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International

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Are FinTechs Too Slow in Adapting Their Transfer Pricing Policies When Faced with Fast Growth?

The FinTech industry has expanded dramatically in the course of last years. The authors explain the main transfer pricing considerations applicable to FinTech firms from the perspective of value creation within the FinTech's value chain. This article is based both on the information publicly available and the practical experience of the authors in the field of the transfer pricing considerations applied to FinTechs.

1. Introduction

In 2021 the FinTech industry recorded a remarkable increase in investments up to EUR 210 billion, almost double the figure of the prior year, reaching the pre-COVID level recorded in 2019.^[1] With the rapidly changing consumer trends and needs, and the regulatory developments (such as PSD2)^[2] investors' interest in FinTech^[3] remains high. Paypal was established 24 years ago in 1998^[4] and is considered one of the first FinTechs in the world, and the sector has been growing exponentially ever since. For example, the number of FinTech startups year-to-date is 26,000; and this number does not take into account (the growth of) established and mature FinTech firms.^[5] Investor interest but also consumers' interest in the next "user-friendly" and "automated" solution that FinTechs have to offer also raises the interest of tax and transfer pricing professionals in better understanding the characteristics of the business carried out by FinTechs, to ensure that any potential tax risks are mitigated in the process of the rapid growth from a startup company to an established business.

In this article, the authors aim to explain the main transfer pricing considerations applicable to FinTech firms from the perspective of value creation within the FinTech's value chain. To set the scene, the second section of the article explains some of the latest global trends contributing to the emergence and expansion of FinTechs. This is followed by analysing the main types of operating models encountered amongst multinational FinTech groups in the third section. Section 4 explores some of the key transfer pricing considerations relevant for the main types of intercompany arrangements observed within a FinTech group. The fifth and final section outlines the key takeaways from a transfer pricing perspective for FinTech groups with cross-border business activities.

2. FinTech: Definition, Evolution and Global Trends

2.1. What is FinTech?

FinTech is often described as the merging of technology and financial services for the purpose of transforming and improving financial activities. By leveraging technology and cloud-based data, financial service companies or institutions are able to offer better tailored products to consumer needs at a lower cost.^[6] Such integration promises the possibility to develop new market opportunities and expand

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1. A. Boukarroum, *Charts: Global FinTech Investment in 2021* (12 Apr. 2022), available at <https://www.practicaledge.com/charts-global-fintech-investment-in-2021> (accessed 22 Sept. 2022).

2. Revised European Union Payment Services Directive, which entered into force in 12 January 2016 and was transposed in local law by most European Union Member States in 2018 and 2019.

3. Throughout the article all references to "FinTech" shall be considered as a reference to *companies or firms* using new technology to compete with traditional financial methods in the delivery of financial services.

4. K. Reddy, *The First FinTech to Go Global – The Paypal Story* (30 Oct. 2017), available at <https://www.ecommerce-nation.com/first-fintech-go-global-paypal-story/> (accessed 22 Sept. 2022).

5. J. Howarth, *57+ incredible FinTech Stats (2022-2024)* (15 July 2022), available at <https://explodingtopics.com/blog/fintech-stats> (accessed 22 Sept. 2022).

6. Arner et al., 2020; Boot et al., 2020; Philippon, 2020; Thakor, 2020, as cited in Y.W. Tok & D. Heng, *FinTech: Financial Inclusion or Exclusion?*, IMF Working Paper no. WP/2022/080, p. 5 (May 2022), available at <https://www.imf.org/en/Publications/WP/Issues/2022/05/06/Fintech-Financial-Inclusion-or-Exclusion-517619> (accessed 23 Sept. 2022).

existing customer services by promoting efficiencies, speed, additional security and cost reduction. In addition, the development of the FinTech industry may also result in other benefits, such as increased access to funding and to financial products for secluded or remote markets or the creation of more robust governance, risk management, and compliance processes.

However, despite the consensus on the major impact that FinTechs have had on the financial services industry, it appears that no common definition of FinTech has yet been agreed upon.^[7] This is partially a result of the great variety of FinTech products, both in scope and scale, as well as the multiple areas that FinTechs encompass. Broadly speaking, these areas can be classified into four main categories: (i) banking and capital raising markets; (ii) payments, clearing and settlement services, including digital currencies; (iii) investment management services; and (iv) insurance.^[8] Each of these broad categories can be even further expanded. This variety presents challenges to establishing a common definition of what the term FinTech means. Furthermore, the FinTech industry is growing rapidly and at a varying speed across regions and countries, so the meaning of “FinTech” is undergoing change over time.^[9] It has been argued that that no one single definition of FinTech exists, which results in implications for scholars, practitioners and policymakers alike, including the OECD.^[10], ^[11] Given the absence of a uniform definition and in order to facilitate a common understanding of the term FinTech, the authors of this article are using the following definition: “FinTech is a new financial industry that applies technology to improve financial activities”.^[12] FinTech also refers to the firms using emerging technology to compete with traditional companies in the delivery of financial services.

