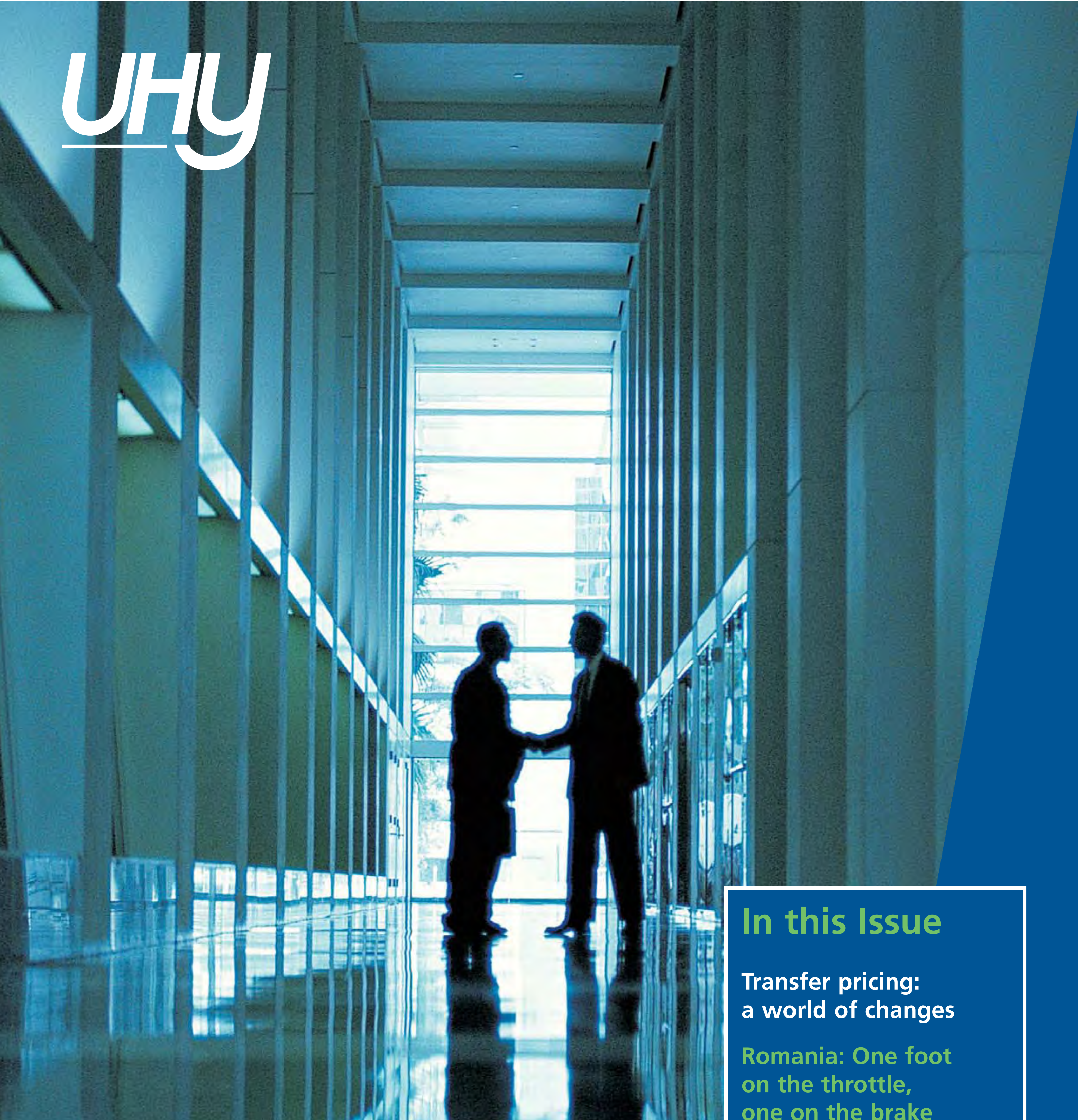


Issue 15

International Business

In this Issue

Transfer pricing: a world of changes

Romania: One foot on the throttle, one on the brake

Foreign investors forced to juggle with political impacts

People processes that support high performance

Transfer pricing: a world of changes

Middle market companies who may have thought they could escape transfer pricing audits are not immune – but they can use transfer pricing affirmatively to plan business growth.

The recent USD 3 billion-plus settlement between the US Internal Revenue Service (IRS) and the UK pharmaceutical giant, GlaxoSmithKline, attracted lots of headlines. But what does it mean for dynamic middle market companies?

