian branches, effectively resulting in a significant portion of the revenue/profits being attributed to the Indian branch.

Although partial relief has been granted by the appellate authority in a few cases, the matter is still being litigated at the Income Tax Appellate Tribunal (ITAT) and has yet to reach any finality.

**Private equity investment advisory – Comparison with investment bankers/merchant bankers**

Transactions involving the provision of investment advisory services have also been the subject of scrutiny by the Indian Revenue, and substantial tax adjustments have been proposed over the last few years.

The advisory model being followed in India is similar to the model followed across the globe, wherein an adviser provides nonbinding recommendations on potential investment/divestment opportunities to their investment adviser/manager abroad. The investment manager is responsible for selecting and managing the investments, and makes all the key decisions with regard to such investments/divestments.

The remuneration model for Indian advisers is generally a recharge of the local operating costs incurred by the advisers, along with a mark-up on such costs, which is generally low. In our experience, the Indian Revenue has, in the past, proposed high mark-ups in the range of 40% to 50% over operating costs which has been the subject of litigation.
In proposing such adjustments, the Indian Revenue has generally held that the advisers add substantial value to the activities undertaken by the investment manager, primarily based on the observation that the Indian advisers have highly skilled and qualified professionals on their payrolls and that they play an important role in assisting the investment manager while making investment/divestment decisions. In some cases, they are also present on the board of the portfolio companies. Based on all these factors, the Indian Revenue surmises that the Indian advisers should receive higher mark-ups. In terms of the benchmarking analysis, the Indian Revenue has often rejected the comparable companies selected by the investment advisers and has selected companies primarily engaged in investment/merchant banking activities. In many cases, this has failed on a functional comparability basis, and the ITAT has provided substantial relief, but the authorities at the field level tend to continue with their approach, waiting for a higher court ruling and not agreeing with the ITAT rulings.

Accordingly, it is of paramount importance for investment advisers to support the limited-risk nature of their advisory activities with a detailed functional and risk analysis backed by internal documentation in the nature of research reports/deal-related papers to demonstrate that they are not involved in any decision-making activities and merely render their services under the directions of the overseas investment manager.

To seek relief from onerous litigation, many private equity players have taken recourse to advance pricing agreements (APAs). This is an area in which the tax authorities have gained significant experience, and an investment adviser can expect an APA application to progress on a fast track. With the thrust provided by the first batch of unilateral APAs concluded in the investment advisory space, which stipulated cost-plus mark-ups in the 20% to 25% range, many more private equity firms have lined up to seek relief under the newly introduced APA regime.

### Investment banking – High attribution to the activities performed by the Indian branches

Foreign banks operating in India are generally involved in investment banking activities such as advisory activities in relation to mergers and acquisitions, securities issue management, underwriting, and distribution of securities. Typically, the operating model of a global investment bank would involve interplay between group companies spanning jurisdictions, often leading to complex and challenging transfer pricing issues. Coming to the operating model, many investment banks operating in India follow the hub-spoke model, whereby the Indian entity, acting as the spoke, is generally responsible for performing research, marketing/origination, and assistance in structuring a deal. The hub (the head office/overseas entity) performs execution, structuring, and arranging capital. These activities involve regular interaction between various participating group companies and, in some cases, are highly integrated so that a part of the execution is undertaken by the Indian entity itself, leading to a mix of execution and origination functions spread across jurisdictions.

In the past, many Indian entities were remunerated on a cost-plus model because India was considered a support location and not much of a trading or booking location. Lately, some of the investment banking firms have developed a few capabilities and have started performing part of the KERT functions on global deals in India. Consequently, there has been a shift to a fee/profit-split approach, depending on the functional and risk profile of the Indian entity. Such application of profit-split may be either under the residual method or under contribution analysis, depending on the facts and circumstances of the case.

Often, investment banking activities include a mix of routine functions and significant intangibles contributions for a particular transaction type. In such a situation, the routine functions may be compensated at an appropriate rate of
return and the residual combined profit may be allocated on the basis of relative value of intangibles contributed by the entities involved in the transaction. In situations when there are no major routine functions and all entities possess unique and valuable intangibles, then contribution analysis becomes essential and is often applied to price the related-party transaction.