Although technology is considered to be at the core of what FinTech means, the authors’ understanding of the term is also aligned with the manner in which the OECD described it in its 2018 Report addressing Digitalization and Finance.^[13] According to this Report, “FinTech involves not only the application of new digital technologies to financial services but also the development of business models and products that rely on these technologies and more generally, on digital platforms and processes”. Therefore, the definition broadens the term FinTech from innovation in digital financial services to the digitalization of the traditional financial services industry.^[14] This process involves transforming traditional (financial) services into new types of businesses by leveraging on certain key value drivers.

The most significant *key value drivers* for digitalized businesses are (i) qualified staff and access to a global talent pool; (ii) intangibles, including intellectual property (IP) such as digital platforms, algorithms, automated business processes, and know-how; (iii) data and access to input data streams, and (iv) marketing strategies.^[15] Among the evident characteristics of these value drivers are that they are: (1) relatively mobile; (2) can remotely contribute to value creation, such as creating enhanced user experience and thus contributing to a low barrier of entry; and (3) need less physical space (often intangible) and less investment in physical capital.^[16], ^[17]

In order to ensure alignment of the operating models adopted by FinTechs with their value chains, it is important to recognize and understand these key value drivers. Furthermore, an ecosystem that promotes innovation and establishment and growth of startups is key for a FinTech’s choice of location. Thus, local regulations in that respect are also relevant when analysing a FinTech’s value chain. The next section outlines some of the main global trends that have an impact on the value creation within a FinTech firm and the operating model it adopts.

2.2. Current global trends: A business challenge or opportunity for FinTech firms?

Understanding value creation within an organization is at the basis of any transfer pricing policy design tasked with ensuring that all associated entities (including branches) earn an arm’s length return. In order to better understand the process of value creation within a FinTech, it is important to understand the main business challenges and opportunities faced by it. The authors have picked two most current business challenges that have a clear impact on how a FinTech does business. These are regulatory pressures and access to talent pools.

2.2.1. Regulatory pressures

The rapid growth of the FinTech industry and the variety of products offered is driving structural changes to the financial services sector while presenting opportunities and challenges for regulatory compliance and supervision. In such a fast-moving environment, overly rigid and hurried regulation carries the risk of undesired outcomes.^[18] However, there are significant risks in refraining from updating policy and regulatory frameworks. For example, FinTech presents challenges such as cyber-related risks, data, consumer and investor protection

7. P. Schueffel, *Taming the Beast: A Scientific Definition of FinTech*, 4 Journal of Innovation Management 4, p. 33 (2016).

8. Y.W. Tok & D. Heng, *FinTech: Financial Inclusion or Exclusion?*, IMF Working Paper no. WP/2022/080, p. 5 (May 2022), available at <https://www.imf.org/en/Publications/WP/Issues/2022/05/06/FinTech-Financial-Inclusion-or-Exclusion-517619> (accessed 23 Sept. 2022).

9. *Supra* n. 5.

10. *Id.*

11. OECD, *Financial Markets, Insurance and Private Pensions: Digitalisation and Finance*, p. 10 (OECD 2018), available at <https://www.oecd.org/finance/Financial-markets-insurance-pensions-digitalisation-and-finance.pdf> (accessed 23 Sept. 2022).

12. *Supra* n. 5 at p. 45.

13. *Supra* n. 9.

14. N. Milogolov, *The emergence of the “technological tax hub” digitally oriented trajectories of reforms in tax planning hub jurisdictions*, 48 Intertax 12, pp. 1104-1124 (2020).

15. *Id.*

16. *Id.*

17. *Id.*

18. G. Deipenbrock, *Digital finance and beyond in the third decade of the 21st century - Observations with a focus on the EU policy and legal perspective*, 33 European Business Law Review 3, p. 322 (2022).

issues and market integrity issues.^[19] As a result, global public institutions such as the European Union (EU) have taken action to enable new technology markets whilst ensuring that FinTechs are responsible for complying with fundamental safeguards such as data protection regulations, anti-money laundering and terrorism finance legislation, amongst others. As an example, EU Digital and FinTech Action Plans,^[20] the Payment Services Directive^[21] and the Directive and Regulation on Markets in Financial Instruments^[22] have extensively considered the benefits of technological innovation in the financial sector.

FinTech has also been a priority area at the international level, for example for the G20 through the Financial Stability Board. In addition, an increasing number of jurisdictions have developed regulatory and supervisory frameworks to address specific forms of FinTech innovation.^[23] Outside Europe, regulators are paying increasing attention to payment methods and services and alternative forms of financing, such as crowdfunding and peer-to-peer lending,^[24] and further setting up of FinTech innovation hubs.

Take InsurTech firms and neo-banks for example. There are a number of regulatory ramifications in insurance and banking sectors that create opportunities in business developments, such as potential lower barriers of entry to the market by having new entrants through the application of innovations and new technologies. On the one hand, that could be advantageous to the consumer, by lowering prices or increasing choices. On the other hand, there are important regulations in place such as prohibitive capital requirements to ensure customer protection.^[25] As a result, there is tension between financial regulation and competition, which requires a balancing act to ensure there is sufficient innovation while mitigating possible risks.

