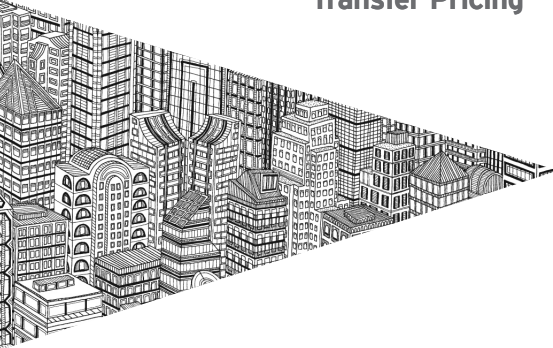


International Tax Alert

News and views from
Transfer Pricing



Interaction of regulatory change and financial services transfer pricing in Asia

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On 14 November 2011, Ernst & Young's Hong Kong Financial Services Transfer Pricing (FSTP) team hosted a transfer pricing seminar discussing the impact of recent regulatory change on transfer pricing in the region. Chaired by James Badenach, Ernst & Young's Asia Pacific Banking & Capital Markets Tax Leader, the session started with Phil Rodd from Ernst & Young's Hong Kong Regulatory Advisory team introducing recent regulatory developments and their application in the Asia region, including Basel III, the UK Independent Commission on Banking and the US *Dodd Frank Act*. Once introduced, Stephen Labrum, Patrick Cheung, Samuel Gordon, Justin Kyte, Jonathan Thompson and David Elwell from our FSTP teams in Hong Kong, New York, London and Tokyo, respectively, discussed the impact these developments are having on banking groups' FSTP policies.

The specific TP areas discussed included funds transfer pricing, the compensation of capital and risk transfer arrangements, living wills, transfer pricing for loss-making affiliates and transfer pricing for cost allocations. The following provides a very brief summary of the topics discussed. For further information on these topics or the seminar, please contact your Ernst & Young representative or any of the authors listed at the bottom of this Alert.

Funds transfer pricing

The proposed introduction of minimum liquidity standards, plus an increased focus on liquidity by virtually all international banking organizations, makes funds transfer pricing one of the most discussed and important areas of transfer pricing at the moment. Many groups are currently evaluating their funding frameworks to ensure that the funding

costs/interest rates charged to related party borrowers are consistent with the arm's length standard and are considered reasonable versus local entities' onshore funding profiles. Our panel discussed the key questions currently being asked including the determination of credit ratings for borrowing entities when operating in a subsidiary structure, ensuring funding matches the underlying business needs and treatment of the costs of liquidity pools being retained at head office level. The panel provided insights from a range of projects performed in Europe, the United States and Asia with a focus on how this will impact transfer pricing in the region, going forward.

Compensation of capital and risk transfer arrangements

The compensation of capital has long been an interesting topic of transfer pricing conversation in the Asia Pacific region. Historic challenges by the National Tax Authority in Japan, the expansion of Asia-based traders booking onto centralized trading books and increasing incorporation of banking branches in Asia mean that the issue is likely to continue for a while.

As was discussed on our panel, recent APA applications in Japan plus the impact of regulatory change defining more specifically the role of capital and the levels that must be maintained, provide an opportunity for groups to review their capital charging mechanisms to ensure consistency with the arm's length standard. Based on our experiences, interesting questions still remain around loss-protection

arrangements and the potential movement of risk management from a compliance reporting role to a higher value function. However, regulatory developments and data may provide groups with a robust starting point for the development of suitable TP policies for compensating the cross-border provision of capital.

Recovery and resolution plans

As a key component of both the UK Independent Commissioners report on Banking, plus Dodd Frank in the United States, significant financial services institutions will be required to prepare a recovery and resolution plan. Commonly known as a "Living Will," the agreement will explain how the group will arrange itself so it can be allowed to fail safely, quickly and without destabilizing the financial system and exposing taxpayers to risk of loss. Given the ever increasing level of related party transactions within banking groups, transfer pricing, particularly in the event of losses, plays a key role in the development of a Living Will. This development has a strong link to centralized booking structures, as closer scrutiny will be applied by regulators to test the capacity of booking locations to bear risk.

Transfer pricing for loss-making affiliates

Banking groups in Asia are increasingly facing pressure from tax authorities and regulators regarding the level of profit generated by onshore banking businesses. Despite losses often being driven by external factors, transfer pricing comes under scrutiny as tax authorities seek to

deny cost allocations or increase revenue shares to the local country in an attempt to maintain profitability.

Our panel explored the concept of being able to use transfer pricing in an arm's length manner to help manage this issue proactively. Discussion focused on the use, application and risks of "contingent services arrangements" as outlined in the US, regulations or the more broadly defined "network support payments" where it may be possible to structure transfer pricing to support loss-making affiliates because the local operation is considered beneficial to the group as a whole.

Cost allocations

The transfer pricing of cost allocations remains a hotly debated topic in the region with many tax authorities challenging allocations. Our panel discussed our extensive experience in this area including the need to focus on examples of service from both the service provider and the service recipients' perspectives, the application of mark-ups on support services and practical ways to help defend cost allocations in an audit in the region. The panel also discussed operational structures to help rationalize cost charging structures, the level of documentation that is recommended and audit defense strategies.

Contact details

Should you have any questions on any of the above or wish to discuss these topics further, please do not hesitate to contact any of the authors of this Alert or your usual Ernst & Young contact.

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