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## Germany

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### Transfer Pricing Considerations for Procurement and Sourcing Entities

This article deals with the arm's length determination of transfer prices for intercompany sourcing activities. In particular, it challenges the view that intercompany sourcing activities represent merely routine services that should be entitled to a low cost-based remuneration without considering any markup on the procurement cost. On the contrary, sourcing activities are usually part of the key value chain of MNE groups meaning that the inclusion of the purchasing cost for raw materials or goods in the cost base is appropriate in the context of the application of the cost-plus method in accordance with the OECD Transfer Pricing Guidelines.

#### 1. Introduction

Transfer prices for intercompany procurement and sourcing activities in an MNE group are currently heavily scrutinized in German tax audits. The German tax authorities regularly take the position, in particular, in outbound cases that a central sourcing company renders only low-value routine services to the other group companies. Consequently, a sourcing entity should be entitled to a small cost-based remuneration. Such a remuneration should cover, in particular, only the cost for personnel and office equipment incurred by the sourcing company.

This article critically examines the approach preferred by the German tax authorities. The transfer pricing issues at stake are illustrated by the following example case:

Asia-Ltd., based in Hongkong, takes the role of a central sourcing company for raw materials within the MNE group Electronic Industries. Asia-Ltd. purchases raw materials (components) in its own name and for its own account from suppliers based in Asia and sells them on to production companies of the MNE group based in Germany and other European countries. The raw materials are delivered directly from the suppliers to the respective production company. The production companies are manufacturing and distributing electronic devices at the European markets.

The employees of Asia-Ltd. perform the following functions:

- purchasing of raw materials (acquisition and selection of suppliers; development of purchasing strategies, negotiation of purchasing conditions with suppliers based on the instructions of the purchasing companies, visits of fairs and potential suppliers, negotiation of purchasing conditions with suppliers, order and payment processing);
- pre-financing of purchasing (30 days between payment to the supplier and receipt of funds from production companies);
- price risk management through hedging;
- quality management;
- handling of complaints and warranty issues; and
- organization of consignment stocks.

Asia-Ltd. employs in total 15 FTE, including a local managing director and personnel in the fields of sourcing, quality management and order processing.

Transfer prices are determined on a cost-plus basis where the cost base is equal to the purchasing cost for raw materials. The cost base is subsequently increased by a markup of 8%. Asia-Ltd. earns an average profit before taxes (EBT) of EUR 10 million.

The German tax audit takes the view that the profit per employee is "much too high". Instead, Asia-Ltd. should be entitled to a low cost-based remuneration covering costs incurred for employees (EUR 2 million) and office equipment (EUR 0.5 million) and increased by a markup of 5%.

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## 2. Classification of the Asia-Ltd. as an Intermediary Trader

If a supplying company does not produce raw materials or goods itself but resells purchased raw materials or goods, the basic form of classification is as a purchasing agent, as a commission agent or as a full-fledged trader.<sup>[1]</sup>

The purchasing agent corresponds to a representative within the meaning of section 164 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB) or a commercial agent within the meaning of section 84 of the German Commercial Code (*Handelsgesetzbuch*, HGB). The commercial agent brokers commercial transactions for another person or concludes them on his behalf. Unlike the commercial agent, however, the purchasing agent does not sell the principal's goods on the sales market but buys goods on behalf of and for the account of the principal on the procurement market. Usually, in addition to purchasing goods in the name and for the account of others, the purchasing agent takes on functions such as establishing contacts with suppliers, analysing the competition and developing new procurement markets.<sup>[2]</sup> For transfer pricing purposes, the purchasing agent is regularly treated as a routine service provider.<sup>[3]</sup>

This is to be distinguished from the commission agent who buys or sells goods for the account of another (the principal) in his own name. The purchasing commission agent therefore buys the goods on the procurement market in his own name but for the account of the principal.<sup>[4]</sup>

The functions performed by a purchasing company organized as a purchasing commission agent generally correspond to those of the purchasing agent. In addition, however, the purchasing agent often takes over the handling of complaints and warranty issues, liability management and purchasing controlling.<sup>[5]</sup>

The full-fledged trader buys and sells goods in his own name and for his own account, so that he does not act legally or economically for another company. In these cases, the full-fledged trader is comparable to a wholesaler or an intermediary sales company in the procurement sector.<sup>[6]</sup> In addition to the usual functions for the purchasing agent and the purchasing commission agent, the full-fledged trader assumes more extensive functions, such as supplier selection, negotiation of contract conditions, quality assurance, supply chain management and logistics functions. Moreover, the full-fledged trader regularly bears price and market risks. This makes the full-fledged trader functionally comparable to a "full-fledged distributor".<sup>[7]</sup>

The OECD also considers the decisive criterion for defining a full-fledged trader or intermediary trader to be that they acquire raw materials or goods in their own name and for their own account. In this context, the OECD qualifies a so-called low-risk distributor as an intermediary trader (a form of full-fledged trader with weaker functions and limited risks) as long as there is at least a transitory acquisition of the goods.<sup>[8]</sup> It is irrelevant that the low-risk distributor's risk profile is very limited and that it acts exclusively for related parties.<sup>[9]</sup> In any case, purchasing in one's own name and for one's own account does not constitute a low-value-added service. This is because, according to the OECD, such low-value-added services are only of a supportive nature and are not part of the core business of the MNE group, i.e. they do not establish profit-making activities and do not contribute to the economically significant activities of the MNE group. As a result, the OECD explicitly clarifies that purchasing activities are part of the MNE group's core business and should not be considered as low-value-added intra-group services.<sup>[10]</sup>

Against this background, a purchasing company structured as an intermediary or full-fledged trader does not provide pure services with low added value, in which the procurement of ownership is only brokered. Rather, the purchasing company is functionally comparable to a distribution company (depending on the function and risk profile in the form of a low-risk distributor or a full-fledged distributor). Both acquire raw materials or goods which they resell. The purchasing company acquires raw materials or goods from the procurement market, which it resells to the affiliated company; the distribution company buys the goods from the affiliated company and sells them on the sales market. While the sales company usually implements marketing measures and has to build up a customer base, the purchasing company is dependent on building up a supplier base and negotiating favourable purchase conditions. Unlike the sales company, the purchasing company regularly assumes additional functions such as quality assurance of the purchased goods and processing of warranty cases and complaints. If a purchasing company purchases goods on the procurement market in its own name and for its own account, it acts as a proprietary or intermediary trader with a corresponding turnover-based remuneration claim.<sup>[11]</sup>

1. See Borstell, in Kessler/Kröner/Köhler, *Konzernsteuerrecht* sec. 8, marginal no. 690 (3rd ed. 2018).
2. See Von Hoyningen-Huene, in MüKo, HGB, sec. 89b, marginal no. 11 (5th ed. 2021); on the terminology, see also OLG Hamburg of 10 Nov. 1966 - 6 U 89/66, MDR 1967, 310 "Einkaufs-Vertreter"; Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.358 (5th ed. 2018); Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1452; Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. N, marginal no. 598 (5th ed. 2020).
3. See Becker/Loose, Ubg 2010, 786 f.; Borstell, in Kessler/Kröner/Köhler, *Konzernsteuerrecht*, sec. 8, marginal no. 690 (3rd ed. 2018).
4. Sec. 383 (1) HGB; see also OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, para. 5 (OECD 2015), Primary Sources IBFD; Becker/Loose, Ubg 2010, 786; Häuser, in MüKo, HGB, sec. 392, marginal no. 45 (5th ed. 2021).
5. See Becker/Loose, Ubg 2010, 787; Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1454.
6. See Becker/Loose, Ubg 2010, 786; Löwisch, in Ebenroth/Boujong/Joost/Strohn, HGB, sec. 84, marginal no. 168 (4th ed. 2020); on the distinction, see Borstell/Hülster, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. M, marginal no. 180 (5th ed. 2020); Puls, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 585.
7. See Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1456.
8. See OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, para. 32.12 (OECD 2015), Primary Sources IBFD; see also Becker/Loose, Ubg 2010, 786 f.
9. See Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.356 (5th ed. 2018); Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise*, ch. N, marginal no. 607 et seq. (5th ed. 2020).
10. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* paras. 1.188, 1.189, 7.47 (OECD 2022), Primary Sources IBFD [hereinafter *OECD Guidelines* (2022)]; referring to this, Federal Ministry of Finance of 14 July 2021 - IV B 5 - S 1341/19/10017 :001, sec. 3.77 [hereinafter VWG 2021].
11. See Macho/Steiner, TPI 2017, 150, 156: "share in residual profit"; Becker/Loose, Ubg 2010, 786 f. "margin between purchase and sales price".

In the example case, the sourcing company (Asia-Ltd.) purchases raw materials from suppliers in its own name and for its own account and sells them to the production companies. The sourcing company thus fulfils the requirements of a trader in the sense of an intermediary trader.<sup>[12]</sup>

If the functional and risk profile of the sourcing company in the example case is compared with the functional and risk profile of a low-risk distributor, the following picture emerges:

Low-risk distributor <sup>[1]</sup>	Sourcing company
<b>Functions</b>	
Purchase goods in their own name and for their own account from related companies and sell them to customers	Purchase raw materials in their own name and for their own account from suppliers and sell them to affiliated companies
Acquisition of new customers	Acquisition of new suppliers
Visits of trade fairs and suppliers	Visits of trade fairs and suppliers
Negotiating price conditions with customers	Negotiation of purchasing conditions with suppliers
–	Development of purchasing strategies
–	Price risk management through hedging
–	Pre-financing of purchasing
–	Quality management
–	Handling of complaints and warranty issues
Order processing	Order processing
Warehouse planning or goods distribution	Organization of consignment stocks
<b>Risks</b>	
Occupancy risk	Occupancy risk
–	Pre-financing risk in relation to purchasing
–	Risk of failed purchasing strategies
–	Investment risk
–	Development risk (in relation to strategic co-operations and purchasing platform)
<b>Use of intangible assets</b>	
Use of a customer base (provided free of charge by the producer)	Use of a supplier base
Sales know-how	Purchasing know-how
–	Quality assurance know-how
–	Self-developed purchasing platform

As a result, the functional and risk profile of the sourcing company in the example case does not only go beyond the activities of a routine service provider; rather, the sourcing company assumes functions that go beyond the functional and risk profile of a low-risk distributor. The sourcing company performs comparable purchasing functions, bears comparable risks and uses comparable assets as a distributor whose functional profile is between a low-risk distributor and a full-fledged distributor. Thus, the sourcing company is to be classified as an intermediary trader for transfer pricing purposes.

### 3. Transfer Prices for Supplies by the Sourcing Company to the Production Companies

#### 3.1. Inclusion of purchase cost in the cost base

In the example case, the prices for raw material supplies by the sourcing company to the production companies were determined using the cost-plus method. The cost basis for determining the price for deliveries by the sourcing company to the production companies is a cost price composed of the purchase costs incurred by the sourcing company after deduction of any volume discounts. Other costs such as employees' salaries (personnel expenses), rental expenses and miscellaneous costs are not taken into account. This means that all costs of the sourcing company, with the exception of the cost price for the purchase of raw materials, must be covered by the markup to be added to the cost base.

The application of the cost-plus method is, in the OECD's view, a valid transfer pricing method for the resale of raw materials from a purchasing company to related companies.<sup>[13]</sup> Basically, the cost-plus method is an appropriate transfer pricing method to reflect

<sup>12.</sup> See also *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.158 (OECD 2010), Primary Sources IBFD [hereinafter *OECD Guidelines* (2010)], where the distinction between a mere purchasing agent or broker and a proprietary trader is determined by whether the purchasing company acquires ownership of the goods, i.e. whether the purchasing company acquires and resells the goods in its own name and for its own account.

<sup>1</sup> See on the functional and risk profile of a low-risk distributor Ditz, in Flick/Wassermeyer/Baumhoff et al., sec. 1 AStG, marginal no. 1654; Dolezel, in Vögele/Borstell/Bernhardt, *Verrechnungspreise* (5th ed. 2020), ch. X, marginal no. 326.

<sup>13.</sup> See para. 9.157 *OECD Guidelines* (2010); Kroppen/Rasch, in Kroppen, *Verrechnungspreise bei Umstrukturierungen der Geschäftstätigkeit*, marginal no. 445.

the function and risk profile of a purchasing company. The core task of the sourcing company is the purchasing and sale of raw materials in its own name and for its own account to affiliated production companies. The contractual obligation of the sourcing company, therefore, consists in the procurement of ownership of the raw materials. In this respect, the purchasing function also requires sales-based remuneration based on individual cost prices of the raw materials.<sup>[14]</sup>

Contrary to the common view of the German tax authorities, a sourcing company does not provide a routine service in which the procurement of ownership between the supplier and the respective production company is only brokered. Rather, the sourcing company in the example case sells raw materials to the production companies, which it owns. The fact that these are direct shipments (i.e. without physical delivery by the production company) does not change the assessment, because even an independent intermediary would try to minimize its own storage risk as much as possible.<sup>[15]</sup>

The application of the cost-plus method on the basis of cost prices is also in line with the OECD Transfer Pricing Guidelines (OECD Guidelines). Section 9.157 of the OECD Guidelines (2010) already stated in the past that it is appropriate for a central purchasing company to purchase raw materials and supplies from third-party suppliers and resell them to the manufacturing companies at a cost-plus markup.

Nothing else applies according to section 1.188 of the OECD Guidelines (2022), according to which the arm's length price would have to compensate the purchasing company for the coordination of the centralized purchasing activities. If the price comparison method (CUP) is not applicable, the OECD suggests applying the cost-plus method in this case. The arm's length price is the cost price for the goods purchased by the purchasing company plus a profit markup. The purchasing advantages from the reduced purchase prices – such as the volume discounts granted by suppliers in the present case – are passed on to the producers in this way. In this respect, the OECD wants to explicitly apply the profit markup to the purchase price for raw materials. This takes into account the fact that the purchasing company acquires ownership of the products and thus also bears increased risks. The acquisition of ownership is associated with more risks than in the case of a mere brokerage.<sup>[16]</sup>

Furthermore, in its paper *Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7* of 22 March 2018, the OECD clarified that a purchasing unit (i) is to be remunerated according to the cost-plus method and (ii) the purchase prices for the purchased goods are to be used as the cost basis. Example 4 (Procurement of goods (related intermediary)) on page 20 states in paragraph 74:

TradeCo pays BuyCo a commission equal to a percentage of the cost of purchases

In the OECD example, BuyCo acts as an agent and purchases goods on the procurement market on behalf of TradeCo. The sourcing company, on the other hand, trades in its own name and for its own account, so that the selling price to the production companies must be derived all the more from the purchasing cost.

The cost-plus method adequately and appropriately reflects the functional characteristics of a purchasing company acting as an intermediary trader if – as in the present case – the cost price (purchasing cost for raw materials) is taken as the cost basis. The fact that the sourcing company has to finance its running costs from the *handling fee* also does justice to its characterization as an intermediary trader. Unlike a routine service provider, an intermediary trader is financed from the trading margin between the purchasing cost for the raw materials and the selling price.<sup>[17]</sup>

The appropriateness of the cost basis is also supported by the fact that, according to general business principles, full costs are used when applying the cost-plus method.<sup>[18]</sup> Full cost accounting is based on the assumption that a prudent and conscientious business manager will strive to cover the full costs of his delivery and, in addition, to make a profit (contribution margin approach).<sup>[19]</sup>

In this respect, it is only logical that the sourcing company's remuneration is based on its expenses directly caused by the purchase (i.e. purchasing cost for raw materials).<sup>[20]</sup>

### 3.2. No comparability of the purchasing activity with a low-value-added service activity

In the opinion of the German tax authorities and the OECD, intra-group low-value-added or limited-risk services are also to be remunerated according to the cost-plus method. However, in these cases only the operating expenses (consisting of personnel and material costs such as rent or leasing cost) are used as the cost basis.<sup>[21]</sup> Low-value-added routine services are characterized by the fact that they:

- have a supportive character;

14. See sec. 433 para. 2 BGB, Weidenkaff, in Grünebert (previously Palandt), BGB, 81th ed., 2022, sec. 433, marginal no. 38: "Purchase price is the consideration for the transfer of the object of purchase".

15. See Macho/Steiner, TPI 2017, 150, 156; Möbus/Masorsky/Freudenberg, BB 2012, 933, 937.

16. See Rasch, in Kroppen/Rasch, *Handbuch Internationale Verrechnungspreise, Verrechnungspreisaspekte bei Umstrukturierungen der Geschäftstätigkeit*, marginal no. 122.

17. See Macho/Steiner, TPI 2017, 150, 156; Elbert/von Jesche, in Vögele/Borstell/Bernhardt, *Verrechnungspreise* (5th ed. 2020), ch. N, marginal no. 372; Möbus/Masorsky/Freudenberg, BB 2012, 933, 937; Becker/Loose, Ubg 2010, 786 f.

18. See OECD Guidelines (2022), para. 2.45; Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.264 (5th ed. 2018).

19. See para. 2.49 OECD Guidelines (2022); Baumhoff/Liebchen, in Mössner, *Steuerrecht international tätiger Unternehmen*, marginal no. 4.264 (5th ed. 2018); Jacobs/Endres/Spengel, in Jacobs, *Internationale Unternehmensbesteuerung* (8th ed. 2016), 572.

20. See Ditz/Greinert, in Flick/Wassermeyer/Baumhoff et al, sec. 1 AStG, marginal no. 1456.

21. See sec. 3.74 VWG 2021; paras. 1.189 and 7.61 OECD Guidelines (2022).

- are not the part of the multinational group's main activity in its external relations with third parties;
- need neither unique nor valuable intangible assets for the provision; and
- for the service provider are neither associated with the assumption or control of significant risks nor result in the creation of significant risks.<sup>[22]</sup>

According to the OECD, the activity of an agent or an intermediary trader can also be considered as such a routine activity.<sup>[23]</sup> Nevertheless, in section 7.47 of the OECD Guidelines (2022), the OECD explicitly states that purchasing activities in relation to raw materials are not to be regarded as low-value-added, limited risk services:

The following activities are not eligible for the simplified approach described in this section:

- purchasing activities related to raw materials, consumables and supplies used in the manufacturing or production process ...

The reference in section 3.77 of the German Transfer Pricing Guidelines (*Verwaltungsgrundsätze, VWG "Verrechnungspreise"*), published on 14 July 2021 to section 7.47 of the OECD Guidelines (2022) shows that the German tax authorities share this view. The German tax authorities explicitly clarify that "sales, marketing and distribution" are not routine activities with low value added. Due to the comparability of the functions and risks of the sourcing company with a distribution company, nothing else can apply to the purchasing activity.

Furthermore, according to the OECD, even the weakest form of a purchasing entity, a purchasing office, is not supposed to perform an auxiliary activity (or mere service) if the employees working in the purchasing office have special purchasing knowledge, check the type and quality of the raw materials to be procured and conduct "supplier visits".<sup>[24]</sup>

Moreover, the sourcing company's purchasing activity is not comparable to that of an agent or broker. This can be illustrated by comparing the sourcing company's purchasing activity with a typical agency activity:

Purchasing activity	Typical agency activity
<b>Functions</b>	
Purchase raw materials in their own name and for their own account from suppliers and sells them to affiliated companies (part of the core business of the MNE group)	Procurement of service providers in the areas of transport, logistics, human resources, maintenance of production facilities, insurance (services are only of a supportive nature)
Acquisition of new suppliers	Acquisition of new suppliers
Visits of trade fairs and potential suppliers	Visits of trade fairs and potential suppliers
Negotiation of purchasing conditions with suppliers	Support of production companies in negotiations with suppliers
Development of purchasing strategies	–
Price risk management through hedging	–
Pre-financing of purchasing	–
Quality management	–
Handling of complaints and warranty issues	–
Order processing	–
Organization of consignment stocks	–
<b>Risks</b>	
Occupancy risk	Occupancy risk
Pre-financing risk in relation to purchasing activities	–
Risk of failed purchasing strategies	–
Investment risk	–
Development risk (in relation to strategic co-operations and purchasing platform)	–
<b>Use of intangible assets</b>	
Use of a supplier base	–
Purchasing know-how	–
Quality assurance know-how	–
Self-developed purchasing platform	–

As a result, the sourcing company usually does not provide routine services with low value added – unlike in the context of agency activities.

22. See sec. 3.75 VWG 2021; para. 7.45 OECD Guidelines (2022).

23. See para. 7.34 OECD Guidelines (2022).

24. See para. 68 OECD Model Tax Convention on Income and on Capital: Commentary on Article 5 (21 Nov. 2017), Treaties & Models IBFD.



### 3.3. Arm's length transfer prices

The profit markup applied should be appropriate in view of the function and risk profile of the sourcing company, its particular contribution to value creation and the assets used. In particular, an independent intermediary trader would be remunerated by a correspondingly higher margin for the exercise of high-value-added purchasing functions such as supplier selection, negotiation of delivery conditions, development of a purchasing platform, coordination of purchasing activities in the MNE group and the assumption of risks such as capacity utilization risk, investment risk and pre-financing risk in relation to purchasing activities.

Further, the appropriateness of the markup can be derived from a comparison with the net return on sales (EBIT-margin) earned by third-party traders of similar goods and raw materials. If the markup of the sourcing company leads to an EBIT-margin within the range of EBIT-margins earned by third-party traders then it would fall within the arm's length range of markups. The comparison with EBIT-margins is necessary due to practical reasons. In many cases the factors need to determine the markup such as purchasing cost cannot be derived from the common benchmark data basis.

## 4. Conclusion

Based on its function and risk profile, a sourcing company can be classified as an intermediary trader that performs comparable purchasing functions, bears comparable risks and uses comparable assets as a distribution company whose function profile is between low-risk distributor and full-fledged distributor. Consequently, the inclusion of the purchasing cost for raw materials or goods in the cost base is appropriate in the context of the application of the cost-plus method in accordance with the OECD Guidelines.

## International

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# How Can Traditional Transfer Pricing Models in the Insurance Sector Adapt to Digitalization?

The insurance sector has undergone significant changes due to digitalization and is expected to fully embrace technological advancements within a decade. The authors explain the main transfer pricing considerations applicable to insurance companies within the context of the digitalized operating models. 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 insurance companies.

## 1. Introduction

The insurance sector has been around for centuries and can be traced back to ancient civilization. In fact, the first formal insurance contract was for marine insurance and was signed in Genoa, Italy in 1347.<sup>[1]</sup> Since then, the insurance sector has experienced drastic changes, just like the whole world. Nowadays, anything and everything can be insured: from having your tongue insured (in Gene Simmons's case) to being insured in the case of abduction by aliens.<sup>[2]</sup> As insurance coverage expands, so do the operating models applied by insurers, with technology playing a more important role in the business. However, many people still consider the insurance sector a paper-based industry heavily reliant on manual processes. This is expected to change rapidly though with "open insurance" bringing new players (i.e. InsurTechs) into the game that rely heavily on digital solutions to gain market share. In fact, Artificial Intelligence (AI) is expected to fully transform the underwriting function by 2030, based on a McKinsey research.<sup>[3]</sup>

This article focuses on the transformation that has been taking place in the insurance sector due to digitalization, and more specifically, on the integration of technology into the day-to-day processes and functions of an insurance group. This provides the context to further explore the shift in value creation within the insurance value chain from a transfer pricing perspective. Such a shift also requires the alignment of transfer pricing models and arm's length remunerations with the digitalization of various functions within an insurance multinational group. Thus, the authors elaborate on their experience as tax advisers and present market research conducted to decipher how the macroeconomic trends in the insurance sector influence today's landscape of value creation within the transfer pricing environment for insurers.

## 2. Is the 2010 OECD PE Report Outdated?

Almost two decades ago in the early 2000s, the Organization for Economic Co-operation and Development (OECD) sought to provide taxpayers and tax administrations with guidance on an overarching approach to the attribution of profits to permanent establishments (PEs) in order to address the complexities and specific considerations for particular business sectors. This led to the publication of the Report on the Attribution of Profits to Permanent Establishments (2010 OECD PE Report) in 2010,<sup>[4]</sup> which included specific guidance for the insurance sector. Prior to this, there was no specific OECD TP guidance specific for the insurance sector.

The 2010 OECD PE Report introduced the concept of Key Entrepreneurial Risk Taking (KERT) functions<sup>[5]</sup> – a term that was initially introduced to acknowledge the strong interlinkage between key functions performed and risks assumed within the financial sector. Within the insurance sector, according to the 2010 OECD PE Report, the underwriting function is considered to be the most important active decision-making function relevant to the assumption of risks.<sup>[6]</sup> Underwriting is the process of classifying, selecting and pricing the insured risks accepted by insurers. Consequently, the risk assumed by insurers when entering into a policy contract (i.e. the insurance risk) is managed by the underwriting function, which determines the levels of risk exposure for the group and defines the insurance premiums

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1. H.O. Nelli, *The Earlier Insurance Contract. A New Discovery*, 39 *The Journal of Risk and Insurance* 2, pp. 215-220 (1972), available at <https://doi.org/10.2307/251881> (accessed 1 Dec. 2022).

2. Martin Insurance Agency, *10 Crazy Insurance Policies That Actually Exist* (26 Mar. 2019), available at <https://www.martininsurance.com/10-crazy-insurance-policies-that-actually-exist/> (accessed 1 Dec. 2022).

3. J. Bilefield, A. Libarikian & P. Schlüter, *Building new digital businesses in insurance* (McKinsey & Company June 2021).

4. OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD June 2010), Primary Sources IBFD [hereinafter 2010 OECD PE Report].

5. 2010 OECD PE Report, Part I, para. 16.

6. 2010 OECD PE Report, Part IV, para. 8.



charged.<sup>[7]</sup> In addition to earning income from premiums, insurers also invest premiums in various assets and thus report investment income. The income from investments is paramount to pay policyholder claims. Consequently, investment risk and its assumption also plays a critical role in the insurance sector as the investment income it generates is detrimental to the financial health of the group.<sup>[8]</sup>

While the underlying functions performed and the risks assumed within the insurance sector have remained largely the same, digitalization has had an irrefutable impact on the insurance sector over the last years. Now more than ever, insurers need to keep up with customers' expectations to have their experience seamless and digital, similar to notable video streaming or ride sharing applications. Thus, insurers must adapt and evolve at the same pace as their customers. As mentioned earlier, within a decade from now, the underwriting function is expected to be fully automated and enabled by AI. While the authors see a clear technological advancement within the sector, the question arises whether the 2010 OECD PE Report accurately captures the evolution of how KERT functions are performed within the value chain.

Although the 2010 OECD PE Report specifically addresses PEs, the industry specific guidance is also relevant on a principle basis to intercompany arrangements between associated legal entities. Assumption of risks and its interconnection with the most important active decision-making functions is also captured in Chapter I of the OECD Transfer Pricing Guidelines (OECD Guidelines).<sup>[9]</sup>

### 3. Emerging Role of Technology in Insurance

The insurance sector is considered broad with its service offering encompassing various types of insurance policies for customized needs. Common types of insurance policies cover life, health, disability, car, social, liability and fire insurance. While the foundational service offering remains the same, many insurance companies have risen and fallen over the last decade. In the current economic environment, the success of insurers is dependent on whether they can keep pace with emerging trends, market competition and customer needs.

#### 3.1. Major recent market trends

##### 3.1.1. Demographic changes

There has been a steep increase in the number of people living on our planet over the last 50 years. The world population today of 7.9 billion is twice the size of what it was in 1975.<sup>[10]</sup> An increasing population also leads to changing needs and increasing demands, and this affects the way insurers do business. Next to population growth, the increase in life expectancy is a trend directly impacting the insurance sector, especially in Europe. This requires insurers to expand their business strategies in order to respond to the changing needs of an aging population, such as investing in health management.<sup>[11]</sup>

##### 3.1.2. Emerging technologies

Common market trends, such as digitalization, continue to push the boundaries of the insurance sector. Automation, blockchain and AI have become common practices or ways of working in order to remain competitive. This has reshaped the insurance sector as it existed a decade ago, with many more changes expected to come hereafter. Furthermore, new technologies and tools that were previously in development have continued to surface. For example, predictive analysis of data allows insurers to collect significant key data concerning their customer behaviour to provide the customized service offering sought by their clients. Accessibility to this type of information may be considered a game-changer in itself. While digitalization efforts are clearly visible, the insurance sector has also experienced an increased focus on efficiency and a push towards cost reduction. This, however, may come at the cost of innovation and evolution as a result thereof.

##### 3.1.3. COVID-19 pandemic

One of the recent key world events that expedited the process of embracing digitalization in day-to-day business activities is the COVID-19 pandemic. It has facilitated the process by embracing emerging technologies in the new ways of working. Due to the COVID-19 pandemic, decades of change have taken place within days. COVID-19 has been largely a driving force pushing insurers to revisit their operations in a strategic manner, which in turn allowed the business to remain competitive. As an example, the COVID-19 pandemic contributed towards creating the need for globalized platforms with a high level of customization to serve customer needs. However, the same globalized platforms have limited in-person touchpoints. While such market trends are often accompanied by opportunities, these may also result in risks. For example, the market volatility during the COVID-19 pandemic resulted in insurance businesses having to revise their pricing schemes and review their costs to further reduce operating expenses. Nevertheless, such consequences and the measures taken by insurers with respect to these trends determine whether they stay relevant in today's competitive environment.<sup>[12]</sup>

7. 2010 OECD PE Report, Part IV, para. 7.

8. 2010 OECD PE Report, Part IV, para. 12.

9. The reference is made to the most recent OECD Transfer Pricing Guidelines published in 2022, which includes all the developments and changes as a result of the BEPS programme initiated in 2013 and finalized with the publication of the consensus report covering the transfer pricing aspects of financial transactions in 2020, introduced as Chapter X in the OECD Guidelines.

10. M. Roser et al., *How has the world population growth changed over time?*, Our World in Data (2013), available at <https://ourworldindata.org/world-population-growth#how-has-world-population-growth-changed-over-time> (accessed 1 Dec. 2022).

11. S. Milian, *Insurers in Europe need to focus on aging population*, Insurance Blog (10 Feb. 2022), available at <https://insuranceblog.accenture.com/insurers-europe-focus-aging-population> (accessed 1 Dec. 2022).

12. J. Bilefield, A. Libarikian & P. Schlüter, *Building new digital businesses in insurance* (McKinsey & Company June 2021).

### 3.1.4. ESG agenda

Another major macroeconomic trend that emerged is an increased awareness in environmental, social and governance (ESG). Businesses and their customers have become more conscious of sustainability and their impact on investments, but so have public governmental bodies. As the public governmental bodies gear towards net-zero emissions, the insurance sector needs to rethink its strategy further, specifically pertaining to its underwriting and investment strategy to assess whether their investment portfolios would remain profitable in consideration of the changes taking place in relation to ESG policies.<sup>[13]</sup>

## 3.2. Digitalization and the role of technology in the value chain

Digitalization has infiltrated society in such an impactful manner by transforming our day-to-day lives. As technology becomes indispensable in our day-to-day lives, it has become essential for businesses to either drive or follow market trends if they want to continue being a key player in their respective industries. This has caused a notable shift in the strategy that businesses adopt to meet market expectations, which is also reflected in their new generation operating models adopted.

As a result of the market trends mentioned above, the necessity for changing the operating models within the insurance sector has become more pronounced. Expenditure on customer-facing technologies has accelerated over the last years. However, lengthy development times have negatively impacted some of the insurers' productivity, product life cycles and service delivery.<sup>[14]</sup> While the necessary technological advancements (e.g. through the development of intellectual property (IP)) are ongoing within the insurance sector, there are still many unanswered questions on how these should be incorporated in the common operating models implemented by insurers. Nevertheless, the evolution and digitalization of the insurance sector is certain. This is driven by the need for customer-centric operating models that are "shaking up" the traditional insurance sector value chain.

Digitalization allows for greater flexibility in delivering customized service offerings in line with customers' needs, whether this is directly to customers or businesses. This enables a positive experience across the customer lifecycle. The shift in importance of the various value chain functions due to digitalization has put pressure on the traditional transfer pricing models applied in the insurance sector. This is due to changes in the functional and risk characterizations of affiliated entities whose day-to-day operations and responsibilities have been altered with the use of technology.

### 3.3. The value chain then versus now<sup>[15]</sup>

The traditional operating models in the insurance sector are decentralized. More specifically, traditional insurers have been carrying out their business operations via their local carriers (subsidiaries or branches) performing the full range of activities locally, from product development and underwriting to claims management.

Part IV of the 2010 OECD PE Report focuses on the most important functions of a traditional insurance model in line with the most common insurance businesses, such as in the property and casualty insurance businesses. The main value chain functions in the insurance sector, according to the 2010 OECD PE Report, are illustrated in the [Figure](#). It should be noted, however, that the value chain for each insurance group may vary considerably due to factors such as the type of insurance, the line of insurance business and product sold.

**Figure – Main value chain functions in the insurance sector**



The key value chain functions have also seen considerable change as a result of globalization and centralization, which have been accelerated by technological advancement. This has created a shift in the value creation (and entrepreneurial function) away from the local entities. The following subsections explore the notable changes for each main function within the insurance value chain.

#### 3.3.1. Product development

Product development, also referred to as product management, comprises risk, technical, legal and mathematical structuring of the product. According to the 2010 OECD PE Report, market research, gathering and maintaining (claims) statistics, legal stipulation of the extent of coverage, mathematical calculation of the premium depending on the features of insurance coverage (geographical, temporal, demographics, etc.) are considered to be the most important processes of product development. The primary features have a direct correlation with the insured risk acceptance and savings processes that take place as a result of product development.<sup>[16]</sup>

13. Id.

14. B. Heale, *Challenges Impacting the Global Insurance Industry in 2015 and Beyond*, Moody's Analytics (Nov. 2014), available at <https://www.moodysanalytics.com/risk-perspectives-magazine/integrated-risk-management/principles-and-practices/challenges-impacting-global-insurance-industry> (accessed 1 Dec. 2022).

15. It is noted that this section makes reference to the insurance sector in general and acknowledges that this may differ for specific insurers and insurance products.

16. 2010 OECD PE Report, Part I, paras. 26-28.