The Indian Revenue, while basing audits on the changing business scenario, has taken the position that the services rendered by the Indian entity are high value-driving activities, and require attribution of a higher percentage of the fee earned on a transaction. She has been actively engaged in transfer pricing compliance, audit and litigation process.

Her assignments include assisting multinational companies with their documentation requirements, planning and defending their pricing arrangements from an Indian perspective.

Neha is a qualified Chartered Accountant from the Institute of Chartered Accountants of India.

**Equity brokerage – Unadjusted application of comparables for benchmarking financial intermediaries**

For this segment of the financial services sector, the issue often relates to the selection of the transfer pricing method, wherein the Indian Revenue has demonstrated a preference for the use of the comparable uncontrolled price (CUP) method rather than the TNMM generally selected by taxpayers. The dispute arises primarily because of the difference in brokerage rates charged to overseas affiliates vis-à-vis the rates charged to third-party institutions.

Many foreign brokerage houses operating in India cater to their overseas affiliates, foreign institutional investors (FIIs), and domestic institutional investors. Thus, the brokerage rate charged to third-party FIIs can be considered an internal comparable for benchmarking the brokerage rate charged to overseas affiliates. In the case of trades with overseas affiliates, generally a lower brokerage fee is charged, because the volume of business from affiliates is generally high compared to third-party trades, and because the Indian entity does not have to undertake marketing and research activities and assumes lower risks while rendering brokerage services to its affiliates.

Although the services rendered under both types of trades are broadly similar, there are numerous differences in the two trades, such as volume of business, level of marketing activity, and the level of risks involved that influence the brokerage rates. Indian entities prefer selection of TNMM in many cases, owing to the fact that quantifying and making appropriate adjustments for the above differences is often a challenge. The Indian Revenue, however, often reject the TNMM approach followed by the Indian entities, and frequently selects the CUP as the most appropriate method by comparing third-party trades to trades with affiliates, without making all the adjustments for the various differences discussed above.

Considering the Revenue’s preference for the CUP method, it is often advisable to maintain robust documentation to substantiate key differences between the two types of trades and to make appropriate adjustments when the CUP is selected as a corroborative method.

**Back office support – Use of high mark-ups on routine cost-plus activities**

Many foreign banks have set up subsidiaries in India to render centralised back office services to their group companies. This transaction has been under close review by the Indian Revenue for almost a decade and is often the first transaction to be scrutinised during audit proceedings.

Back office support services are generally in the form of accounting, human resources, legal, regulatory, processing of contracts, information technology, product-specific accounting, and finance support and administrative assistance. The remuneration model is generally a recharge of
the local operating costs incurred by the Indian entity, along with a low mark-up on such costs. However, the mark-up charged by the Indian entities has been a subject of intense litigation, where we have seen that the Indian Revenue proposes mark-ups in the range of 25% to 30% over operating costs. Disputes also arise regarding the characterisation of the Indian entity, that is, whether the activities are in the nature of a back office service or knowledge process outsourcing services. In a few cases, the Indian Revenue has also taken the position that the activities being rendered by the Indian entity are in the nature of knowledge process outsourcing services warranting a higher mark-up.

There are a few favourable rulings at the ITAT level providing relief to the Indian entities on the level of mark-up proposed by field officers. However, field officers continue to charge high mark-ups on this transaction during the audit stage. As a long-term solution to protracted litigation, many entities have chosen to address this issue through the APA/Mutual Agreement Procedure (MAP) route. It can be said, without any doubt, that APAs are a good option to offer much-needed clarity and certainty to taxpayers rendering back office support services. Many APAs pertaining to back office support services are at an advanced stage of negotiation. In addition, there has been a favourable development with respect to MAP cases relating to provision of low-end/back office support services, with many cases having already been successfully resolved and the pending cases being fast-tracked.