Settlement of this long case involving one of the world's largest corporations brings transfer pricing back into focus, not only as an indispensable tax planning tool for cross-border operations but also as the 'enforcement mechanism of choice' as cash-strapped governments turn a jaundiced eye toward companies of all sizes conducting business with offshore affiliates.

As companies go international at ever earlier points in their lifecycle, and as their success is increasingly dependent on inherently 'portable' items such as intangible property and services, transfer pricing must not only be addressed as a component of enterprise risk but also exploited as a planning tool.

For example, in the case of companies operating in the US, the need to get transfer pricing right is not only a matter of assuaging the IRS. It is also, in the context of audited financial statements under the Sarbanes-Oxley law, an opportunity to impact the company's effective tax rate and therefore its value in the marketplace.

One of the most daunting tasks is defining transfer pricing. Broadly, it refers to how related parties deal with one another, including the allocation of risks and rewards in accordance with the economic substance of their relationship. This involves not only the price at which they sell products but also many less obvious arrangements with economic consequences, such as interest-free lines of credit and head-office time spent on subsidiaries' business operations.

'Some mid-size companies have been dragging their feet and playing the audit lottery in the hope they won't be caught'

Historically, multinationals have sought to allocate the most profits to countries with the lowest tax rates and the least profits (or maximising deductions) to countries with the highest tax rates. Because related parties have the power to control which party earns what, the tax authorities have assumed that companies would manipulate arrangements to reap the greatest tax advantage. The bigger the multinational group, the greater the opportunities for price manipulation and lost revenue for the treasuries of high-tax countries, in the view of tax collectors.

Until the last few years, when corporate tax rates have been plummeting, this meant a quest by the so-called industrialised countries with high tax rates to maximise income and limit deductions. Ideally, however, transfer pricing, and economic studies embodying the concept, is supposed to result in profits among related parties mirroring those earned by unrelated parties in similar circumstances – the arm's length standard.

With a few exceptions, countries around the world revere the arm's length standard as the holy grail of transfer pricing. This means that the arrangements between related parties are consistent with what an unrelated party would charge another unrelated party in the same transaction under similar circumstances. Underlying this conclusion was the assumption that two unrelated parties, considering all the risks, benefits and other conditions surrounding their transaction, would arrive at a meeting of the minds – a price with which both parties, neither being under any compulsion, would be content. The trick for taxpayers was demonstrating, through an economic analysis comparing results of third parties, that the arrangements they were using met the arm's length standard. And for tax authorities, it was demonstrating that arrangements among related parties fell outside the range of what third parties would do.

The earliest focus of transfer pricing enforcement in the US was on the sale of goods and involved three methods for measuring arm's length pricing as found in regulations issued by the US Treasury in 1968 and largely embodied in transfer pricing guidelines issued by the Organization for Economic Co-operation and Development (OECD), the club of leading developed

economies, in 1979. If the price in a controlled transaction (between related parties) is what third parties would use, then the price was arm's length.

By the late 1980s, transfer pricing was emerging as a leading enforcement tool for the IRS, and other tax authorities, leading to large multinational companies adopting pervasive transfer pricing policies in an attempt to forestall a full-scale audit by tax authorities whose resources in this specialty were tightly constrained.

By the early 1990s, the IRS beefed up its resources and economists were increasingly involved in tax audits. Moreover, in the case of a transfer pricing audit, regulations shifted the burden of proof to the taxpayer. Not only must the taxpayer show that the IRS methodology is flawed, but that the taxpayer's approach is superior. This led to protracted battles between taxpayer and tax collector with the result that both parties, bloodied and exhausted, were happy for a settlement.

Then the Treasury upped the ante by issuing regulations requiring that taxpayers have "contemporaneous documentation" of their transfer pricing policies, and issued penalties for those failing to produce one on audit. This led any remaining stragglers among the ranks of large multinationals without a transfer pricing policy to put one in place and arrange for periodic updates. But some mid-size companies have been dragging their feet and playing the audit lottery in the hope that they won't be caught.

Other areas of commerce were also subject to transfer pricing audits, including financing, services, and the use of intangible property. Indeed, so heightened was the US Congress' concern that US companies were moving their valuable patents, copyrights, trademarks, trade names and know-how offshore, to be exploited from low tax jurisdictions, tighter limitations were added.