In the past, the functions related to product development were largely performed locally. There was more focus on the creation of products based on skills and talent pool rather than on customers' needs. Traces of this unwieldy legacy product infrastructure still remain in the current environment. Due to the emerging market trends, it has become vital to modernize product development. In today's world, the collaboration between new product development, technologies and processes is referred to as digital engineering. The inter-application between these three elements is of critical importance as it determines the success of the integration with legacy insurance products and applications. Optimizing this process with the development team would be considered as a comparative advantage in itself.<sup>[17]</sup> Technology has come to drive the product development function to meet customer's needs. This has led to the function being performed centrally resulting in cost efficiencies or additional revenue opportunities, but also across cross-functional teams dependent on their skills, talent pool and technological abilities to ensure that the specific needs of the customers are met.

In order to implement the necessary digitalized changes and to keep pace with the customers' expectations, insurance companies continuously require up-to-date software, systems, technologies and tools. Whilst some insurance companies opt to partner with technology and analytics-type firms, others opt to perform this type of product development in-house, often times where the group headquarters is located.

### 3.3.2. Sales and marketing

The sales and marketing function is governed by the general marketing strategy, which allows for the identification and analysis of customers' needs.<sup>[18]</sup> The sub-processes as part of sales, marketing and acquisition include acquiring and advising clients, assessing requirements and providing quotes and proposals.<sup>[19]</sup> The brokers, who perform the sales and marketing functions, attempt to acquire customers by creating client relationships.<sup>[20]</sup> The importance of this function is highly dependent on the type of insurance. For example, the marketing function is critically important for travel insurance due to its intrinsically profitable nature.<sup>[21]</sup>

In the past, the sales and marketing efforts were conducted through brokers in their respective jurisdictions. Often times, this was done in combination with other functions, such as the underwriting function.<sup>[22]</sup>

The manner in which sales and marketing functions are performed nowadays has evolved drastically with the introduction of the Internet and expansion of distribution channels. There is an increased focus on reaching a greater clientele via popular social media platforms. This process takes place in combination with the increased amount of data available about clients, which allows for targeted marketing campaigns.

Additionally, the introduction of embedded insurance further reduces underwriting risks and distribution costs for insurers. Embedded insurance simplifies the process of bringing the insurance coverage directly to the point of sale. For example, think of opting for a travel insurance when purchasing your flight ticket for your holiday. The concept of embedded insurance has allowed customers to gain instantaneous access to the insurance that meets their needs in their preferred channels.<sup>[23]</sup> Embedded insurance is largely dictated by the general marketing strategy defined centrally, which targets a bigger clientele in comparison to the traditional (local) marketing strategies.

All in all, these changes have resulted in certain main sales and marketing activities being performed centrally (or regionally) as opposed to locally.

### 3.3.3. Underwriting and management of underwriting risk

In the past, the underwriting activity was performed manually by underwriters typically located where the main business function was performed. This was mainly locally where the insurance policies were issued, but also to some extent centrally, where the group policy and general guidelines were defined. The underwriting function and the underlying processes to evaluate the risk of insuring a customer and determining the premium was inherently a time-consuming process. Currently, on account of technological advancements, AI and other data management tools, the underwriting function has transformed and is expected to deliver even further advantages.

Firstly, data management allows for risks to be evaluated and decisions to be made based on an increased amount of data categories containing up-to-date data, as opposed to historical data. Secondly, decisions are not solely based on judgement, but are also backed by science-based research supported by data through means such as, AI, automation and machine learning.<sup>[24]</sup> Thirdly, there is also a greater understanding within the insurance sector of the effects and consequences of the underwriting process, which in turn, leads to better lead time and adapting to customer expectations.

17. Cognizant, *Modernizing the Insurance Value Chain: Top Three Digital Imperatives* (Mar. 2019), available at <https://www.cognizant.com/us/en/whitepapers/documents/modernizing-the-insurance-value-chain-top-three-digital-imperatives-codex4334.pdf> (accessed 1 Dec. 2022).

18. 2010 OECD PE Report, Part I, para. 29.

19. 2010 OECD PE Report, Part I, para. 30.

20. 2010 OECD PE Report, Part I, para. 32.

21. 2010 OECD PE Report, Part I, para. 32.

22. 2010 OECD PE Report, Part I, para. 33.

23. FinTech Global, *Embedded Insurance: the future of insurance distribution* (7 Mar. 2022), available at <https://member.fintech.global/2022/03/07/embedded-insurance-the-future-of-insurance-distribution/> (accessed 1 Dec. 2022).

24. C. Dilmegani, *AI in the Underwriting: Data-driven Insurance Operations* (29 Sept. 2021), available at <https://research.aimultiple.com/ai-underwriting/> (accessed 1 Dec. 2022).

These advantages work in parallel with cost reductions as the turnaround time for the underwriting decision making process has reduced. This has been a game changer within the insurance sector, as this diligent and fastened process has allowed for enhanced and comprehensive decision making, which eventually leads to increased profitability.

While automation and AI are not expected to fully replace the underwriter, the related time and cost savings and consequently risk reduction (through more accurate risk assessments) are expected to be high. As a result, the process of underwriting is no longer executional, but evolved into a more strategic function.

### 3.3.4. Risk management and reinsurance

Within an insurance group, risk management may either take place at the strategic or a more active operational level and it covers risks such as insurance risk, commercial risk and investment risk. The risk management function is carried out in line with internal group policies, namely claims adjustment policy, portfolio policy, reinsurance policy and investment policy, including asset-liability management (ALM). As part of the reinsurance policy, guidelines are determined whether to use reinsurance to manage the insurance risk exposure of an insurance company.<sup>[25]</sup> Reinsurance is a mechanism through which the original insurer (ceding company), transfers risks undertaken by entering into a reinsurance contract with a reinsurer.<sup>[26]</sup> Reinsurance allows for the ceding insurer to limit the volatility in case of negative market circumstances. In addition, it also increases the level of capital available. Reinsurance can be done at varying types of risk transferred, risk size and agreements based on which such a transfer is formalized.

In the past, risk management was primarily conducted locally following general guidelines and policies set at the central group level. Currently, more and more strategic and tactical risk management activities are carried out regionally or centrally. This was enabled by technological advancements and data processing solutions. This also covers reinsurance, which has been specifically affected by the blockchain and ledger technologies. For example, B3i launched a smart contract management system for Property Cat XOL contracts, which is a type of reinsurance for catastrophe insurance. Each reinsurance contract is written using blockchain technology to create smart contracts with executable code on the same shared infrastructure. When a catastrophic event, such as a hurricane or earthquake, takes place, the smart contract evaluates data points and automatically calculates pay-outs to affected parties.<sup>[27]</sup> This is a notable example of how the insurance sector has reduced its lead times through automation to remain competitive.

### 3.3.5. Contract and claims management

Contract and claims management covers the monitoring of a contract (or a group of contracts) over its life cycle and the claim management and reporting process.<sup>[28]</sup> Insurance companies may also provide tangible and intangible insurance help, such as assistance, replacement in kind and physical and emotional help for clients.<sup>[29]</sup>

In the past, contract and claims management was a bureaucratic end-to-end function, which was done manually. The rudimentary manner of conducting contract and claims management left customers with high lead times. In the last decade, however, contract and claims management has become an increasingly digitalized and automated process, which has led to an exponentially higher amount of claims being processed in less time. Chatbots, advanced analytics, the Internet of Things (IoT), custom mobile apps and blockchain are some of the technologies that enabled this progress.<sup>[30]</sup>

### 3.3.6. Asset management

Asset management covers the investment of the reserves and surplus that an insurance company maintains and the monitoring of risks associated with those investments.<sup>[31]</sup> Insurers may often decide to outsource the asset management to third parties.

Currently, due to sophisticated analytical tools, asset managers are able to offer a value-driven approach to investments based on enhanced quantitative research supported by algorithms based on historical market cycles. Such insights maximize the upside while minimizing the downside of risks. Asset management can achieve better results when performed centrally for the group leveraging from a few individuals/experienced asset managers within the group.

Furthermore, the increased focus on transparency and sustainability (e.g. green investments) is defining the direction of the asset management industry. Such direction is also impacting the asset management function within the insurance value chain.

25. 2010 OECD PE Report, Part I, para. 38.

26. 2010 OECD PE Report, Part I, para. 40.

27. CB Insights, *How blockchain is disrupting insurance* (19 July 2022), available at <https://www.cbinsights.com/research/blockchain-insurance-disruption/#:~:text=Reinsurance%20protects%20insurers%20when%20large,reinsurers%20up%20to%20%2410B> (accessed 1 Dec. 2022).

28. 2010 OECD PE Report, Part I, para. 42.

29. 2010 OECD PE Report, Part I, para. 43.

30. G. Gençer, *Top 7 Technologies that Improve Insurance Claims Processing* (7 Feb 2022), available at <https://research.aimultiple.com/claims-processing/> (accessed 1 Dec. 2022).

31. 2010 OECD PE Report, Part I, para. 38.



## 4. Evolving Technology-Driven Functional Profiles and Transfer Pricing Models

As evidenced above, the next generation operating models in the insurance sector have a strong emphasis on technology and digitalization. Nevertheless, the current operating models are often either still very much traditional or a hybrid between traditional insurance operating models and a digitalized insurance operating models. This is predominantly because traditional insurers are large organizations with legacy systems that require significant efforts and costs to implement substantial changes. Furthermore, the extent technology has influenced the business is often not fully understood or cannot yet be fully measured and subsequently reflected in updated transactional flows.

Nevertheless, it is evident that there has been a shift in value creation within the traditional insurance value chain due to digitalization. As a result, typical functional profiles and transfer pricing models encountered in the insurance sector are facing the risk of becoming obsolete and challenged by tax administrations.

This section analyses the main value chain functions within the insurance sector and the bearing their digital evolution has on the appropriate arm's length remuneration of affiliates performing these functions. In doing so, the authors highlight the recent OECD Guidelines which can help insurers adapt their transfer pricing models to ensure that they still adhere to the arm's length principle, in an effort to mitigate tax controversy risk and avoid double taxation.

### 4.1. Main transfer pricing arrangements encountered in traditional insurance operating models

As mentioned earlier, traditional operating models in the insurance sector are largely decentralized. Under such a model, the local carrier within a multinational insurance group, incorporated as a legal entity or branch, would be acting as the entrepreneur performing the main underwriting function, assuming the insurance risk and other related business risks. The local carrier would drive the local sales & marketing efforts, sign insurance policies, collect premiums, and perform the relevant contract and claims management activities. The headquarters of the group would perform a range of activities in support of the local carriers, such as setting group guidelines and policies. Following from this, the main transfer pricing arrangements within a traditional insurance group have been intercompany service charges and cost allocations. These generally follow the guidance included in Chapter 7 of the OECD Guidelines. Under such service arrangements, the relevant costs related to central or regional activities which are benefiting local carriers, are charged to local entities and branches following a cost-plus methodology, whereby specific allocation keys are applied. The allocation keys would largely depend on the type of activity and benefit provided, but often would incorporate an element of business performance of the local carrier, such as the net insurance premiums issued locally.

Another aspect worth mentioning is that intercompany intangibles arrangements generally did not exist within insurance groups. This was due to the fact that the main valuable intangible within an insurance group, which was and most likely still is the customer relationships, was owned locally. Furthermore, the brand in itself was not considered to have a standalone value, as its value was built locally and determined by local marketing efforts. Any brand protection efforts incurred centrally by the headquarters were typically recovered via the intercompany headquarters service charges allocated to local carriers.

Finally, any intercompany reinsurance contracts were generally based on the pricing agreed between the insurance group overall and third-party reinsurance. Thus, the internal comparable uncontrolled method was applied to intercompany reinsurance arrangements.

#### 4.1.1. Increased challenges by local tax authorities

The traditional operating models in the insurance sector have faced increasing transfer pricing challenges in the last years. In an effort to increase the local tax base, tax authorities from both the central location, where the parent or headquarters of the group is located, and the local tax authorities where the local carrier is operating, have attempted to challenge various aspects of the intercompany headquarters charges.

On the one hand, from a local perspective, tax authorities make great efforts in reviewing and challenging the proof of benefit provided by the headquarters' activities performed for which service fees are charged. In certain jurisdictions, such as China, taxpayers may even have to accept that only a certain share of the intercompany headquarters charges will be accepted as deductible, as it is rare for the tax authorities to accept full deductibility.

On the other hand, the tax authorities in the headquarters location would try to argue that the headquarters is involved in more value adding activities. In such case they would expect a remuneration higher than a cost-plus service fee and rather a value-based fee or profit split instead. Specifically, the role of the risk management function and the treasury function within the headquarters are often recognized to be more than a service and to potentially contribute to the value creation within the insurance business. In an effort to avoid practical implementation challenges of profit splits, such type of discussions with tax authorities has led to applying a higher markup (sometimes a double-digit figure) on the costs related to certain activities identified as more value adding. Such position was also confirmed in certain advance pricing agreements (APAs) with tax authorities, for example in the Netherlands.

Additionally, the group headquarters is faced with challenges of partial non-deductibility of costs incurred, as tax authorities argue that the level of costs maintained and labelled as "shareholder activities" should not be borne by the headquarters but instead charged out

to the local carriers. This issue becomes more complex when insurance groups are trying to take a digital leap forward and invest in technology. Often these efforts are taking place centrally, which also bears the related costs. In the initial years of an IP development, it can be challenging to include technology development costs in the headquarters services cost base, if there is no apparent benefit yet for the local carriers.

## 4.2. Evolving role of the IP owner

As important changes occur in the insurance sector with the increasing role of technology, the transfer pricing models applied by insurance groups require the recognition of the IP and the IP owners enabling the digital transformation. This should ensure that an appropriate remuneration is allocated to the affiliated entities involved in the value generated by the IP, translated into margin increase or cost reduction. In most cases, any deployment of automation projects are carried out centrally at the headquarters level, which in turn benefits the local underwriters and insurance business.

Below, the authors highlight two main examples of the digital functions encountered in the new generation operating models in the insurance sector.

### 4.2.1. Digital underwriting

The ability to accurately evaluate the risk of insuring a customer and pricing their coverage appropriately is the backbone of the insurance industry, thus it makes sense that this is considered to be the KERT function within the sector. However, in the current digitalized environment, the manner in which the underwriting function is performed has been evolving. This brings the new term of “digital underwriting” afloat. Digital underwriting is defined as underwriting with new sources of data and technology to make better strategic decisions. Digital underwriting limits the executional tasks performed by an underwriter as the role evolves to become more strategic in nature, while the risk analysis and execution is performed by the software. Thus, the local underwriter’s role and functions diminish on account of the increasing contribution of the automated technologies.

### 4.2.2. Automation of claims management

The shift from bureaucratic to digitalized processes from the insurers’ side have a successive impact on the customer’s experience. From a customer’s perspective, whilst at first sight, the digitalized processes may seem to reduce customer-facing activities, it increases customer touchpoints with customer centricity at its core. Customer support is no longer antique due to the digitalized development. The customer has the complete end-to-end process accessible on their phone, with the autonomy to manage their policy and have the necessary insights at all times on their claims-handling process.

When performing the contract and claims management function, the local carrier monitors the contracts (or a group of contracts) over their life cycle. The respective local insurer is also engaged in the loss and claims reporting process – the establishment and maintenance of a loss reporting system, developing reliable claims statistics, defining and adjusting claims provisions and introducing measures to protect and reduce claims in future. However, as the customer experience gets simplified for the claims management process due to digital solutions such as mobile apps, the functions performed at the back-end locally also decrease.

Similar to underwriting, certain contract and claims management functions cease to exist due to digitalization. Thus, as the functions narrow down, the arm’s length pricing needs to be reconsidered.

### 4.2.3. DEMPE functions and relevance to new generation operating models in insurance

As insurance companies continue to develop intangibles (IP) centrally (or within a specific entity), new intercompany transactional flows need to be considered in order to establish an appropriate arm’s length remuneration of the parties involved and eventually of the IP owner. When it comes to IP and appropriate IP returns, the DEMPE concept, which stands for development, enhancement, maintenance, protection and exploitation of intangibles is key. The concept of DEMPE was first introduced in 2015 in the final BEPS Actions 8-10 report covering the Transfer Pricing Aspects of Intangibles.<sup>[32]</sup> It is considered to be the epicentre of profit allocation pertaining to intangibles, which upon the release of the concept resulted in significant changes in how multinational groups implement the arm’s length principle. DEMPE ensures that the allocation of the returns from the exploitation and the allocation of costs related to intangibles is performed by compensating related group entities for their functions performed, assets used and risks assumed, whereby economic ownership and contribution is recognized as value driving as opposed to the legal ownership.

An analysis should be performed to determine where the DEMPE functions are being carried out in order to determine the arm’s length remuneration that should be allocated to the respective affiliated entities. For example, if the legal owner performs no DEMPE functions, then it will not be entitled to any portion of the profits, other than compensation for its IP holding activities, if any.

Concisely, with evident changes taking place in the insurance value chain, appropriate compensation for the affiliated entities involved in the DEMPE functions of digital solutions needs to be rethought in order to reflect the arm’s length principle.

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32. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report* (OECD 2015), Primary Sources IBFD.



#### 4.2.4. Transfer pricing models covering use of IP

When IP becomes paramount for the value creation in the new generation operating models within the insurance sector, different transfer pricing models with IP at the centre may need to be considered. In practice, the following transfer pricing models can be used to provide IP rights to local carriers within an insurance group:

- licensing;
- cost contribution arrangement (CCA); or
- incorporating the value of IP into the price of a product or service.

The licensing model would be most appropriate in situations where the development of IP and the related business risks are maintained centrally, by the parent or headquarters. In such case, the IP or digital solution would first be developed, tested, and only later rolled out locally. 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 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.

Alternatively, an insurance group may prefer to maintain the entrepreneurial risk of developing and using an IP locally. In such case, the local carriers may consider entering into a CCA which would align with the traditional decentralized operating model in the insurance sector. 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 and maintain the relevant processes.

Finally, in certain cases there may be business considerations to incorporate the remuneration for the use of technology and IP in the price of a product or service charged to the local carriers. This methodology may, however, add complexities in benchmarking of the appropriate arm's length pricing of the product or service provided. In a fully digitalized operating model, such remuneration may take the form of a value-based fee. Such a fee would be determined as the residual profit after remunerating the local insurers with an appropriate target margin, taking into account their limited functional and risk profile.

### 4.3. Evolution of risk control functions

Since the Internet has transformed the way sales and marketing activities take place, this is also often done in a cost-efficient manner. The headquarters often rolls out a central sales and marketing strategy and localization is performed when necessary. Moreover, increased regulation has pushed insurance companies to take control of their risk management function at a more central level. These trends have naturally shifted the risk control and management functions to the headquarters for the sales and marketing activities, but also for the overall risk management and compliance function.

In transfer pricing, the term "risk management" is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation.<sup>[33]</sup> Thus, if this function no longer takes place solely locally (as done in the past), the arm's length remuneration for the headquarters needs to be re-determined in line with its functions performed, risks assumed and assets used. Such transfer pricing analysis would have to balance between the technical merits but also practical considerations of applying a specific transfer pricing method as recognized by the OECD Guidelines. While a profit split type of methodology may be considered more appropriate due to the inter-related activities performed, the implementation of such a method may cause unnecessary burden. As such, in practice parties have often resorted to the application of a cost-plus method where a double digit markup was considered to reflect the value adding activities performed.

## 5. Conclusion

It is evident that the insurance sector has undergone significant changes due to digitalization. All in all, everything from customer touchpoints through increasing digital presence, to enhancing services provided, has shaken up the value chain of the prototypical operating model in the insurance sector.

Whilst the 2010 OECD PE Report provides pivotal guidance to the insurance sector and introduces the ground-breaking concept of KERT (which may also be applied to legal entities), it has become apparent that the 2010 OECD PE Report may be considered outdated in

33. OECD Guidelines, para. 1.61.

today's environment. More specifically, as the shift in the key value chain functions takes place, importance is placed on the underlying strategic decisions of each function as the routine functions continue to become automated.

As the operating models shift towards centralized models, the role of the headquarters has become increasingly important as it takes on risk management for certain value chain functions in which it plays a bigger role centrally. Thus, a transfer pricing analysis has become increasingly important to demonstrate whether the arm's length principle is appropriately captured within the transfer pricing operating model.<sup>[34]</sup> This type of analysis needs to be continuously updated to reflect any changes in the group (e.g. through business restructurings), but also in light of the ever-changing transfer pricing landscape (e.g. regulatory environment) to help mitigate risks and exposures.

With the increasing amount of developments in the financial sector, various tax authorities around the world have now designated teams focused on the insurance sector. These teams actively monitor trends and developments within the sector to understand the impact on the transfer pricing models. Increased access to information and sector-specific knowledge puts the tax authorities in an advantageous position during an audit. Thus, it is ever more important for insurance companies to properly articulate, update and document their transfer pricing policies.

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<sup>34.</sup> OECD Guidelines, para. 1.2.

## International

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# Transfer Pricing in the Automotive Supplier Industry

Automotive suppliers are characterized by a centralized IP ownership, centralized provision of services, and a global presence of local plants that sell and invoice manufactured components directly to their customers' local production facilities. All this makes cross-border intercompany transactions and the respective transfer pricing of automotive suppliers with respect to intangibles, manufacturing and services very challenging.

## 1. Introduction

The automotive industry in general and the automotive supplier industry in particular have followed a centralized strategy with a global presence but centralized technology and trademark IP ownership in few locations since many years. It is one of the industries with the highest volume of cross-border intercompany transactions and several types of those transactions, such as the sale of goods, the licensing of IP and the provision of intra-group services. The Original Equipment Manufacturer's (OEM) local production facilities are situated around the globe and automotive suppliers have established nearby these facilities. The increased intensity of tax audits focussing on transfer pricing comes as no surprise. The article is organized as follows: section 2. gives an overview of past developments and business trends in the automotive supplier industry. Next, section 3. presents typical operating structures in the automotive supplier industry. Section 4. then focuses on selected key themes in transfer pricing in that industry.

## 2. Past Developments and Business Trends

The period after the global financial crisis of 2008/09 was characterized by substantial growth for the automotive industry. In the last decade, sales levels in China grew above global average and made China the most important market for the automotive industry, measured in the number of vehicles sold. The automotive market in Europe also experienced an above average expansion until 2017. Globally, sales volumes of the automotive industry peaked in 2017, when 94.3 million vehicles were sold. Sales levels started to decline slowly in the subsequent years and took a markable hit during the COVID-19 pandemic. The level of sales volume is predicted to surpass its past peak in 2026.<sup>[1]</sup>

The revenue of the automotive supplier industry peaked in 2018 but was impacted negatively by the pandemic. The pandemic resulted in an estimated loss of around 15% to 20% of global revenues for the automotive supplier industry; the United States and Europe have been hit hardest. The average margin performance of automotive suppliers declined in the course of the pandemic, causing debt levels of automotive suppliers to climb to unforeseen levels.<sup>[2]</sup> The pandemic also caused extensive disruptions in supply chains and continued lockdowns in China are a dominant topic which especially affects automotive suppliers with production facilities in China.

Another dominant issue is the global shortage of chips. This shortage caused production volumes in the automotive industry to fall by 7.7 million units,<sup>[3]</sup> which in turn affected the revenues of the automotive supplier industry. The war in Ukraine also impacts the automotive industry itself and the automotive supplier industry. Crucial components such as wire harnesses cannot be delivered anymore because a substantial proportion of them was produced in Ukraine. This adds to the chip crisis and COVID-19-related supply chain disruptions. The omission of the sales markets in Ukraine and Russia will, according to Deloitte, result in a decrease in production volume of around 2.6 million vehicles in 2022 and 2023 globally.<sup>[4]</sup>

The challenges which emerged after 2020 due to the pandemic and the war in Ukraine stand behind the more fundamental and long-term challenge of the shift of the automotive industry towards electrification. Several countries set binding targets to phase out cars powered by

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1. Lazard & R. Berger, *Global Automotive Supplier Study 2020: COVID-19 crisis as a window of opportunity?* (Nov. 2020), available at <https://www.lazard.com/media/451494/global-automotive-supplier-study-2020.pdf> (accessed 30 Nov. 2022).

2. Id.

3. Deloitte, *Global Automotive Supplier Update: Local insights from the Triad Markets on trends and developments* (2022), available at <https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/consumer-business/deloitte-cn-cb-automotive-suppliers-preparing-for-transformation-en-220526.pdf> (accessed 30 Nov. 2022).

4. Id.

internal combustion engines. By 2035, the European Union set the target of registering only zero-emission cars. Canada, China, Japan, Türkiye and the United States set targets as well.<sup>[5]</sup> In the coming years, there will thus be a substantial shift towards electric or biofuel-powered vehicles. Electric vehicles require different components than cars powered by internal combustion engines and thus, numerous core products of automotive suppliers will face falling demand. A radical shift in strategy is required.<sup>[6]</sup> It is likely that many automotive OEMs will invest in the area of research and development to develop more fuel-efficient vehicles. Technologies relevant in this regard include fuel cell technology for hydrogen-powered vehicles, ethanol vehicles and plug-in hybrid electric vehicles.

Furthermore, trends such as vehicle connectivity and digitalization as well as autonomous driving and car sharing are of growing importance. In the near future, high-tech equipment such as in-vehicle telematics, which provides drivers with instant safety, communication, and infotainment services, is likely to become part of the standard equipment in vehicles. Also among the practical applications are vehicle fault detection, voice-assisted driving instructions, and vehicle-to-vehicle communications, which serve to avoid collisions by ensuring that vehicles maintain a safe distance from each other. These changes are expected to have an encouraging impact on multinational companies in the automotive industry. In addition, there is increasing pressure on automotive OEMs to develop global platforms upon which vehicles are designed, engineered and produced, to use the most capital-intensive facilities and resources first and localize them later reflecting regional preferences. In order to remain successful, automotive OEMs must recognize the developing nature of consumer perceptions and preferences.

The automotive industry is changing from a traditional vertical structure to a more horizontal structure with these new trends and developments. Under this horizontal structure, automotive OEMs are sourcing electronic components from semiconductor companies or may use network services from telecommunications companies to respond to evolving consumer demands for greater fuel efficiency and connectivity in vehicles. In addition, companies that have not supplied products to automotive OEMs in the past may now become important suppliers to the automotive industry. This is due to the fact that the automotive sector is investing significantly in the development of hybrid and electric vehicles, as well as in telematics. Due to these recent developments, the landscape of the automotive industry has changed, making it important for automotive manufacturers to anticipate cross-industry and cross-regional opportunities while remaining mindful of the business and tax requirements in different industries and markets.

### 3. Typical Operating Structures in the Automotive Supplier Industry

#### 3.1. Overview

Automotive suppliers and OEMs form a narrow market. Generally, OEMs require automotive suppliers to establish their plants nearby the OEM's production facilities in order to secure just-in-time delivery. Often, automotive suppliers' local plants invoice directly to the OEM's local production facilities. In contrast to OEMs, the accounting of automotive suppliers' delivery of manufactured components generally does not include intra-group sales of manufactured components from its local plants to its principal or full-fledged manufacturer followed by their sales to the OEM's production facility. However, automotive suppliers' local plants often use technology and trademarks developed and owned by their principal. Moreover, local plants make use of intra-group services provided by the principal or other centralized service provider, such as procurement and sales. For instance, sales contracts are often negotiated between the OEMs' headquarters and automotive suppliers' entities, which are in close proximity to the OEMs' headquarters. Separate sales entities of automotive suppliers have been increasing in practical relevance but are still an exception. All this makes the intra-group transactions with local plants very important for the transfer pricing of automotive suppliers. Against this background, automotive suppliers' operating structures are often described by the following types of "units" according to their function and risk profiles: (i) principal or full-fledged manufacturer; (ii) licenced manufacturer; (iii) contract manufacturer; (iv) toll manufacturer; and (v) limited-risk distributor. Although the boundaries between these terms are sometimes unclear and they may oversimplify complex manufacturing profiles, this description is often useful in describing typical transfer pricing issues associated with the automotive supplier sector.

#### 3.2. Principal or full-fledged manufacturer

Activities such as production planning, input procurement, supply chain management, quality control, long-term capacity utilization planning and perhaps sales to third-party customers may be the responsibility of a principal entity or a full-fledged manufacturer. The full-fledged manufacturer may bear a number of risks associated with these activities, such as warranty, capacity utilization, product liability, pricing risks and market demand. In addition, the principal or full-fledged manufacturer may also be significantly engaged in R&D activities, wherein it bears the risks inherent in the development, enhancement, maintenance and protection of valuable intangible assets that may result from the R&D activities.

A full-fledged manufacturer generates profits from both routine functions (including routine manufacturing activities) and from its contribution to valuable intangible assets. Considering a simplified model with only one principal or full-fledged manufacturer and many other manufacturers and eventually distributors in the value chain of a multinational automotive supplier, several units may generate profits from the performance of routine functions based, for instance, on the benchmarked profitability of functionally comparable companies, whereas the principal or full-fledged manufacturer receives all residual profits or losses from the value chain. In an ideal world, the

5. Id.

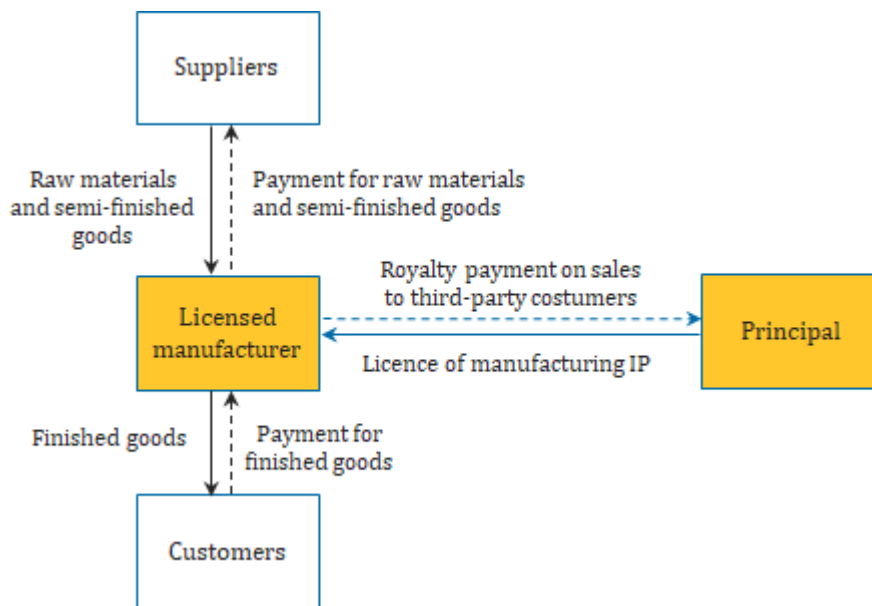
6. Deloitte, *Automotive suppliers: preparing for transformation* (2022), available at <https://www2.deloitte.com/cn/en/pages/consumer-business/articles/automotive-suppliers-preparing-for-transformation.html> (accessed 30 Nov. 2022).

profitability of the routine units is generally low but relatively stable, as it is subject to a benchmarked fixed profitability margin. In contrast, significant fluctuations are possible with regard to the profitability of the principal or full-fledged manufacturer compromising the aggregate profit level of the entire group. This is reflected in their higher risk profile.

### 3.3. Licensed manufacturer versus routine manufacturer

Under a licensed manufacturer framework, the manufacturer (licensee) produces goods under a licence agreement, according to which it uses intangible assets, such as product designs, patents, know-how, and manufacturing processes, which the principal (licensor) owns. In return for the use of the licensed intangible assets, the licensed manufacturer pays royalties to the principal. In addition, the licensed manufacturer usually purchases raw materials and semi-finished products for its own account and holds inventories of raw materials and finished products. The risks associated with holding inventories and selling products, including demand and pricing risk, are thus allocated to the licensed manufacturer. Normally, the licensed manufacturer owns the plant and equipment necessary for the production. This is illustrated in Figure 1.

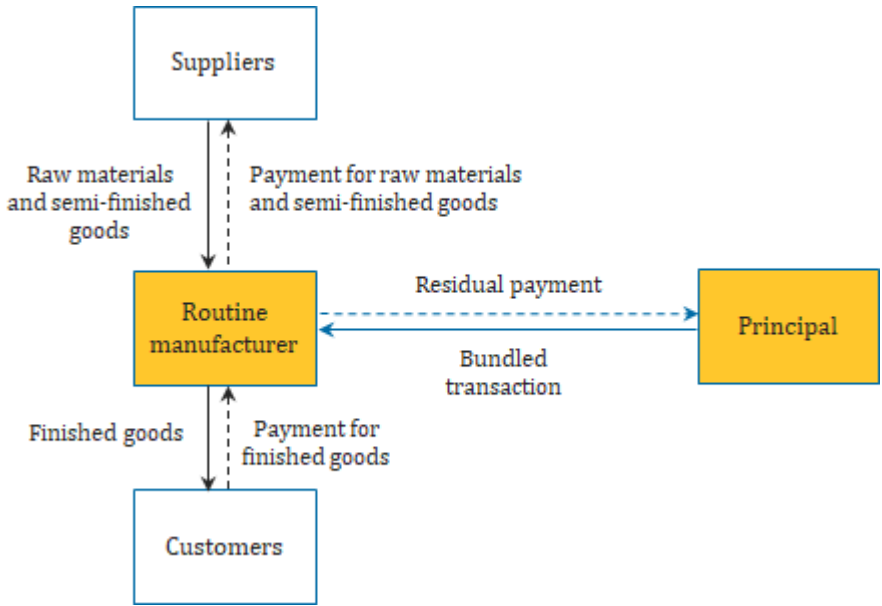
**Figure 1 – Licensed manufacturer structure**



A routine manufacturer is considered to bear less risk than a licensed/full-fledged manufacturer. The routine manufacturer is responsible for the production of the goods while the principal or licensed/full-fledged manufacturer directly bears the risk of demand and final customer prices. The principal or licensed/full-fledged manufacturer may guarantee acceptance of goods. Like the licensed manufacturer, the routine manufacturer typically sells directly to third-party customers at market prices. The routine manufacturer generally owns plant, equipment and the raw materials, and it has customer receivables. Thus, it bears the risks associated with owning fixed assets, raw material inventories and receivables. In order to ensure the generation of low but relatively stable profits from the performance of routine functions, the routine manufacturer may generate profits based on the benchmarked profitability of functionally comparable companies,

whereas the routine manufacturer pays all residual profits (or losses) from the value chain to the principal or full-fledged manufacturer. See Figure 2.