Concluding remarks
As the Indian tax authorities’ approach to analysing financial services transactions has evolved, it has become imperative for taxpayers to undertake a detailed and careful evaluation of their existing transfer pricing arrangements to ensure that those arrangements are mapped to the group’s global policy, and are consistent with their functional and risk profile. Further, with BEPS around the corner, it becomes essential for the financial services industry to focus on the transparency of information relating to global value chain of the multinational enterprise.

Consequently, the financial services industry must deploy a risk management framework for mitigating transfer pricing risks by maintaining robust and effective documentation.
PE issues in global insurance distribution

Sebastian Ma’ilei & Jeremy Brown, of Deloitte UK, describe how permanent establishment issues can arise from global insurance distribution models and explain how taxpayers can prepare and defend themselves.

The competitive nature of the insurance sector has led to the increased use of global distribution models by multinational insurance groups. Technology is reshaping distribution and the sales culture within insurance companies. For example, in the property and casualty (P&C) markets, mobile application technology and online distribution channels are commonly used by insurers to differentiate their sale processes due to the increased competition.

Under traditional global distribution models, underwriters and senior executives of multinational insurance groups have often delegated underwriting authority to bind business or at least participate in material contractual pricing negotiations. This is common in global multinational insurance programmes where underwriters and actuaries tend to travel regularly to different jurisdictions to meet potential clients and negotiate the terms of policies either directly with clients or with insurance intermediaries (for example, brokers and independent financial advisers).

In certain markets, companies or partnerships known as managing general agents (MGAs) or cover holders in the Lloyd’s market have been delegated underwriting authority to conclude insurance contracts on behalf of the insurer under a binding authority agreement for full or limited authority. The level of underwriting authority is determined by reference to a number of factors, including senior management’s trust in the underwriter and the underwriter’s experience in writing that class of business.

The act of negotiating and concluding insurance contracts by mobile underwriters, senior executives, and MGAs risks creating a taxable presence or permanent establishment (PE) of the primary insurer or reinsurer in the jurisdiction where these activities take place. When a PE is created, profits must be attributed to the PE for tax purposes, and the insurer will be required to file a corporation tax return in that jurisdiction.

The focus of this article is identifying those circumstances under which a PE is created (the so-called PE threshold) in the insurance sector, which are set out in Article 5 of the OECD Model Tax Convention, and reflected in many double tax treaties.

The PE threshold has also been a recent focal point for the OECD as part of its Base Erosion and Profit Shifting (BEPS) initiative, in particular Action 7 of the BEPS Action Plan, which deals with “Preventing the Artificial Avoidance of PE Status”.
Existing rules
The threshold of activity that triggers the existence of a PE under the current OECD Model Tax Convention (and is present in many double tax treaties) is typically determined by two tests in Article 5. First, under the fixed place of business test, there must be “a fixed place of business” through which the business of an enterprise “is wholly or partly carried on”. When it is concluded that there is no fixed place of business, it is still possible for the activities of a dependent agent to create a PE for a foreign principal. Under the OECD model treaty’s Article 5(5), the test for assessing whether an agent creates a permanent establishment in a particular country is as follows:

“…[W]here a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State …”

The “agent of an independent status” to whom paragraph 6 applies is defined in Article 5(6) as “a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business”.

In addition, the Commentary to Article 5(6) states that there is also a test of legal and economic dependence, and case law in this area has considered similar factors as well. For example, the Canadian case American Income Life Insurance Co. v. The Queen, 2008 DTC 3631, 2008 TCC 306 (AIL) took into account factors such as control and ownership, income and remuneration of agents, exclusivity, and the bearing of economic risk.

Traditionally, the practical difficulties with the application of the test under Article 5(5) in the insurance sector have involved the operation of the independent agent exemption under Article 5(6), and this will likely continue given the proposed changes under the OECD’s BEPS project. However, the proposed changes to Article 5(5) will also likely create challenges for insurance enterprises going forward.