Similarly, RegTech is an emerging area within FinTech focused on using technology to execute regulatory and compliance requirements (such as know your client (KYC)^[26], anti-money laundering or counter-terrorism financing, among others) more effectively and efficiently.^[27] The relevant technologies in this subcategory of FinTechs may include machine learning, AI, biometrics, the interpretation of unstructured data, the use of application programming interfaces (APIs) and the use of algorithms.^[28] All these tools may be used to aggregate big data, risk modelling for stress testing, monitoring of capital-requirement compliance, and many other existing regulatory requirements.^[29] However, while this area grows, questions arise as to how to ensure that the algorithms used are compliant with market conduct regulations and what could be the unintended consequences of algorithms.^[30]

In broad terms, when it comes to technology, regulators are concerned with facilitating the emergence of new technological solutions to enable innovative business models. However, in order to ensure that the stability and integrity of the global financial system is maintained, they provide clear licensing requirements, such as capital, reporting and strict governance. In addition, through the introduction of common standards, they are also trying to encourage both competition but also cooperation between different stakeholders and market players. Thus, unlike general startups and scale-ups in the non-financial sector, FinTechs also have to take into account the common standards and licensing requirements imposed by regulators when adopting their operating models.

2.2.2. Access to talent pools

In the “great resignation” era – a term coined to describe the surge in people quitting jobs in 2021 – employees are looking for more meaning and purpose in their day-to-day working lives by re-evaluating their careers and holding employers to higher standards and different expectations.^[31] In this environment, startups (and scale-ups) seem to be better positioned in hiring talents.^[32] The flight from traditional financial institutions into FinTech is likely to intensify as FinTech compensation and job security comes closer to more established financial service organizations.^[33] However, while it may still not be easy to compete with large multinational groups on traditional forms of compensation, startups seem to understand what employees are looking for and have more flexibility in adapting

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19. Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on FinTech Action plan: For a more competitive and innovative European financial sector, 8 March 2018 COM(2018) 109 final, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109#footnote11> (accessed 23 Sept. 2022).
 20. European Union, European Commission, Digital Education Action Plan (2021-2027), available at [https://education.ec.europa.eu/focus-topics/digital-education/action-plan#:~:text=The%20Digital%20Education%20Action%20Plan%20\(2021%2D2027\)%20is%20a,States%20to%20the%20digital%20age.](https://education.ec.europa.eu/focus-topics/digital-education/action-plan#:~:text=The%20Digital%20Education%20Action%20Plan%20(2021%2D2027)%20is%20a,States%20to%20the%20digital%20age.) (accessed 23 Sept. 2022).
 21. Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (Text with EEA relevance).
 22. Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and Regulation EU 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.
 23. Communication from the Commission to the European Parliament, The Council, The European Central Bank, the European Economic and Social Committee and the Committee of the Regions on FinTech Action plan: For a more competitive and innovative European financial sector, 8 March 2018 COM(2018) 109 final, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109#footnote11> (accessed 23 Sept. 2022).
 24. Id.
 25. *Supra* n. 9.
 26. KYC stands for Know Your Client procedures.
 27. *Supra* n. 9.
 28. Id.
 29. Id.
 30. Id.
 31. P. Sawers, *Despite remote work and the economic downturn, some companies look to London for expansion*, Tech Crunch (3 Aug. 2022), available at <https://techcrunch.com/2022/08/03/despite-remote-work-and-the-economic-downturn-some-companies-look-to-london-for-expansion/> (accessed 23 Sept. 2022).
 32. A. Gupta, *Startups get the edge over corporates in hiring talents amid the ‘Great Resignation’ era*, The Economic Times (17 Aug. 2022), available at <https://economictimes.indiatimes.com/news/company/corporate-trends/startups-get-the-edge-over-corporates-in-hiring-talents-amid-the-great-resignation-era/articleshow/93613759.cms> (accessed 23 Sept. 2022).
 33. B. Zaben, *Winning the War for FinTech Talent in 2022: Compensation Issues*, AC Lion (9 Mar. 2022), available at <https://aclion.com/winning-the-war-for-fintech-talent-in-2022/> (accessed 23 Sept. 2022).

benefit packages to what new hires are looking for. For instance, startups place more importance on non-financial incentives such as the work-life balance, adjusting to hybrid-work arrangements and utilizing technology to achieve this, all of which are particularly attractive to new generations of workers.^[34]

Labour mobility is one of the non-financial incentives that has been gaining importance among the working population. The term “labour mobility” describes the movement of workers both geographically, between different locations within the same country or across borders, and occupationally, between different job patterns or through the acquisition of new skills.^[35] COVID-19 expanded the extent of labour mobility and the categories of workers involved as a result of major changes in labour patterns, introducing home office work, digital nomadism, and decentralization of jobs.^[36] The FinTech industry has not been immune to these changes in labour mobility, albeit with varying degrees as compared to traditional corporations. FinTechs are better positioned than traditional financial institutions in the labour market force as lately they have been better able to attract and retain talent by implementing flexible human resources (HR) policies.