**Figure 2 – Routine manufacturer structure**



**3.4. Contract manufacturer and toll manufacturer**

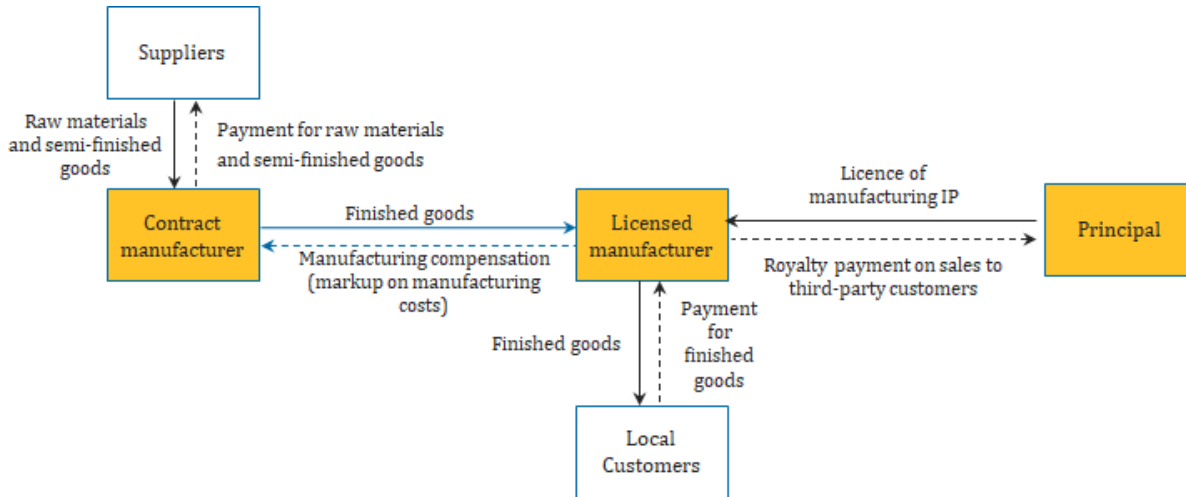
Like the routine manufacturer, a contract manufacturer is also considered to bear less risk than a licensed/full-fledged manufacturer. The contract manufacturer is responsible for the production of the goods while the principal or licensed/fully-fledged manufacturer directly bears the risk of demand and final customer prices. The principal or licensed/full-fledged manufacturer may guarantee acceptance of goods if the products manufactured by the contract manufacturer meet the principal’s product and quality specifications. Therefore, only relatively low risks are inherent in the warehousing and sale of finished goods at a contract manufacturer, as compared to a licensed/full-fledged manufacturer. The contract manufacturer generally owns plant, equipment and the raw materials. Thus, it continues to bear the risks associated with owning fixed assets and raw material inventories. A licensed/full-fledged manufacturer can often perform some contract manufacturing activities that are an adjunct to its other manufacturing activities.

A common intercompany transaction between a contract manufacturer and the licensed manufacturer (or full-fledged manufacturer) consists of the contract manufacturer selling the manufactured goods to the latter manufacturer, which deviates from the above-described routine manufacturer (see Figure 2 for illustration). Typically, the contract manufacturer is compensated by the licensed/full-fledged



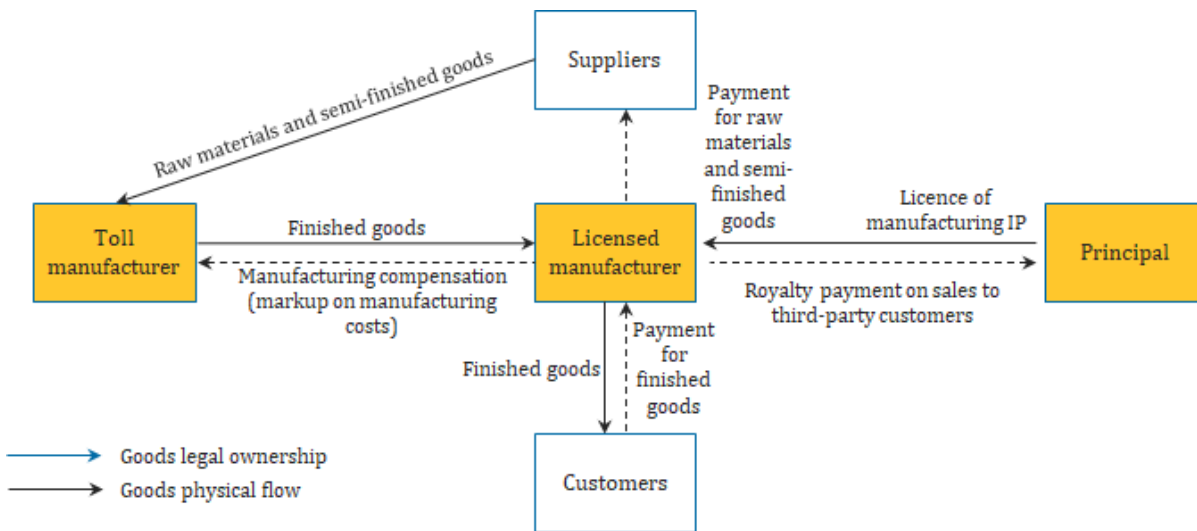
manufacturer through a return that allows the contract manufacturer to earn an arm's length markup on total costs, meaning a return on value-added manufacturing services as a return on its capital investment and investment in raw material inventory. See Figure 3.

**Figure 3 – Contract manufacturer structure**



Toll manufacturing frameworks provide that the principal or licensed/full-fledged manufacturer retains ownership of the raw materials, work-in-process and finished goods during the manufacturing process. In this framework, the principal or licensed/full-fledged manufacturer owns the raw materials and provides them to the toll manufacturer for processing (i.e. the toll manufacturer does not acquire ownership of the raw materials). A common third-party transaction consists of the licensed/full-fledged manufacturer selling the manufactured goods to local customers. This is illustrated in Figure 4. Thereby, the toll manufacturer provides the processing services and is compensated for this by the licensed/full-fledged manufacturer through a service fee, which is usually charged as a profit markup on the processing costs. Risks related to the warehousing of raw materials and finished products and the final demand and price risk are borne by the licensed/full-fledged manufacturer.

**Figure 4 – Toll manufacturer structure**

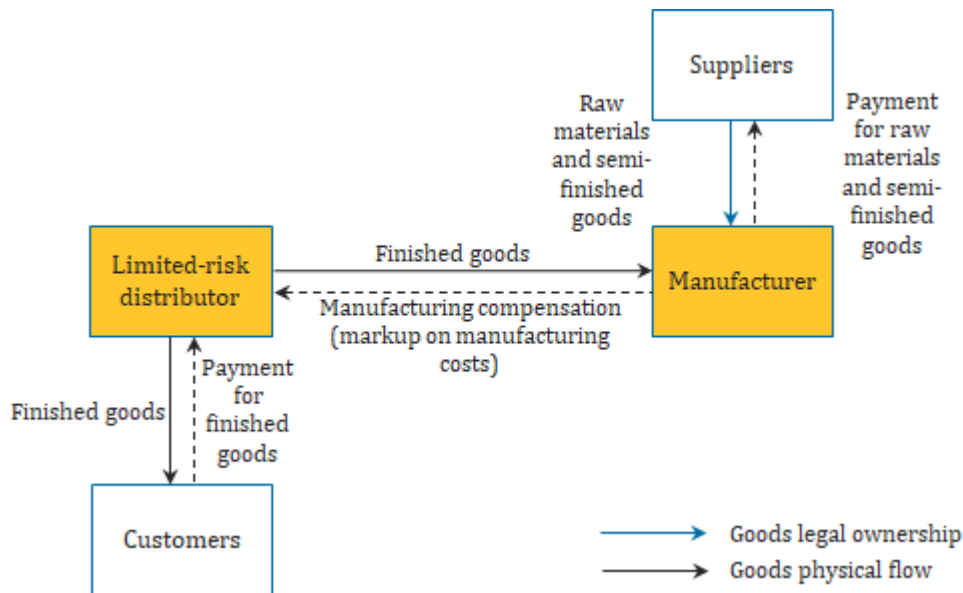


**3.5. Limited-risk distributor**

A limited-risk distributor is responsible for the sale of the goods to the customers while the principal or licensed/full-fledged manufacturer directly bears the risk of demand and final customer prices. If existent, the limited-risk distributor sells directly to third-party customers at market prices, instead of the licensed manufacturer/full-fledged manufacturer/routine manufacturer. The limited-risk distributor generally employs sales personnel, owns the finished products, and it has customer receivables. Thus, it bears the risks associated with finished

goods inventories and receivables. In order to ensure the generation of low but relatively stable profits from the performance of routine functions, the limited-risk distributor may generate profits based on the benchmarked profitability of functionally comparable companies, whereas it is not entitled to the residual profits (or losses) from the value chain. In the automotive supplier industry, limited-risk distributors are, however, very rare. See Figure 5.

**Figure 5 – Limited-risk distributor structure**



## 4. Key Themes in Transfer Pricing

### 4.1. Intangibles

In transfer pricing analysis involving intangibles, it is essential to:

- (1) Identify with specificity the intangibles involved.
- (2) Identify the owner and those that contribute to the value of the intangibles.
- (3) Characterize the transaction involving the use or transfer of intangibles.
- (4) Determine the arm's length conditions of the transaction involving intangibles.

The following paragraphs provide an overview of the most common peculiarities and issues that may arise in the context of a transfer pricing analysis of an MNE group in the automotive supplier industry.

#### 4.1.1. Identification of significant/valuable intangibles

Chapter 6 of the OECD Guidelines defines the intangible as “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.<sup>[7]</sup> In addition, according to the OECD Guidelines, “the identification of an item as an intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case” and “that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances”.<sup>[8]</sup>

Generally speaking, in the automotive supplier industry (but not only), the identification of the intangibles involved in intercompany transactions that deserve compensation is complicated by the following specificities:

7. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), para. 6.6., Primary Sources IBFD [hereinafter OECD Guidelines].  
8. Para. 6.10 *OECD Guidelines*.

- usually the bundle of technological intangibles shared among associated companies is formed by product and/or process know-how and experiences that may be patented or not and, depending on circumstances, for smaller MNEs unregistered know-how may not be properly identified and formalized, being it embedded in habits, unwritten procedures or simply certain key employees making it, therefore, difficult to show and prove the existence of actual valuable know-how;
- especially for those OEM suppliers that sell customized products to their clients (i.e. products specifically developed for – or jointly developed with – each OEM based on the characteristics of the vehicle and the technical requirements of the OEM), the technological intangibles are the sum of different instructions, procedures and operating manuals on how a specific product should be designed, developed and mass-produced based on previous project/experiences, so it might be actually complicated to identify each time the intangibles actually used or shared in a controlled transaction and the value of such intangible for the specific product developed for the OEM client;
- among the technological intangibles put at the disposal of the group entities, there might be know-how and technical solutions that might be employed only in the future, while having little or nil value in a specific fiscal year;
- the value of OEM suppliers' trademarks is generally limited or even absent and, in any case, it cannot be considered and evaluated in isolation from the technological intangibles. Considering that it is a B2B transaction, the technological content and the design, development and mass-production capabilities are more valuable to the OEM; and
- any process know-how should not be confused with any potential location-specific advantages from the manufacturing activities (e.g. lower labour, energy and in general production cost).

The above list shows that within an MNE group that supplies products to an OEM it might not always be straightforward to identify and evaluate the intangibles shared among group entities, especially in those situations where more than one group entity is actually a contributor to the value of the intangibles: this is a typical situation that can be seen when the MNE group supplies to the OEM products specifically designed and developed for such OEM and such design and development is performed at the local manufacturer level based on know-how located at the central level.

#### 4.1.2. Identification of the owner of the intangible and contributors to the value of the intangibles

According to the OECD Guidelines, the allocation of the return derived by the MNE group from the exploitation of intangibles, and the allocation of costs and other burdens related to the intangibles among members of the MNE group is accomplished by compensating members of the MNE group for functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles.<sup>[9]</sup>

This is true also for transfer pricing analysis of OEM suppliers, where, however, as anticipated, the identification of the contributors to the value of the intangibles (and the evaluation of such contributions) may not always be a straightforward exercise, especially for those OEM suppliers that adopt a decentralized operating model where local manufacturers have an entrepreneurial role (usually as licensed manufacturers). Generally OEM suppliers that supply products/components directly to an OEM (so-called Tier 1 suppliers) have a large role in the design of parts/components for vehicle manufacturers since they are usually awarded contracts for the life of a vehicle model and they are involved since the early stages in the design of the products and of the relevant processes; moreover, due to the globalization and the just-in-time production processes, Tier 1 suppliers have been pushed in the recent decades to locate their production facilities close to the ones of their OEM clients. Such characteristics of the automotive supplier industry combined with the peculiarities of decentralized operating models (with a local manufacturer with an entrepreneurial role) may give rise to complexities in identifying and evaluating the contributions of local manufactures to the value of the intangibles.

Such complexities are typically related to the cross-fertilization of IPs and R&D processes and to know-how developed locally and then shared within the group. Notably, in the industry at stake, the product development process generally involves several functions that may be located in different subsidiaries within the group and it relies on previous experience and know-how acquired by the different subsidiaries of the group and/or on specific researches carried out at the central/regional level: these different flows of transfer of know-how within the group (from HQ to local manufacturers and/or vice versa), can make it quite complex to identify the contributions and the level of the contributions of the different members involved. Another source of complexities derives from know-how (typically process/manufacturing know-how) developed over the years at a local level and then exported within the group for new local operations: also in these circumstances, it is essential to understand the role (performance of functions, use of assets and more importantly the management of the risk related to the DEMPE activities) of the local manufacturers and HQ in the development of such know-how to understand who is actually entitled to the return of the intangible.

#### 4.1.3. Characterization of the transaction involving intangibles

The characterization of intercompany transactions involving intangibles is crucial for the performance of the comparability analysis (i.e. identification of the controlled transaction and comparison with transaction between independent parties) and ultimately for determining

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9. Para. 6.32 *OECD Guidelines*.

the arm's length conditions of such intercompany transactions. Moreover, although the OECD Guidelines acknowledge that the characterization of a controlled transaction for transfer pricing purposes is not relevant for the purposes of the definition of royalties in accordance with article 12 of the OECD Model Tax Convention,<sup>[10]</sup> it is, however, reasonable to assume that, in particular with reference to the distinction between the supply of know-how and services,<sup>[11]</sup> the characterization of a transaction for transfer pricing purposes should be ultimately reconciled with the characterization according to the principles of article 12 of the OECD Model Tax Convention, or that in any case the principle of such article can be of assistance in the characterization also for transfer pricing purposes.

According to the OECD Guidelines,<sup>[12]</sup> the transactions involving intangibles can be characterized in the following two general types:

- (1) transactions involving transfers of intangibles or rights in intangibles; and
- (2) transaction involving the use of intangibles in connection with the sale of goods or the provision of services.

With specific reference to the situation of automotive suppliers groups, in the case of decentralized operating models (with local manufacturers with an entrepreneurial role), the transaction involving intangibles between the HQ licensee and the licensed local manufacturer usually does not raise particular characterization issues, being generally characterizable as a true licence agreement and therefore falling ordinarily in the first category (transactions involving transfers of intangibles or rights in intangibles); conversely, in the case of more centralized operating models, the transactions involving intangibles between the HQ and the local manufacturers certainly give rise to more doubts.

As previously highlighted, generally OEMs require automotive suppliers to establish their plants (and therefore manufacturing subsidiaries) nearby the OEM's production facilities and to invoice to the OEM's local production facilities directly from the automotive suppliers' local subsidiaries, regardless of whether they are licensed manufacturers or routine manufacturers. Although for both licensed manufacturers and routine manufacturers the formal set-up may formally appear the same (with the licensed manufacturer and the routine manufacturer making a payment to the HQ for intangibles and services), the actual characterization of the intercompany transactions with the HQ assumes a different meaning depending on the functional profile of the local subsidiaries and consequently the extent of the involvement of the HQ in the management and control of core functions and risks.

Notably, while the transaction between a HQ licensee and a licensed local manufacturer usually is limited to the transfer of intangibles and therefore characterizable as a pure intangibles licence agreement (usually supporting services rendered by HQ to the licensed manufacturer are separately formalized and remunerated), the transaction between the HQ and a local routine manufacturer definitively exceeds a pure licence agreement and usually includes several core services (e.g. commercial, operations, etc.). Depending on the actual complexity of the routine manufacturer's functional profile and notwithstanding both the licensed and the routine manufacturers sell directly to third-party OEMs, such transaction can be either characterized:

- as a transfer of limited right in intangibles in combination with the supply of tangible assets and/or services, when the local routine manufacturer is more involved in the management and control or core activities and risks. In this case, the transaction assumes the form of a bundled transfer of limited rights on intangibles and intra-group services, with generally a fixed (or with limited/capped fluctuation) remuneration granted to the HQ; or
- as a transfer involving the use of intangibles in connection with sales of goods or performance of services when the functional profile of the routine manufacturer is so limited that the actual nature of the relationship with the HQ is the one between a contract/toll manufacturer and a principal (with the routine manufacturer substantially providing to the HQ/principal manufacturing services and invoicing services). In this last situation, the transaction between the routine manufacturer and the HQ will take the form, depending on the case, of:
  - floating royalties and service charges from the routine manufacturer to the HQ/principal in case there is residual profit to be attributed to the HQ/principal; or
  - flexible contributions from the HQ/principal to the local manufacturer when the latter does not achieve the routine manufacturing arm's length return.

#### 4.1.4. Determination of the arm's length conditions of the transaction involving intangibles

The different characterization of the transactions between a local manufacturer and its HQ has a huge impact on the process and method selection for the determination of the arm's length conditions: in the case of transfer of limited right in intangibles (e.g. licence transactions), even in combination with other business transactions, it is appropriate to determine directly the arm's length conditions of the transaction (or transactions in the case of other transactions connected) while, in cases where there is a substantial intra-group transfer involving the use of intangibles in connection with performance of services (e.g. deemed contract manufacturing services notwithstanding the direct invoicing from the manufacturer to the OEM clients), it might be appropriate to determine the arm's length conditions of such bundled transaction indirectly (on a residual basis) after having attributed to the routine manufacturer a routine return for its functions.

<sup>10.</sup> Paras. 8 to 19 *OECD Model: Commentary to Article 12*.

<sup>11.</sup> By way of example, the distinction between the supply of know-how and services (see paras. 11 to 11.6 *OECD Model: Commentary to Article 12*).

<sup>12.</sup> Para. 6.87 *OECD Guidelines*.

It can be fairly stated that the direct evaluation of intangibles in the case of transfer of intangibles (or limited rights on intangibles) gives rise to more complexities and sources of controversies with tax authorities compared to the indirect evaluation of intangibles in the case of use of intangibles in connection with sales of goods or performance of services.<sup>[13]</sup>

In cases involving the transfer of intangibles or rights in intangibles, according to the OECD Guidelines, the CUP method and the transactional profits split method are the transfer pricing methods that most likely prove useful for direct evaluation of the intangibles (or rights in intangibles) transferred,<sup>[14]</sup> while one-sided methods are generally considered not reliable.<sup>[15]</sup> With specific reference to the application of the CUP method, it is worth highlighting that in the automotive supplier industry (as well as in many other industries) the identification of reliable comparables may be very difficult if not impossible when internal comparables are not available. Indeed, considering the limitations<sup>[16]</sup> of the mostly used commercial databases (e.g. RoyaltyStat, BvD TP Catalyst, ktMINE, etc.) and the (usually not adjustable) comparability issues of the potential comparables derived from such databases, the CUP method based on external comparables usually is not able to achieve a sufficient level of accuracy and reliability of the comparability analysis and it might prove useful, based on a practical and flexible approach, merely to supplement or corroborate the indications deriving from the application of other appropriate methods.

Conversely, in most cases, a CUP analysis based on internal comparables proves to be sufficiently reliable and robust, considering the direct and closer relationship between the controlled transaction and the internal comparable. However, it is worth mentioning that even internal comparables rarely prove to be fully reliable comparables because, in most instances, it is impossible to retrieve a transfer of rights of intangibles with third parties involving the same intangibles or the same combination (or all the intangible of a group) of intangibles to be used in the very same industry for the core business of the MNE, as it happens within a group (indeed, MNEs do not share with third parties in their industries the same combination of intangibles, e.g. jointly all their technological and marketing intangibles). Therefore, in most cases, the internal comparables that can be retrieved are observations with a more limited or partial content (in terms of intangibles, geographical scope, industry/product scope, etc.) compared to the controlled transactions. Notwithstanding the above, also the OECD Guidelines recognized that the difficulties and complexities should not preclude the possible application of the CUP method, and that “practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy”.<sup>[17]</sup>

As per the application of the profit split method in the case of licence transactions, the OECD Guidelines state that it can be utilized to evaluate the respective contributions of the parties to the consolidated profits when reliable uncontrolled comparables are not available.<sup>[18]</sup> In transfer pricing analysis of MNEs in the automotive supplier industry, considering the complexities highlighted above in terms of identification of valuable intangibles transferred within the group and of contributors to the value of the intangibles, the level of integration of the activities of the group entities and the potential comparability issues of the internal CUPs, it can prove useful also in conjunction with or as a supporting/corroborative method to the internal CUP method since it can actually provide a practical solution taking into account specific facts and circumstances of the controlled transactions that may not be present between independent parties. However, it is to be noted that in practice, including in the automotive supplier industry, the profit split method has still limited application among taxpayers and by the tax authorities especially in the context of unilateral or bilateral APA, due to the inherent complexities in its application.

## 4.2. Manufacturing

Risk delineation and assumption is at the heart of transfer pricing comparability analysis since it allows to determine which party is in control and, consistently with this outcome, the compensation for risk management.<sup>[19]</sup> The OECD Guidelines provide a six-step analysis to detect risk in a given transaction aimed at identifying the risk management function which consists of three elements: (i) capability to make decisions in relation to the risk assumption; (ii) capability to decide whether and how to respond to the risk; and (iii) capability to mitigate risk.

This approach requires that, at arm's length, it is possible – given a specific risk category – to identify the entity that effectively exercises control over risk, meaning that it has:

- (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.<sup>[20]</sup>

It is important to note that:

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13. In this last case, the source of the controversies with the tax authorities is generally related to the actual characterization of the transaction, as explained in the previous paragraph.

14. See para. 6.145 *OECD Guidelines*.

15. See para. 6.141 *OECD Guidelines*.

16. Mostly in terms of sources, geographical perimeter and available information of the observations.

17. Para. 2.17 *OECD Guidelines*.

18. Para. 6.152 *OECD Guidelines*.

19. Para. 1.56 *OECD Guidelines*.

20. Para. 1.65 *OECD Guidelines*.



- the actual capability of control over a specific risk depends on the degree of information that the parties involved in a specific intercompany transaction possess, which on the one hand depends on assessing the “foreseeable downside and upside risk outcomes” of a decision and, on the other hand, requires “competence and experience in the area of the particular risk for which the decision is being made”;<sup>[21]</sup> and
- not all risks can be managed since they “... are a general condition of commercial activity affecting all businesses undertaking that activity. For example, risks associated with general economic conditions or commodity price cycles are typically beyond the scope of an MNE group to influence” [emphasis added].<sup>[22]</sup>

In this respect it is common background among transfer pricing practitioners that the COVID-19 crisis impacted on transfer pricing policy and necessitated introducing some departures from the transfer pricing ordinarily applied. This was due to the fact that the arm’s length principle functions mostly where the economic cycle is characterized by a certain degree of stability. In the case of an unpredictable downturn, the possibility to consistently apply the arm’s length principle by mirroring independent parties’ behaviour is no longer an option. In light of this, the OECD published a document dealing with the application of the arm’s length under the pandemic crisis<sup>[23]</sup> whose main take-aways can be summarized as follows:

- the lack of availability of information regarding contemporaneous uncontrolled transactions may justify the use of alternative approaches to test the arm’s length (e.g. take into account information that becomes available after the close of the taxable year, use of more than one transfer pricing method, inclusion in the benchmark of loss-making comparables);
- given the relevance of the crisis, independent parties may not strictly hold another party to their contractual obligations, particularly if it is in the interest of both parties to renegotiate the contract or to amend certain aspects of their behaviour;<sup>[24]</sup> and
- allocation of operating or exceptional costs would follow risk assumption and how third parties would treat such costs.<sup>[25]</sup>

We are now facing a further crisis that is not linked to the demand side but starts from the supply side and will impact the production capabilities. This will be especially true for capital-intensive industries (such as the automotive one) where increased energy costs will not easily be automatically shifted to the OEM and, hence, the automotive suppliers will need to determine if and how to adapt their transfer pricing models.

It is first of all necessary to understand whether such kind of risk may represent a general economic condition (which, as stated above, cannot be controlled) or, if, conversely, this represents a risk that may be managed. If one takes the first view, then (likewise for the COVID-19 experience) a departure from the arm’s length can be justified regardless of the transfer pricing model applied (e.g. licence-based models where all the entities are acting as entrepreneurs and principal-based models where there is just one entity acting in such capacity).

The main consequences of such approach may be depicted as follows. Under a licence-based model the main issues will be whether to adjust the royalty rate to reflect the decrease in the net margin incurred by the manufacturer of automotive components due to increased operational costs. In a nutshell is possible to state that if the licensee is acting transfer pricing wise as a full-risk entrepreneur, consistently one would assume that the royalty rate should not be modified.

However, this position may trigger distortions in light of different factors: (i) royalty rates are generally benchmarked relying on comparables selected in ordinary market circumstances; (ii) the amount of royalties to be paid to the licensor is based on the value of the net sales but the added value of the licensed intangibles economically is heavily impacted by the increased operational costs; (iii) *coeteris paribus*, royalty rates (which approximate a profit split mechanism) should reflect a proper allocation of the relevant risks between the parties, i.e. in the ordinary bargaining position the licensee would agree on the amount of the royalty to the extent they are expecting to get part of the extra-profit deriving from the exploitation of the relevant intangibles (for instance, in the case at stake, product know-how); (iv) the unpredictable increase in the energy costs (which does represent a part of the market risk) does not fall under the control of the licensee who is not in the position to undertake concrete actions aimed at lowering the magnitude of such risk.

Moreover, the kind of risk does not appear to be one that can be influenced by the MNE’s decision.

In light of this, one could argue that royalty rates should be reviewed to reflect the modified economic circumstances and:

- either provide for an integration of the determination of the royalty rate using as a floor the net marginality that should be left to the licensee at least to remunerate its routine functions; or
- provide for reduction of the royalty rates in the same percentage represented by the impact of the energy costs on the sales.

21. Para. 1.66 *OECD Guidelines*.

22. Para. 1.67 *OECD Guidelines*.

23. OECD, *Guidance on the transfer pricing implications of the Covid-19 pandemic* (18 Dec. 2020), available at <https://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm> (accessed 30 Nov. 2022).

24. *Supra* n. 23, para. 43.

25. *Supra* n. 23, para. 48.



In certain circumstances it could be even envisaged that royalty payments may be suspended until the ordinary market conditions are restored to the extent that the detrimental effect of such kind of risk (general unforeseeable conditions) may cause a business discontinuity to the licensee.

In the case of principal-based models, it can be debatable whether extra operational costs should be included in the cost base of manufacturer entities (either contract or toll manufacturers). In this regard some guidance can be found in the work on the impact of the COVID-19 pandemic developed by the OECD where in dealing with exceptional costs the following approach is suggested: (i) exceptional costs should generally be excluded from the net profit indicator except when those costs relate to the controlled transaction as accurately delineated; (ii) when determining a cost basis it is important to consider whether the basis should include or exclude exceptional costs that are deemed to relate to the controlled transactions and, if included in the cost basis, whether such costs should or should not be treated as pass-through costs to which no profit element should be attributed; and (iii) accounting consistency may be required to improve comparability.<sup>[26]</sup>

Since the issue related to whether or not a limited-risk entity may incur losses exceeds the scope of the present contribution, in light of the position expressed by the OECD with reference to the COVID-19 crisis one could propose two different approaches:

- (1) including in the price setting also loss-making comparables; or
- (2) using an outcome testing approach and allowing compensating adjustments.

### 4.3. Services

Automotive suppliers operate many plants that have been established nearby the OEM's production facilities, which receive technical, managerial and/or sales support from centralized service providers. The volume of intra-group services is likely to continue to increase in the future, especially due to the need to increase efficiency. This will be accompanied by an increased potential for conflicts within the automotive supplier. On the one side, this will likely be caused by the nature of internal cost allocation between units providing and plants receiving services. On the other side, the tax-compliant determination and allocation of service fees is also decisive. In practice, the cost-plus method clearly dominates the setting of transfer prices for intra-group services. Although several issues are often the focus of tax disputes with the tax authorities, such as issues in determining which services are chargeable, how to distinguish them from non-chargeable shareholder expenses, and the profit markup, tax auditors question the cost basis of charging for intra-group services particularly critically. In this respect, automotive suppliers are also confronted with many permanent establishment risks. In practice, plants are sometimes supported by central engineering teams which provide on-site support. In addition, agency permanent establishment risks are a major topic for automotive suppliers because their local plants invoice directly to the OEM's local production facilities, while automotive suppliers' entities, which are in close proximity to the OEMs' headquarters, provide local sales and marketing support or negotiate commercial terms of supply. These risks could be mitigated by the establishment of limited-risk distributors, which therefore could become more relevant in the automotive supplier industry, at least in selected countries.

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<sup>26.</sup> In these terms, *supra* n. 23, paras. 52-54.

## International

Giuseppe Abatista<sup>[1]</sup>

# Luxury Fashion and Transfer Pricing: IP Owners, Distributors, Supply Chain and Digitalization at the Beginning of a New Era

High profitability, worldwide physical presence and strong leverage on intangibles make the luxury fashion businesses ideal targets for transfer pricing scrutiny. The industry dynamics are rapidly transforming, with digital revolution and younger customer base being the main factors. New transfer pricing issues are already adding to the existing ones: progressive lack of comparables due to expansion along the supply chain, double taxation remedies still costly and slow, increasing interest in APAs as the only viable solution to secure transfer pricing risk.

## 1. Business Landscape

Until recently, businesses which are now obviously included in the luxury sector were seen as part of the industry of the goods or services they produced and sold: fashion, automotive, jewellery and so on.

Yet Comité Colbert – the association of the major French luxury businesses – was founded as early as 1954.<sup>[1]</sup> Starting from the 1990s, similar associations of high-end businesses operating in different “traditional” sectors were formed in Italy and other European countries.<sup>[2]</sup> The seven organizations now compose the European Cultural and Creative Industries Alliance (ECCIA), including over 600 brands and cultural institutions in Europe.

In 2012 the European Commission, in a communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions<sup>[3]</sup> observed that “fashion and high-end industries ... rely on a strong cultural and creative input”, stating that the sector includes “high-end fashion, jewellery and watches, accessories, leather goods, perfumes and cosmetics, furniture and household appliances, cars, boats, as well as gastronomy, hotels and leisure”.

In 2022, the luxury industry is universally recognized as an industry with its own features, regardless of the range of products and/or services provided by each business operating in the luxury segment. Within luxury, “personal luxury goods” (including high-end fashion) is the second largest industry after automotive<sup>[4]</sup> and the most resilient one in the last 15 years.

In such a timeframe, luxury fashion has been fast-growing, has recovered quickly after crisis moments and has seen extensive business transformation – an ongoing process that has been accelerated by the COVID-19 pandemic.

After the 2008/09 economic crisis caused by the credit crunch, the 2010s have registered steady growth in the sector, mainly through the expansion to new markets, especially in the fastest growing economies (first of all China, but also India, Brazil, Russia, Taiwan and others). The expansion happened not only through geographically broader distribution, but also through a constant increase of the number and presence of directly operated points of sale (DOS) by all luxury fashion brands. On the one side, this trend allowed the *maisons* to increase their profitability, and on the other side it enabled better, broader and more consistent brand awareness worldwide: luxury fashion extensively leveraged on brand power, together with continuous design innovation.

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1. M. Chevalier & G. Mazzalovo, *Luxury Brand Management*, p. 86 (4th ed., Wiley 2021):

We are so used to the idea of luxury brands that we tend to forget that this is a relatively new concept. For many years, businesses that we now include in the luxury sector were considered completely separate and were represented by different federations: the Federation of Ready to Wear, the Federation of Leather Goods, the Federation of Perfumes and Cosmetics, and so on. On the face of it, in the manufacturing and sales processes, a bottle of champagne and a lady’s dress have very little in common. The champagne is produced through an automated system using very modern machinery. It is then sold in wine stores, but also in supermarkets and hypermarkets. However, a lady’s dress is often made by hand and in very limited numbers, and sold in exclusive luxury stores around the world. The French were probably the first to understand the fact that a bottle of champagne and a sophisticated dress do have something in common, and this is why in 1954 they created the Comité Colbert, an association to promote the concept of luxury.

2. Fondazione Altgamma in Italy (1992), Walpole in United Kingdom (founded in 1990 as The Churchill Group, renamed as Walpole in 1992 and focused on luxury since 2005), Círculo Fortuny in Spain (2011), Meisterkreis in Germany (2011), Gustaf III Kommitté in Sweden (2018) and Laurel in Portugal (2021).

3. See *Promoting cultural and creative sectors for growth and jobs in the EU*, COM(2012) 537 final.

4. Luxury fashion is estimated to have reached EUR 288 billion in 2021 and luxury automotive EUR 551 billion, out of a total of EUR 1.140 billion for the whole luxury sector. See Bain & Co. – Altgamma, *Luxury Goods Worldwide Market Study*, 20th ed. (Fall 2021), available at [www.altgamma.it/studi-e-ricerche/](http://www.altgamma.it/studi-e-ricerche/) (accessed 28 Nov. 2022).