BEPS – What is going to change and what are the potential practical implications for the insurance sector?
The focus of the OECD’s BEPS project is ensuring that profits are taxed in the locations where the economic activities that generate those profits take place. As part of the BEPS project, a series of new guidelines have been proposed, including lowering the threshold for the creation of PEs under Action 7 of the BEPS Action Plan.

Following publication of an initial Action 7 discussion draft in October 2014 and a public consultation on the same, the OECD released a subsequent discussion draft on PEs in May 2015 for further comments, with a final version expected in September or October 2015 to serve as the basis for updating the Model Tax Convention. Implementation of the new rules in some double tax treaties is expected to occur via a multilateral instrument under Action 15 by the end of 2016. However, not all countries are likely to participate in the multilateral instrument; the US, for example, may opt out.

The first Action 7 discussion draft released in October 2014 floated the idea of a separate PE rule specific to the insurance sector. However, the May 2015 discussion draft states that “…no specific rule for insurance enterprises should be added to Article 5”. It further states that insurance is to be instead dealt with by means of the general provisions set out in the revisions to Article 5, or via transfer pricing or special measures.

Although some uncertainty remains regarding the final output on Action 7, many of the proposed changes in the May 2015 discussion draft are close to finalisation. This article details a number of focus areas, outlined below, that are most likely to be of specific interest to the insurance sector.

Artificial avoidance of PE status
Part A of the May 2015 discussion draft targets the use of arrangements put in place to shift profits from a country where sales take place (Country A) to another country (Country B) without creating a permanent establishment of a company resident in Country B in Country A.

To address this, the May 2015 discussion draft, in paragraph 23, proposed changes to the text of Articles 5(5) and 5(6). Article 5(5) has been redrafted so that a person who “habitually concludes contracts, or negotiates the material elements of contracts” on behalf of an enterprise “…shall be deemed to have a permanent establishment”. This introduction of a subjective element — “negotiates the material elements of contracts” — represents a clear departure from the existing rules, and the draft commentary provides guidance on what this might mean in practice.

The May 2015 discussion draft proposes amending Article 5(6) to remove the references to “broker” and “general commission agent”, referring only to “independent agent”. Certain countries (including the UK) have a form of the broker exemption in their domestic legislation; given this proposed change, the future of these domestic exemptions is uncertain. Article 5(6) now also limits the potential accessibility of independent agent status in the case of related parties, stating that: “Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is connected, that person shall not be considered to be an independent agent…” For companies, connection is defined as possessing “at least 50 percent of the aggregate vote and value of the company’s shares or of the beneficial equity interest”, or control.
Given these potentially wide-ranging changes, the focus of this article will be on the proposed changes to Article 5(5) and 5(6).

Profit attribution to PEs and interaction with action points on transfer pricing

The May 2015 discussion draft specifically excluded any coverage of attribution of profits issues for PEs, by clarifying in paragraph 57 that this work “will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7”.

Case studies

Notwithstanding the fact that the existing PE rules are expected to change under BEPS, tax authorities have continued to raise PE challenges based on existing PE rules. The following case studies illustrate two common arrangements that are becoming increasingly scrutinised and are likely to continue to be in a post-BEPS world.

Case study 1 – mobile sales forces

As set out in Diagram 1, Insurer in Country A has a mobile team of underwriters who travel frequently to various jurisdictions, including Country B, to meet potential clients, develop local relationships, and negotiate the terms of policies locally. However, these individuals do not have any authority to bind the Insurer; this authority is retained by senior personnel based in Country A, and all contracts are signed in Country A. These individuals do not have an office or other dedicated premises at their disposal from which they work, instead working from hotels and client sites that vary from visit to visit.

Existing rules

It would be difficult to assert a fixed place of business PE of the Insurer under the current fixed place of business PE rules, because client premises in Country B are not at the disposal of the Insurer in Country A to carry out its business.

Under the existing Article 5(5), the activities of the mobile sales force should not create a dependent agent PE of the Insurer, because the sales force does not have the authority to conclude contracts. For example, in the AIL case, the court found that a US-resident life insurance company did not have a permanent establishment in Canada. The offices of its Canadian agents were not at its disposal (it did not have freedom to enter the buildings, did not have control over the manner in which the buildings were used, and did not pay the expenses of the premises). Furthermore, the Canadian agents did not habitually exercise in Canada an authority to conclude contracts in the name of the taxpayer.