The growth of the FinTech industry, driven by factors such as improved regulatory environments and increased digital adoption, has led to a greater demand for talent. Take Singapore and the United Kingdom, for example, where demand for FinTech talent continues to outpace local supply and where reliance on overseas talent therefore becomes paramount.^[37] Moreover, there is an increased demand for talent with specialized skillsets across all financial services and technology sectors.^[38] Access to the right level of highly skilled talent to realize business growth is one of the biggest challenges in the financial services and technology sectors alike. In particular, four types of distinct talent profiles are required in the FinTech industry: (i) commercial, focused on building business and increasing revenue; (ii) technological, driving innovation; (iii) operational, supporting users and infrastructure; and (iv) corporate, providing strategic shared services across the organization.^[39]

There are no predetermined rules about what FinTech recruitment strategies, HR policies or even operating models should look like. The choice should be made by each FinTech based upon its own specific focus and needs. However, it is clear that decentralized business models may enable FinTechs to target more and larger talent-rich jurisdictions, while very rigid centralized models may result in difficulties in finding talent to manage and control key business processes and risks centrally.^[40]

3. Evolving Operating Models within FinTechs with Cross-Border Operations

Over the past decade, FinTechs have been evolving from startups to large corporations, either via organic growth or mergers and acquisitions. Throughout the growth cycle, the strategic focus would fluctuate depending on the maturity stage of the FinTech. For example, in the early startup phase, a FinTech is primarily focused on ensuring its offerings are validated by the market and on obtaining funding to survive, while in the scale-up phase, it is more concerned with expanding into new markets and finding the right talent.^[41]

In the previous section the authors analysed how certain macro-trends are impacting the FinTech's value chain. This article aims to describe the main business operating models commonly encountered in the FinTech industry and at which stage of the growth journey these models are adopted. Specifically, the authors explore the applicability of centralized and decentralized operating models and variations thereof, such as the multihub model, and the involvement of virtual teams.

3.1. When is a centralized model most likely to be adopted?

At the initial startup phase, a FinTech is generally more concerned with identifying problems and solutions, product prototypes and finding the right market. The product development phase follows soon after, when FinTechs begin to focus on the placement of minimum viable products in relevant markets and piloting to attract initial revenue. This stage is known for having a low number of employees, which could either be in the same location or at multiple locations, and is associated with a centralized operating model where the value creation and decision making is driven centrally.

As FinTechs become larger and begin to scale up geographically, organic growth and changes in business objectives could eventually lead to the misalignment of business operating models with the value creation and the transfer pricing setup, increasing local tax risks

34. *Supra n. 30.*

35. J. Long & J. Ferrie, *Labour Mobility*, Oxford Encyclopaedia of Economic History (2011), as cited in G. Beretta, *Work on the Move: Rethinking Taxation of Labour Income under Tax Treaties*, 5 *International Tax Studies* 2, p. 2 (2022).

36. Note that “non-standard forms of employment” is another important trend in the labour market that does not seem to have a significant impact on the FinTech industry at this point in time and hence has not been discussed further. See G. Beretta, *Work on the Move: Rethinking Taxation of Labour Income under Tax Treaties*, 5 *International Tax Studies* 2, p. 5 (2022).

37. Singapore FinTech Association and Accenture, *FinTech Talent Report 2021*, available at <https://singaporefintech.org/wp-content/uploads/2021/11/SFA-Accenture-Fintech-Talent-Report-2021.pdf> (accessed 23 Sept. 2022); S. Farazi, *How a dual approach will ensure UK FinTech maintains skills for success* (EY), available at https://www.ey.com/en_uk/financial-services/how-a-dual-approach-will-ensure-uk-fintech-maintains-skills-for-success (accessed 23 Sept. 2022); and P. Sawers, *Despite remote work and the economic downturn, some companies look to London for expansion*, Tech Crunch (3 Aug. 2022), available at <https://techcrunch.com/2022/08/03/despite-remote-work-and-the-economic-downturn-some-companies-look-to-london-for-expansion/> (accessed 23 Sept. 2022).

38. Singapore Fintech Association and Accenture, *Fintech Talent Report 2021*, available at <https://singaporefintech.org/wp-content/uploads/2021/11/SFA-Accenture-Fintech-Talent-Report-2021.pdf> (accessed 23 Sept. 2022)

39. Id.

40. J. Camillo, M. Mealey & K. Stals, *How multi-hub models can enhance operations and reduce tax risk* (EY), available at https://www.ey.com/en_gl/tax/how-multi-hub-models-help-operations-and-cut-tax-risk (accessed 23 Sept. 2022).

41. J. van der Kroft & D. Sweers, *A FinTech journey: What to consider when growing from start-up to scale-up* (EY), available at https://www.ey.com/en_nl/banking-capital-markets-transformation-growth/a-fintech-journey-what-to-consider-when-growing-from-start-up-to-scale-up (accessed 23 Sept. 2022).

as such. Hence, FinTechs need to understand how their value chain is impacted during the scale-up process by evaluating whether their operating model and transfer pricing setup are still aligned. In this regard, the features of a centralized operating model versus a decentralized structure should be considered, as well as the potential advantages and disadvantages of both.

Centralized business models mean the strategic decision making over the value creation, including management and control of risks, is concentrated at one single location. For FinTechs specifically, where IP is at the core of the value chain, a centralized model implies the existence of a single IP entity, which is the legal and economic owner of the IP. Funding and sales may reach up to the same level of importance for the value creation, and in a centralized model these would also be expected to be done centrally, with support from affiliated entities located in local markets.