The 2020s started with the COVID-19 pandemic. 2020 brought the sector's growth to an abrupt halt, but the recovery was very fast in 2021. In 2022 fashion is expected to reach a new historical peak, beyond 2019 turnover and profitability.<sup>[5]</sup>

In terms of competitive landscape, in the 2010s big luxury conglomerates formed and/or consolidated. LVMH,<sup>[6]</sup> Richemont<sup>[7]</sup> and Kering<sup>[8]</sup> now dominate the sector, together with Chanel and Hermès, the only mono-brand companies comparable in size to the three bigger players.<sup>[9]</sup> A small group of companies controlling more than one brand constitutes the second tier: Capri Holdings,<sup>[10]</sup> Prada,<sup>[11]</sup> OTB,<sup>[12]</sup> Tod's.<sup>[13]</sup> The third tier is composed of single-brand companies (such as Burberry, Ferragamo, Zegna and others), presently struggling to keep the pace of the bigger players in innovation investments, omni-channel strategy and communication. Finally, new and emerging small brands are trying to gain market shares either on the more classical styles or in cutting edge innovative ones, leveraging the digital channel. In the next years some of them may succeed in growing enough to enter the third tier, or being acquired by a conglomerate.

The pandemic acted as an important accelerator of trends already present in the industry, but even before it luxury fashion was already in the midst of a transformation phase.

Such transformation is driven by many factors, the crucial one being the increasing share of new generations among the luxury customers. It is estimated that by 2025 over 60% of consumers will be millennials and from the Z-generation.<sup>[14]</sup> Of course, this implies the need for technological and digital evolution with customer engagement being the primary focus of technology adoption.

On the distribution side, the rigid separation between channels is fading, leaving the scene to a unique bubble where the consumer may freely navigate towards the brand and its offer without strict borders: consistency between digital and physical experience, omni-device access, pick up in store, remote sales, personalized assistance are some essential elements of the omnichannel diktat.

Sustainability is another crucial driver for transformation, together with environmental, social, and corporate governance and social responsibility. These drivers certainly are common to many – if not all – sectors at the moment, but in luxury fashion the pressure from increasingly aware consumers is particularly felt, with fashion being one of the most polluting industries in the world.<sup>[15]</sup> All brands are making significant investments and trying to make their business model more and more sustainable, circular, inclusive, transparent and responsible – and they are communicating it, of course.

The rush for sustainability, the omnichannel model and the pandemic outdated some delocalization choices. “The gradual increase in costs, including in the so-called “low cost” countries (including part of China and Eastern Europe), the recent interruptions and delays in supply chains in all sectors and, in the near future, also the claims for a greater transparency, sustainability and social responsibility”<sup>[16]</sup> are bringing the industry towards more centralized supply chain models.

The higher cost of doing business is another preeminent feature of the present business landscape – again, the issue is common to many if not all sectors, but has its own peculiarities in luxury fashion. Higher regulatory and compliance requirements, inflation caused by the pandemic and then the Ukraine war, calls for digitalization, product sustainability and supply chain traceability and the increase in energy costs: it is all leading to either reduced profitability or price increases. The industry chose to repeatedly increase prices in the last collections, but this is for sure a short-term strategy. Efficiencies in production and operating model must be achieved in the near future.

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5. C. D'Arpizio from Bain & Co. on the occasion of the presentation of the *Altagama - Bain Monitor on the Worldwide Market for Personal Luxury Goods – Spring Update 2022* in June 2022, observed:  
Despite significant macroeconomic challenges, including hyperinflation, slower growth of GDP and the Russian-Ukrainian conflict, the luxury personal goods market has once again proven resilient. Luxury goods brands began this year showing particularly strong growth, and playing a leading role in the sustainable and digital transformation taking place around the world.  
See [https://altagama.it/media/source/PRESS%20RELEASE\\_%20Altagama%20Consensus%20e%20Monitor%20Update%202022\\_def%20ENG%5B6%5D.pdf](https://altagama.it/media/source/PRESS%20RELEASE_%20Altagama%20Consensus%20e%20Monitor%20Update%202022_def%20ENG%5B6%5D.pdf) (accessed 28 Nov. 2022).
  6. LVMH Group, based in France, is the largest luxury conglomerate (EUR 64.2 billion revenue in 2021), with a portfolio of dozens of luxury brands in various sectors: wine and spirits, jewellery and watches, *hôtellerie*, perfumes and fashion. The main fashion brands are: Louis Vuitton, Dior, Fendi, Bulgari, Loro Piana, Céline, Emilio Pucci, Givenchy, Kenzo, Marc Jacobs, Loewe, Berluti and Off-White. The group is also present in high-end fashion distribution, owning DFS Group (leader in travel retail distribution in Asia) and the Parisian department stores Le Bon Marché and La Samaritaine.
  7. Richemont Group is the second largest conglomerate (EUR 19.2 billion revenue in 2021-2022). More focused on jewellery and watches, Richemont is present in the leather accessories segment through brands such as Montblanc, Cartier, Delvaux, Serapian Milano, and in fashion through Chloé, Azzedine Alaïa and Dunhill. It also acquired the online high-end fashion distributor Yoox – Net-à-porter, presently co-owned by the other online high-end fashion distributor Farfetch.
  8. Kering Group, also based in France, is the third largest conglomerate (EUR 17.6 billion revenue in 2021), including various jewellery and watches and fashion brands. Among the latter: Gucci, Yves Saint Laurent, Bottega Veneta, Balenciaga, Brioni and Alexander McQueen.
  9. Chanel (USD 15.6 billion revenue in 2021) is a total-look brand, historically leader in perfumes and cosmetics as well. Hermès Group (EUR 9.0 billion revenue in 2021) expanded over the years along the supply chain, buying producers of raw materials, semi-finished and finished goods and building factories. It owns shoe brand John Lobb and various brands of home textiles and tableware.
  10. Capri Holdings (USD 5.7 billion revenue in 2021-2022) owns Versace, Jimmy Choo and Michael Kors.
  11. Prada Group (EUR 3.4 billion revenue in 2021) includes Prada, Miu Miu, Church's and Car Shoe.
  12. OTB Group (EUR 1.5 billion turnover in 2021) owns Diesel, Maison Margiela, Marni, Viktor&Rolf, DSquared2 and Jil Sander.
  13. Tod's Group (EUR 0.9 billion turnover in 2021) includes Tod's, Fay, Roger Vivier and Hogan.
  14. Boston Consulting Group X Altagama, *True Luxury Global Consumer Insights* (June 2021), available at [https://altagama.it/media/source/PRESS\\_True%20Luxury%20Global%20Consumer%20Insight.pdf](https://altagama.it/media/source/PRESS_True%20Luxury%20Global%20Consumer%20Insight.pdf) (accessed 28 Nov. 2022).
  15. Fashion is considered by many the second most polluting industry after oil and gas, but this has been questioned by many studies. Recently, the World Economic Forum classified it as the third most polluting industry: see World Economic Forum, in collaboration with Boston Consulting Group, *Net-Zero Challenge: The supply chain opportunity*, available at [www3.weforum.org/docs/WEF\\_Net\\_Zero\\_Challenge\\_The\\_Supply\\_Chain\\_Opportunity\\_2021.pdf](http://www3.weforum.org/docs/WEF_Net_Zero_Challenge_The_Supply_Chain_Opportunity_2021.pdf) (accessed 28 Nov. 2022). For an extensive summary of the main studies published in recent years on the topic, see A. Wicker, *Fashion Is Not the 2nd Most Polluting Industry After Oil. But What Is It?*, Ecocult (Jan. 2022), available at <https://ecocult.com/now-know-fashion-5th-polluting-industry-equal-livestock/> (accessed 28 Nov. 2022).
  16. See F. Scucciati, *The 10 challenges for today's Fashion and Luxury industry* (The European House – Ambrosetti, Feb. 2022), available at <https://www.ambrosetti.eu/en/news/the-10-challenges-for-todays-fashion-and-luxury-industry/> (accessed 28 Nov. 2022).

Still, the whole luxury fashion industry is strongly based on IP rights, which stay at the core of the industry's value chain. The power of the brand is stronger than ever and continuous innovation in design is the pivot for staying relevant. Then, it is “just” a matter of customer engagement, the right communication and selective distribution.

## 2. Macro Trends Short- to Mid-Term

Sustainability, cost efficiency and quality control are pushing brands to expand along the supply chain through industrial verticalization and insourcing, by acquiring tanneries, leather cutting facilities, shoes and bags factories, jewellery makers and all kind of high-end manufacturers, especially in Italy.<sup>[17]</sup> More mergers and acquisitions in the supply chain are expected to happen in the next decade.

On the governance side, big conglomerates keep buying other brands and it is likely that new conglomerates will form in the coming years.<sup>[18]</sup> Another factor pushing the industry towards greater concentration and transparency is the increasing presence of private equity funds, attracted by the high profitability of the sector: it is *common lieu* that any luxury business achieves a two-digit EBIT margin at group level even in the worst years.

Such two phenomena are leading – as in many other industries – to an increased share of the global turnover being implemented through infra-group transactions: the transfer pricing perimeter for the industry is destined to constantly increase.

Additionally, the luxury fashion businesses are increasing the number and dimension of central functions and shared services among subsidiaries (some core, some ancillary): again, this will lead to increasing volumes of infra-group transactions in the coming years.

The need for central functions comes from many factors. The luxury fashion consumer is global and moves in a global environment, hence brand communication, customer engagement, retail management, merchandising strategy and product creation must be more and more uniform and centralized.

Omnichannel strategy (which is, total integration between the physical and digital distribution channels, so-called “phygital”) and new customers are demanding a wide range of after sale services. Personalized assistance, delivery and pickup, repair, remote returns, and customization are a must-have for all brands. Consequently, stock management, logistics, IT infrastructure, service hubs and retail training are playing a crucial role in delivering such services in a timely and effective way.

Digital transformation has been a cross-industry mantra in these last years. In luxury fashion the problem can be conceptually split into three parts: the creative part, the customer engagement and retail transformation part and the production area part.

3D design and prototyping have been used and developed in the recent years. The industry has been able to attract talent and innovate, enhancing cost efficiency in the creation and product development process.

Digitization of physical retail appears to be slower than expected, but the new functionalities available through augmented reality and biometrics are one of the key drivers for the future of e-commerce (and the whole of retail). Digital presence is the more and more focused on content and engagement, through communication of the brand values and digitalization of the luxury experience. Crypto currencies are already accepted for retail payments by various brands. Metaverse and non-fungible tokens now seem to open a new distribution channel.

On the industrial side the sector is still struggling to make the transformation happen. IT integration with external producers, forecasting and resource/stock planning using artificial intelligence, blockchain certifications of the supply chain and process digitalization through co-working IT tools are just some of the key challenges for the next years.<sup>[19]</sup> The only new technology widely adopted is radio-frequency identification, used both for counterfeit and logistics purposes. Brands belonging to the largest groups are 2.1 times faster than competitors in experimenting and adopting the new technologies.<sup>[20]</sup>

To summarize, in the next four to five years the whole industry is going to transform its way of doing business, trying to capture innovation trends from other sectors, understand the changing taste and needs of its consumers and ultimately maximise growth and profitability in a sustainable way.

## 3. Typical Operating Models in the Industry Sector Considered

### 3.1. Stars, hubs and conglomerates

A business in the luxury fashion industry typically operates according to one of the following models:

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17. A peculiar feature of Italy is the presence of various specialized manufacturing districts, composed mainly by family-owned small to medium-sized enterprises, such as the Tuscan leather district, the silk district in the Como area (Lombardy), the sneakers district in the surroundings of Lecce (Apulia), the jewellery districts of Arezzo (Tuscany) and Valenza (Piedmont), and so on.
  18. Every now and then the idea of an Italian luxury conglomerate is spoken of, but until now only French brands were able to pursue a consolidation strategy. The latest talk about the Italian alternative to the big French Groups came from Renzo Rosso, founder and majority shareholder of OTB: see <https://www.businessoffashion.com/articles/luxury/diesel-comeback-reignites-otbs-ambitions-to-build-italian-fashion-empire/> (accessed 28 Nov. 2022).
  19. See F. Scucciati, *The 10 challenges for today's Fashion and Luxury industry* (The European House – Ambrosetti, Feb. 2022).
  20. For the status of technology innovation in the industry, see Comité Colbert – Bain & Co., *Luxe et technologie. Les débuts d'une nouvelle ère* (Sept. 2022), available at [www.comitecolbert.com/app/uploads/2022/09/comite-colbert-x-bain-rapport-luxe-et-technologie-2022.pdf](http://www.comitecolbert.com/app/uploads/2022/09/comite-colbert-x-bain-rapport-luxe-et-technologie-2022.pdf) (accessed 28 Nov. 2022).

- “Stellar” mono brand group model. Here staff functions, central core functions, IP rights, creative department, R&D, production and first level distribution (hence, logistics) are concentrated in one legal entity, which is the ultimate parent company as well. This model may encompass regional distribution hubs and/or headquarters, such as Hong Kong or Singapore for Asia-Pacific, the United States for the Americas and so on.
- Hub-based model. Under this model certain key functions are separated and distributed along the supply chain, e.g. Luxembourg or Dutch IP owner, UK design centre, Italian or Eastern European R&D centre, Swiss or Italian logistic hub, Italian, French or Chinese manufacturer, French or Italian formation hub, and so on.
- Big conglomerates. Born through acquisitions of single brands, for some years their headquarter functions have been limited to top management, finance and M&A, leaving each brand independent and allowed to maintain its original group structure. Lately, certain key functions are centralized for all or some brands in the portfolio, such as logistics, after sales services, e-commerce and digital, manufacturers (specialized in certain product categories), and so on. In this way, groups are achieving economies of scale, verticalizing the production of certain merchandise categories and empowering digital and after sale services innovation on a larger investment scale.

Of course, certain features of each model can be mixed in the operating structure of each business.

### 3.2. The shift to retail

The entire sector has been inexorably shifting from wholesale to retail distribution in the last three decades. Regardless of the model, all businesses operate DOS through local limited-risk distributors (LRD) under exclusive retail distribution licence for a single market.

Retail allows direct control over brand positioning, customer experience, after sale services, visual merchandising, operational excellence and merchandising intelligence.

In recent years, central functions were developed and empowered to guide and support retail operations, enhancing consistent brand image and communication. Typically, a central function sets up strategy and goals, action plans, projects and field marketing initiatives and gives guidelines and drives the global budget, while local functions in LRD execute plans and guidelines provided by central functions.

The big conglomerates are striking deals with all the main malls around the world, securing prime locations for a certain number of their brands, sometimes getting discount on rent rates. Consequently, brands from the second and third tier are struggling to get the better locations and are sometimes paying a higher rent – lower traffic and higher costs negatively impact their profitability compared to brands belonging to conglomerates.

### 3.3. Licences

Presently it is common for *maisons* to license out their brands for the production and distribution of non-core products, such as glasses, watches, perfumes, skin care and make-up, hotel amenities, and accessories. Essilor Luxottica dominates the eyewear market, being the largest licensee of luxury brands.<sup>[21]</sup>

In the past it was not uncommon to have a licensed casual, sport or jeans line, but the phenomenon progressively disappeared during the 2000s. For example, in 2010 Dolce e Gabbana discontinued their successful D&G casual line to re-position their brand higher in the luxury pyramid.

In recent years some major brands have internalized the production of certain non-core lines. In 2015 Kering created the Kering Eyewear division, internalizing the production and distribution of glasses for the major brands of the group, starting from Gucci. On the other side, in 2021 Ferragamo discontinued the internal production of perfumes and hotel amenities, licensing it to a third party. Chanel has its own history as a pioneer, creating perfumes and cosmetics since 1924.

### 3.4. Producers and industrial districts

Many brands were born as outstanding producers of one single merchandising category: Louis Vuitton and Prada were luggage manufacturers, Hermès produced horse-riding leather goods and accessories, Ferragamo and Tod's were leading shoemakers and so on. All brands progressively became total look designers and producers, using external high-end manufacturers to complete their product offer.

All players in the industry have this mix of internal and external production, and even if they are expanding along the supply chain, they leverage on manufacturing districts to secure variety and excellence in product.

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21. The main luxury brands licensed to Essilor Luxottica are: Burberry, Bulgari, Chanel, Dolce e Gabbana, Ferrari Automobiles, Giorgio Armani, Miu Miu, Prada, Ralph Lauren, Tiffany & Co. and Versace. Revenue in 2021 amounted to EUR 17.9 billion.



## 4. Transfer Pricing Considerations

Luxury fashion businesses are highly profitable, present all over the world and their business model mostly relies on intangible-generated added value, hence they represent fertile terrain for transfer pricing based challenges from tax authorities all over the world.<sup>[22]</sup> End markets are pushing for profit split methods through the enlargement of the concept and relevance of marketing intangibles. Despite the BEPS guidance on the matter, the post-BEPS era still needs to address some of the issues that BEPS intended to solve.

### 4.1. The land of intangibles

Trademarks and logos take the lion's share among the intellectual property rights in the industry: brand is king – it has always been, and it is today more than ever. Iconic details and logos embedded in products (such as the LV monogram of Louis Vuitton, the GG of Gucci, the crossed CC of Chanel, Bottega Veneta's twined leather and so on) are usually registered as trademarks as well. As a consequence, DEMPE testing should be the starting point of any FAR analysis.

Each collection implies the development and registration of thousands of new designs and models, created through a complex designing and prototyping process, which constitutes the core of the R&D activity in the industry, including extensive research of new materials.

Patents have played an important part in the past, with many brands coming from a history of product excellence and innovation. As an example, Salvatore Ferragamo registered many patents in the first decades of the 20th century while inventing the modern women's shoe. In more recent years patents have become residual in luxury fashion's landscape, but it is likely that the innovation towards sustainability and a circular economy will see a new era of patents for raw materials and processes: patents will be relevant again. Manufacturers, then, may hold patents in the near future, provided they have an R&D centre able to invent and register patents. If not, they will need a licence to use patented innovative materials and processes from third parties.

Know-how is legally protected in a few legal systems and is tricky to register; most of the time it can be used as comparability factor.

### 4.2. One brand, many channels

The industry is characterized by a multitude of distribution channels. Retail includes directly owned mono-brand stores and outlets, branded corners or shop-in-shops, and licensed departments/concessions. The e-commerce channel is composed of brand.com, concessions, marketplaces, and multi-brand clients' platforms. The wholesale channel includes multi-brand retailers (department stores), mono-brand stores operated by third parties, and travel retail (mainly airports and downtown duty free).

The first transfer pricing issue here is how to properly remunerate each player along the distribution chain, based on risks assumed, functions performed and economics of the channel (assets owned are usually absent or residual). Internal comparables may differ from the tested parties in some ways, and comparability adjustments shall be needed. For example, travel retail relies more on carry-over items (i.e. products sold through more than one season), hence the inventory risk is lower than in DOS. Multi-brand retailers leverage on the variety of their offer and can better seize the momentum of one brand or product type, balancing risk in an efficient way.

How to recognize the existence of marketing intangibles and how to remunerate them is maybe the trickiest issue. The BEPS Final Report on Actions 8-10 has undoubtedly brought useful clarifications, but the new economies loudly advance different points of view and are keen to be more aggressive when it comes to the existence and remuneration of marketing intangibles.<sup>[23]</sup>

We may say that local limited-risk distributors are increasingly limited in their power to set up specific market strategy, to assume risks and to drive performance. Central functions increasingly guide their operations through group strategies, policies and training. On the other hand, the hit of the pandemic on luxury retail has shown us that market risk is riskier than we thought. Still, most principals made contributions to LRD to stop/limit their losses: a "pain-sharing" approach seems the most appropriate one for the industry in the years 2020 and 2021.<sup>[24]</sup>

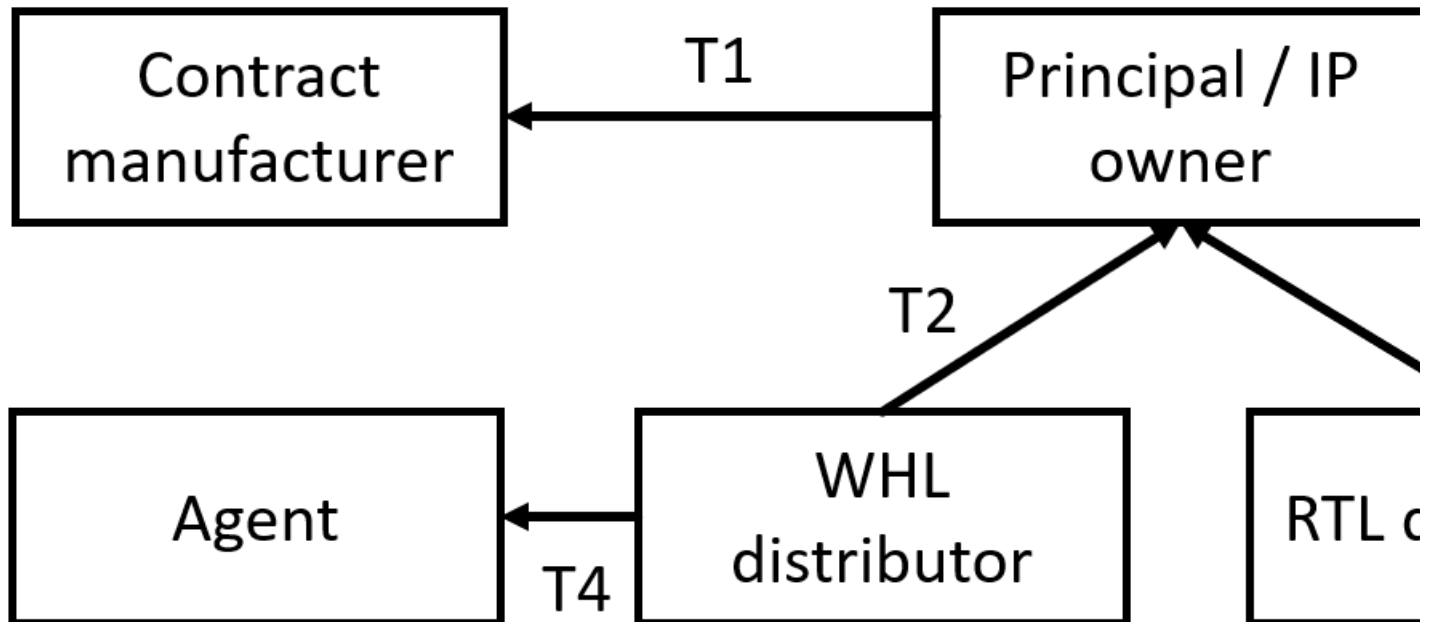
- 
22. See M. Levey, *The Bare Truth About Luxury Business & Tax*, Luxury Society (2015):  
Transfer pricing is a fertile issue for Luxury & Fashion companies due to the inherent subjective nature of the area and the vast potential revenue that may be placed in issue. [...] taxing authorities are seeking the same revenues within a supply chain ...
23. See United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (2021), Part D – Country practices, available at [www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-10/Transfer%20Pricing%20with%20new%20cover.pdf](http://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2021-10/Transfer%20Pricing%20with%20new%20cover.pdf) (accessed 28 Nov. 2022).
24. Despite that OECD Guidance on the impact of the pandemic basically resulted in a case-by-case approach recommendation, the pain-sharing approach appears to be consistent with the considerations included in the guidance. The first APAs covering the pandemic years, signed in the last months, have either used adjusted indicators or comparable searches including 2020. See OECD, *Guidance on the transfer pricing implications of the COVID-19 pandemic* (Dec. 2022), available at <https://www.oecd.org/coronavirus/policy-responses/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic-731a59b0/> (accessed 28 Nov. 2022).



### 4.3. Transactions and how to manage them

The typical infra-group transactions in the luxury fashion sector can be schematized as shown in the Figure (where the arrows indicate payment flows).

Figure – Infra-group transactions in the luxury fashion sector



**T1 = Production of finished goods**

**T2 = Sale of finished goods to a wholesale distributor**

**T3 = Sale of finished goods to a retail distributor**

**T4 = Agency activity in the interest of a distributor**

**T5 = Licence of trademark (general or for specific product categories)**

**T6 = Rendering of service (core or ancillary)**

Apart from the right transfer pricing method to be applied, it is important that the infra-group agreements regulating such transactions conform to the arm's length behaviour, i.e. the contractual regulations should align to agreements of the same kind entered into between third independent parties. Of course, this applies even more so when internal comparables are available.

#### T1 – Production of finished goods

It is very common to find all kind of external and internal comparables for this transaction, since production is often externalized in the industry. This is even more true for Italian brands, still widely leveraging on the variety, efficiency and flexibility of the Italian manufacturing districts. Hence, the transaction can be easily priced according to the CUP, cost-plus or RPM methods.

Brands often purchase raw materials and externalize only the *façon*. It is not uncommon that the largest external manufacturers have raw material warehouses and product facilities exclusively dedicated to one brand. Quality control by the brands is always very strict, and sometimes a certain minimum threshold of defectiveness (1% or so) is accepted without penalty applied.

#### T2 – Sale of finished goods to a wholesale distributor

Distribution agreements are usually limited to a geographic area and/or a distribution channel (travel retail/domestic retail).

Internal comparables usually show an average gross margin guaranteed for each product order. The difference between a “light” distributor (e.g. having no warehouse) and an agent can be difficult to establish from an economic standpoint, despite the legal arrangements. In such a case, the gross margin achieved should be similar.

Provisions on the right of return are key in determining the kind of inventory risk borne by the distributor; in case of differences between related and unrelated parties, comparability adjustments are needed.

The parties usually agree to share advertising, marketing and promotion expenses (AMP): the distributor is obliged to invest a certain percentage on the turnover, under strict control and direction by the brand, which in its turn contributes to such expenses in a certain percentage (20 to 50% is the most common range). Such AMP contributions are key in the DEMPE analysis, constituting ultimately the cost borne by the brand owner for enhancing the brand awareness even where the marketing and communication activities are not directly performed. The same applies to AMP contributions in other transactions.

At the end of the contractual term, the distributor may be obliged to pass to the principal the list of customers, sometimes for consideration. Such a clause should be included in infra-group arrangements as well. Also, whenever distribution rights are transferred from a subsidiary to another one, the latter should pay a lump-sum amount to the former distributor for the customer list, the assignment of the commercial agreements in place and generally out of goodwill, possibly applying a discounted cash-flow method in determining the transfer price.

### **T3 – Sale of finished goods to a retail distributor**

Retail distributors can operate mono-brand stores and shops-in-shop. The distribution rights are always exclusive and limited to a country/region. When the rights are granted to third parties, they are often referred to as “franchisees”. In distribution agreements with third parties, the licensor is usually obliged to pay two kinds of contributions: (i) CapEx contributions for the layout of newly opened or renovated mono-brand stores; and (ii) AMP contributions. On its part, the distributor guarantees the AMP investment to be at least a certain percentage on the turnover (5% to 9% is pretty common, depending on the maturity and strategic importance of the market). TNMM is extensively used in APAs covering LRD all over the world.

### **T4 – Agency activity in the interest of a distributor**

The contractual scheme is less and less common between third parties and brands, due to the increasing need for the latter to control brand positioning and selective distribution worldwide. Yet, it can be useful in infra-group relationships, leveraging on proximity to certain wholesale markets by certain managers or divisions.

Agency agreements with third parties usually include: (i) an additional/premium agency fee in case of overperformance; (ii) strict rules excluding the agent from entering into any agreement with customers; (iii) non-competition clauses or limitations to the number and positioning of brands the agent can represent; and (iv) end-of-term indemnification according to national legislations. Commission should be based on CUP. When no comparable agents are available, light distributors can be used as comparables, with adequate adjustments.

### **T5 – Licence of trademark (general or for specific product categories)**

The general licence of trademark as a phenomenon has mostly disappeared. In the past, common cases were: (i) the licence granted by the owner of a once successful trademark, or of a niche brand, to a third party intending to relaunch or expand the brand; or (ii) the infra-group licence of the trademark to the principal by a low-tax jurisdiction entity, mostly for tax planning purposes. The latter structure has been jeopardized and hence outdated by the BEPS Project and the introduction of the DEMPE test. Due to the lack of exact comparables, CUP may be difficult to apply, unless extensive comparability adjustments are made. Profit split may be the solution, where of course intangibles are owned on both sides of the transaction.

Instead, it is still very common practice – as illustrated in section 2. – to license for specific non-core product categories such as eyewear, perfumes, cosmetics, watches, accessories.

Licence agreements with third parties usually show: (i) minimum guaranteed royalties per year; (ii) design guidelines by the brand; (iii) brand approval of the merchandising set-up of each collection; (iv) AMP contributions paid by the licensee for collection campaigns paid for the brand and including licensed products; (v) selective distribution and AMP investment obligations for the licensee; and (vi) strict rules attributing to the brand the right to exercise control and direction over the marketing and communication strategy.

In case of such licences to internal divisions producing non-core products, CUP would be easily applicable.

### **T6 – Rendering of service (core or ancillary)**

The author extensively mentioned in the first part of this article the business trends in the industry leading to an increased number of services rendered infra-group. The crucial point here in applying the OECD Guidelines lies in the distinction between low value-adding services and core ones: in certain cases, the business transformation makes the analysis more uncertain. For example, designing, building and maintaining an e-commerce platform integrated with retail operations and logistics (enabling omnichannel), consistent with the brand image and able to enhance customer engagement strategies, may be seen as an IT service (yet a sophisticated one) to be simply charged back according to mere cost sharing, or deemed as a value-adding activity to be remunerated.

## 5. Summary/Outlook

Luxury is nowadays recognized as an industry and, within the industry, luxury fashion is the second largest sector. High profitability, worldwide physical presence and strong leverage on intangibles make the businesses of this industry ideal targets for transfer pricing scrutiny.

The industry dynamics are rapidly transforming and are at the dawn of a new era: the change is driven by the digital revolution and the younger consumers rapidly gaining shares of the market.

A cultural shift for the whole sector is on its way, and the capability of each player to adapt its business model and make investments in the right direction will be crucial to winning competition and profiting from the non-stop growth of luxury fashion.

New transfer pricing issues are already adding to the existing ones. Expansion along the supply chain by all major players is leading to the progressive lack of comparables, which will make transactional profit methods the more and more appropriate. Double taxation remedies are still costly and slow: APAs may be the only solution for businesses to effectively manage their transfer pricing and secure tax risk worldwide. The post-BEPS era still needs to address some of the issues that BEPS intended to solve, finding viable and more rapid remedies to double taxation and controversies.

## International

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# Tax Challenges Arising from the Digitalization of the Economy: The Calculation of the Effective Tax Rate – Pillar Two versus Financial Accounting

Under Pillar Two, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting members have agreed to enact a jurisdictional-level minimum tax system with a minimum effective tax rate of 15%. Multinational enterprises and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million will be within the scope of Pillar Two. In this article, the authors discuss the relevant rules for calculating the effective tax rate (ETR) under Pillar Two. Subsequently, the authors will compare these rules with the rules that are applied to calculate the ETR under financial accounting. The main aim of this article is to set out the key differences between the ETR calculation under Pillar Two and financial accounting. For the comparison, the authors take the International Financial Reporting Standards (IFRS) as the applicable accounting standard under financial accounting.

## 1. Introduction

Today one of international taxation's greatest challenge lies in the tax challenges arising from the digitalization of the economy. This is exactly why the Organization for Economic Co-operation and Development (OECD) – as a result of its work following the Base Erosion and Profit Shifting (BEPS) Action 1 – initiated a plan that (can) have a major impact on (international) taxation and the accounting thereof. This is the reason why – although still a work in progress and further and relevant OECD documentation is still becoming available – the authors believe it is warranted to discuss it already and provide the reader with a sound understanding of the OECD's pillar plans and potential consequences. The authors focus in this article on the tax accounting consequences of especially Pillar Two and its respective top-up tax.

As of October 2021, over 135 countries and jurisdictions have joined a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate.

The reason(s) for this new two pillar system is relatively simple. It is now becoming increasingly clear that the current and nearly 100-year-old (international) tax system – in its current form – no longer functions properly. In principle, this system is in line with the physical presence of companies: taxation also takes place where the company is established. For the levy of taxes on the profit, the supply side is used instead of where the market is located (the demand side).

In the pre-war economy, where the vast majority of goods and services were produced for the national market, such a basic assumption made sense. Cross-border companies – if there were any – were not yet working with centrally-driven business models. In fact, communication technology and physical distances made this impossible. To the extent that these companies did operate across borders, they had completely independent operating companies in the various jurisdictions. A profit allocation focused on the supply side was therefore appropriate for the business model.

However, 100 years later in the current era of 'elusive' internet giants, centralized and massively operating across national borders, the above no longer applies. The business model is no longer appropriate for a supply-side profit allocation. The view that the current system should be revised is therefore becoming increasingly widespread.

In addition, with the rise of the globalized economy, tax avoidance and evasion are an increasingly serious problem. Anti-abuse measures, national and international, have been introduced in recent decades. The OECD BEPS Project and the European Union's Anti-Tax Avoidance Directives have recently brought international reforms, but the end is probably far from in sight.

The most recent OECD proposals are to distribute tax revenue more fairly (through the so-called Pillar One proposal) and to levy tax more fairly by introducing a minimum profit tax (through the Pillar Two proposal).

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Although 140 countries are members of the OECD Inclusive Framework (IF) and it is therefore an enormous challenge to achieve political agreement on the details of the reform of the international corporate tax system, 137 countries (as of 4 November 2021) reached a historic agreement on Pillar One and Pillar Two.

## 1.1. Pillar One – A fairer distribution of tax rights

The aim of Pillar One is to achieve an adjustment of the international corporate tax system whereby profits and tax rights are allocated to the jurisdictions where companies carry out activities. These are the so-called market jurisdictions. As a result of the digitization of the economy, it is no longer necessary for companies to have a physical presence in every jurisdiction, i.e., an entity or permanent establishment from which the activities are carried out. As a result, in recent years a discrepancy has arisen between where activities are carried out, where profits are made and where companies are taxed.