Out of these enforcement efforts grew a revived interest in transfer pricing as a tax planning tool. But other countries did not stand idly by as the US sought an ever-larger piece of the worldwide income pie. They reacted by developing their own transfer pricing rules, not only to increase the size of their piece of the pie but to whittle down helpings available to other countries, such as the US. Most followed the OECD approach, adopting an arm's length standard, but some, such as Brazil, substituted minimum profit percentages for the arm's length standard in certain transactions.

US and foreign governments, especially those in the major industrialised nations, promoted the Advance Pricing Agreement (APA) as a way to lock in some certainty on income and deductions in two or more countries at the same time. We tend to think of the APA as the creature of giant multinational companies, but increasingly countries such as Mexico have been using the APA for small and medium-sized enterprises as well. To review a country's approach to transfer pricing, including what rules have been promulgated and the approach to enforcement, see the *UHY Global Transfer Pricing Guide* (details right).

In the realm of double taxation treaties, where governments agree to carve up their rights to tax income according to type and source, the mechanism known as Competent Authority Relief has taken on a higher profile. In the case of a dispute over transfer pricing, a US taxpayer can seek competent authority relief. Paradoxically, the taxing authority that had just been 'beating up' on the taxpayer becomes its champion to negotiate with the other country a resolution of transfer pricing adjustments so that double taxation is avoided. Without a treaty, the result of an unsuccessful transfer pricing dispute will leave the taxpayer with double taxation.

For middle market companies expanding across borders, the best advice is to be creative in international tax planning and use all the tools available. In the case of transfer pricing, this means preparing the studies required by law or regulation as well as using the data they yield to plan for greater tax efficiency in worldwide operations.

For more information, see *UHY Global Transfer Pricing Guide* at: http://www.uhy.com/media/UHY-GTPG.pdf

Contact: Meril Markley, UHY Advisors, US
Email: mmarkley@uhy-us.com

UHY

One foot on the throttle, one on the brake

"We must be careful that this economical growth does not destroy our macro-stability. When a car is driven one foot is on the throttle but the other one must be on the brake" – Mugur Isarescu, Governor of the National Romanian Bank.

Throttle: The Raw Domestic Product of Romania grew in the first quarter of this year by 6% compared with the same period last year.

Brake: But… government statisticians made a point of announcing that economic growth recorded in the first quarter this year was slower than in the same period last year, when Romania had a 6.9% growth.

Brake: Authorities in Bucharest estimate an economic growth of 6.5% for the whole year 2007, a decrease compared with 2006, when the recorded economic growth was of 7.7%.

Brake: The International Monetary Fund (IMF) has warned about deficit growth, and inflationary pressures caused by growth in domestic demand, fed by a fast expansion in credits and higher salaries.

In fact, Juan Jose Fernandez–Ansola, the IMF's representative in Romania, suggested the time might be right for Romania to implement, during this year, a more restrictive fiscal policy. He appreciated plans for fiscal strengthening and enlargement of the tax base but, for this year, he estimated Romania's inflation could grow by 4.5%-5.5%.

Throttle: But IMF believes Romania's economic growth will be between 6.5% and 7% this year. Direct foreign investments will this year reach seven billion euros.

Brake: The Governor of the National Romanian Bank, Mugur Isarescu, often shows his concern about the appreciation of the national currency (Leu) against the euro. "They [the IMF] are more relaxed than me where the appreciation of our currency is concerned," he says.

Throttle: But the Governor's appraisal comes into context when the value of the Leu against the euro grows. In June, it went to its highest level recorded in the last four-and-a-half years, buoyed by the admission of Romania to the European Community.

And Romania recorded eight continuous years of economic growth – which is expected to continue for another 10 years, barring major political barriers. Forecasts indicate a 6.3% growth in 2008, after which there will be a slower rhythm until 2013, when the economic growth should reach 5.7%.

According to Governor Isarescu, the rating granted to Romania by international agencies of financial evaluation will not go below the 'investment grade' category – indicating to investors that risks are low.

Isarescu also believes two economic issues have been resolved – one about obtaining a rating that signifies low risk, and the other about growth in official currency reserves that led to the improvement of Romania's financial credibility internationally.

Throttle: Romania offers investment opportunities in industrial markets with a significant yearly rate of growth.