Centralized business models are often seen as more efficient vis-à-vis decentralized structures because these are considered to be less complex from an operational and control perspective. For example, centralized structures can simplify the integration of newly acquired structures.^[42] Apart from the operational efficiency gains, the additional benefits of a centralized business model include a more administrable corporate governance processes, including the use and commercial exploitation of IP, such as decision-making processes and control over the risks related to the IP.

In addition, some jurisdictions have taken steps to increase the benefits of a centralized approach by offering a number of incentives that are aimed to attract the business, such as R&D and IP development incentives and subsidies.

However, on the other hand, centralized structures are less agile and adaptive to an ever-changing business environment. For example, FinTechs in the scale-up process may wish to access a broader talent pool and provide local entities with more responsibility over important decision-making functions to adapt the products to specific market needs or requirements.

Another disadvantage of centralized models is that they are more exposed to tax controversy risks in the countries where “routine functions” are set up, when the whole group and business is profitable. Local tax authorities are more likely to challenge the characterization of certain entities as “routine” by arguing that important strategic functions are performed locally and that these need to be remunerated with a higher profit share.

Altogether, considering these disadvantages along with the growth phase a FinTech is in, its business strategy and talent availability, the adoption of a decentralized model may seem more advantageous.

3.2. Consideration for implementation of decentralized or multihub models

As mentioned above, the transition from centralized to decentralized models typically happens with the growth of the business, whereas a potential misalignment between value creation and the operating model might emerge. When expanding into new markets during the scale-up phase, FinTechs may begin to naturally shift towards decentralized models, for example, expanding geographically by attracting additional talent in new jurisdictions to perform more strategic roles.

The scale-up phase might lead to a shift of key important responsibilities and decision-making functions as well as the control over significant risks outside the central location in charge of the strategic decision-making, including the development and enhancement of IP. This may occur, for example, by focusing locally on strategic sales or by establishing regional centres of excellence to increase focus on customer experience through digital enablement.

A decentralized operating model provides for the involvement of a number of local entities, acting as local entrepreneurs in key decision-making associated with the purchase, manufacture and sales, and controlling of significant risks with regard to its value chain, that is, risks relevant to purchasing, processing and selling of the products.^[43] For example, under such a model, local entities would have a stronger say on business strategies around the key IP or have a higher degree of independence in performing strategic sales in their location or region. In case of IP, although generally only one single legal entity could be deemed to be the legal owner of the IP, local entities could be considered as economic owners of IP from a tax and transfer pricing perspective, due to the decision-making power and control over significant risks with regard to such IP that they perform. In such case, they should be entitled to higher than routine returns.

One advantage of a decentralized model is that it provides more flexibility in respect of geographic expansion needed during the scale-up phase. Decentralization helps counter the inefficiencies created by having a central decision-making headquarters, such as not having access to complete information during the decision-making process or timing inefficiencies caused by communications with the local entities that are responsible for implementation but which are mostly separated from the decision-making.^[44] Many FinTechs struggle to expand when trying to maintain centralized control over doing business in new local markets.

42. S. Penttilä & A. Isomaa-Myllymäki, *Centralization of Intangibles and Transfer Pricing under BEPS and Finnish Tax Law*, 58 Eur. Taxn. 2/3, p. 83 (2018), Journal Articles & Opinion Pieces IBFD.

43. V. Chand, A. Turina & L. Ballivet, *Profit Allocation within MNEs in Light of the Ongoing Digital Debate on Pillar I – A “2020 Compromise”? : From Using A Facts and Circumstances Analysis or Allocation Keys to Predetermined Allocation Approaches*, 12 World Tax J. (2020), Journal Articles & Opinion Pieces IBFD; see also V. Chand, *Impact of Pillar I on Decentralized MNE Consumer Facing (Goods) Business Models: An Initial Assessment Through an Illustration* (Kluwer International Tax Blog, 28 Feb. 2020), available at http://kluwertaxblog.com/2020/02/28/impact-of-pillar-i-on-decentralized-mne-consumer-facing-goods-business-models-an-initial-assessment-through-an-illustration/?print=print&doing_wp_cron=1595684166.9614369869232177734375 (accessed 23 Sept. 2022).

44. J.E. Hass, *Transfer Pricing in a Decentralized Firm*, 14 Management Science 6, pp. B310-31 (1968), available at <http://www.jstor.org/stable/2628164> (accessed 5 Oct. 2022).

In addition, geographic expansion through local entrepreneurial type of activities might allow connecting to a wider talent pool. Furthermore, customer journeys can be made more resilient, agile or adaptive to the specific customer needs of each region. Decentralized models also offer an enhanced business flexibility, access to more incentives offered by local governments and can lower tax controversy risks.

On the disadvantages side, under a decentralized model, the legal and corporate governance aspects are more complex and require careful consideration for any tax compliance issues. For example, multiple IP ownership locations by multiple legal entities would create more complex transactional models, remuneration mechanisms and compliance challenges. In addition, managing (financial) risks or managing certain intangible assets, such as IP which has a prominent place within a FinTech's value chain, is generally easier done from a single location.