Under Pillar One's so-called "unified approach", it is sufficient for a company to make turnover in a certain jurisdiction for the allocation of taxing rights. In short, Pillar One focuses on multinational companies with a global turnover of more than EUR 20 billion and a profitability of more than 10% (the profit before tax divided by the turnover, the 'residual profit'). EncoPol Europe expects that less than 80 multinational companies will be affected by Pillar One. Depending on a successful implementation, the turnover threshold could be lowered to EUR 10 billion after seven years. As a result, only the largest and most profitable companies will fall under Pillar One. Exceptions are proposed for companies engaged in regulated financial services and natural resources (currently subject to consultation).

The exact interpretation of the reallocation of tax rights under Pillar One is still subject to a political compromise. Based on the Pillar One Blueprint and the statement of the IF of 1 July 2021,<sup>[1]</sup> the taxing rights are allocated on the basis of two components:

- Amount A: a new taxing right for market jurisdictions to which a portion of a company's non-routine profit is allocated.
- Amount B: a standard fee for routine marketing and distribution activities based on the well-known arm's length principle (ALP).

In this article, the authors will not further discuss the technical details around (and calculations of) Amount A and B and the possibilities for the avoidance of double taxation in this contribution. As said, the authors focus on the (in their view) more interesting and (potentially) more impactful part of the two-pillar plan and that is that of the minimum taxation called Pillar Two.

## 1.2. Pillar Two – A minimum profit tax

Where Pillar One focuses on the redistribution of tax rights between countries, Pillar Two focuses on combating residual base erosion and profit shifting (the so-called Global Anti-Base Erosion, GloBE) by introducing an (effective) minimum profit tax of 15%. Although the OECD has not previously expressed an explicit opinion on the level of the minimum rate, most countries within the Inclusive Framework (IF) have now supported the agreement on the introduction of a worldwide minimum rate for profits tax of 15%.<sup>[2]</sup>

The purpose of Pillar Two is twofold. First, Pillar Two aims to make it less attractive for companies to shift profits to low-tax jurisdictions. In addition, Pillar Two must stop the so-called "race to the bottom". The latter has to do with the situation where countries compete with each other on their corporate tax rate to ensure that they retain the companies already established in their country and attract new companies.

Pillar Two aims to ensure that multinational companies always pay a minimum level of profit tax. If a multinational company has to be taxed effectively at a minimum rate, it is no longer attractive for countries to continue with mutual tax competition (at least not below the minimum rate to be determined). To achieve this minimum level, the OECD has introduced a 15% minimum profit tax accompanied by two interlocking domestic rules (together commonly referred to as the GloBE rules).

The Income Inclusion Rule (IIR) is Pillar Two's primary rule, flanked by other measures to ensure that the IIR can come into its own. The precise interaction and ranking depends on political consensus and the precise design of the measures. It is essential that double taxation is avoided as much as possible.

The IIR includes an additional levy at the level of the (ultimate) parent company if and insofar as the ETR of the subsidiary (or permanent establishment) is below the minimum rate. It is assessed per jurisdiction whether or not the subsidiary in that country complies with the effective minimum rate (in other words, the so-called per-jurisdiction approach). In fact, this additional tax principle already exists in the current controlled foreign company (CFC) provision (resulting from the first BEPS Project) that deals with passive income, such as interest and royalties. With the introduction of the IIR, active income is also brought under the scope of the additional tax mechanism.

Next to the IIR, a so-called "undertaxed payment rule" (UTPR) has been introduced. The UTPR acts as a backstop to the IIR. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity (UTPR taxpayers) under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction.

1. OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy (OECD 2022), available at <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>.

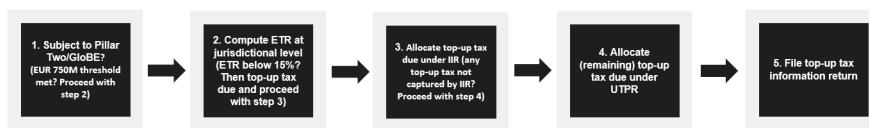
2. J. Rond et al., *Internationaal fiscaal stelsel na 100 jaar toe aan verandering*, PwC Spotlight 2021 3rd edition, pp. 27-34 (2021).

Both the IIR and UTPR will only apply in group relationships. It has been proposed to align the GloBE rules as much as possible with the principles already in force for country-by-country (CbC) reporting, such as the turnover threshold of EUR 750 million. Pillar Two introduces an effective minimum profit tax, which means that, in addition to the minimum rate, consensus must also be reached on a somewhat common base determination. Financial reporting (such as IFRS or US GAAP) can serve as a basis for determining the tax base. Where the market approach in Pillar One is an unprecedented “game changer”, the choice to no longer take the taxable profit, but commercial profit, as the starting point for the tax base is in Pillar Two.

In the precise design of Pillar Two, both the feasibility of the rule and the shaping of the measure in line with the objective are important. In light of this, it has therefore been suggested to exclude certain sectors from the minimum profit tax. Examples include excluding government enterprises, non-profit organisations and investment and pension funds.

As said in the introduction to this section, the authors believe that the (possible) introduction of the two-pillar system and especially the introduction of Pillar Two (can) have a major impact on (international) taxation and the accounting thereof. Without going into too much detail, the, in the authors’ view, complex rules and required calculations to determine whether or not a top-up tax is due – if it is determined that the minimum percentage is not met – create a whole new world of GloBE accounting rules. To illustrate these new rules and the general mechanics of Pillar Two, a five-step process overview of Pillar Two has been included in Figure 1.

**Figure 1 – General overview of Pillar Two**



Pillar Two introduces a jurisdictional-level minimum tax system with a minimum ETR of 15%. Multinational enterprises (MNEs) and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million are within the scope of Pillar Two (step 1).

If an MNE group is within the scope of Pillar Two, an ETR should be in principle calculated for each jurisdiction in which the MNE group is active. If the ETR for a certain jurisdiction is below the minimum rate of 15%, then a top-up tax is in principle due (step 2).

Pillar Two consists of two domestic interlocking rules to allocate the top-up tax due within the MNE group. The primary rule is the IIR. The IIR works by imposing a top-up tax on a parent entity in respect of the low-taxed income of group entities. The IIR applies on a top-down basis, which means that it is applied by the entity that is at, or near, the top of the ownership chain in the MNE group. In general, the top-up tax will be allocated to and levied at the level of the ultimate parent entity (UPE) (step 3).

It could be the case that the top-up tax due as determined under step 2 is not fully allocated under the IIR. For these cases, the UTPR will apply. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction. The UTPR acts in essence as a backstop to the IIR (step 4).

Pillar Two also introduces new filing obligations. Information that is used to compute the Pillar Two ETR and corresponding top-up tax has to be disclosed in a so-called top-up tax information return. This return has to be filed with the tax authorities no later than 15 months after the last day of the fiscal year (step 5).

In the following sections of this article, the authors will discuss each step in more detail. The primary focus in this article will be on step 2 – the calculation of the Pillar Two ETR – because the authors believe it will be predominantly this step that will result in the most questions and complexities. The main reason being that the relevant rules for calculating the ETR under Pillar Two differ (significantly) from the rules that are applied to calculate the ETR under financial accounting.

*Note: This article does not purport to address Pillar Two in full detail. This article is based on information available up to 31 August 2022 and includes details of the Pillar Two Blueprint dated October 2020 [3] (Pillar Two Blueprint), GloBE Model Rules dated 20 December 2021 [4] (GloBE Model Rules), the draft Pillar Two EU-Directive dated 16 June 2022 [5] (Pillar Two EU-Directive) and the Pillar Two Commentary dated 22 March 2022 [6] (Pillar Two Commentary).*

3. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020) [hereinafter Pillar Two Blueprint], available at <https://doi.org/10.1787/abb4c3d1-en>.
4. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* (OECD 2021) [hereinafter GloBE Model Rules] available at <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>.
5. European Commission, Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, 16 June 2022, [hereinafter Draft Pillar Two EU-Directive] available at <https://data.consilium.europa.eu/doc/document/ST-8779-2022-INIT/en/pdf>



## 2. Scope

MNEs with an annual global consolidated revenue above EUR 750 million in at least two of the four fiscal years immediately preceding the tested fiscal year will be within the scope of Pillar Two. In addition, so-called large-scale purely domestic groups in an EU Member State that meet the aforementioned revenue threshold will also be within the scope of Pillar Two.<sup>[7]</sup> The latter is implemented in order to ensure compliance with the fundamental freedoms of the European Union.

Entities that are excluded from Pillar Two are government entities, international organisations, non-profit organisations, pension funds, investment funds and real estate investment vehicles which are ultimate parent entities of a MNE group (so-called “excluded entities”). Pillar Two also includes an exception for constituent entities (i.e., entities that are part of an MNE group or a large-scale purely domestic group. Hereinafter: CE) that are largely investment or ancillary vehicles whose shares are predominantly held by excluded entities.<sup>[8]</sup> For the latter group of entities, Pillar Two provides for an election not to treat such entities as an excluded entity. This election is a five-year election and has to be specified in the so-called top-up tax information return that has to be filed with the local tax authorities (see section 6.).

Elective GloBE safe harbour rules have also been announced to reduce administrative burdens, where particular operations of an MNE are almost certain to be taxable above the minimum rate of 15%. These rules will be further established as part of the work undertaken by the IF to develop the GloBE Implementation Framework. The GloBE Implementation Framework will facilitate the coordinated implementation and contains administrative guidance of the Pillar Two rules and is expected to be published at the end of 2022.

## 3. The Calculation of the Jurisdictional Effective Tax Rate

### 3.1. Introduction

If an MNE group falls within the scope of Pillar Two, it should first calculate the ETR of each jurisdiction in which the MNE operates. Pillar Two provides for an election to apply the so-called “de-minimis exclusion” where jurisdictions with average revenues and profits (both determined pursuant to Pillar Two standards for the current and the two preceding fiscal years) below EUR 10 million and EUR 1 million respectively are excluded from the ETR calculation.<sup>[9]</sup> This election is a one-year election and has to be specified in the Top-Up Tax Information Return that has to be filed with the local tax authorities (see section 6.).

Unlike the ETR that is calculated under the financial accounting standards (which is usually calculated at entity or consolidated level), Pillar Two prescribes that the ETR should be calculated at a jurisdictional level. Hence, Pillar Two has its own ETR concept, which is further illustrated hereafter.

Under Pillar Two, the ETR is determined by dividing the amount of adjusted covered taxes (i.e., the Pillar Two total tax amount) by the amount of net qualifying income (i.e., the Pillar Two tax base). First, both determinants have to be calculated for each CE separately. Subsequently, the adjusted covered taxes and qualifying income of the CEs located in the same jurisdiction are aggregated to arrive at the jurisdictional adjusted covered taxes and net qualifying income. Dividing both jurisdictional amounts then gives the Pillar Two ETR (jurisdictional ETR). The aforementioned can be illustrated by the following equation:

<p><b>Jurisdictional ETR =</b></p> $\frac{\text{Aggregated adjusted covered taxes in jurisdiction (numerator)}}{\text{Aggregated net qualifying income in jurisdiction (denominator)}}$
-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

6. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD 2022) [hereinafter Pillar Two Commentary], available at <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>

7. Art. 2 para. 1 Draft Pillar Two EU-Directive.

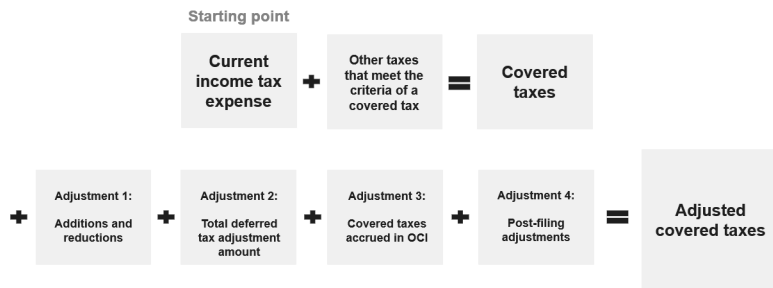
8. Id., at art. 2 para. 3.

9. Id., at art. 29.

## 3.2. Adjusted covered taxes (Chapter IV Directive)

Pillar Two introduces its own tax classification. Taxes that are regarded for Pillar Two purposes are presented as so-called “covered taxes”. To arrive at the adjusted covered taxes, four major sets of adjustments have to be made on the covered taxes. The relevant steps to compute the adjusted covered taxes (numerator) under Pillar Two is summarised and illustrated in figure 2.

**Figure 2 – High-level overview adjusted covered taxes**



### 3.2.1. Covered taxes

The starting point is to take the current tax expense accrued in the financial accounting net income or loss of the relevant CE. Under Pillar Two, the following taxes are considered as covered taxes: (i) any tax amount recorded in the financial statements with respect to an entity’s income or profits; (ii) taxes on (deemed) distributed profits; (iii) any taxes imposed in lieu of a generally applicable income tax; and (iv) taxes on retained earnings and corporate equity.<sup>[10]</sup>

Taxes resulting from Pillar One and the so-called “subject to tax rule” (STTR) are also considered as covered taxes for Pillar Two purposes (i.e., both taxes increase the numerator of the jurisdictional ETR). The STTR is a treaty-based rule within Pillar Two that would apply to royalties, interest, and other defined payments (covered payments) made by a CE located in a developing country to another CE located in an IF member state that applies a nominal corporate tax rate lower than a minimum STTR rate of 9% on the payment. The effect of the STTR will be to allow the payer jurisdiction to apply a top-up tax for the difference between the STTR minimum rate of 9% and the (lower) tax rate that would otherwise apply to the payment. The STTR is reduced by the amount of withholding tax (WHT) that is already levied under a double tax treaty. Therefore, the STTR is expected to have a limited tax impact in practice.

Pillar Two also prescribes several rules on the allocation of covered taxes to the several jurisdictions. Taxes that may require allocation include CFC taxes, distribution taxes and taxes in respect of a permanent establishment, tax transparent entity or a hybrid entity.

#### 3.2.1.1. Comparison with financial accounting

The definition of covered taxes includes taxes levied in lieu of a generally applicable corporate income tax. The “in lieu of” part includes taxes that are not covered under the generally applicable income tax definition, but which operate as substitutes for such taxes. As an example, Pillar Two mentions tonnage taxes that use income earning capacity as a proxy for income and are designed to act as a substitute for corporation tax.<sup>[11]</sup> The definition of taxes is therefore broader under Pillar Two.

Secondly, the authors would like to point out that the STTR tax is in essence a top-up tax/additional WHT on covered payments (e.g., interest and royalties) that is ultimately borne by the recipient entity. From a tax accounting perspective, it should be considered whether these taxes are within the scope of IAS 12.<sup>[12]</sup> IAS 12 is silent on the treatment of WHTs related to interest and royalties in the recipient’s financial statements. If a reporting entity has determined that the WHT is within the scope of IAS 12, it should present the WHT on the income tax line in the profit and loss (and hence the WHT will be taken into account as taxes in the calculation of the financial accounting ETR). If a reporting entity has determined that it is not an income tax, the WHT is presented above the income tax line (e.g., as operational expenses and hence it will not be taken into account as taxes in the calculation of the financial accounting ETR). Under Pillar Two, it is not relevant whether the STTR tax is recorded above or on the tax expense line as it is always considered as a covered tax. As such, the STTR tax will be included in the computation of the jurisdictional ETR.

10. Id., at art. 19.

11. Para. 111 Pillar Two Blueprint.

12. The standard that governs income taxes within IFRS is IAS 12.

Another important difference between Pillar Two and financial accounting relates to the allocation of covered taxes incurred by certain types of CEs, amongst others (i) WHT on dividend distributions and (ii) CFC taxes. Under Pillar Two<sup>[13]</sup>, the WHT related to dividend distributions is considered as a covered tax at the level of the distributing entity, while under IFRS<sup>[14]</sup> the WHT is considered as an income tax at the level of the recipient. With respect to CFC taxes, these are considered as a covered tax at the level of the CFC entity itself under Pillar Two<sup>[15]</sup>, while under financial accounting these taxes are included as part of the income tax in the financial statements of the parent entity that owns the shares in the CFC entity. The rationale behind these allocations under Pillar Two is that in general, the distributing and CFC entity is the one that originally generated the income. Under Pillar Two, covered taxes should be allocated to the tax jurisdiction of the entity that originally generated the underlying income.

### 3.2.2. Adjustment 1: Additions and reductions

After having determined the total amount of covered taxes of the relevant CE, four major sets of adjustments have to be made on the covered taxes. The first set of adjustments to be applied pertains to several additions and reductions to the amount of covered taxes.

#### 3.2.2.1. Additions to the amount of covered taxes:

Pursuant to article 20 paragraph 2 of the draft Pillar Two EU-Directive, the covered taxes should be increased by the following:

- any amount of covered taxes accrued as an expense in the profit before taxation in the financial statements;
- any amount of qualifying loss deferred tax asset (DTA) utilized (further discussed in section 3.2.3.5.);
- covered taxes related to an uncertain tax position (UTP) that were treated as a reduction (see hereafter) in a prior year, but is paid in the current fiscal year; and
- any amount of credit or refund in respect of a qualified refundable tax credit (i.e., a refundable tax credit that will be received in cash/cash equivalents within four years from the moment an entity satisfies the conditions for receiving the credit) that is recorded as a reduction to the current tax expense.

#### 3.2.2.2. Comparison with financial accounting

Under financial accounting, a clear distinction is made between the presentation of income taxes (presented on the income tax line) and other taxes (presented above the income tax line, e.g., as operational expenses). Only taxes presented on the income tax line are taken into account in the calculation of the financial accounting ETR (as also mentioned in section 3.2.1.1.). Under the first addition, any amount of covered taxes accrued as an expense in the profit and loss should be taken into account in the calculation of the jurisdictional ETR, regardless of whether it is accrued on or above the income tax line. This will lead to an increase of the administrative burden of companies as any amount of covered taxes that is accrued as an expense in the profit and loss (so not only the amounts recorded on the income tax line) have to be traced and taken into account as covered taxes in the calculation of the jurisdictional ETR.

From the third addition, it can be derived that current tax expenses which relate to an UTP may be only included in covered taxes unless and until the amount is actually paid. Under financial accounting, a current tax expense related to UTPs (regardless of whether it is paid or not) is considered as an income tax and is therefore always included in the computation of the financial accounting ETR.

Pursuant to the fourth addition, any amount of refund or equivalent credit in respect of a qualified refundable tax credit that has been recorded as a reduction to current tax expense (i.e., current tax benefit) in the profit and loss is added back to the covered taxes under Pillar Two. At the same time, the full amount of the refund or credit will be treated as income in the calculation of the qualifying income (see section 3.3.2.1.). The aforementioned adjustments will have a positive impact on the jurisdictional ETR. The rationale for this rule is that Pillar Two considers qualified refundable tax credits as equivalents to government grants that form part of income, given that they are in effect government support for a certain type of activity that can ultimately be received in cash or cash equivalent.<sup>[16]</sup> As such, the fourth addition will not apply if the refund or credit is already recorded as an income above the income tax line (e.g., as operational/other income) in the profit and loss. Under financial accounting, these refunds or credits will be taken into account in the calculation of the financial accounting ETR if these are recorded on the income tax line.

#### 3.2.2.3. Reductions to the amount of covered taxes

Pursuant to article 20 paragraph 3 of the Pillar Two EU-Directive, the covered taxes should be reduced by the following:

- the amount of current tax expense with respect to income excluded from the computation of the qualifying income;

<sup>13.</sup> Art. 23 para. 5 Draft Pillar Two EU-Directive.

<sup>14.</sup> IAS 12, para. 2.

<sup>15.</sup> Art. 23 para. 3 Draft Pillar Two EU-Directive.

<sup>16.</sup> Ch. 3 paras. 110-114 Pillar Two Commentary.

- any amount of credit or refund in respect of a non-qualified refundable tax credit that was not recorded as a reduction to the current tax expense;
- any amount of covered taxes, except for any qualified refundable tax credit, refunded or credit that was not treated as an adjustment to current tax expense in the financial accounts;
- current tax expense related to UTPs; and
- any amount of current tax expense that is not expected to be paid within three years as from the last day of the current fiscal year.

### 3.2.2.4. Comparison with financial accounting

The key difference here between Pillar Two and financial accounting is that actual payment of taxes is important under Pillar Two (i.e., cash tax paid basis). Under financial accounting, taxes may already be taken into account in the calculation of the ETR if these have been accrued but not paid yet (i.e., accrual basis. For example: taxes related to UTPs or deferred taxes on unremitted earnings (see hereafter)). Under Pillar Two, these taxes are not taken into account until the moment of actual payment. In addition, any amount of current tax expense that is not expected to be paid within three years may also not be taken into account. If it turns out that a current tax expense that was taken into account as a covered tax in a previous year is not paid at the end of the third year, then this amount has to be recaptured pursuant to the post-filing adjustment mechanism in the third year (see section 3.2.5.).

### 3.2.3. Adjustment 2: Total deferred tax adjustment amount

The second set of adjustments relates to the accounting of temporary differences and prior year losses. This is achieved by adjusting the covered taxes for the so-called “total deferred tax adjustment amount”.<sup>[17]</sup>

The starting point is to take *the total deferred tax expense* accrued in the financial statements. Pursuant to chapter 4 paragraph 70 of the Pillar Two Commentary, it is clear that the total deferred tax expense may be either positive (i.e., when total deferred tax expenses exceed total deferred tax benefits) or negative (i.e., when total deferred tax benefits exceed total deferred tax expenses).

In situations where the applicable nominal tax rate is above the minimum rate of 15%, the deferred tax expense has to be recast at (i.e., recalculated to) the minimum rate of 15%.<sup>[18]</sup>

#### 3.2.3.1. Additions to the total deferred tax adjustment amount

Subsequently, article 21 paragraph 3 prescribes that the deferred tax expense should be increased by the following:

- the amount of any disallowed accrual or unclaimed accrual paid during the current fiscal year; and
- any recaptured deferred tax liability (DTL) determined in a preceding fiscal year which has been paid during the current fiscal year.

Disallowed accrual means any movement in deferred tax expenses accrued in the financial statements that relates to either an UTP or distributions from a CE. Unclaimed accrual means any increase in a DTL recorded in the financial statements for a fiscal year that is not expected to be paid within five years. Recaptured DTL stands for the deferred tax expenses related to a DTL that was taken into account in the total deferred tax adjustment amount in a previous year, but that is not ultimately paid within the five subsequent fiscal years. Such DTLs (and therefore also the deferred tax expenses) are then in principle recaptured and treated as a reduction to the covered taxes in the fifth preceding fiscal year (also commonly referred to as the DTL recapture rule). However, if such DTL is still paid in the current fiscal year, then such recaptured DTL may be considered in the calculation of the jurisdictional ETR. In the draft Pillar Two EU-Directive<sup>[19]</sup> and GloBE Model Rules,<sup>[20]</sup> a list is provided that includes items that are not subject to the DTL recapture rule. These items are, inter alia, (i) tangible assets (including IFRS 16), (ii) research and development expenses and (iii) foreign currency exchange net gains. In practice, DTLs related to goodwill or intangibles will likely fall within the scope of the DTL recapture rule as these assets generally have a long lifetime.

For the sake of completeness, the authors would like to point out that the Pillar Two Commentary clarifies that article 4.4.7 of the GloBE Model Rules<sup>[21]</sup> provides for a compliance simplification option with respect to the DTL recapture rule. This article permits (by way of an annual election) a CE to exclude from the total deferred tax adjustment amount any DTL that is not expected to be paid within five years. This simplification allows for the exclusion of DTLs that are almost certain to require recapture, which reduces compliance monitoring such DTLs and recalculating top-up tax five years later.<sup>[22]</sup>

17. Art. 21 Draft Pillar Two EU-Directive.

18. Id., at art. 21 para. 2.

19. Id., at art. 21 para. 8.

20. Art. 4.4.5 GloBE Model Rules.

21. The equivalent article included in the Draft Pillar Two EU-Directive is art. 21 para. 1b.

22. Chapter 4 para. 112 Pillar Two Commentary.

### 3.2.3.2. Comparison with financial accounting

Whereas the Pillar Two Blueprint seemed to suggest that deferred tax accounting is not considered under Pillar Two, the GloBE Model Rules and draft Pillar Two EU-Directive now confirm that deferred tax accounting – to some extent – is applied in the computation of the adjusted covered taxes. However, the deferred tax accounting concept under Pillar Two differs significantly from the concept as applied under financial accounting.

The first major difference pertains to the recasting of the deferred tax expenses at the minimum rate of 15% for situations in which the applicable tax rate is above the minimum rate. Therefore, deferred taxes under Pillar Two could be taken into account at a lower rate (against max 15%) compared to financial accounting (against statutory corporate income tax (CIT) rate of the jurisdiction). The following example may illustrate this.

Assume that CE A has acquired a tangible asset for an amount of 100 on 1 January 20XX. At the acquisition moment, the book and tax value amounts to 100. Assume further that the local tax rules allow for an accelerated depreciation period of 3 years. Under financial accounting, the asset is depreciated over a period of five years. CE A is located in a jurisdiction that applies a CIT rate of 25%. CE A will record the following financial accounting journal entries with respect to the depreciation of the asset:

Debit depreciation expenses (profit and loss line item)	20 (100/5)
Credit tangible asset (balance sheet line item)	20 (100/5)

The tax journal entries are as follows:

Debit depreciation expenses (profit and loss line item)	33.33 (100/3)
Credit tangible asset (balance sheet line item)	33.33 (100/3)

Hence, a temporary difference of 13.33 exists as per year 31 December 20XX (tax book value: 66.67 vs financial accounting book value: 80). This temporary difference will reverse over time and subsequently CE A will pay higher taxes. As such, the difference of 13.33 is also commonly referred to as a *taxable* temporary difference for which a DTL shall be recognized in the financial accounts.<sup>[23]</sup> The journal entry for the recognition of a DTL is as follows:

Debit deferred tax expense (profit and loss line item)	3.33 (13.33*25%)
Credit DTL (balance sheet line item)	3.33 (13.33*25%)

Under financial accounting, the deferred tax expense amounts to 3.33 (recorded on the tax expense line in the profit and loss). As this amount is calculated based on a CIT rate (in this example: 25%) that is above the minimum rate of 15%, the deferred tax expense should be recast against 15%. Therefore, the deferred tax expense that is taken into account under Pillar Two amounts to 2.00 (3.33/25%\*15%) instead of 3.33.

The second difference between Pillar Two and financial accounting relates to the disallowed accruals. These accruals are defined as the movement in deferred tax expenses related to UTPs and distributions.<sup>[24]</sup> The latter pertains to deferred taxes recorded for unremitted earnings and is also commonly referred to as outside basis differences under financial accounting.<sup>[25]</sup> Unlike Pillar Two, these disallowed accruals are considered as deferred taxes under financial accounting, regardless of whether these are actually paid or not in the current year.

At last, the DTL recapture rule is a new concept introduced under Pillar Two. Under financial accounting, deferred tax expenses are taken into account irrespective whether these will be paid or settled within a period of five years.

The aforementioned shows that Pillar Two leans toward a cash tax paid basis for both the current (section 3.2.2.) and deferred (this section) taxes.

### 3.2.3.3. Reductions to the total deferred tax adjustment amount

Subsequently, the total deferred tax adjustment amount should be reduced by the following:

- (1) the amount that would have reduced the deferred tax expense if a local tax loss DTA (not the DTA for qualifying loss election<sup>[26]</sup>) for the fiscal year had been accrued;<sup>[27]</sup>

23. IAS 12, para. 15.

24. Art. 21 para. 1 Draft Pillar Two EU-Directive.

25. IAS 12, para. 39.

26. The qualifying loss election will be discussed later in this article.

27. Art. 21 para. 4 draft Pillar Two EU-Directive.



- (2) Pillar Two provides for a possibility to recast the DTA on a qualifying loss to the minimum rate of 15%, if such DTA has been recorded at a rate lower than the minimum rate. The amount resulting from the recast (i.e., increase of the DTA) should be taken as a reduction of the deferred tax expense;<sup>[28]</sup>
- (3) the amount of recaptured DTL;<sup>[29]</sup>
- (4) the amount of deferred tax expense with respect to items excluded from the computation of the qualifying income or loss;<sup>[30]</sup>
- (5) the amount of deferred tax expenses with respect to disallowed accruals and unclaimed accruals;<sup>[31]</sup>
- (6) the impact of a valuation adjustment or accounting recognition adjustment with respect to a DTA;<sup>[32]</sup>
- (7) the amount of deferred tax expense arising from the remeasurement with respect to a change in the applicable domestic tax rate;<sup>[33]</sup> and
- (8) the amount of deferred tax expense with respect to the generation and use of tax credits.<sup>[34]</sup>

### 3.2.3.4. Comparison with financial accounting

Under financial accounting, a DTA shall only be recognized for unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.<sup>[35]</sup> If there is a history of recent losses, IAS 12 paragraph 35 also prescribes that convincing other evidence should be available that reflects the future taxable profitability of the relevant entity (i.e., heavier burden of proof). From the first reduction, it can be derived that the aforementioned recognition criteria are disregarded under Pillar Two. Under Pillar Two, the deferred tax benefit that would have arisen from the recognition of a DTA on a current year local tax loss should be taken into account in that year regardless of whether the recognition criteria for a DTA on tax losses are met. The rationale of this rule is to prevent the jurisdictional ETR falling below the minimum rate of 15% in a year where a tax loss is incurred. The following example may illustrate this.

In Year 1, CE A incurs a qualifying loss and local tax loss of (100) in jurisdiction A (applicable CIT rate: 25%). Assume that CE A is the only CE of the MNE Group that is located in jurisdiction A. In absence of any profit forecasts, no DTA (and hence no deferred tax benefit) is recognized for financial accounting purposes. The total tax expense for CE A is as follows:

a) Current tax expense	0 (no current tax as CE A is in a taxable loss position)
b) Deferred tax expense	0 (no deferred taxes as no DTA is recognized)
Total tax expense (a+b)	0

As the total tax expense is zero, the financial accounting ETR also equals zero.

In order to understand the first reduction, it should be noted that the following journal entry is made if a DTA on the local tax loss of (100) would have been recognized under financial accounting:

Debit DTA (balance sheet line item)	25 (100*25%)
Credit deferred tax benefit (profit and loss line item)	25 (100*25%)

Pursuant to the first reduction, the deferred tax benefit (in this example: 25) that is recorded if a DTA would have been recognized for the local tax loss should be taken into account as a reduction in the total deferred tax adjustment amount. It is a reduction because the deferred tax relates to a benefit (i.e., negative deferred tax expense). It should be noted that the deferred tax benefit that is taken into account under the first reduction should also be recast against the minimum rate of 15%.

Given the aforementioned, the total adjusted covered taxes for CE A are as follows:

a) Current tax expense	0 (no current tax as CE A is in a taxable loss position)
b) Total deferred tax adj. amount	-15 (due to the first reduction and incl. recast, 100*15%)
Total adjusted covered taxes (a+b)	-15 (i.e., net tax benefit)

The jurisdictional ETR is calculated by dividing the total adjusted covered taxes (i.e. -15) by the qualifying income or loss (i.e. -100). Accordingly, the jurisdiction ETR under Pillar Two equals to 15% and no top-up tax will be due in this loss year.

Pursuant to IAS 12 paragraph 37, a reporting entity has to reassess any unrecognised DTAs at the end of each reporting period. The entity recognizes a previously unrecognized DTA to the extent that it has become probable that future taxable profits will allow the DTA to be

28. Id., at art. 21 para. 6.

29. Id., at art. 21 para. 7.

30. Id., at art. 21 para. 5a.

31. Id., at art. 21 para. 5b.

32. Id., at art. 21 para. 5c.

33. Id., at art. 21 para. 5d.

34. Id., at art. 21 para. 5e.

35. IAS 12, para. 34.

recovered. The same applies, *a contrario*, for the derecognition of recognized DTAs. Any deferred tax resulting from the (de)recognition of (un)recognized DTAs is recorded as deferred taxes in the profit and loss. The aforementioned is not followed for Pillar Two purposes under the sixth reduction – the impact of a valuation adjustment or accounting recognition adjustment with respect to a DTA is excluded from the deferred tax expense.<sup>[36]</sup> The rationale of this rule is to ensure that DTAs are recorded for Pillar Two purposes in the same year as the economic loss which gives rise to such assets.

Pursuant to IAS 12 paragraph 47, DTAs and DTLs shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been (substantively) enacted by the end of the reporting period. As such, deferred tax expenses/benefits resulting from re-measurement due to tax rate changes are considered as deferred taxes under financial accounting. The aforementioned measurement is not followed under the seventh reduction – the amount of deferred tax expense arising from the remeasurement with respect to a change in the applicable domestic tax rate is excluded from the deferred tax expense. Under Pillar Two, the deferred tax expenses resulting from tax rate changes are taken into account in a different manner via the post-filing mechanism which will be discussed in more detail in section 3.2.5. of this article.

Under financial accounting, the deferred taxes resulting from the generation and use of tax credits are taken into account in the calculation of the ETR. Under Pillar Two, these deferred taxes are disregarded under the eighth reduction. To understand this adjustment, it is relevant to know what journal entries would have been recorded if (i) a DTA is generated with respect to a carry forward tax credit and (ii) if the DTA reverses because the carry forward tax credit is utilized. The following example may illustrate this in more detail.

Assume CE A incurs non-deductible interest of 100 (which is eligible for carry forward) due to an earnings stripping rule in year 1. CE A is located in jurisdiction A that applies a CIT rate of 25%. The following journal entry is recorded if a DTA would have been recognized for the carry forward non-deductible interest of 100:

Debit DTA (balance sheet line item)	25 (100*25%)
Credit deferred tax benefit (profit and loss line item)	25 (100*25%)

Pursuant to the first part of the eighth reduction, the deferred tax benefit with respect to the generation of the DTA on the tax credit (i.e., 25) is disregarded under Pillar Two.

Assume further that CE A has sufficient headroom to utilize the carry forward non-deductible interest of 100 in year 2. The following journal entry is recorded with respect to the utilization of the carry forward credit:

Debit deferred tax expense (reversal DTA, profit and loss line item)	25 (100*25%)
Credit DTA (balance sheet line item)	25 (100*25%)

Pursuant to the second part of the eighth reduction, the deferred tax expense with respect to the utilization/use of the tax credit (i.e., 25) is disregarded under Pillar Two.