Proposed rules

It would be difficult to assert a fixed place of business PE of the Insurer under the proposed fixed place of business PE rules, because client premises in Country B are not at the disposal of the Insurer in Country A to carry out its business.

However, under the proposed revisions to Article 5(5), the fact that the mobile sales force negotiates the key terms of contracts is critical and could result in this team creating a PE of the Insurer in Country B if the “negotiates material elements” test is met. The proposed commentary in paragraph 32.5 and 32.6 offers some insight in this regard, explaining that the threshold is “aimed at situations where contracts that are essentially being negotiated ... are subject to formal conclusion, possibly with further approval or review, outside that State”, and broadens the scope to cover standardised contracts as well.
Case study 2 – Cover holders and MGAs operating under binding authority agreements

Existing rules
It would appear that the test of concluding contracts under Article 5(5) is satisfied. The implication is that the MGA will create a PE of the Insurer in Country B. Thus, in this example the Insurer would, on the face of it, be required to attribute profits to the PE and file corporate income tax returns locally.

The next practical issue to consider is whether the MGA can qualify for the independent agent exemption under Article 5(6). If the MGA is an independent agent and acts in the ordinary course of its business, then the Insurer in Country A will not be found to have a PE under the test. As a result, the fundamental distinction lies in the extent to which the MGA is regarded as an independent agent for these purposes.

Under the current rules, whether an agent is independent is determined by reference to a number of factors, none of which is determinative in isolation. This is discussed in detail in the current commentary:

- The commentary refers to the degree of control the principal exerts over its agent as being important for determining if there is the requisite level of independence. In circumstances when the MGA is subject to very detailed instructions or control, the MGA would not normally be regarded as operating in an independent manner. In addition, the commentary notes that a principal’s reliance on the agent’s special skill or knowledge (for example, of the local market or of certain lines of business) to perform a service that the principal would not be able to perform itself is evidence of the agent’s independence.
- As noted above, the commentary states that there is also a test of economic dependence. In practice, many MGAs also write business on behalf of third-party insurers and therefore may qualify for the independent agent exemption on the basis that they are legally and economically independent. It is also imperative that the MGA be able to demonstrate that it is able to support its own assets and risks. This seems to be the determinative test applied by tax authorities in practice.

Given the above, whether the MGA is considered to be independent will depend on the facts and circumstances of the case. For example, if it is found that the Insurer relies on the MGA’s expertise and that the MGA is legally and economically independent, the implication could be that the MGA is an independent agent that does not create a PE of the Insurer in Country B.

Proposed rules
Under the proposed changes to Article 5(6), a key test is that if the MGA in Country B acts “exclusively or almost exclusively on behalf of one of more enterprises to which it is connected” it would not qualify as an independent agent. The proposed commentary does not specifically define “almost exclusively,” noting only that activities performed on behalf of enterprises to which a person is not connected would need to make up a “significant” portion of that person’s business, and citing an example in Paragraph 38.7 where these fall below 10 percent as not meeting the test.

Furthermore, the ability to access legal and economic independence in the round under the existing commentary has been eliminated in the May 2015 Discussion Draft. As such, although the MGA could potentially demonstrate such independence, it is no longer a relevant factor for consideration.

Therefore, in this example, because the MGA writes business exclusively on behalf of the Insurer it would not meet the independent agent test under the proposed Article 5(6) and therefore it would create a PE.

Diagram 2: Binding authority agreements and MGAs

![Diagram](https://example.com/diagram.png)
So what if you have a PE?
As noted earlier, in circumstances where a PE of the foreign insurer is created, profits must be attributed to the PE for tax purposes and the foreign insurer will be required to file tax returns for the PE in that jurisdiction. Failure to do so can lead to potential penalties or interest accruing on outstanding tax.