3.3. Virtual teams

The increased attention to this form of operating model is the result of global competition to access talent pools and the new ways of working impacted by the COVID-19 pandemic. The macro-trends discussed in the previous section have driven many businesses to increasingly work through virtual teams spread across the globe.

Today, modern business models and globalization greatly diminish the necessity or importance of having a physical presence to carry on a business. Some startups are also incubated in this manner and remain as such in the initial phases of their journey. As they begin to scale up in certain locations, they may rely on third-party service providers that have developed outsourcing solutions for organizations wishing to operate in such kind of models, allowing them to access multiple talent-rich markets while reducing their regulatory complexities by simplifying regulatory hurdles, for example, through the provision of support services in multiple jurisdictions.

In some respects, the advantages of this model are similar to the advantages of a decentralized model. Virtual teams might broaden the pool of talent to a global level, as well as cut down on initial HR costs. Hence, this model is more flexible and adaptive to specific market needs. In addition, the model might be less burdensome from a compliance, given the simplified legal structure.

On the other hand, the virtual teaming model has its disadvantages. Virtual teams in general would not have all the compliance processes in place, and thus are more exposed to challenges from tax authorities, such as the permanent establishment risk, particularly if revenues start to substantially increase whereas the presence in a jurisdiction might be still "light".

In conclusion, while businesses can decide between adopting a centralized or decentralized model depending on their business strategies or priorities, such a decision should be carefully assessed and aligned with value creation. Thus, when a FinTech transitions from a centralized to a more decentralized way of doing business or vice-versa, the various intercompany transactional flows in the value chain should change to ensure that the local or regional contributors to value creation (i.e. group entities or local branches) are appropriately remunerated in line with the functions performed and risks assumed, meaning that appropriate returns (or even losses) are shared amongst these contributors based on the arm's length principle.

4. Main Transfer Pricing Considerations Relevant for FinTech Groups

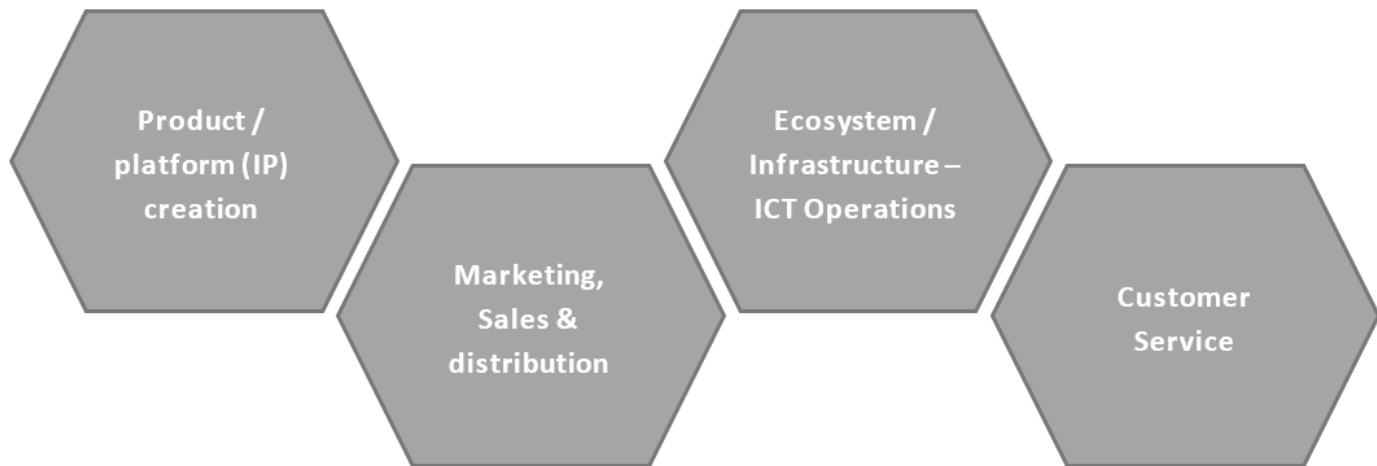
Having analysed some of the main features of the operating models adopted by FinTech groups in the previous section, the authors will further focus on the transfer pricing considerations thereof. In particular, the aim of this section is to review the main intercompany arrangements encountered in the FinTech industry and the transfer pricing models (TP models) applied, as well as the rationale for the choice of a specific one.

4.1. FinTech value chain and the choice for a specific TP model

Among transfer pricing professionals, it is emphasized that the operating model of a corporate group, including the intercompany transactional flows between affiliated entities, should be aligned with the business and economic reality underlying the value creation in the value chain. Consequently, the rationale for the choice for the specific TP model in the FinTech industry should be linked to *value creation*. Nonetheless, certain TP models implemented by FinTechs are common not only for a single type of operating model, as described in the previous section, but are relevant for both centralized and decentralized operating models.

While the value chains of FinTechs can differ based on business focus (e.g. payment service provider vs. Insurtech or neo-bank), an example of a typical high-level value chain in the FinTech industry is shown in Figure 1:

Figure 1 – High-level value chain in the FinTech industry



In the case of a FinTech with a multinational reach, each element of the value chain would generally require the undertaking of certain types of intercompany transactions for which a specific TP model need to be considered. The following main intercompany arrangements are further analysed below:

- the use of IP;
- intra-group financing;
- marketing, sales & distribution; and
- intra-group services: both support services and contract R&D.