The pharmaceutical industry represents a market of about 1.2 billion euros, with an annual growth of about 35%. Another sector where forecasts are explosive for the next few years is the building industry. A Big Four study shows that, until 2010, the Romanian market for the building industry will reach 10 billion euros, and the number of employees will be between 450,000 and 500,000. These figures will become reality only if Romania, by 2010, has, as the authorities promise, 1,000km of highways and 500,000 sq m of commercial locations. Currently, the Romanian market for the building industry has a yearly growth of more than 9%.

According to Global Property Guide.com, Romania also has one of Europe's most attractive real estate markets for investors – similar in value to those of Turkey, Bulgaria and Hungary. Top slot is given to Slovakia.

Another Romanian sector with sustained growth is spare parts manufacturing. This sector has attracted, in recent years, hundreds of billion of euros in investment, especially into 'green field' projects. The automotive industry, and sectors connected with it, have attracted about 5.8 billion euros in investment, according to data from the Association of Automobile Constructors from Romania.

Also emerging is an orientation toward management consultancy, a concept which has not been marketed widely in Romania to date. The value of management consultancy has this year exceeded 20 million euros, a growth of 33% compared with last year.

Contact: Camelia Dobre
UHY Audit CD S.r.l., Romania
Email: camelia.dobre@auditcd.uhy.ro

Juggling with political impacts

Latin America has been prospering from US ties. Such has been the flow of trade between Latin America and the US that, over the past ten years, Latin America's economic and political climate has mostly improved beyond recognition.

The US has been encouraging these ties – advocating that the best way for countries to achieve political stability, economic development and investment is through free trade agreements.

But, try as the US might, when the political stability of one of its target nations starts to unravel, often through the inflammatory words and actions of a controversial figurehead, newly-built confidence is undermined and, if prolonged, can send that nation's economy into freefall. Little wonder that foreign investors, juggling with political uncertainties, periodically have to consider whether to stay put or pull out, fearing crippling tax crackdowns or, worse still, state takeover of private enterprises through nationalisation policies.

UHY member firms have been advising foreign investment clients in one of the latest Latin American hotbeds of political turbulence, Venezuela. Should they stay, or should they go? Should they wait to see what happens? It might all blow over. Even if the economy becomes unstable, could their businesses be adapted so they still prosper? Once, or if, Venezuela is converted into the socialist state perceived by its president, will there still be a place for their businesses to thrive?

Such political issues impacting on business – sometimes only temporarily, other times for longer periods and with more deep-rooted effects – and the need for 'political forecasting' are a far cry from the predominantly economic uncertainties managed by foreign investors in the world's more politically stable regions.

Latin American leaning

For some while now a new wave of Left-leaning governments have been emerging across Latin America. Presidents in Brazil, Bolivia, Uruguay and Venezuela have characterised the march towards Leftist politics – and election results have confirmed that most are here to stay in the short to medium term. Venezuela's President Hugo Chavez has a clear mandate to rule for the next six years and is seeking to reform the constitution to remove limits on how many times he can be re-elected. Critics accuse him of being authoritarian, but there is no doubting his popularity, especially among the poor. It has been tested and proven in successive elections and a referendum.

Venezuela has vast discrepancies between rich and poor – the poorest 20% have only a 4% share of the country's wealth – yet the president's new form of socialism pushes populist policies aimed at helping the poor, such as free health care,

A Venezuelan media cartoonist attacks the president after he closed the RCTV television station and replaced it with a state-sponsored broadcaster.

UHY

Venezuelan university students manifest their opinion and inconformity daily. The pictures show how they try to avoid confrontation, but commentators wonder for how long they will be allowed to continue their demonstrations.

subsidised food and land reform. Emergency health, education and welfare programmes, introduced by the government since 2003, have changed the lives of millions. About 14.5m now receive free primary health care through the Barrio Adentro programme, supported by Cuban doctors as part of an oil-related deal.

Buoyed by election results, President Chavez has focused on state control of oil and gas assets – often expressing his policies through inflammatory rhetoric about imperialist foreigners plundering the country's wealth. Bolivia's president Evo Morales, the country's first president of indigenous origin, has repeated almost verbatim President Chavez's denouncements – and both have gone ahead with the seizure of energy operations.

President Morales introduced hydrocarbon laws that put the state-owned Yacimientos Petrolíferos Fiscales Bolivianos in control of all Bolivian oil and gas projects. Troops were sent in to take charge.

President Chavez's hydrocarbon laws, which increased royalties paid by private companies from 1-17% to 20-30%, guaranteed the state-owned Petroleos de Venezuela S.A. a majority share of all new projects in the sector. When France's Total and Italy's ENI, operators of the Jusepín and Dación fields, refused to sign new agreements, the government took control of those operations.