### 3.2.3.5. The Qualifying Loss Election

In lieu of applying the deferred tax accounting rules as set out here above, a more simplified loss carry-forward equivalent may be elected which provides for appropriate recognition of losses arising in jurisdictions in a fiscal year.<sup>[37]</sup> According to the Commentary, this election is expected to be of greatest utility as a simplification in jurisdictions that do not impose a CIT or impose one at a very low rate.<sup>[38]</sup>

If such an election is made, a qualifying loss DTA (i.e., a Pillar Two DTA for Pillar Two losses, not regular tax losses) is established in each fiscal year in which there is a net qualifying loss for a jurisdiction. If there is a net qualifying income in a subsequent fiscal year for that jurisdiction, the qualifying loss DTA will be utilized (i.e., reduced) up to an amount equal to the lower of the net qualifying income multiplied by the minimum rate of 15% or the amount of available GloBE loss DTA. As part of the additions to the covered taxes as discussed before (see section 3.2.2.1.), the amount of utilised qualifying loss DTA should then be added to the amount of covered taxes (i.e., it increases the numerator of the jurisdictional ETR).

### 3.2.3.6. Comparison with financial accounting

In contrast to the total deferred tax adjustment amount (which is determined at an entity level basis), the qualifying loss election may only be applied if there is a net qualifying loss at jurisdictional level. Therefore, this election does not apply on individual qualifying losses of a CE in a jurisdiction if there is a total net qualifying income for that jurisdiction.

Under financial accounting, a DTA on tax losses may be only accounted for if several conditions are met.<sup>[39]</sup> Under Pillar Two, it is a matter of an election and no (additional) conditions are imposed to account for a qualifying loss DTA. As such, the application of the qualifying loss DTA is essentially a simplified loss carry forward system (with an unlimited carry forward period) in which Pillar Two losses from a

<sup>36.</sup> The Pillar Two Commentary confirms that this also entails valuation allowances (US GAAP concept); see Ch. 4 para. 76 Pillar Two Commentary.

<sup>37.</sup> Art. 22 Draft Pillar Two EU-Directive.

<sup>38.</sup> Ch. 4 para. 113 Pillar Two Commentary.

<sup>39.</sup> IAS 12, paras. 34 and 35.

given year may be carried forward to a subsequent profit year. The timing difference of a qualifying loss is then accounted for by way of an increase of the covered taxes in the profit year (so not by means of a reduction of the qualifying income, see section 3.2.2.1).

The rationale behind this adjustment is that a decrease of the qualifying loss DTA (i.e., decrease of a Pillar Two asset) results in a fictional deferred tax expense (not recorded in the financial statements) that may be taken into account as an increase of the covered taxes. The following example may illustrate this.

Assume that in year 1 a qualifying loss DTA of 15 (qualifying loss of 100 multiplied by minimum rate of 15%) is established in jurisdiction A. In year 2, jurisdiction A has a net qualifying income of 100. Hence, the qualifying loss DTA may be fully utilised in this year. The following fictional Pillar Two journal entry could be made:

Debit fictional deferred tax expense (reversal qualifying loss DTA)	15
Credit fictional Qualifying Loss DTA	15

As part of the additions to the covered taxes as discussed before (see section 3.2.2.1.), the amount of utilized qualifying loss DTA (i.e., the fictional deferred tax expense of 15) should then be taken into account as an addition to the covered taxes (i.e., it increases the numerator of the jurisdictional ETR).

Note: the authors emphasise that these journal entries are not recorded under financial accounting. Also, it is currently not clear how to account for Pillar Two DTAs in the financial statements. Hence, the abovementioned journal entries are only fictional Pillar Two journal entries and are included *for illustrative purposes only*.

### 3.2.3.7. Article 20 paragraph 5 Draft Pillar Two EU-Directive

Finally, the authors would like to point out that the GloBE Model Rules<sup>[40]</sup> and the draft Pillar Two EU-Directive<sup>[41]</sup> contain a remarkable provision (very technical) that could lead to top-up tax in situations when there is a net qualifying loss in a jurisdiction and the amount of adjusted covered taxes for that jurisdiction is negative and less than an amount equal to the net qualifying loss multiplied by the minimum tax rate of 15% (also referred to as “the expected adjusted covered taxes”). Consequently, the top-up tax liability is the amount equal to the difference between the amount of adjusted covered taxes and the amount of expected adjusted covered taxes.

The said provision could be triggered if a CE has (i) a net qualifying loss, (ii) a negative permanent difference (i.e., additional deduction for tax purposes that is permanent in nature. For example: tax deduction for tangible investments. In Dutch: *kleinschaligheidsinvesteringsaftrek*) and (iii) no DTA recorded for the current year tax loss in the financial statements. Under these circumstances, article 21 paragraph 4 of the draft Pillar Two EU-Directive (or article 4.4.2.c of the GloBE Model Rules) prescribes that a fictional amount of deferred tax benefit (which would have been incurred if a DTA was recorded in the financial statements) has to be taken into account in the calculation of the total deferred tax adjustment amount (and hence the adjusted covered taxes). In absence of any other covered taxes, the aforementioned will result in a negative amount of adjusted covered taxes for the current year. The presence of a negative permanent difference is necessary in order to create a situation where the negative amount of covered taxes (i.e., the fictional deferred tax benefit amount) could be less than the expected adjusted covered taxes. This would be the case if the fictional deferred tax benefit is recast against the minimum rate of 15% pursuant to article 21 paragraph 2 of the draft Pillar Two EU-Directive. Given that the fictional deferred tax benefit and expected adjusted covered taxes are determined on the basis of respectively the taxable loss and the qualifying loss, the only difference between both amounts should be (in the authors' simplified example, *ceteris paribus*) the negative permanent difference. On the latter amount, a top-up tax will be due pursuant to article 20 paragraph 5 of the draft Pillar Two EU-Directive. The remarkable outcome of this provision is therefore that a top-up tax may be due on a negative permanent difference without the presence of any qualifying income.

### 3.2.4. Adjustment 3: Covered taxes accrued in equity or other comprehensive income

The third adjustment prescribes that the increase or decrease in covered taxes that is not recorded in the profit and loss, but is recorded in equity or other comprehensive income (OCI, subpart of equity) shall be treated as an adjustment to the covered taxes when the amounts of income or loss to which such taxes relate is taken into account in the computation of the qualifying income or loss. This adjustment shall only apply where the amount of income or loss to which the covered taxes relate is subject to tax under local tax rules.

### 3.2.5. Adjustment 4: Post-filing adjustments and tax rate changes

The last adjustment on the covered taxes pertains to post-filing adjustments (i.e., adjustments to the covered taxes for a prior year after the top-up tax information return of that year has been filed). Pillar Two prescribes a special adjustment mechanism to account for such adjustments.<sup>[42]</sup>

40. Art. 4.1.5 GloBE Model Rules.

41. Art. 20 para. 5 Draft Pillar Two EU-Directive.

42. See id., at art. 24 para. 1.

To the extent the adjustment pertains to a positive adjustment to the covered taxes for a previous year (i.e., the prior year covered taxes were understated), such prior year adjustment shall be treated as an additional adjustment (i.e., increase) to the covered taxes of the current fiscal year.

When the covered taxes for a previous year would have been lower (i.e., the prior year covered taxes were overstated), then the jurisdictional ETR and the corresponding top-up tax of that year shall be recomputed in accordance with article 28 paragraph 1 of the draft Pillar Two EU-Directive. The resulting top-up tax liability will then be taken into account as an additional top-up tax that will increase the total jurisdictional top-up tax amount (further explanation is provided in section 3.4.).

Under Pillar Two, CEs may elect to treat the negative prior year adjustment as an additional adjustment (i.e., reduction) to the covered taxes of the current fiscal year subject to the conditional that the negative prior year adjustment is immaterial (i.e., less than EUR 1 million at jurisdictional level).

Article 24 of the draft Pillar Two EU-Directive also contains two provisions regarding changes in tax rates. The first provision<sup>[43]</sup> provides that when there is a reduction to the applicable domestic tax rate to a rate below 15%, such reduction must be taken into account under the rules of article 24 paragraph 1 of the draft Pillar Two EU-Directive. The first provision ensures that when a domestic tax rate is subsequently reduced the deferred tax expense previously claimed as a covered tax is adjusted to the correct value, which is the amount of such tax that will actually be paid upon reversal of the DTL. When such reduction is material, then the jurisdictional ETR and the corresponding top-up tax of that year in which the deferred tax expense was claimed shall be recomputed in accordance with article 28 paragraph 1 of the draft Pillar Two EU-Directive.

If a deferred tax expense was taken into account at a rate lower than the minimum tax rate of 15% in a prior year and the applicable tax rate is subsequently increased, the amount of deferred tax expense that results from such increase shall be treated *upon payment* as an additional adjustment (i.e. increase) to the covered taxes of the current fiscal year pursuant to the second provision.<sup>[44]</sup> This adjustment is capped at an amount equal to the deferred tax expense recast at the minimum rate of 15%.

### 3.2.6. Comparison with financial accounting

Under Pillar Two, the rules on how to account for prior year adjustments are complex. It is important to make a clear distinction between positive prior year adjustments and negative prior year adjustments. The former is taken into account as an additional adjustment to the current year covered taxes (mechanism is in line with financial accounting), while the latter is not (unless the adjustment is immaterial and an election has been made). Material negative prior year adjustments will cause an obligation to recalculate the prior year's jurisdictional ETR. If the recalculation of a prior year's jurisdictional ETR leads to an ETR lower than 15%, then the resulting top-up tax shall be due in the current year (further explanation is provided in section 3.4.).

Under financial accounting, deferred taxes with respect to tax rate changes recorded in the profit and loss are fully taken into account in the calculation of the ETR. Under Pillar Two, tax rate changes are only taken into account when (i) the domestic tax rate drops below the minimum tax rate of 15% or (ii) if the domestic tax rate increases (but impact capped at max 15%). Therefore, not all deferred taxes resulting from tax rate changes are considered as covered taxes in the calculation of the jurisdictional ETR.

### 3.3. Qualifying income or loss (Chapter III Directive)

Pillar Two also introduces its own definition of tax base (referred to as “qualifying income or loss”). As the adjusted covered taxes, the qualifying income or loss is first determined on an entity level basis and subsequently aggregated to arrive at a jurisdictional amount.

To compute the qualifying income or loss of a CE, the financial accounting net income or loss (i.e., bottom line result) should be first identified. Subsequently, numerous required or elective adjustments have to be applied to the financial accounting net income or loss to arrive at the qualifying income or loss. As a last step (if applicable), Pillar Two also prescribes several allocation rules to ensure that the qualifying income or loss is allocated appropriately in case there are permanent establishments and flow-through entities in the group structure.<sup>[45]</sup> These allocation rules will not be further discussed in this article.

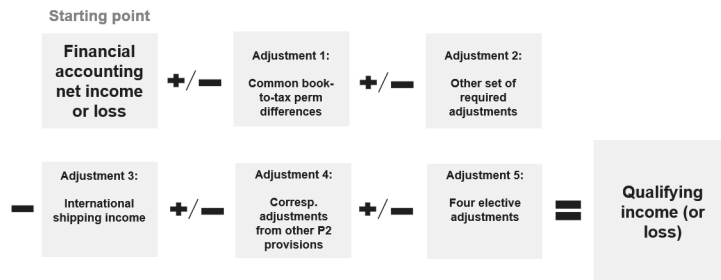
43. Id., at art. 24 para. 2.

44. Id., at art. 24 para. 3.

45. See id., at arts. 17 and 18.

The relevant steps to compute the qualifying income (or loss) (denominator) is summarised and illustrated in Figure 3.

**Figure 3 – High-level overview Qualifying Income (or Loss)**



### 3.3.1. Financial accounting net income or loss

The starting point for calculating the qualifying income or loss is the financial accounting net income or loss of a CE (before any consolidation adjustments for intra-group transactions) as determined under the applicable financial accounting standard as used by the UPE in the preparation of its consolidated financial statements.

If it is not reasonably practicable to determine the financial accounting net income or loss for a CE based on the accounting standard used by the UPE, Pillar Two also allows the financial accounting net income or loss of that CE to be determined based on another acceptable financial accounting standard or an authorised financial accounting standard, provided that (i) the financial accounts of that CE are maintained based on that other accounting standards, (ii) the information contained in the financial accounts is reliable and (iii) any permanent differences in excess of EUR 1 million that arise from the application of that other accounting standard to items of income or expense or transactions, which differs from the UPE's accounting standard are conformed to the treatment required under the UPE's accounting standard.<sup>[46]</sup>

Under Pillar Two, IFRS (main rule) and its equivalents are considered as acceptable financial accounting standards. In addition to the Pillar Two Blueprint, the draft Pillar Two EU-Directive and GloBE Model Rules also now have included the accounting standards of the Member States of the European Union as the generally accepted accounting standards.<sup>[47]</sup>

In cases where an UPE has not prepared its consolidated financial statements in accordance with an acceptable financing account standard as outlined here above, Pillar Two prescribes that the consolidated financial statements of the UPE shall be adjusted to prevent any material competitive distortion.<sup>[48]</sup> The accounting treatment on any item or transaction to which the material competitive distortion pertain shall then be conformed to the treatment required under IFRS. Under the draft Pillar Two EU-Directive, a material competitive distortion means, in respect of the application of a specific principle or procedure under a set of generally acceptable accounting principles, an application that results in a variation of more than 10% of revenue or an aggregate variation greater than EUR 75 million in revenue in a fiscal year as compared to the amount that would have been determined by applying the corresponding IFRS principle or procedure.

### 3.3.2. Required and elective adjustments

The adjustments to be applied on the financial accounting net income or loss can be divided in two groups: (i) the required adjustments and (ii) elective adjustments. These adjustments are covered under article 15 and 16 of the draft Pillar Two EU-Directive and are outlined below.

#### 3.3.2.1. Required adjustments

The first set of required adjustments pertains to the elimination of a number of common book-to-tax differences where that adjustment is justified on policy grounds. These adjustments include, inter alia, net tax expenses (to arrive at the profit before tax amount), dividends and equity gains/losses (avoids double taxation and alignment with participation exemptions), stock-based compensation, certain expenses (e.g., penalties and fines) and foreign currency gains and losses arising from, for example, different currencies used for accounting and

<sup>46.</sup> Id., at art. 14 para. 2.

<sup>47.</sup> See id., at art. 3 para. 22.

<sup>48.</sup> Id., at art. 14 para. 3.



tax purposes (to prevent distortions of foreign currency effects). A complete list of the permanent items to be adjusted for is provided in article 15 paragraph 2 of the draft Pillar Two EU-Directive.

The second set of required adjustments consist of some other relevant adjustments (not linked to each other) and can be summarised as follows:

- transactions between CEs located in different jurisdictions shall be accrued for the same amount in the financial accounts of the CEs and for an amount consistent with the ALP;<sup>[49]</sup>
- any refundable tax credit that is regarded (i.e., qualified) under Pillar Two shall be treated as income for the purpose of calculating the qualifying income or loss;<sup>[50]</sup>
- specific adjustment for insurance companies only: any amounts charged to policyholder for taxes paid by the insurance company in respect of returns to the policy holders shall be excluded from the qualifying income or loss;<sup>[51]</sup>
- reductions to the equity attributable to distributions paid or payable in respect of additional tier one capital issued by a CE shall be treated as an expense for the purpose of calculating the qualifying income or loss;<sup>[52]</sup> and
- any expenses attributable to a financing arrangement whereby one or more members of an MNE group provide credit to one or more other members of the same group shall not be taken into consideration in the computation of the qualifying income or loss if certain conditions are met.<sup>[53]</sup>

It is interesting to note that the fifth adjustment (i.e., expenses attributable to a certain financing arrangement) is actually an anti-abuse provision that has been included in the draft Pillar Two EU-Directive and GloBE Model Rules<sup>[54]</sup> to prevent the use of hybrid instruments to inflate the jurisdictional ETR.

The third set of required adjustments relates to the exclusion of international shipping income (and any ancillary international shipping income) that meets the definition criteria as set out under article 16 of the draft Pillar Two EU-Directive.

The fourth and last set of required adjustments relates to adjustments that are necessary to reflect the requirements of the relevant provisions as set out in chapters VI and VII of the Directive. In this respect, article 33 (transfer of assets and liabilities) of the draft Pillar Two EU-Directive is worth mentioning. This article prescribes the amount of the carrying value of a transferred asset or liability to be taken into account by the acquirer in regular (taxable) transactions vis-a-vis tax free reorganisations (also defined as “Reorganisation”). Consequently, this article may lead to adjustments to be applied on for example the depreciation amount of an asset as determined under the applicable financial accounting standard.

### 3.3.2.2. Elective adjustments

Next to the required adjustments as discussed, Pillar Two also provides for in total four elective adjustments. These elective adjustments are as follows:

- (1) election that allows stock-based compensation to be accounted for under the relevant local income tax rules (rather than applying financial accounting concepts);<sup>[55]</sup>
- (2) election that allows a CE to apply the realisation principle for assets and liabilities that are subject to fair value or impairment accounting;<sup>[56]</sup>
- (3) election that allows to carry back and off-set the total net gain from the disposition of immovable property incurred in the current fiscal year with any net losses from the disposition of immovable property incurred in the four prior fiscal years;<sup>[57]</sup> and
- (4) election that allows for the application of consolidated accounting treatment (i.e., elimination) to income, expense, gains and losses from transactions between CEs that are located in the same jurisdiction and included in a tax consolidation group (e.g., fiscal unity).<sup>[58]</sup>

Elections (1), (2) and (4) are a five-year election, whereas election (3) is a one-year election. All elections (when opted for) have to be specified in the top-up tax information return that has to be filed with the local tax authorities (see section 6.).

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49. Id., at art. 15 para. 4.  
 50. Id., at art. 15 para. 5.  
 51. Id., at art. 15 para. 10.  
 52. Id., at art. 15 para. 11.  
 53. Id., at art. 15 para. 8.  
 54. Art. 3.2.7 GloBE Model Rules.  
 55. Art. 15 para. 3 draft Pillar Two EU-Directive.  
 56. Id., at art. 15 para. 6.  
 57. Id., at art. 15 para. 7.  
 58. Id., at art. 15 para. 9.

### 3.3.3. Sub-conclusion

From the aforementioned, it may be clear that Pillar Two introduces its own definition of taxes and tax base that significantly differs from the definitions as applied under the financial accounting standards/IFRS. The adjustments to be applied on the covered taxes and the financial accounting net income or loss are extensive and complex.

### 3.4. Jurisdictional ETR (Chapter V of the Directive)

After having calculated the adjusted covered taxes and qualifying income or loss per CE, both determinants of all the CEs located in the same jurisdiction have to be aggregated to arrive at the jurisdictional adjusted covered taxes and net qualifying income (i.e., *qualifying income of the CEs minus qualifying losses of the CEs*). Dividing both amounts then gives the jurisdictional ETR.

In case the calculated jurisdictional ETR of a certain low tax jurisdiction [Y] is below the agreed minimum tax rate of 15%, a top-up tax percentage must be computed for that jurisdiction. The top-up tax percentage can be illustrated by equation (1):

$$(1) \text{ Top-up tax percentage of juris. [Y]} = \text{Minimum tax rate (15\%)} - \text{Jurisdictional ETR of jurisdiction [Y]}$$

Subsequently, the jurisdictional top-up tax for a fiscal year is calculated by equation (2):

$$(2) \text{ Jurisdictional top-up tax [Y]} = (\text{Top-up tax percentage of juris. [Y]} * \text{Excess profit of juris. [Y]}) + \text{Additional top-up tax of juris. [Y]} - \text{Domestic top-up tax of juris. [Y]}$$

#### 3.4.1. Excess profit

The Excess profit for a certain jurisdiction [Y] can be illustrated by equation (3):

$$(3) \text{ Excess profit of jurisdiction [Y]} = \text{Net qualifying income of juris. [Y]} - \text{Substance based income inclusion of juris. [Y]}$$

MNEs will receive a substance based carve-out on income for 5% of the carrying value of their tangible assets and payroll, with a transition period of ten years that offers an exclusion of 8% of tangible assets and 10% of payroll in 2023, gradually declining to 5% in 2033.<sup>[59]</sup> This carve-out amount therefore reduces the net qualifying income, which will have a positive impact on the jurisdictional ETR (i.e., it will increase the jurisdictional ETR).

#### 3.4.2. Additional Top-Up Tax

The additional top-up tax is any amount of incremental top-up tax arising from the recalculation of the jurisdictional ETR of the MNE group for a prior fiscal year. Under the draft Pillar Two EU-Directive and GloBE Model Rules, there are several provisions included that require a recalculation of the jurisdictional ETR for a prior fiscal year if there is a specific adjustment to covered taxes or qualifying income (or loss). Article 28 paragraph 1 of the draft Pillar Two EU-Directive provides for a full list of relevant articles in the draft Directive that include such a recalculation obligation. One of those articles has been already discussed earlier in this article and relates to the required recalculation of the prior year jurisdictional ETR when the covered taxes for that year were materially overstated (i.e., material negative prior year adjustment, see section 3.2.5.). The resulting top-up tax liability will then be regarded as an additional top-up tax that will increase the total jurisdictional top-up tax amount for the current year.

#### 3.4.3. Domestic Top-Up Tax

EU Member States can opt to apply the top-up tax domestically to CEs located in its territory under article 10 of the draft Pillar Two EU-Directive (domestic top-up tax). This election allows that the top-up tax is charged and collected in a jurisdiction in which low-level of taxation occurred, instead of collecting all the additional tax at the level of the UPE. These domestic top-up taxes (when incurred) will reduce the total amount of jurisdictional top-up tax.

If the jurisdictional top-up tax for the low tax jurisdiction has been calculated, then the top-up tax has to be allocated to the CEs in that low tax jurisdiction that have qualifying income for the fiscal year. The top-up tax is allocated to the CEs in proportion to their qualifying income and can be illustrated by equation (4):

$$(4) \text{ Top-up tax of a CE in [Y]} = \text{Jurisdictional top-up tax [Y]} * (\text{Qualifying income of the CE in [Y]} / \text{Total qualifying income of the CEs in [Y]})$$

<sup>59</sup> Id., at art. 46.

The top-up tax of a CE is first imposed under IIR on a parent entity with an ownership interest in the low-taxed CE. If there is any residual amount of top-up tax that remains unallocated after the IIR applies, the UTPR allocation mechanism results in a liability to top-up tax in the jurisdictions that implemented the UTPR. Both the IIR and UTPR are also referred to as GloBE rules and are further described in sections 4 and 5 of this article.

## 4. The Income Inclusion Rule

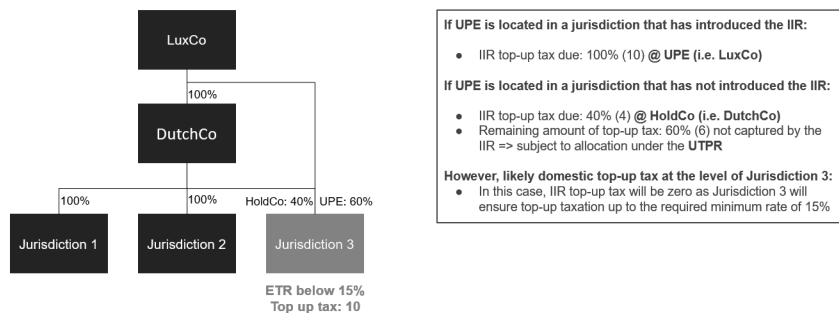
If the jurisdictional ETR for a certain jurisdiction is calculated below the minimum agreed rate of 15%, then a top-up tax is due. Under Pillar Two, this top-up tax is generally allocated to the UPE based on the IIR. The Pillar Two Blueprint mentions that the IIR operates in a way that is similar to a CFC rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary.

The primary mechanism for coordinating the interaction between different IIRs in different jurisdictions is the top-down approach. As a result of the top-down approach, the UPE will be subject to the top-up tax in most of the cases. In cases where the UPE does not apply the IIR, one or more intermediate parent entities will have to apply the IIR to their low-taxed CEs.<sup>[60]</sup> In addition to the top-down approach, Pillar Two also contains complex allocation rules on split-ownership structures for shareholdings below 80%.<sup>[61]</sup> Under the split-ownership rules, the top-up tax is allocated to the so-called “partially owned parent entity” and not the UPE. In such cases, to avoid double taxation, the UPE refrains from applying the IIR.

Under the draft Pillar Two EU-Directive, EU Member States shall also ensure that, where an UPE located in an EU Member State is a low-taxed CE, it is subject to the top-up tax together with its low-taxed CEs located in the same EU Member State for the fiscal year (so not only with respect to its foreign low-taxed CEs).<sup>[62]</sup> In addition, EU-Member States can opt to apply the top-up tax domestically to CEs located in its territory under article 10 of the draft Pillar Two EU-Directive (domestic top-up tax). This election allows that the top-up tax is charged and collected in a jurisdiction in which low-level of taxation occurred, instead of collecting all the additional tax at the level of the UPE.

A numerical example of the application of the IIR is included here below.

**Figure 4 – Numerical example IIR**



A parent entity that seeks to apply the IIR to the income of an exempt permanent establishment (PE) will, however, be prevented from doing so where the parent jurisdiction has entered into a bilateral double tax treaty that obliges the parent jurisdiction to exempt the income of the PE. For these circumstances, Pillar Two introduced a so-called “switch over rule” (SOR). The SOR comes into play in situations where the head office is required to apply the IIR to the low-tax income of its PEs (of which the taxing rights normally belong to the source state). Under the SOR, the residence state of the head office can tax the low-taxed profits of a PE up to the agreed minimum rate of 15%, using the same jurisdictional ETR test as the IIR.

## 5. The Undertaxed Payment Rule

The UTPR acts as a backstop to the IIR. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity (UTPR Taxpayers) under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction.<sup>[63]</sup> Importantly, under this formula, there is no requirement that a UTPR Taxpayer actually makes deductible payments to the low-taxed entity.

60. Id., at art. 6.

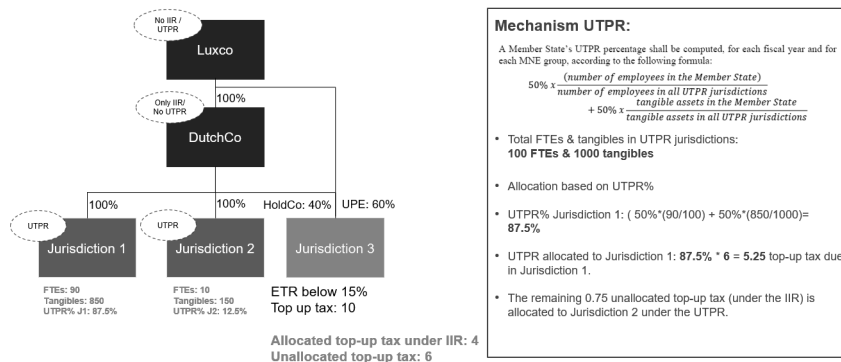
61. See id., at art. 7.

62. See id., at art. 5.

63. See id., at arts. 11, 12 and 13.

A numerical example of the application of the UTPR is included here below.

**Figure 5 – Numerical example UTPR**



A temporary exclusion (i.e., transition relief) from the UTPR will be available for “new” MNEs, i.e., MNEs with no more than EUR 50 million of tangible assets abroad and that operate in no more than six countries.<sup>[64]</sup> The exclusion will be limited to five years after the date on which the MNE becomes in-scope for the GloBE rules for the first time. If the MNE is in-scope at the time the GloBE rules come into effect, the MNE will be subject to the UTPR only after five years as from 1 January 2024.

## 6. Pillar Two Compliance Obligations

From the draft Pillar Two EU-Directive, it is also clear that a so-called top-up tax information return has to be filed with the tax authorities no later than 15 months after the last day of the reporting fiscal year.<sup>[65]</sup> A transitional relief is provided in the first reporting year (i.e., transitional year) where an MNE group initially enters within the scope of the GloBE rules. For such a transitional year, the top-up tax information return has to be filed no later than 18 months after the last day of the transitional year.<sup>[66]</sup>

The filing obligation of the top-up tax information return primarily lies at the CE. If the return is already filed by the UPE or a so-called “designated filing entity” that is located in a jurisdiction that has a bilateral or multilateral agreement or arrangement that provides for the automatic exchange of annual top-up tax information return with the jurisdiction in which the CE is located, the CE only has the obligation to file a notification to the tax authorities to inform them which entity has filed the return. The filing mechanism of the top-up tax information return is therefore quite similar to the mechanism as applied under CbC reporting.

The top-up tax information return should contain, inter alia, the identification of the CEs (including their tax identification numbers), overall corporate structure, information necessary to compute the jurisdictional ETR and top-up tax and a record of the elections made in accordance with the relevant provisions as stated in the Directive. The authors emphasise that the top-up tax information return should not by any means be perceived as a tax return.

## 7. Concluding Remarks

As stated in the introduction the authors – alike the OECD – believe that today one of international taxation’s greatest challenge lies in the tax challenges arising from the digitalization of the economy.

The authors also believe that the OECD with its Two Pillar proposals to (i) distribute tax revenue more fairly (through the so-called Pillar One proposal) and to (ii) levy tax more fairly by introducing a minimum profit tax (through the Pillar Two proposal) is one of the greatest and – if ultimately introduced – historic changes in international taxation.

Where Pillar One’s focus is on the distribution of tax revenue more fairly and in its current form having a rather limited – but still important especially from a conceptual perspective – impact given the expectation that it will ‘only’ impact 80 multinationals, the authors’ focus in this article has been on the minimum profit tax under the Pillar Two plan.

Under Pillar Two, the OECD/G20 IF on BEPS members have agreed to enact a jurisdictional-level minimum tax system with a minimum effective tax rate of 15%. MNEs and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million will be within the scope of Pillar Two.

64. Id., at art. 47.

65. Id., at art. 42.

66. Id., at art. 48.

In this article, the authors have provided a general overview of the mechanism of Pillar Two and primarily focused on the calculation of the Pillar Two ETR. The authors have elaborated on the rules to calculate the ETR under Pillar Two and compared these with the rules that are applied to calculate the ETR under financial accounting.

The authors conclude that the rules to calculate the ETR under Pillar Two are extensive and highly complex. Although the OECD leverages on financial (tax) accounting principles for the calculation of the ETR under Pillar Two, the authors do observe significant differences. These differences mainly relate to the tax accrual versus tax cash paid basis and the application of the deferred tax accounting concept.

At the same time, having a solid understanding of the principles of financial (tax) accounting will help to better understand the rules to calculate the ETR under Pillar Two. The authors have attempted to demonstrate this by, *inter alia*, showing what journal entries would have been recorded under financial accounting and how this translates to Pillar Two. Also, knowing when and why a DTA or DTL is (not) recorded under financial accounting helps to better understand the rationale of some provisions included in the deferred tax accounting part of Pillar Two (i.e., the provisions related to the deferred tax adjustment amount). The fact that the financial accounting treatment may also be significantly different depending on which financial accounting reporting standard is applicable makes the application of the Pillar Two rules even more complex.

Therefore, in view of the envisaged implementation of Pillar Two, having a solid understanding of financial (tax) accounting concepts will be more important than ever. In addition, the authors would like to stipulate that although one can hardly be against the rationale for introducing the Two Pillar system, being the fairer distribution (Pillar One) and levy of taxes (Pillar Two) in an international context, the (tax accounting) workload, technological implementation in financial (enterprise resource planning (ERP)/tax reporting) systems and the overall compliance burden and thus the “costs of compliance” of MNEs will significantly increase in the coming years.



## 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.<sup>[1]</sup> With the rapidly changing consumer trends and needs, and the regulatory developments (such as PSD2)<sup>[2]</sup> investors' interest in FinTech<sup>[3]</sup> remains high. Paypal was established 24 years ago in 1998<sup>[4]</sup> 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.<sup>[5]</sup> 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.<sup>[6]</sup> 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.<sup>[7]</sup> 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.<sup>[8]</sup> 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.<sup>[9]</sup> 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.<sup>[10]</sup> , <sup>[11]</sup> 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’.<sup>[12]</sup> 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.<sup>[13]</sup> 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.<sup>[14]</sup> 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.<sup>[15]</sup> 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.<sup>[16]</sup> , <sup>[17]</sup>

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.<sup>[18]</sup> 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.<sup>[19]</sup> 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,<sup>[20]</sup> the Payment Services Directive<sup>[21]</sup> and the Directive and Regulation on Markets in Financial Instruments<sup>[22]</sup> 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.<sup>[23]</sup> 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,<sup>[24]</sup> 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.<sup>[25]</sup> 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)<sup>[26]</sup>, anti-money laundering or counter-terrorism financing, among others) more effectively and efficiently.<sup>[27]</sup> 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.<sup>[28]</sup> 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.<sup>[29]</sup> 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.<sup>[30]</sup>

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.<sup>[31]</sup> In this environment, startups (and scale-ups) seem to be better positioned in hiring talents.<sup>[32]</sup> 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.<sup>[33]</sup> 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.<sup>[34]</sup>

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.<sup>[35]</sup> 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.<sup>[36]</sup> 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.<sup>[37]</sup> Moreover, there is an increased demand for talent with specialized skillsets across all financial services and technology sectors.<sup>[38]</sup> 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.<sup>[39]</sup>

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.<sup>[40]</sup>

### 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.<sup>[41]</sup>

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](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](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](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.<sup>[42]</sup> 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.<sup>[43]</sup> 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.<sup>[44]</sup> 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](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

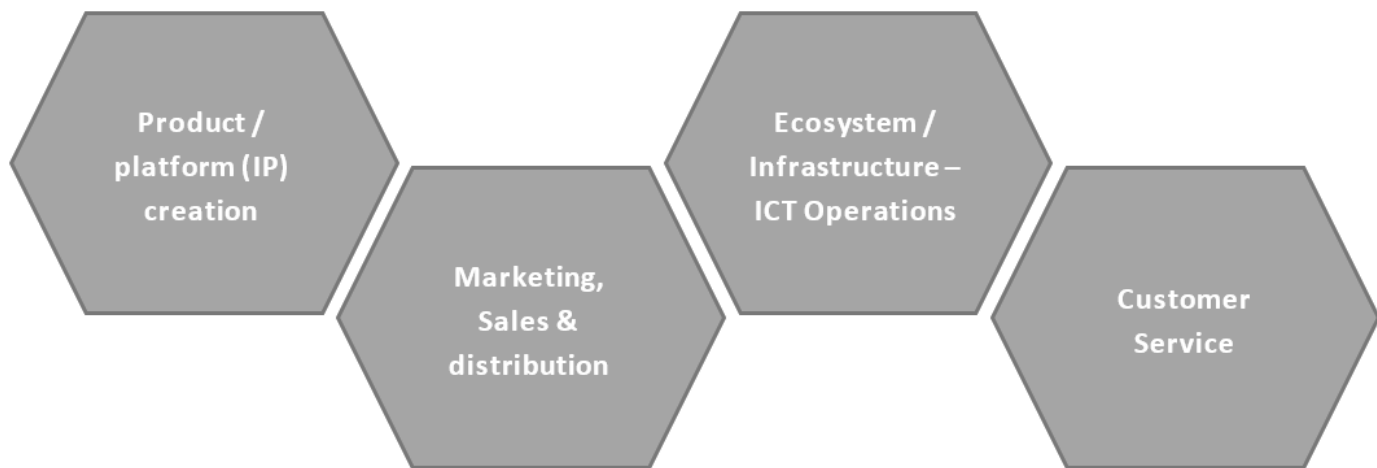
Having analysed some of the main features of the operating models adopted by FinTech groups in the previous section, the authors will further focus on the transfer pricing considerations thereof. In particular, the aim of this section is to review the main intercompany arrangements encountered in the 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	<b>Develop</b>	▶	All key processes and decisions which contribute to the development of Intangibles (e.g. a new brand, or new product)
E	<b>Enhance</b>	▶	All key processes and decisions which contribute to the enhancement of existing Intangibles
M	<b>Maintain</b>	▶	All key processes and decisions which contribute to the maintenance of Intangibles (e.g. ongoing advertising campaigns to keep the brand/product relevant)
P	<b>Protect</b>	▶	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	<b>Exploit</b>	▶	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:<sup>[45]</sup> (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.