4.1.1. Use of IP

For FinTechs, IP represents the paramount prerequisite for the value creation and profit generation. In order to grow faster and penetrate or expand into a market, FinTechs tend to apply different operating models aimed at the exploitation of the IP, which starts with IP development. In practice, the following two models can be used by FinTechs to provide IP rights within a group:

- licensing;
- cost contribution arrangement (CCA);
- incorporating the value of IP into the price of a good or service provided under an intercompany buy-sell transaction; and
- residual profit remuneration covering the performance of a bundle of activities including central (headquarter type of) services and IP use.

The choice between the TP models listed above is dependent on several aspects, including inter alia the maturity of the business as such, operating model adopted, the transfer pricing compliance controls set up within the group, etc. Nevertheless, the licensing of IP can be found in both centralized and decentralized operating models.

In particular, the licensing of IP is widely used by multinationals that have a clearly designated IP owner (legal and economic). The notion of legal and economic ownership of the IP, as set out in Chapters VI and IX of the Organization for Economic Co-operation and

Development's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), is linked to the fulfilment of the so-called DEMPE functions. Figure 2 shows each of the DEMPE function as outlined in the OECD Guidelines:

Figure 2 – DEMPE functions

D	Develop	▶	All key processes and decisions which contribute to the development of Intangibles (e.g. a new brand, or new product)
E	Enhance	▶	All key processes and decisions which contribute to the enhancement of existing Intangibles
M	Maintain	▶	All key processes and decisions which contribute to the maintenance of Intangibles (e.g. ongoing advertising campaigns to keep the brand/product relevant)
P	Protect	▶	All key processes and decisions which contribute to the protection of Intangibles (e.g. file patents, register trademarks, monitor and act upon infringements/violation of Intellectual Property)
E	Exploit	▶	All key processes and decisions which contribute to the exploitation of the Intangibles (e.g. use brands, use of products or enjoying the financial upsides/downsides of the Intangible)

The licensing of IP entails the provision of IP rights to users in exchange for an arm's length remuneration, typically in the form of a royalty payment (e.g. a percentage of revenue or lump sum). Such a royalty payment is subject to a transfer pricing analysis and benchmarking based on the principles outlined in the OECD Guidelines, specifically included in Chapter VI of the OECD Guidelines. Take an InsurTech that wants to enter into new geographic markets, for example. Such an InsurTech would have the software covering its insurance products & solutions, including the digitalized underwriting function, developed centrally. When entering into a new market, its local affiliate, after obtaining the necessary licence to operate as an insurer in the local market, would have to enter into a licensing agreement with the parent company and owner of the software & IP for the use of such IP to generate business locally.

As an alternative, a FinTech may consider entering into a CCA, which is more common for mature businesses and decentralized operating models, such as multihubs. A CCA is aimed at the joint development of an IP and is designed to compensate the participants' contribution and costs incurred for the joint development of the IP, by means of a compensation payment mechanism. A CCA ensures that no separate licensing of IP rights between the CCA participants is required. Any licensing of IP rights and royalty compensation would be paid only by non-CCA participants, to the extent relevant. While the CCA mechanism may be considered to provide more flexibility to the participants in comparison to the licensing of IP (e.g. number of participants or types of IP in scope), the design and maintenance of the CCA itself may create challenges as it would require significant time and resources to set up the relevant processes.

4.1.2. Intra-group financing

For FinTechs, funding represents one of the key elements to ensure (continuous) IP development and market expansion. FinTechs are generally funded by investors, ranging from crowd funding to venture capital or private equity, or external bank loans, in the case of more mature businesses. While the funding from external parties is generally attracted in one single location, most often the location of the parent company, the FinTech group needs to ensure that the relevant funds reach the locations and affiliates in need of financing. In practice, the funding of intra-group business is implemented either by means of a capital contribution or through intercompany loans or cash-pool arrangements.

Intra-group debt financing (loans or cash-pool arrangement) is of interest from a transfer pricing perspective, since any payments resulting from such a transaction (with the repayment of the principal or the interest due) may ultimately have an impact on the reported profits and eventually on tax paid. In this sense, the release of Chapter X of the OECD Guidelines in February 2020 was a significant milestone for transfer pricing professionals. In particular, the OECD chapter describes the key considerations for intercompany financing, including inter alia the need for accurate delineation of the transactions, and determination of interest rates based on the arm's length principle.

As FinTech groups expand cross-border and start funding their local operations with intercompany debt, these may opt for a more practical approach in estimating what the arm's length interest rate might be, without performing extensive and time consuming benchmarking

analyses to cover intra-group credit rating assessment and interest rate policies. Nevertheless, any practical approach taken should consider the main principles outlined in Chapter X of the OECD Guidelines, including the business purpose and commercial rationale of the loan, the options realistically available to both borrower and lender, parental implicit support for the credit rating of affiliates, and trends in market interest rates. In light of the above, proper monitoring and documentation of the delineation of intercompany financing transactions should be performed, keeping in mind consistency in approach.