The prospect of what else was to come became clear when the government presented a Conoco oil project with a tax claim of more than USD 465 million – the largest tax bill in the nation's history.

The move came only days after the nation's energy minister said Venezuela was 'in conflict' with Conoco over its refusal to sign an accord recognising the government's takeover of heavy crude oil projects.

President Chavez has also threatened to take over Venezuela's private banks and its largest steelmaker. But, in these cases, the government made threats conditional, saying they could avoid takeover if they adapted their businesses to better take into account 'the national interest'. Banks are being urged to prioritise domestic loans, and demands on the steelmaker are that it should focus more on supplying the local market with cheap products.

"If they do not accept right now a change in the process, then they are going to force me to nationalise," said the President.

Takeovers and rhetoric have led to the share price of Latin America's largest steelmaking company Ternium, which owns the threatened Ternium-Sidor company, touching a three-month low – even though the President said he was reluctant to take over Ternium-Sidor because its investors were Latin American.

Protestors also point to the Electoral National Council presenting the president with data on approximately 12.5 million referendum voters. Through that information, the voters have been identified, through their national identity card numbers, as "voters for" or "voters against" the president. That list (the Tascon List) is being used, it is reported, to exclude political opponents from state contracts. Among them are 30,000 employees fired from the Venezuelan Oil Company PDVSA who did not receive severance payments nor pensions and were expelled from the houses where they lived in the oil camps.

Meanwhile, Venezuelan university students manifest their opinion and inconformity daily. The pictures above show how they try to avoid confrontation, but commentators wonder for how long they will be allowed to continue their protests.

Future investment potential

Yet, despite all the political turbulence, often accompanied by the president's anti-American rhetoric, Venezuela continues to have significant investment opportunity – not least as a result of US interests.

The US supplies approximately one-quarter of Venezuela's food and is its biggest customer for petroleum exports.

Other countries also have established interests. Among them, China is one of its fastest-growing customers for crude oil and Venezuela, one of the founding OPEC nations, is still estimated to have the largest oil reserves in the Western hemisphere, making it a magnet for Western investors. The oil sector accounts for more than 75% of the country's export

revenues, about half of total government income. The country has a daily revenue of USD 198 million from oil.

With oil prices expected to remain high for a prolonged period, it is often more a question of mathematics, than politics, for foreign investors wondering whether to leave the country – so long as they can hold on to at least some of their stake. Even though inflationary pressures appear permanent, oil prices are likely to stop the economy spiralling out of control in the short term.

The government meanwhile is swallowing excess liquidity through the emission of bonds and debt, and it is expected to keep the exchange rate fixed at VBS 2,150:USD1. It is also expected to apply tougher price controls and increase food imports for low-income individuals. The combination of these factors is expected to offset inflationary pressure and keep inflation in low two digits – quite attractive considering Venezuela in the 1980s and 1990s used to have inflation of up to 120%.

Experienced investors in the region point to Latin America's penchant for socialistic leaders in the past and how they have failed to establish a permanent 'economic footprint' in their bid to wipe out inequality. Nothing much has changed, some say; politics may be unfriendly, but the likelihood is that current political extravagance will, in time, become tamed through economic necessity.

UHY has several Latin American firms including one in Venezuela.
For more information contact:
James Vrac in the London, UK, office for details. Email: j.vrac@uhy.com

Support for high performance

Attracting good people is not so much a question of recruitment as of courtship. Business leaders need to be talent spotters, networking to find the right sort of people (perhaps those who are already seeking to move are not the right kind of people at all).

Creating a clear vision and common purpose for various units within a business, and developing a high performance culture, will be key factors in attracting people. So businesses need to ask themselves: "Why would highly talented people want to become part of our team?" It goes back to the purpose. Is it inspiring? Is it worthwhile?

Unless businesses can answer these questions positively, they will be driven into having to offer high monetary packages to compensate for the lack of intrinsic reward they can offer. The starting point for recruitment is therefore not to recruit at all, but to establish the kind of organisation that people would want to be part of. The parallel with customers is unmistakeable. You want to build a reputation that has them knocking on your door, rather than having to chase them down the street to persuade them to join you. A business should therefore market itself not only to customers but to professionals too.

It follows that attracting people to the organisation is not a responsibility that can simply be pushed to a HR department. Attracting good people is a leadership responsibility, particularly if that business depends wholly on the talents of their people.