## India

**Vispi T. Patel,  
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## IT Sector in India

This article analyses the IT sector in India, the impact of the COVID-19 crisis and transfer pricing issues in the IT sector.

### 1. Introduction with Focus on India

Information technology (IT) refers to various computing and new communication technologies covering the development, maintenance and use of computer software, hardware and networks.

The Information technology industry in India has played a key role in putting India on the global map and India is now the global centre for IT. The IT and Business Process Management (BPM) sector is one of the most important growth catalysts for the Indian economy contributing considerably to India's gross domestic product (GDP)<sup>[1]</sup> and public welfare. The industry has played a major role in transforming India's image from a slow-moving bureaucratic economy and offering traditional outsourced data entry, to a land of strengthening its digital capabilities and deploying emerging technology solutions, and becoming a global player in providing world class technology solutions and business services.

The IT industry accounted for 8% of India's GDP in 2020 and it is expected to contribute 10% to India's GDP by 2025.<sup>[2]</sup> According to the National Association of Software and Service Companies (NASSCOM), the Indian IT industry's revenue touched USD 227 billion in financial year (FY) 2022,, i.e., 1 April 2021 to 31 March 2022, a 15.5% year over year growth. As per a survey by Amazon Web Services (2021), India is expected to have nine times more digitally skilled workers by 2025. This indicates that a total of ~ 3.9 billion digital skill trained workforce is expected by 2025.<sup>[3]</sup>

According to the NASSCOM Enterprise CXO Survey 2022, 60% of the CXOs indicate a 6% higher technology spend in 2022 over 2021, with focus areas around customer service, supply chain, and sales and marketing. End-user enterprises are emerging as technology job creators; about 30% of respondents intend to increase their technology team by over 15%. FY 2023 growth estimates for the technology industry reflect the optimism of FY 2022. 72% of the CEOs indicate 2022 technology spend to be in line with 2021 (NASSCOM Tech CEO Survey 2022). Various research and development investments are expected to have grown between 10% and 20% over the last year.<sup>[4]</sup>

The IT-BPM industry's (excluding e-commerce) total revenue crossed the USD 200 bn mark to reach USD 227 bn in FY 2022. The export revenue from this industry (excluding e-commerce) has been estimated at close to USD 178 bn in FY 2022. In terms of foreign direct investment (FDI) inflow, the computer software and hardware sectors attract the second highest FDI and in between April 2000 and March 2022, it attracted over USD 85 bn.<sup>[5]</sup>

Further, India is one of the most preferred destinations and plays host to a flourishing Global Capability Centres (GCCs) community. GCCs are creating significant value within the Indian technology Industry. In FY 2021, more than 1,430 GCCs have more than 2,300 GCC units in India, employing more than 1.38 million professionals. Over 45 new data centres are expected to come up in India by 2025. Investment in Software-as-a-Service (SaaS) has increased 62.5% over 2021 and is expected to reach USD 6.5 bn in 2022. There are over 1,150 active Indian SaaS companies; 17 of which have achieved the unicorn status.<sup>[6]</sup>

The R&D spending is back in focus and over 75% of the CEOs have expressed their confidence in achieving double-digit revenue growth. The sentiment is truly resilient and resurgent! These testing times have accelerated the challenges too. Further, as hybrid work models

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1. GDP is the most commonly used measure for the size of an economy.

2. See <https://www.ibef.org/industry/information-technology-india> (accessed 13 Oct. 2022).

3. See <https://www.financialexpress.com/industry/indian-it-revenues-grow-fastest-in-a-decade-to-usd-227-bn-in-pandemic-hit-fy22/2434619/> (accessed 13 Oct. 2022).

4. See <https://community.nasscom.in/communities/bpm/technology-sector-india-2022-resilience-resurgencestrategic-review> (accessed 13 Oct. 2022).

5. See <https://www.investindia.gov.in/sector/it-bpm> (accessed 13 Oct. 2022).

6. See <https://community.nasscom.in/communities/global-house-centers/global-capability-centers-gccs-india-reimagine-future> (accessed 13 Oct. 2022).

evolve, coherent policies and continuous communication will be required and security measures would need to evolve, to provide safety to data and secret information of clients.<sup>[7]</sup>

The government of India has also undertaken some major initiatives to promote the IT and information technology enabled services (ITeS) sector in India. Both Central and State governments in India have taken steps towards developing technology solutions to digitally enable citizen services. The government plans to focus on areas such as cybersecurity, hyper-scale computing, artificial intelligence and blockchain.

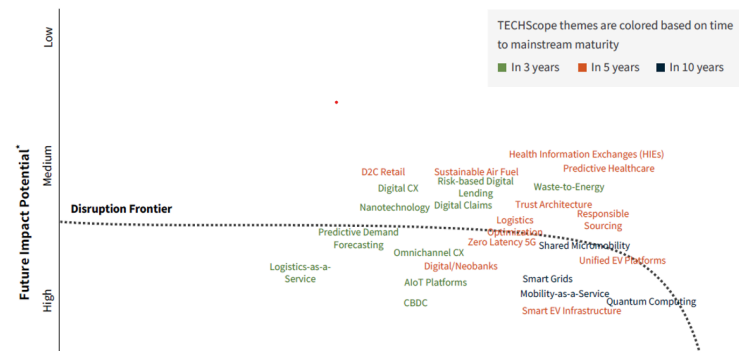
The Indian telecom industry is offering 1GB mobile data at USD 0.086, which is one of the cheapest rates globally. The advantage to consumers by offering such affordable data is easy access to services like banking, business dealings, hospitality, governance and more. Further, India has now the second highest number of internet subscribers in the world. The regulatory atmosphere is also friendly, as it provides 100% FDI in data processing, software development and computer consultancy services, software supply services, business and management consultancy services, market research services, technical testing, and analysis services, under the automatic route.<sup>[8]</sup>

NASSCOM TECHScope offers a view of the 25 highest priority technology solutions that will invite large investments; these solutions will have a strong impact on the core industry, the value chain, and the overall Indian economy. See Figure 1.

**Figure 1**

**Top 25 NASSCOM TECHScope Themes**

2022 and Onwards



**Source:** Nasscom-Annual-Strategic-Review-Executive-summary-2022.

## 2. Opportunities and Challenges in IT/ITeS Sector in India

The IT sector will see greater offtake of productivity software, cybersecurity solutions, etc. Over time, the Indian IT industry has evolved and has created a sizeable product business market opportunity locally. The improvements in the talent and support ecosystem, innovations in software product technology, delivery/business models and changes in the Indian economy are helping in the development of the domestic market. India's tax policy initiatives of granting various incentives under Income-tax, Customs, Excise and local VAT exemptions have been growth catalysts in the industry.

The factors that have contributed to the increase in demand for IT services in India and the United States are: higher COVID-19 vaccination rates, launching of new products and service lines to make sure businesses are prepared to withstand the disruptions caused by COVID-19, return to normal commerce patterns i.e., normalized consumer buying behaviour, automation in industries to help in continuing business, even if any disruptions are caused, labour costs and availability of skilled workers.

The following additional factors that have contributed to the increase in demand for IT services in India are low cost of operation and tax advantages, adoption of new technologies like cloud computing, artificial intelligence, big data, etc., availability of technically skilled manpower, supportive government policies, government established special economic zones (SEZs), which are entitled to various regulatory and fiscal incentives.

The rapid pace of change, mounting pressure to accelerate digital transformation and a shortage of software developers have made it difficult for teams to meet these software development changes. The pandemic and the move to work from home has accelerated the need for digital workplace platforms that can help organizations in their workflow. The biggest challenge in the IT industry is the lack of skilled developers, which has led to the development of new innovations and platforms such as no-code or low code tools that allow the stakeholders to build software. Further, to meet the added demands and growth in 2022, the IT industry/software developers are taking advantage of new tools and technologies that allow them to work more effectively from home.

7. See <https://nasscom.in/sites/default/files/publication/nasscom-annual-strategic-review-executive-summary-2022.pdf> (accessed 13 Oct. 2022).

8. See <https://www.investindia.gov.in/foreign-direct-investment> (accessed 13 Oct. 2022).

New digital workspace platforms are enabling the teams to align on projects and responsibilities as well as organize tasks in a centralized application, allowing the same to be completed in an efficient and effective manner. Software developers use new solutions to become more customer centric in the provision of services. This leads to maximizing value and creating new initiatives that help to meet customer demands and eliminate pain points and achieve true transformation.

Further, the changes that have taken place in the US job market have also had the effect of increasing the recruitment of talent in India and consequently, the growth of the IT sector. The changing trends of workers in the United States, shifting to new work, etc., affected the employers, who in turn had to look for remote employees and offshore workers. This led to the need to hire talent in countries like India where the talent pool was so large that it was feasible for the US firms to employ Indian talent, at reduced costs. The attrition rates in US IT companies have been a driver for the IT job market in India.

The challenges the IT sector will face in 2022 have been significantly impacted by the disruption caused by the pandemic such as challenge to digital adoption, bridging the gap between technology and skill set, finding the appropriate talent, attrition, cloud security, and so on. IT companies for the second year have played a key role in helping organizations to stabilize IT, reduce overheads, manage employee engagement, and meet changing customer demands.<sup>[9]</sup>

Due to work from home (WfH)/remote location culture, proper team bonding has not been developed, and due to conversations mostly taking place digitally, communication has become a major hurdle faced by the organizations. This leads to a large number of resignations and bigger attrition rate across the IT industry. Further, WfH has also impacted the ability of new recruits to adapt to the new organization, as there is a lack of contact with the senior employees and, hence, mentoring has taken a back seat. As employees, have experienced the benefits of WfH culture, bringing back the culture of working from the office has now become a challenge. Many employees still want to continue the culture of WfH. It is also seen that there have been massive resignations in some of the bigger IT organizations when they announced the return of the office work culture.

Further, flexible HR policies will be necessary as a mutual win-win situation for the employer and employees in the IT industry. Some of the policies, already implemented by various IT companies in India are, for example, employees being given the option of WfH (wherever it is practical to do so); flexible timings for employees who are required to work from the office; or smaller co-shared offices at different locations in the city or at different places in different towns, so that employees can work from an office that is closer to their homes. In view of the flexibility demanded by the employees, it is becoming difficult for organizations to plan their future costs of infrastructure (that is, whether to have small offices at different locations or what size of office space is required).

As more and more organizations are moving towards the IoT, data streaming, the option of working remotely and cloud native apps, the problem of cyber security has risen exponentially. Organizations in the past two to three years have been affected by constant ransomware attack threats, data breaches and major IT outages that have affected the IT industry exponentially. 2022 is still a challenging year, as there is still a large talent pool to fill up for efficient and effective cybersecurity measures. It is also estimated that cyberattacks will be persistent in attacking small and medium scale businesses.

There is also a huge gap between the skills that the work demands and the skills that job applicants have. The education system in India still needs to be revamped and the present shortcomings affect the industries that seek highly skilled employees. Unemployment is high in India, but the fact is that many organizations are not able to find talent to fill the positions. Further, the COVID-19 pandemic has led many people to reevaluate their career paths; and due to increasing demand, top talents demand their own set of requirements, such as working in a hybrid model, or asking for full WfH policies, with additional perquisites. It is not always feasible for employers to meet these demands, thus, they have further fuelled the talent shortage and made it more challenging to acquire or retain incumbent talent pool.

More companies are opting for outsourcing due to the talent shortage or for purposes of cost reduction; but outsourcing has created some challenges like security threats, problems with data confidentiality, legal complications, cultural and time zone issues, etc.

### 3. IT Sector and Transfer Pricing

Transfer pricing (TP) provisions were introduced in the Income-tax Act back in 2001, which thus broadly aligned itself with the OECD guidance. Over two decades, transfer pricing law in India has undergone massive changes and seen various new issues emerging, while also resolving older ones.

The IT sector has been a key area for transfer pricing litigation since the inception of the transfer pricing regulations in India. The use of technology has been widespread globally and is used in all walks of life. The rapid increase in technology and its application in various businesses generates new and complex transfer pricing issues.

The Central Board of Direct Taxes<sup>[10]</sup> (CBDT), to minimize the number of disputes and improve the quality of such disputes, has constantly been working on this by issuing various instructions and circulars. Alternative dispute resolutions have also been introduced.

The various IT sector services as understood from a functional perspective in transfer pricing both by the taxpayers and the tax department can be broadly classified as below:

9. See <https://www.crn.in/columns/challenges-that-it-leaders-must-look-out-for-in-2022/> (accessed 13 Oct. 2022).

10. The Central Board of Direct Taxes is a statutory authority functioning under the Central Board of Revenue Act, 1963.

- software development services;
- IT enabled services. These services include back-office operations, data processing, etc.;
- knowledge process outsourcing (KPO);
- business process outsourcing (BPO); and
- R&D services.

Transfer pricing for technology companies has its unique challenges. These companies can be large multinationals with a global presence, Indian multinational companies having international presence, and even start-ups that provide unique solutions and services globally.

Tax practitioners and companies around the world have been trying to grapple with the new and advanced business models due to rapidly changing technology. On a global scale, technology companies have unique and complicated services like SaaS, Platform as a Service (PaaS), IP valuations, etc. that may give rise to complex transfer pricing issues.

Technology companies need to factor in the various costs incurred, location of service centres, employee attrition rates, etc., to correctly determine the arm's length price of the international transactions (i.e., related-party transactions) as required by the income tax law (i.e., section 92 of the Income Tax Act 1961). Thus, appropriate transfer pricing policies need to be in place for avoiding unnecessary tax disputes. The below steps can be considered for mitigating the risk for the same:

- (1) appropriate delineation of the services/transactions, to understand the true nature of the services rendered. This will help the companies in their correct economic characterization and to identify comparable uncontrolled transactions/companies;
- (2) analysing the business model of the company and the MNE group as a whole;
- (3) analysing existing intercompany arrangements;
- (4) administration of employee locations, since remote work is a common practice in IT companies;
- (5) understanding where true value is created for the services provided;
- (6) documentation to be maintained to correctly demonstrate the economic substance of the international transaction; and
- (7) benchmarking analysis to select and apply the most appropriate method (MAM) and determine the ALP, as required by the law.

#### 4. Indian IT Companies and Transfer Pricing

Indian IT companies are largely based on the outsourcing model and are usually captive service providers to their associated enterprises (AEs/group companies) or may provide services to third parties overseas. Different types of services are often outsourced by MNEs and are performed as per instructions of the MNE. Functional comparability, the markup on costs and turnover are usually the most disputed areas in this sector.

*Meaning of IT/IteS in Indian income tax law*

As per rule 10TA(m) of the Income-tax Rules 1962:<sup>[11]</sup>

“software development services” means, –

- (i) business application software and information system development using known methods and existing software tools;
- (ii) support for existing systems;
- (iii) converting or translating computer languages;
- (iv) adding user functionality to application programmes;
- (v) debugging of systems;
- (vi) adaptation of existing software; or
- (vii) preparation of user documentation,

but does not include any research and development services whether or not in the nature of contract research and development services.

Further, as per Rule 10TA(e) of the Income-tax Rules 1962:

“information technology enabled services” means the following business process outsourcing services provided mainly with the assistance or use of information technology, namely: –

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11. See <https://incometaxindia.gov.in/Pages/rules/income-tax-rules-1962.aspx> (accessed 13 Oct. 2022).

- (i) back office operations;
  - (ii) call centres or contact centre services;
  - (iii) data processing and data mining;
  - (iv) insurance claim processing;
  - (v) legal databases;
  - (vi) creation and maintenance of medical transcription excluding medical advice;
  - (vii) translation services;
  - (viii) payroll;
  - (ix) remote maintenance;
  - (x) revenue accounting;
  - (xi) support centres;
  - (xii) website services;
  - (xiii) data search integration and analysis;
  - (xiv) remote education excluding education content development; or
  - (xv) clinical database management services excluding clinical trials,
- but does not include any research and development services whether or not in the nature of contract research and development services;

It is generally seen from various tax jurisprudence and the information available from the public domain that in majority of cases the IT companies in India provide services to their AEs on a net cost or total cost-plus basis.

Further, since the IT-sector is a gamut of a wide variety of services, it is also witness to a high number of disputes with respect to the different type of services.

The IT sector in India has faced scrutiny in transfer pricing since its inception. Some major repetitive issues giving rise to disputes, include issues pertaining to comparability. The OECD Guidelines 2022<sup>[12]</sup> provide the following steps to determine comparability (paragraph 1.36):

- characteristics of the services performed;
- functions performed by the parties (considering assets used and risks assumed);
- contractual terms;
- economic circumstances of the parties; and
- business strategies pursued by the parties.

Highly relevant comparability issues are, for instance, whether KPOs can be compared to BPOs or ITes can be compared with IT and software development services, etc. These are important as comparability determines the uncontrolled transactions/companies, which is critical in determining the correct arm's length price. It also needs to be evaluated whether exact comparability can be obtained wherever possible with respect to functions, assets and risks of both the taxpayer and the comparable companies. However, if the same cannot be obtained, then similar comparable uncontrolled transactions should be evaluated. In a recent case, the Karnataka High Court<sup>[13]</sup> admitted the tax department's appeal that the Income Tax Appellate Tribunal (ITAT)<sup>[14]</sup> was not right in seeking exact comparability.<sup>[15]</sup> The Delhi High Court<sup>[16]</sup> also held that even though annual reports of comparable companies may have similar terminologies, these companies may not necessarily be functionally comparable. The Court held that "the analysis at such a broad level, based upon the appearance of such similar terminologies, does not by itself make the functions similar in nature." Another important judgment in determining comparability was given by the Hon'ble Delhi High Court<sup>[17]</sup> in *Agnity India*, wherein it held that a company that has a high brand value, as well as a high turnover cannot be compared to any ordinary company. The comparable company in question was Infosys Limited, a technology giant, engaged in diversified activities which include consulting, application design, development, re-engineering and maintenance, system

12. [OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations](#) (OECD 2022), Primary Sources IBFD.

13. The High Court is the highest court of appellate jurisdiction in each state and union territory of India.

14. The Income Tax Appellate Tribunal (ITAT) is a quasi judicial institution, the second appellate authority under the direct taxes, the first independent forum in its appellate hierarchy and is also the ultimate fact finding authority.

15. See <https://www.taxsutra.com/news/hc-hear-revenues-appeal-selection-exact-comparables-vs-similar-comparables-under-tnmm-june> (accessed 13 Oct. 2022).

16. IN: Delhi High Court, 19 Sept. 2017, *Avenue Asia Advisors Pvt Limited* [TS-737-HC-2017(DEL)-TP], Case Law IBFD.

17. IN: Delhi High Court, 10 July 2013, *Agnity India Technologies Pvt Ltd* [TS-189-HC-2013(DEL)-TP], Case Law IBFD.



integration, package evaluation and implementation and business process management, etc., whereas the tested party undertook only contract software development services within the group and hence could not be compared based on functionality as well as high turnover.

The other issues of dispute include differences in the turnover, size and scale of operations between the tested party and various comparable uncontrolled companies identified by the tax department and the taxpayer; the treatment of various costs incurred; selection and application of the most appropriate method (MAM), etc.

Some filters commonly used while analysing the comparability of IT/ITeS companies include related-party transactions, extraordinary events/costs, export filter, inadequate financial or segment information, etc. Appropriate segment information is crucial in this sector, as a company that may be engaged into KPO/BPO services may not be comparable with one that also provides software development services along with KPO/BPO services, unless complete segmental information is available.

Availability of segmental information is also important with regard to comparability. However, mere availability of segmental information may not be enough. It may sometimes be necessary for both the taxpayer and the transfer pricing officer to analyse the segmental information and also give credence to other information, e.g. the notes to accounts, and evaluate whether the segmental information is reasonable and can be used.

While differentiating KPO and BPO services, a special bench ruling of the Mumbai ITAT<sup>[18]</sup> held that KPO is an evolution of BPO and is an upward shift in the BPO industry. This may make it difficult to classify certain companies as strictly BPO or KPO and hence no bifurcation of ITeS companies would be necessary. This Ruling suggested that:

The principal functions performed by the tested party should be identified and the same can be compared with the principal functions performed by the entities already selected to find out the relatively equal degree of comparability. If it is possible by this exercise to determine that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated. The examination of controlled transactions ordinarily should be based on the transaction actually undertaken by the AE and the actual transaction should not be disregarded or substituted by other transactions.

Contrary to the above judgment, the Hon'ble Delhi High Court<sup>[19]</sup> held that a BPO does not involve advanced skills while a KPO does involve use of advanced skills for providing various services. The term "KPO" indicates an ITeS provider providing a completely different nature of services than any BPO service provider. A KPO would also be functionally different from BPOs, with respect to functions performed, type of resources employed, business model, etc.

Turnover filter is also an extremely important filter that determines the volume of a company's operation. A significantly high or low turnover may not be comparable with that of the tested party. Generally, a range of ten times the turnover of the tested party and one-tenth of its turnover is considered reasonable for functional comparability. This has been upheld by the Pune ITAT<sup>[20]</sup> in a ruling stating that:

Turnover filter is a relevant criteria for determining of ALP of international transactions entered into by assessee and, thus, so far as range of turnover filter is concerned, picking up comparable cases with *10 times below and 10 times higher* turnover of assessee, is appropriate for companies... [Emphasis added.]

The Hon'ble Bombay High Court in the case of *CIT v. Pentair Water Pvt.Ltd.*, by order dated 16/09/2015 in ITA No. 18/2015, upheld rejection of companies having a high turnover, holding that turnover is a relevant factor in considering comparability of companies. The Court held that "[w]hile making the selection of comparables, the turnover filter, in our opinion, has to be the basis for selection. A company having turnover of Rs.11 crores cannot be compared with a company which is having turnover of Rs.260 crores which is more than 23 times the turnover of the assessee. This company cannot be regarded to be in equal size to the assessee."

Other adjustments include working capital adjustments, risk adjustments, location savings, etc.

Another important area of distinction in the IT sector is classifying and distinguishing software development companies from ITeS companies. In a Pune Tribunal<sup>[21]</sup> ruling it was held that ITeS companies cannot be compared with software development companies as they are functionally very different and also require different skill sets.

Over the years, India has seen a high number of litigations in the IT sector, wherein MNEs were subjected to transfer pricing additions on account of lower price/margins earned by the Indian group companies, under the assumption that there was, thus, transfer of profits to overseas group companies. However, the government has modified the transfer pricing regulations to lessen the long-drawn litigations and penalties. Various alternate dispute resolution mechanisms have been introduced such as:

- advance pricing agreements;
- mutual agreement procedure; and
- safe harbour rules.

18. IN: ITAT Mumbai, 14 Dec. 2012, *Maersk Global Centres (India) Pvt. Ltd. v/s. ACIT* (ITA No.7466/Mum/2012), Case Law IBFD.

19. IN: Delhi High Court, 10 Aug. 2015, *Rampgreen Solutions Pvt Ltd vs CIT* 377 ITR 533.

20. IN: ITAT Pune, 9 Sept. 2019, *Tetra Pak India (P.) Ltd v. ACIT* [2019] 108 taxmann.com 208 (Pune - Trib.).

21. IN: ITAT Pune, 31 Jan. 2017, *TIBCO Software India (P.) Ltd v. DCIT* [2015] 56 taxmann.com 91, Case Law IBFD.

**Advance pricing agreement (APA)** – The APA rules aim to provide certainty and relief to MNEs and reduce transfer pricing litigations. The APA program in India has seen immense success over the years. In the IT sector, being a large contributor to India's GDP, a huge number of APAs have been filed and signed. The IT sector APAs cover a large variety of transactions, i.e., provision of IT services, ITeS services, engineering design services, contract R&D, etc. Before concluding APAs, a detailed functional, asset and risk (FAR) analysis of the company is carried out, including functions carried out, the size and skill set of employees within the group; and the tax department makes site visits to understand the actual conduct of business. Up to FY 2017-18, around 145 APAs were concluded in the services sector, mainly for the IT/ITeS industry. In FY 2018-19, a total of 164 international transactions had been covered under the 41 unilateral APAs entered. 11 transactions relating to the provision of IT services and 12 relating to the provision of ITeS were signed among the 41 agreements.

As per the latest reports, around 421 total APAs have been concluded and in most years it can be seen that around 30% of the total APAs for a given year were requested for the IT/ITeS sector.

**Mutual agreement procedure (MAP)** – The MAP is an alternative mechanism for the resolution of international tax and transfer pricing disputes. MAP provisions are invoked by taxpayers when they are of the opinion that tax is levied by tax authorities that is not in line with the double taxation avoidance agreement/tax treaty entered by India with another country.

The objective of the MAP process is to:

- negotiate an acceptable arm's length price by the tax authorities of both contracting states; and
- to avoid economic double taxation for the taxpayers.

**Safe harbour rules (SHR)** – Safe harbour rules were issued by the CBDT in 2013 under which the tax authorities will accept the transfer price declared by the taxpayer. Taxpayers opting for the SHR need to file the return of income for the year on or before the date of furnishing the prescribed Form 3CEFA for opting for the SHR. These Rules provide the procedure for adopting a safe harbour, the transfer price to be adopted, the compliance procedures upon adoption of the prescribed safe harbour and circumstances in which a safe harbour adopted may be held to be invalid. The latest SHR applicable to IT sector is shown in Table 1.

**Table 1 – Safe harbour rules applicable to IT sector**

Eligible international transaction	Safe harbour rule
Provision of <i>software development services/ITeS</i>	Operating profit margin to operating expense
- where the aggregate value of such transactions $\leq$ INR 100 crores (USD approx. 12.5 mn)	$\geq 17\%$
- where the aggregate value of such transactions $>$ INR 100 crores but less than INR 200 crores (USD approx. 12.5 mn to 25 mn)	$\geq 18\%$
Provision of <i>contract research and development services</i> wholly or partly relating to software development, where the value of the international transaction $\leq$ INR 200 crores (USD approx. 25 mn)	$\geq 24\%$
Provision of <i>knowledge process outsourcing services</i> where the value of the international transaction does not exceed INR 200 crores (USD approx. 25 mn) and the employee cost in relation to operating expense	
- is at least 60%	$\geq 24\%$
- is 40% or more but less than 60%	$\geq 21\%$
- does not exceed 40%	$\geq 18\%$

The above provisions for safe harbour law are contained in section 92CB of the Income Tax Act 1961 and rule 10TD of the Income Tax Rules 1962

## 5. Impact of the Pandemic on the IT Sector

The IT sector was affected in the beginning of the pandemic when many employees were laid off, as demand fell and strict lockdowns were imposed. Major costs incurred by this sector, like all other sectors, due to the pandemic involved setting up IT infrastructure costs, i.e., work from home (WfH) costs, security costs to prevent data leakage for their own employees, etc. However, due to the immense surge in demand for remote-working technology, social media and digital interactions, there was huge innovation in the IT sector, which was hastened due to lockdowns, etc.; thus, this sector saw a quick recovery and increase in profits.

Technology giants reported enormous profits at the start of the pandemic as a large part of the population became more technology dependent. For instance, companies like Apple, Microsoft and Google saw their profits double. Huge demand for online services because of the sudden onset of the pandemic led to the rise in profits of these tech companies.

Similarly, in India, while most sectors suffered huge losses, IT companies reported a surge in their profitability. This can be attributed to the growing need for digital transformation as more and more companies are going permanently online, especially in the retail sector, banking services, various technology based companies, healthcare and education sectors, etc.

Fitch ratings Report<sup>[22]</sup> in October 2020 predicted that the pandemic will accelerate digital IT spend and the pandemic-related impact is likely to be only moderate and short term, as customers focus on transforming their businesses digitally, moving services and work platforms online, and minimise spending on legacy services.

This Report added that it expected that the Indian industry to continue to take advantage of its low-cost operations and maintain its strong foothold in the global IT landscape.

However, even though companies in this sector benefitted largely during the initial days of the pandemic, they experienced a steady decline in profits and margins as the pandemic progressed. One of the largest tech companies, Google's parent company Alphabet, saw its slowest quarterly revenue growth as of April 2022 since 2020: an indication that the large demand for its services during the pandemic has begun to fade. Other large technology companies also have reported a downward trend. This is reflected in India where major technology companies like Tata Consultancy Services and Infosys Limited have reported lower margins in FY 2022 when compared with the pandemic boom in FY 2021.

A report by Crisil in July 2022<sup>[23]</sup> stated:

The information technology services sector will see a sharp fall in revenue growth to 12-13 per cent in FY23 from 19 per cent in FY22.

However, the current depreciation in the rupee, strong demand for new age technologies like artificial intelligence, cloud computing and Internet of Things will help the over USD 220-billion sector maintain a double digit growth.

## 6. COVID-19 and Transfer Pricing

The pandemic has brought about many changes in the way a company functions. Such changes are also clearly visible across the IT and ITeS sector. IT and ITeS companies quickly adapted to the new normal, i.e. developing an appropriate IT infrastructure to be able to work from home and evaluating the impact of the crisis situations to modify their business models wherever necessary.

As discussed above, these changes should be appropriately delineated to understand the true impact of the pandemic. Such delineation would involve:

- (1) evaluating the unusual and extra costs arising due to the pandemic, such as cancellation of contracts, supply costs, employee costs etc., and how such costs are to be allocated;
- (2) evaluating the costs of underutilized resources in various BPO and KPO centers and their impact;
- (3) evaluating digitization / technology related costs;
- (4) evaluating risks borne by various entities within an MNE group;
- (5) undertake a detailed FAR analysis to understand and evaluate the changes necessary as per the market circumstances;
- (6) make capacity adjustments due to the sudden nature of the pandemic wherever necessary;
- (7) review the existing intercompany arrangements and check whether any modifications to the same are required; and
- (8) evaluate the benchmarking methods for the international transactions undertaken and check whether any modifications are required.

Specific issues that need to be considered due to COVID-19 with respect to transfer pricing are discussed in section 7.-10.

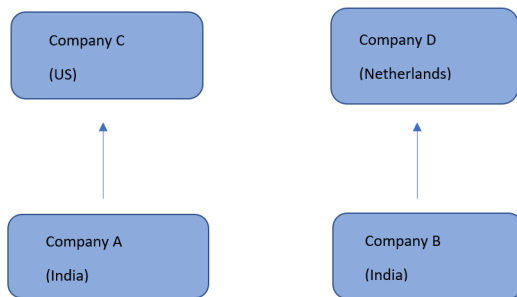
22. See <https://www.fitchratings.com/research/corporate-finance/spotlight-indian-it-services-industry-06-10-2020> (accessed 13 Oct. 2022).

23. See <https://www.crisil.com/en/home/newsroom/press-releases/2022/07/it-services-to-log-double-digit-revenue-growth-this-fiscal-too.html> (accessed 13 Oct. 2022).

## 7. Comparability adjustments

As a result of the pandemic, some companies that were comparable pre-pandemic may no longer be so. See figure 2.

**Figure 2 – Comparable companies that may become not comparable due to the pandemic**



For instance, prior to the pandemic, both Company A and Company B provided similar captive services to third parties respectively. However, as the United States was more adversely affected by the pandemic than the Netherlands, Company A and B no longer remain comparable. To still consider the companies as comparable, certain comparability adjustments may be required.

## 8. Use of Multiple Year data

Multiple year data as prescribed by rule 10CA(1) of the Income Tax Rules, 1962 may also not be feasible as pre-pandemic years could be more profitable than the COVID-19 period, which would mean they are no longer comparable.

The OECD Guidelines point out that historical data cannot be relied on in correctly determining the arm's length price in case of certain transactions and information of comparable uncontrolled transactions undertaken in the same period is more reliable.

## 9. Renegotiation of APAs

Companies that opted for SHR in earlier years may find it difficult to meet the criteria in the COVID-19 years. Therefore, such companies may choose to opt out of the same for the relevant years.

Companies that have opted for an APA need to evaluate the effect of the pandemic on such an APA and whether there would be a need to change or modify the agreement, considering the current economic conditions.