However, based on our experience, tax authorities may take a practical approach and not assert a PE when the transfer pricing of the commission paid to the MGA is equal to or greater than the underwriting profit that would have been attributable to the PE under Article 7. In those circumstances, there would be no incremental profit over and above the transfer pricing remuneration for the tax authority to tax.

Furthermore, creating a PE increases the potential risk of double taxation for multinational insurance groups, where the profits or income are subject to tax in both the country of residence and the PE country, because the two tax authorities may not be able to agree on the PE position and attribution of profits. From an accounts and financial statement perspective, insurers will be required to analyse and disclose or provide for potential tax liabilities associated with the PE exposure. Given the uncertainties involved in assessing the PE risk and in determining the profits attributable to the PE, the quantification of the PE exposure can be a time-consuming and difficult process.

What should you do about it?
All in all, the practical considerations in determining whether a PE is created are complex and the analysis should be based on the specific facts and circumstances. Given the momentum of the BEPS Action Plan, coupled with increasing tax authority scrutiny, multinational insurance groups should continue to monitor the PE developments closely, not only to avoid being caught off guard but also to make a timely assessment of the potential impact of any changes. In the first instance, this would entail a detailed factual and functional analysis to identify the insurer’s core profit-generating functions (such as core underwriting, claims management, etcetera) and the extent to which these activities are carried out by underwriters and senior executives who regularly travel to conduct business in overseas operations.

Multinational insurance groups can engage with tax authorities in certain jurisdictions to obtain PE clearances, perhaps in the form of an informal agreement with a tax authority on the PE position. Some tax authorities may provide a “low risk rating” on the PE position. Alternatively, taxpayers could obtain a tax ruling to attain certainty on the PE position. In some countries, a PE clearance can be obtained as part of an advance pricing agreement, which can provide certainty both on the PE position and the transfer pricing of intragroup transactions.

Sebastian Ma’ilei
Deloitte
Tel: +44 (0) 20 7007 1596
smailei@deloitte.co.uk

Sebastian leads the UK insurance transfer pricing team. He has more than 12 years of transfer pricing experience in the insurance industry. He has advised clients operating in the Lloyd’s, London-Bermuda and life insurance markets. He worked on the first UK unilateral reinsurance APA and the first UK-German bilateral APA on branch profit attribution.

Jeremy Brown
Deloitte
Tel: +44 (0) 20 7007 5350
jerebrown@deloitte.co.uk

Jeremy specialises in transfer pricing for financial services clients in Deloitte’s London office, with a particular focus on the insurance and asset management sectors. He has broad experience in advising multinational clients on transfer pricing documentation, planning, economic analysis and defence.
Some things in the world are changing
Others are not

Most nominations for the sixth straight time in Euromoney’s latest Guide to the World’s Leading Transfer Pricing Advisers. With professionals in more than 150 countries, Deloitte Touche Tohmatsu Limited member firms bring a powerful and holistic approach to transfer pricing.

To learn how you can win in a changing world, visit www.deloitte.com/transferpricing.
Global Transfer Pricing
Proactively addressing global tax planning and tax compliance

Multinational organizations are operating in an environment of unprecedented complexity. Rising volume and variety of intercompany transactions and transfer pricing regulations, accompanied by increased enforcement activities worldwide, have made transfer pricing a leading risk management issue for global businesses.

Deloitte’s transfer pricing professionals apply in-depth knowledge and experience to help develop, refine and maintain an effective transfer pricing program. We understand the current focus of tax authorities, and we have the technical and practical experience and tools necessary to help you navigate the transfer pricing environment in the U.S. and globally.

Deloitte's global transfer pricing practice specializes in 15 industries, our services include:

- Advance Pricing Agreement Inbound
- Global Documentation
- Controversy Inbound
- Strategic Transfer Pricing Review
- Controversy Outbound
- U.S. & India Advance Pricing Agreement
- Business Model Optimization (BMO) Intellectual
- Property Tax Planning and BMO Supply Chain

To learn how you can win in a changing world, visit www.deloitte.com/transferpricing.

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.