Some organisations talk about having to attract the 'best' people. This begs the question 'best at what?' It is much more instructive to think about attracting the right kind of people who share the organisation's goals and values, and who will love doing what the organisation wants them to do.

In recruiting professional people, the traditional style of reviewing CVs and conducting interviews provides little benefit. Perhaps it would be more instructive to ask individuals about their future CV (i.e. about what they want to achieve) to ensure there is a match with the organisation's own aspirations, than to dwell on what an individual has done in the past (which often bears little relation to what they will do in the future).
It is unwise to make assumptions

UHY

If management is about...	Leadership is more about...
Enforcing rules	Instilling values
Setting objectives	Offering a vision
Instructing	Coaching
Pushing	Pulling
Telling	Involving
Delegating	Empowering
Being supported	Supporting
Having ideas	Bringing out others' ideas
Demanding respect	Showing respect
Processes	People

about what drives individuals. Each individual will have his or her own motivations and goals. Part of a leader's responsibility is to uncover those goals and ensure that there is a match with what the business is trying to achieve.

It is sometimes assumed that employees are driven almost entirely by money. In attracting people, businesses should be wary of placing too much emphasis on financial rewards alone.

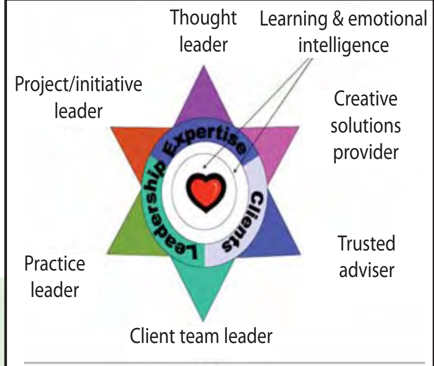
Many organisations talk about the need to retain their good people, yet retention strategies are negative. Would you want to be 'retained'? The strategy should be to get people to want to stay longer. That does not mean throwing more money at them, or locking them in so that they cannot move. It means involving them in worthwhile activity that supports their own goals.

It should be noted that managers cannot create motivation in people; all they can do is draw out the motivation that lies within. Unfortunately, many leaders, and the processes they use in the name of people management, do not draw out motivation. Inevitably some, perhaps many, people will move on to pursue their ambitions elsewhere. That should be accepted and when people do move on their success should be celebrated. Exit interviews should ensure they are moving on for positive reasons rather than because of dissatisfaction with the organisation.

How will professional service firms address this challenge?

It is time to jettison the old model of the well-rounded professional. As many firms create comprehensive competency profiles for their partners and professional staff, it must surely become obvious that expecting everyone to take on the same mantle is both unrealistic and fails to play to individual strengths.

The figure below shows a new model for achieving success in professional firms. At the core there needs to be a passion for the kind of work the professional will be doing. Professional life demands commitment and enthusiasm. This cannot be faked – there has to be a genuine urge to pursue a worthwhile career with energy and self-motivation.



There are also some essential skills that all professionals need to have. Emotional intelligence is one: the ability to build relationships and communicate effectively. Learning is another key skill; professions are in a state of change and being prepared to develop is essential for anyone seeking success in the future.

Beyond these essential skills are three main dimensions. All professionals need to be good in each of these areas, but to become successful they will need to become excellent in at least one, possibly two. It is unlikely that any individual can become excellent in all three.

Someone who has a passion for client development might set their sights on becoming a 'trusted adviser'. Trusted advisers have very close professional relationships with their chosen clients. They are excellent at developing new relationships and bringing in new work for the firm, and they are highly regarded by clients. Often, trusted advisers are closer to their clients than they are to their firm.

Someone with an enthusiasm for the technical aspects of their field and a pioneering outlook might set their sights on becoming a specialist guru or 'thought leader'. This does not just mean specialising in something – it means being at the very leading edge in their chosen field. They have probably written the book and are very active on the lecture circuit. They are certainly regarded as a leader in their chosen specialism. They may, however, be less effective with clients because, to them, ideas are more important than relationships and their ideas may lack the practical edge that clients demand.

Firms need to find new models that reflect a diversity of opportunities and aspirations. At a minimum, the career ladder needs to be replaced with a career climbing frame in which professionals can move around, developing their skills and exploring new opportunities.

Recruitment consultant for UHY Hacker Young, UK, is Phil Gott
Website: www.philgott.com
Email: philgott@peopleism.co.uk