4.1.3. Sales & marketing

The commercial exploitation of an IP or technology by means of its marketing and sales represents one of the key elements of the value creation in the FinTech industry. Depending on the maturity of the business and operational model, FinTechs may apply different strategies (i.e. models) for setting up the sales & marketing function.

4.1.3.1. Direct sales from Principal/IP owner to customers (central to local)

The direct sales model applies to the situation where the IP owner is directly engaged in the sales & marketing activities. This model is typically applied by FinTech startups that are still at the beginning of their growth journey but it may also be encountered in mature businesses. Under such a model, the IP owner receives all client revenues directly and, in the case of a centralized operating model, is entitled to the full residual profits.

The IP owner or parent would then receive services from local affiliated entities engaged in (local) marketing and promotion activities for the benefit of the IP owner. In such a case, the local entity is typically characterized as a limited risk sales & marketing support service provider and is often remunerated on a cost-plus basis. The IP owner would then be entitled to the entire residual profit after having remunerated the sales & marketing support function for its activities performed locally.

4.1.3.2. Local sales to customers (local to local)

This model represents a more mature or developed model for the commercial exploitation of FinTech IP or technology, whereas the local affiliated sales entity is included in the supply and client invoicing chain. In particular, this model entails that the sales & marketing function is undertaken by the local sales company, which receives directly the local client revenues and would be entitled to an arm's length remuneration. This model can have the following implications for the local sales entity:

- Local entrepreneur(s): this entity along with the IP owner is engaged in the execution of the entrepreneurial functionality (sets up the sales strategy, engaged in the logistics, etc.), takes significant commercial or market risks and owns significant tangible and intangible assets. In this case, the local entrepreneur is entitled to a higher remuneration (e.g. applying a higher operating margin percentage or in some instances a profit split).
- Local limited risk distributor: this type of entity is typically involved in the buy-sell transactions and client invoicing flows, having (however) a limited functionality not bearing significant market risk, which is instead borne by the IP owner. Such sales entities would be entitled to a more routine remuneration based on an operating margin, and in some case, a cost plus a higher markup.

In certain cases, depending on the value adding nature of the sales function within the overall value chain of a FinTech group, certain variations of the above may apply. For example, if the sales generated by a local entity constitute a significant part of the group's overall revenue and that local entity is involved in establishing and maintaining the relationship with one of the group's key customers, the remuneration may be set as the higher of a certain percentage of sales (i.e. operating margin) or a high (even double-digit) markup applied to the relevant direct and indirect costs.

4.1.4. Intra-group services: Support services and contract R&D

Similar to other industries, FinTechs may enter into different types of intercompany services arrangements, such as contract R&D, headquarters or management services, mid- or back-office, customer support, etc. The main goal for entering into those transactions is the receipt of benefits for a services recipient. From a transfer pricing perspective, in accordance with the provisions of Chapter VII of the OECD Guidelines, the analysis of the intra-group services transactions consists of two parts:^[45] (i) consideration of the fact that the services has been provided; and (ii) consideration of the arm's length remuneration. The key elements to be considered under the first step are proof of the benefit provided and the non-duplicative nature, as well as any consideration for shareholder activities. Under the second step, careful attention should be paid to reflecting the nature of the activities performed (value adding versus low-value adding) in the type of remuneration applied.

In recent years, controversy in the area of intra-group services, and specifically covering the identification of the appropriate cost base and proof of the benefit provided, has been increasing across various jurisdictions. For contract R&D type of services specifically, tax authorities in host countries have increasingly tried to challenge the service nature type of the activities performed, claiming that potentially certain DEMPE functions are being built up locally. This emphasizes the importance for FinTech groups to closely monitor

45. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 p. 314, para. 7.5 (OECD 2022), Primary Sources IBFD.

the concentration of R&D activities in certain jurisdictions, set up clear reporting lines, as well as triggers for further looking into when certain DEMPE or risk control functions are being performed locally and would require a higher remuneration than a cost-plus service fee and/or adjust their operating model accordingly.

5. Conclusion

The rapidly growing FinTech industry over the last decade represents a unique point of interest and attention for tax and transfer pricing professionals. This article provides the authors' view on the most important aspects of the FinTech industry from a transfer pricing perspective. It is clear that some of the biggest current global trends such as the fight for talent and rapidly evolving regulatory environment influence the business decisions that FinTech firms are taking, and potentially even the operating models they are adopting. For example, during the scale-up phase, initial business models should be revisited and adapted to align with growth objectives, taking into consideration external factors, such as local regulatory environment, including tax considerations. While the management of a FinTech group may be preoccupied with business decisions and rapid growth, due attention should be made to any tax risks that may arise in the process. Specifically, when the value creation shifts from central to local or otherwise in the FinTech's business growth journey, the operating models and intercompany transactional flows should be timely aligned with the evolving functional profiles of group entities or related parties and with the value creation in the value chain. Failure to do so may result in tax risks.

As such, the implementation of proper transfer pricing governance and compliance processes, such as designing and updating transfer pricing policies considering the overall value creation, TP documentation preparation, etc., is of paramount importance for FinTech firms.



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