In its 2020 Guidance on the transfer pricing implications of the COVID-19 pandemic<sup>[24]</sup> (see section 10.), the OECD suggests that taxpayers whose APAs are affected by the pandemic should determine the impact and take corrective steps.

Various negotiation options are also suggested at para. 109 of this Guidance:

For example, consideration could be given to agreeing a short period APA covering the period affected by the COVID-19 pandemic and a separate APA covering the post-COVID period. Another solution could be to conclude the APA for the whole period (e.g. APA period of 2020-2024) with a condition that the relevant impacts of the COVID-19 pandemic will be analysed and reported annually once they are known, and retrospective amendments to the APA made accordingly, when appropriate. Another solution could be to extend the period of the APA to mitigate the short term effect of the pandemic, depending on the magnitude and the length of such effect. Additionally, the use of a cumulative or term test throughout the APA period could be given consideration. In this context, it is important that taxpayers be transparent and disclose all relevant information concerning the impact of the COVID-19 pandemic on the covered transactions in a timely manner.

While many established MNEs struggled to retain employees and business as the pandemic spread, India and the rest of the world saw a boom in various technology start-ups aimed at providing specific services that benefit users during the pandemic.

These companies provided essential services in times of the pandemic. They mostly comprise healthcare technology (healthtech), education technology (edtech) and financial technology (fintech). Such enterprises are focused on introducing technology in essential services. They have grown rapidly over the period of the pandemic, and some have shown potential for successful business models.

Transfer pricing for these companies needs to be evaluated right from the investment phase to implementation. Some critical issues that may need to be evaluated include the detailed business model, capital and ownership structure, types of services, cost allocations, etc.

24. See OECD, *Guidance on the transfer pricing implications of the COVID-19 pandemic* (OECD, 2020), available at <https://www.oecd.org/coronavirus/policy-responses/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic-731a59b0> (accessed 4 Nov. 2022).

Going forward, these types of companies will be more common with hybrid business models. It will be necessary to maintain appropriate and robust documentation to demonstrate the correct arm's length price, as the onus for the same will remain with the taxpayer.

## 10. OECD's Guidance on Transfer Pricing Implications of COVID-19

In response to the pandemic, the OECD published guidance on the transfer pricing implications of COVID-19 in December 2020 (the Guidance),<sup>[25]</sup> addressing the various difficulties faced in determining the arm's length price, in the comparability analysis, allocation of costs, treatment of losses, government regulated changes etc.

The Guidance deals with:

- the comparability analysis;
- extraordinary costs; and
- APAs.

The Guidance also discusses in detail the factors to be kept in mind while undertaking a comparability analysis. It points out that historical data cannot be relied on in correctly determining the arm's length price in case of certain transactions, and that contemporaneous information of comparable uncontrolled transactions is more relevant. This also reflects how independent parties have responded to the crisis. The Guidance also lists sources from which contemporaneous data may be obtained for the comparability analysis.

The Guidance considers the various challenges faced by taxpayers due to the pandemic, and offers certain pragmatic approaches that can be adopted by revenue authorities to minimize disputes when taxpayers make efforts in good faith to determine arm's length prices, despite the information deficiencies associated with the pandemic. These approaches are discussed below.

### *(1) Allowing reasonable commercial judgement combined with contemporaneous information to set a reasonable estimate of the arm's length price*

The Guidance states that both taxpayers and tax administrations should recognize that delayed availability of contemporaneous data and determining the arm's length price requires flexibility and exercise of good judgement. It encourages taxpayers to undertake reasonable and appropriate due diligence to evaluate effects of the COVID-19 pandemic and the consequent impact on transfer prices. It states that "MNE groups should document the best available market evidence currently available, which may be in the form of internal comparables, external comparables, or other relevant evidence of the economic impact of the COVID-19".

### *(2) Where feasible, allow for an arm's length outcome testing approach*

The Guidance suggests that out of the two approaches described in the OECD Guidelines, i.e. the "price-setting," approach that uses historical data updated to reflect any changes in economic conditions and the "outcome-testing" approach that allows information that becomes available after the close of the taxable year to determine the arm's length conditions, wherever possible, the latter approach should be used, even if on a temporary basis.

### *(3) Use of more than one transfer pricing method*

The Guidance also recognizes the possibility of applying more than one transfer pricing method considering the specific challenges of the pandemic and the guidance given in the OECD Guidelines.

Additionally, the Guidance discourages the use of data from any prior crisis for the comparability analysis (e.g. the financial crisis of 2008/2009) because each situation presents itself with unique and unprecedented challenges and hence a transfer pricing analysis should be carried out by evaluating the actual prevalent economic circumstances.

## 11. Way Forward – Challenges and Opportunities

Transfer pricing requires an analysis of the actual conduct of business and, thus, is based on the economic substance of the transaction. The need for such an in-depth analysis is accentuated during an economic crisis, like the one brought about by the pandemic. The maintenance of pertinent robust documentation to correctly demonstrate the impact of the pandemic; various measures taken to mitigate this impact; changes introduced in the various intercompany arrangements, etc. cannot be emphasized too much. Further, short-term as well as long-term impacts of the pandemic will need to be evaluated.

The onus is on the taxpayer to correctly demonstrate the economic fallout of the pandemic and the economic adjustments required to be made to benchmark the controlled transactions. All this will help taxpayers to mitigate litigation risks, reduce disputes and demonstrate their transparency and trustworthiness.

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<sup>25</sup>. Id.



Though first the pandemic turned out to be a boost for the business of IT companies, when the effects of COVID-19 became milder and employees started returning to the office, the demand for technology began to go down. IT companies need to constantly evolve to meet the challenges of the changing economic environment.

Benchmarking of various transactions from a transfer pricing perspective, during the COVID-19 period will prove to be a challenge for IT companies. Especially the pre- and post-pandemic comparable companies may be different and taxpayers will have to be aware of the comparability adjustments that may be required to be made. The arm's length standard (ALS), which is the heart of transfer pricing law in India and globally, will also be tested, as an economic crisis can accentuate the defects of any standard, especially with regard to tax matters.

The arm's length standard is a universal standard, which has weathered many an economic crisis. The ALS foundation lies in performing a correct comparable analysis, which also gives it the flexibility to account for drastic changes in the economic scenario by adopting a pragmatic approach to the selection of comparable uncontrolled data, and making economic adjustments wherever required.

Both the taxpayer and the revenue authorities would also need to be fair in their approach to apply the ALS in an equitable manner, to resolve the issues that may arise during the TP audits pertaining to the pandemic period and the later period.

## International

Xaver Ditz and  
Christian Heider<sup>[1]</sup>

# Allocation of Profits to Construction or Installation Permanent Establishments

The construction or installation permanent establishment has considerable practical importance. If a construction or installation permanent establishment has been established under domestic law and article 5(3) of the OECD Model, the question arises as to how to determine its profit. On the one hand, the OECD does this based on the generalized principles set out in the Authorised OECD Approach (AOA). On the other hand, Germany's tax authorities have issued detailed regulations on determining profits for construction or installation permanent establishments, some of which are not consistent with the principles set out in the AOA.

## 1. Introduction

Under article 5(3) of the OECD Model, construction or installation permanent establishments constitute temporary permanent establishments. This is in contrast to permanent establishments within the meaning of article 5(1) of the OECD Model, given that no permanent commercial activity is carried out in them; rather, their business activity regularly surrounds a specific project and consequently lasts for a limited period of time.<sup>[1]</sup> In addition, in the case of construction or installation work, services for the (external) client are usually performed equally by the parent company and the permanent establishment. Services of two business units are often so closely related that it is difficult or even impossible to allocate individual partial services to the parent company or the construction or installation permanent establishments.

According to the AOA, these special features have a direct impact on allocating profits between a parent and a construction or installation permanent establishment. Although the OECD did not stipulate any special regulations for construction or installation permanent establishments in its 2010 report on permanent establishments, Germany's tax authorities have issued detailed regulations in this regard. Given, then, that there is no internationally coordinated guidance, it must be recognized that cross-border problems can arise when allocating income.

## 2. Function and Risk Analysis as a Starting Point

Determining the profit of a construction or installation permanent establishment – according to the general rules of the AOA – must be done based on a function and risk analysis of the permanent establishment.<sup>[2]</sup> Initially, the functions of the permanent establishment carried out by its personnel (“people functions”) are to be determined. Based on the analysis of the “people functions performed at the permanent establishment, the assets necessary for these functions assigned to it must be allocated to it. Subsequently, the opportunities and risks associated with the assigned people functions and assets must be identified and the appropriate capital must be allocated. Secondly, “internal dealings” between the parent company and the permanent establishment need to be identified on the basis of the function and risk analysis and evaluated using the arm's length principle. As a result, there are no differences from the methodological application of the AOA for construction or installation permanent establishments to “normal” permanent establishments.

The concept of people functions is also of key importance in the context of determining profits for construction or installation permanent establishments. This is because it determines which assets, opportunities and risks (especially in the form of the construction or installation contract), which capital, which liability items and which business transactions are to be allocated to the permanent establishment. The change in people functions between the construction or installation permanent establishment and the parent (the rest of the construction or installation company) can therefore result in the transfer of assets, for example, with the corresponding realization of profit. Germany's tax authorities define the “people function” as a business-related activity performed by a company's own personnel on behalf of the company.<sup>[3]</sup> With regard to the business activities carried out in the context of construction or installation, the following people functions can be identified:<sup>[4]</sup>

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1. See OECD Model Tax Convention on Income and on Capital: Commentary on Article 5 para. 3(49), Models IBFD.

2. See OECD, Report on the Attribution of Profits to Permanent Establishments, p. 14 (July 2010), Primary Sources IBFD.

3. See sec. 2(3) German Regulation on the Allocation of Profits of Permanent Establishments (*Betriebsstättengewinnaufteilungsverordnung*, BsGaV).

4. See also S. Hentschel & G. Kraft, *Funktionsverlagerungen in anstehenden Außenprüfungen – eine Bestandsaufnahme potenzieller Streitfragen*, IStR (2015), p. 193 et seq.

- Obtaining orders:
  - preparing an offer; and
  - conducting negotiations.
- Financing and insuring construction-related work:
  - organizing the financing of the project (own financing and development of financing arrangements for the client); and
  - insuring the project (including procuring export credit insurance).
- Construction planning/engineering:
  - providing process technology;
  - planning the project (preparing a technical, economic and legal concept required for the contract);
  - preparing a plan required for the order (“engineering”); and
  - selecting suitable subcontractors, suppliers and other project partners in the country where the permanent establishment is situated.
- Material procurement/acquisition:
  - acquiring or developing own necessary know-how required for the orders;
  - producing own or externally purchasing materials required for the project;
  - storage; and
  - transport.
- Construction or installation:
  - construction or installation in a narrower sense (including commissioning the structure or plant);
  - installing of “local content”, i.e. parts that are directly purchased, manufactured or provided by the client in the country where the permanent establishment is situated;
  - construction or installation supervision (also of subcontractors, if applicable);
  - commercially and technically coordinating the project;
  - offering technical, legal or tax advice on site;
  - delivering specific software;
  - granting licences;
  - conducting trial operation of the structure or plant;
  - rectifying defects identified at the time the structure or installation was accepted; and
  - educating and training the client’s personnel in the country where the permanent establishment is situated.
- Managing after sales:
  - developing training and education materials;
  - processing notices of defects after the structure or installation was accepted; and
  - technically assisting any optimization of production processes.

In principle, people functions must be assigned to a permanent establishment for as long as it performs them. According to an administrative opinion in Germany, the allocation is independent of the exercise period. The decision surrounding allocation should be based on the place where the people function is performed.<sup>[5]</sup>

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5. See M. Freudenberg, S. Stein & M. Trost, *Gewinnabgrenzung bei Bau- und Montagebetriebsstätten – Umsetzung aus Sicht der Beratungspraxis*, ISR (2016), p. 162.

## Example

The project manager A of a construction company, situated in Germany, takes a three-week trip to Luxembourg, where construction company operates a permanent establishment within the meaning of article 5(1) of the OECD Model. There, A prepares for his assignment at the construction company construction or installation plant in Brazil. There is no connection between the preparatory activity of A and the activity of the permanent establishment in Luxembourg.

A's activity at the permanent establishment in Luxembourg is not a people function to be allocated to this permanent establishment. Rather, it is a people function to be allocated to the construction or installation permanent establishment in Brazil. The possible use of the infrastructure of the permanent establishment in Luxembourg by A must be remunerated at arm's length, indirectly via the parent, to the construction or installation permanent establishment.

### 3. Allocation of Assets and the Construction or Installation Contract

According to the general rules, assets are to be allocated to the permanent establishment on the basis of the assigned people functions. The authorities in Germany define assets as economic goods and benefits, which include in particular tangible economic goods (assets), intangible values including intangible assets, participations (stakes) and financial assets as well as other assets.<sup>[6]</sup> These general allocation rules also apply to construction or installation permanent establishments, meaning that here too the assets "follow" the people functions.<sup>[7]</sup> However, from a German tax perspective, the allocation of assets to a construction or installation permanent establishment requires, in addition to the relevant people functions, an "additional" people function with regard to acquisition, production, disposal or performance. Consequently, in the opinion of the tax authorities, the allocation of assets to the construction or installation company is limited to exceptional cases. According to the view of the German legislator, there is usually no acquisition of assets by the construction or installation permanent establishment, but only a use of the assets acquired or produced by the rest of the company (parent company) for a limited period of time.<sup>[8]</sup> Although the legal basis and economic justification of an additional people function is not clear from the perspective of the tax authorities in Germany, this assumption leads to the fact that assets are almost routinely to be allocated to the parent company and, as a result, there are no issues of an exit or welcome tax when the corresponding asset is used by the construction or installation permanent establishment. On the one hand, this is to be welcomed from a practical point of view. This is due to the fact that it leads to simplifying the profit allocation to construction or installation permanent establishments. On the other hand, it is highly questionable whether foreign tax authorities accept this approach. It is obvious that this gives rise to international double taxation risks.

From a German tax perspective, a tangible asset used in a construction or installation permanent establishment must be attributed thereto only if, in addition to such use, people functions are also performed there that relate to the acquisition, the production, the disposal or the usage of the tangible asset.<sup>[9]</sup> Consequently, the mere use of a tangible asset in the construction or installation permanent establishment is not sufficient to allocate it to the construction or installation permanent establishment for the purposes of determining profits. Rather, according to the authorities in Germany, the tangible asset usually remains with the rest of the company (parent), meaning that it is provided free of charge to the construction or installation permanent establishment for the purposes of profit allocation. In practice, tangible assets can, for example, be allocated to the construction or installation permanent establishment if construction machinery, etc. is scrapped or sold after use in the country where the permanent establishment is situated.

6. See sec. 2(6) German Regulation on the Allocation of Profits of Permanent Establishments.

7. With regard to the attribution of people functions, see S. Hentschel, *The Taxation of Permanent Establishments*, Diss. (2021), p. 197.

8. See sec. 31(2) German Regulation on the Allocation of Profits of Permanent Establishments.

9. See sec. 5(1) sentence 1 German Regulation on the Allocation of Profits of Permanent Establishments.

## Example

A construction company situated in Germany was commissioned to construct a business centre in Wrocław, Poland. To perform the contract, various construction machinery belonging to the construction company will be used on the construction site in Poland, and will be used again in Germany after the project has been completed.

From a German tax perspective, the construction machinery can be seen as tangible assets whose relevant people function relates to usage. Given that this usage is performed at the construction site in Poland, the construction machinery would have to be allocated to the construction or installation permanent establishment in accordance with the AOA's principles. However, the German legislator still requires that the construction or installation permanent establishment, in addition to the people function of usage, performs another function with regard to acquisition, production, sale or usage. These "additional" people functions, on the other hand, are performed by the parent in Germany, meaning that an allocation of the construction machinery to the construction or installation permanent establishment in Poland is ruled out from the perspective of the tax authorities in Germany. This does not restrict Germany's right of taxation regarding construction machinery, meaning that there is no exit tax.

For the allocation of an asset to a construction or installation permanent establishment, it is necessary that the importance of the people functions performed by the construction or installation permanent establishment clearly outweigh that of the parent in terms of quality.<sup>[10]</sup> As a result, the assets of construction or installation permanent establishments are generally allocated to the parent, since the people functions of acquisition, production, sale or usage are carried out there.<sup>[11]</sup> These allocation rules also apply to all other assets, especially intangible assets. Therefore, if the construction or installation company's intangible assets are used by the construction or installation permanent establishment (e.g. in the form of patents, know-how or trademarks), these are generally deemed to be provided to the construction or installation permanent establishment free of charge.

A construction and installation contract can include various service elements, such as planning, construction, material supply, construction or installation supervision or training. The allocation of the construction and installation contract is significant for the profit allocation because a large number of business transactions are directly related to the contract. The construction or installation contract is a business transaction with a third party, the allocation of which is generally made according to national principles, according to which the conclusion of the business transaction is considered the decisive people function. Deviating from this, from a German tax perspective, the construction or assembly contract is generally assigned to the parent company. This is appropriate insofar as construction or installation permanent establishments did not regularly exist at the time the contract was concluded and therefore an allocation to the construction or installation permanent establishment is ruled out. In practice, it is often the case that the management of the rest of the company (parent) negotiates the contract. The same applies to subcontractor contracts. Nevertheless, with regard to subcontractor contracts, further people functions must be identified (e.g. coordination and supervision of the subcontractor's activities) which represent a significant contribution to the fulfilment of the contract and can thus justify a different allocation.

## 4. Internal Dealings

### 4.1. General

Based on the function and risk analysis, the intercompany supply and service relationships identified between the construction or installation permanent establishment and the parent are evaluated and "settled" on the basis of the arm's length principle within the framework of the profit allocation to a permanent establishment in accordance with the AOA. Therefore, one must consider there cannot be contractual supply and service relationships between the parent and the permanent establishment in the sense of the law of obligations, but that a fictitious exchange of services must be assumed for the purposes of determining taxable profits (internal dealings). In this context, from a German tax perspective, the involvement of a construction or installation permanent establishment during the performance of a construction or installation contract, which has been concluded by the construction or installation company, is usually considered a fictitious service provided to the rest of the company (parent company). According to the tax authorities in Germany, it is rebuttably presumed that the construction or installation permanent establishment as a fictitious service represents a routine activity that must be priced according to a cost-based transfer price method (cost-plus method or TNMM).<sup>[12]</sup>

According to the tax authorities, a routine activity is to be assumed if the construction or installation permanent establishment only performs the actual construction or installation work, even if this is technically difficult and demanding, while the actual value creation takes place in the rest of the company (parent company). However, such a categorical classification of the construction or installation permanent establishment as a (fictitious) routine company is not convincing. Rather, with regards to each construction or installation permanent establishment, it must be examined whether or not it fulfils the requirements of a routine function. A typical feature of a routine function is

10. See sec. 31(1) sentence 2 German Regulation on the Allocation of Profits of Permanent Establishments.

11. See A. Neumann-Tomm, *Der Gewinn von Bau- und Montagebetriebsstätten nach der BsGaV*, IWB (2015), p. 168.

12. See sec. 32(1) German Regulation on the Allocation of Profits of Permanent Establishments.



that functions or activities are performed without a construction or installation permanent establishment's own market opportunities and risks being assumed.<sup>[13]</sup> Nevertheless, the construction industry is often subject to high risks (e.g. of a contractual, business management, technical or planning nature), which can result in the fact that precisely no routine activity exists.<sup>[14]</sup>

## Example

A construction company situated in Germany is commissioned with the turnkey construction of a power plant in France. The construction work leads to the establishment of a construction or installation permanent establishment within the meaning of article 5(3) of the OECD Model. Contrary to previous planning, domestic specialists will be sent to the construction or installation permanent establishment to take over the planning, coordination and supervision of the project on site.

The added value is essentially created by the specialists who work at the construction or installation permanent establishment. In this respect, it is not appropriate to classify the construction or installation permanent establishment as a routine company with a low bearing of risk. Therefore, the construction or installation permanent establishment is either to be remunerated with a higher profit markup using the cost markup method, or the transactional profit split method is to be applied.

The example illustrates that the application of a cost-based method is not mandatory. Rather, it follows from the arm's length principle that other transfer pricing methods may also apply if they are customary between independent third parties. This applies in particular to the CUP method regarding the allocation of the arm's length remuneration of the construction or installation permanent establishment. For example, the price comparison method in the sense of an internal price comparison is to be considered if the construction or installation permanent establishment also provides corresponding services to independent customers in addition to its parent. In addition, an external price comparison is applicable if the construction or installation services are also provided on the market by independent companies. If this is the case, the market prices to be determined in this respect for the provision of services of the construction or installation permanent establishment can be settled.

The service that the construction or installation permanent establishment provides to the rest of the company (parent) must be settled continuously according to the services provided, irrespective of whether the construction or installation company has a payment claim against the principal only upon acceptance or partial acceptance of the service owed. Thus, profit realization is independent of when, i.e. in which assessment period, the profit is realized for the company as a whole. This is appropriate insofar as the AOA abstracts precisely from the realization of profits in the external relationship for the company as a whole. However, the tax authorities in Germany allow for a different settlement if this leads to a result that is more in line with the arm's length principle in the individual case.<sup>[15]</sup>

By using the (rebuttable) basic rule of classifying the construction or installation permanent establishment as a routine function, the German legislator takes a path that is not aligned with the OECD. It is true that according to the AOA, taking into account a corresponding function and risk profile of the construction or installation permanent establishment, the application of a cost-oriented method may be appropriate when performing purely routine functions. However, to provide this as a fixed basic rule is extensively and internationally misaligned. In practice, international double taxation often occurs in this context, given that the foreign state – contrary to the regulations set by the tax authorities in Germany – does not classify the construction or installation permanent establishment precisely as a fictitious “subcontractor” but determines its profit while considering the expenses and income allocated to it. As a rule, such double taxation can only be avoided through international mutual agreement procedures.<sup>[16]</sup>

## 4.2. Application of cost-oriented methods

When applying the cost-plus method to determine the performance remuneration of a construction or installation permanent establishment, the determination of the cost base and the profit markup is of central importance in particular. The details are as follows.

### Determination of the cost basis

The (original) personnel costs of the construction or installation permanent establishment from its own exercise of people functions must be included in the cost base. This includes all wages and salaries of the personnel of the construction or installation permanent establishment who carry out the actual installation or construction activity, construction supervision, integration of subcontractors, etc. According to the German tax authorities, non-wage labour costs must also be included in the cost base. Personnel costs directly caused by the performance of people functions at the construction or installation permanent establishment include, in particular, costs for personnel

13. See H. Baumhoff, X. Ditz & M. Greinert, *Die Besteuerung von Funktionsverlagerungen nach der Funktionsverlagerungsverordnung vom 12. 8. 2008*, DSr (2008), p. 1950.

14. Also according to M. Freudenberg, S. Stein & M. Trost, *Gewinnabgrenzung bei Bau- und Montagebetriebsstätten – Umsetzung aus Sicht der Beratungspraxis*, ISR (2016), p. 166.

15. See sec. 32(3) sentence 2 German Regulation on the Allocation of Profits of Permanent Establishments.

16. See X. Ditz, *Betriebsstätten-Handbuch* (2018), para. 11,319.)

actually working at the construction site. In addition to direct personnel costs, personnel overheads and other overheads (e.g. of the personnel department) must also be taken into account. Such inclusion of personnel overheads in the cost base is appropriate and in line with the arm's length principle.

Costs incurred by the construction or installation permanent establishment that are not directly based on the exercise of people functions, e.g. own procurement of materials or independent engagement of subcontractors, must also be included in the cost base from a German tax perspective.<sup>[17]</sup> However, a profit markup is not applied to these transitory costs. This is in line with the view taken by the OECD.<sup>[18]</sup>

If a construction or installation permanent establishment only carries out routine activities and, thus, in the opinion of the tax authorities, no assets are to be allocated to it as a result, no fictitious dealings are assumed – breaking with the system of the AOA – but rather a free provision of the assets to the construction or installation permanent establishment by the parent is assumed. Therefore, according to the tax authorities in Germany, costs related to assets (e.g. depreciation, wear and tear, maintenance, servicing) should not be included in the cost base of the construction or installation permanent establishment. It is highly doubtful whether foreign tax authorities share this exact same opinion.

## Determination of the profit markup

Determining the profit markup of the construction or installation permanent establishment is based on the general principles when applying the cost markup method. It must be taken into account that there is no such thing as the “right” markup. Rather, a range of appropriate profit markups can at best be determined – in relation to the individual case of a construction or installation permanent establishment – which is based on the (people) functions performed by the construction or installation permanent establishment, the risks assumed and the assets used. Several methodological approaches exist to determine an appropriate markup. These essentially concern:

- an internal comparison of operations (“customary internal profit markups”);
- an external comparison of operations (“customary industry profit markups”); and
- flat-rate markups set in percentages.

The determination of customary profit markups by means of an internal comparison of operations is based on profit margins agreed or achieved by the construction and installation company with third parties for comparable construction and installation activities. As far as possible, transactions undertaken under comparable circumstances should be used as a benchmark. For example, internal profit margins from previous projects of the construction and installation company can be used. If such internal profit margins are not available, profit markups customary in the industry may be used. These can be determined by an external comparison of operations, i.e. reference is made to profit margins achieved by construction and installation companies in comparable business among themselves. Databases are often used to determine these. However, such database studies can only serve as a guide in the area of construction or installation activities, as it is usually not possible to find comparable companies for construction or installation permanent establishments. In practice, companies typically have a function and risk profile that goes beyond that of a pure construction or installation activity as usually carried out by construction or installation permanent establishments.<sup>[19]</sup> Therefore, an internal comparison of operations based on past projects is generally preferable.

In transfer pricing practice, the tax authorities in Germany often accept profit markups of 5% to 10% on the cost of goods sold (i.e. the full costs determined according to the principles of business cost accounting) when applying the cost markup method in the area of routine functions.<sup>[20]</sup> This range of profit markups is, however, too inflexible and too narrow in view of the possible forms of construction or installation activities. The more functions and risks are performed by a construction or installation permanent establishment, the higher its profit margin must be. Its value creation ratio must ultimately be reflected in the profit attributable to it from an arm's length perspective.

### 4.3. Application of profit-based methods

According to the tax authorities in Germany, under certain conditions, the transfer prices for internal dealings between the construction or installation permanent establishment and its parent are not to be determined according to a cost-based transfer price method, but according to the transactional profit split method. The precondition for this is that the people functions that are performed in each case by both the construction or installation permanent establishment and the parent company with regard to the fulfilment of the construction or assembly contract do not constitute routine activities. Therefore, they result in comparable opportunities and risks allocated in each case (first alternative), or unique intangible values are developed or acquired by both the construction or installation permanent establishment and the parent company themselves for the fulfilment of the construction or assembly contract (second alternative).

If these requirements are met, the transactional profit split method must be applied, meaning from a German tax perspective, there is no right to choose, but instead an obligation to apply this methodology. This is appropriate insofar as the construction or installation

17. German guidance on the Regulation on the Allocation of Profits of Permanent Establishments (*Verwaltungsgrundsätze Betriebsstättengewinnabgrenzung*, VWG BsGa), no. 359.

18. See *OECD Guidelines 2022*, para. 7.34.

19. See S. Bendlinger, *Die Betriebsstätte in der Praxis des internationalen Steuerrechts*, 3rd edition (2016), 374.

20. See H. Kuckhoff & R. Schreiber, *Grenzüberschreitende Funktionsverlagerung aus Sicht der Betriebsprüfung (Teil I)*, IStR (1999), p. 327.

permanent establishment in these cases does not carry out routine activities, but rather activities that add value. To the extent that the tax authorities additionally demand that, in addition to these prerequisites, the prerequisites of the transactional profit split method according to the OECD Guidelines must also be met, this demand is misguided. This is because, in the OECD's view, the transactional profit split method is only applicable if two associated companies carry out highly integrated activities or have valuable intangible values and use them in the course of their business.<sup>[21]</sup> Thus, the scope of application of the transactional profit split method is broader according to the OECD's view than according to the tax authorities in Germany. This is due to the fact that, going beyond the requirements of the OECD, a comparable (parity) allocation of opportunities and risks from people functions between the parent and the construction or installation permanent establishment is required, meaning that the parent and the construction or installation permanent establishment must be classified as strategy carriers.

Under the transactional profit split method, the profit or loss resulting from a construction or assembly project for the whole company must be allocated between the parent and the construction or installation permanent establishment, according to an appropriate key variable between the construction or installation permanent establishment and the parent company.

## 5. Permanent Establishment Accounts and Transfer Pricing Documentation Requirements

From a German tax perspective, the financial result of the construction or installation permanent establishment must be determined by means of "auxiliary and ancillary accounts". The auxiliary and ancillary accounts include all components that are to be allocated to the permanent establishment due to its people functions. Consequently, the construction or installation permanent establishment's auxiliary and ancillary accounts must show the assets that are attributable to it according to its people functions. In addition to the assets, the construction or installation permanent establishment's auxiliary and ancillary accounts also includes its capital, the other liability items, the related operating income and operating expenses as well as the notional operating income and expenses.

In addition, the internal dealings and the applied transfer pricing method of the construction or installation permanent establishment must be described according to general principles within a transfer pricing documentation (Local File). Furthermore, it must be analysed whether the result from internal dealings allocated to the permanent establishment is in line with the arm's length principle.<sup>[22]</sup>

## 6. Conclusion

The construction or installation permanent establishment has considerable practical significance – especially for the mechanical engineering industry in Germany. It is therefore to be welcomed that the German tax authorities provide detailed guidelines for the profit allocation of the construction or installation permanent establishment according to the AOA. These lead – at least from a German point of view – to greater legal certainty.

However, it is obvious that the tax authorities aim to allocate as little profit as possible to the construction or installation permanent establishment within the framework of the application of the cost-plus method/TNMM (basic rule) and the transactional profit split method (exception rule). This is already evident in the basic classification of the construction or installation permanent establishment as a routine company, combined with the consequence of not assigning to it either substantial assets or the construction or installation contract. With this basic rule, the tax authorities in Germany follow a path not agreed with the OECD. As a result, it is not surprising that in practice it is already clear that numerous foreign states do not follow the German tax authorities' interpretation of the AOA regarding construction or installation permanent establishments. The result is legal uncertainty and the risk of international double taxation of permanent establishment profits.

21. See *OECD Guidelines 2022*, marginal no. 2.119-2.120.

22. See *OECD Guidelines 2022*, para. 5.22 and Annex II of ch. V.

## International

Philippe Paumier<sup>[1]</sup>

# Transfer Pricing in the Pharmaceutical Industry

Through economic and value chain analysis, this article aims at depicting some of the specific transfer pricing issues in an industry that has generated a substantial level of tax controversy over the last decades: the pharmaceutical industry.

## 1. Introduction

Over the last three decades, the pharmaceutical industry has crystalized many of the political and technical tensions between tax administrations and taxpayers in the realm of international tax and transfer pricing. In the last decade, these tensions have increasingly also extended to policymakers and public opinion.

The purpose of this article is to better understand the sources of these tensions as they relate to three main aspects:

- product and profitability: pharmaceutical products present certain characteristics that deeply impact supply and demand behaviour, with a high level of regulation and intermediation (section 2.1.). They are also characterized – when they gain approval and are successfully launched – by the profitability they yield, a profitability that is perceived as above average (section 2.2.);
- the coherence between the value chain of the industry and the most common transactional framework in pharmaceutical multinational enterprises (MNEs) (sections 3. and 4.), including the entitlement to residual profits or the impact of certain facets of operational transfer pricing; and
- common transfer pricing issues (comparability and benchmarking, intangibles valuation) that are exacerbated by certain features of the industry, including its diversity and of course, its profitability.

Because the pharmaceutical and life science industry include a significant number of sub-segments, the focus of this article is on the prescription drugs (Rx) segment. However, section 5.3. also attempts to analyse the reach of certain sub-segments' differences on transfer pricing policies.

## 2. Economic and Financial Aspects

### 2.1. By nature, a highly regulated market

From an economic standpoint, pharmaceutical products are not easily characterized as either public goods, merit goods or private goods. This complexity partially relates to the extreme diversity of pharmaceutical products and their therapeutic areas. But because access to effective and quality medicines is an essential element of the right to health, many countries have developed a regulatory framework that affects both supply and demand factors of the pharmaceutical market. Different models for regulation exist and these are generally determined by the size of the pharmaceutical market and the availability of resources, as well as public health needs.<sup>[1]</sup>

Among the common features of the regulatory models is the separation, on the demand side, of roles across four parties:<sup>[2]</sup> the patient, the ultimate consumer of the product; the physician, serving as an agent on behalf of the consumer; insurers, private and/or public who cover the costs of the drugs;<sup>[3]</sup> and the pharmacist, the dispensing point of the product, who is also qualified to provide additional information to the patient and in some cases empowered to select the version of the drug ultimately given to the patient. One of the main purposes of this segmentation has historically been to avoid the potential market failures associated with information asymmetry.

Regulations in the industry are also prevalent on the supply side:

- intellectual property protection usually embeds incentives to product substitutions (generics), and incentives to ensure a large spectrum of innovation;<sup>[4]</sup>

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1. P.-L. Lezotre, *International Cooperation, Convergence and Harmonization of Pharmaceutical Regulations* (Academic Press 2014).

2. S.O. Schweitzer & Z.J. Lu, *The Demand for Pharmaceuticals in Pharmaceutical Economics and Policy: Perspectives, Promises, and Problems* (3rd edn., Oxford Academic 2018).

3. Note the increasing importance of co-pay systems, the requirement of out-of-pocket expenditure from patients, or systems in which patients are the sole payers.

4. Examples being: research and development (R&D) tax incentives, general or for certain therapeutic areas, but also pediatric extensions or specific dispositions on exclusivity for orphan drugs or rare diseases.

- effectiveness and quality validation by public bodies (Federal Drug Administration (FDA), European Medicines Agency, country agencies),<sup>[5]</sup> including continuous safety monitoring, applicable to innovation and research processes (good development practices) as well as to manufacturing (good manufacturing practices);
- price control regulations in many countries (applying different methods)<sup>[6]</sup> and cost containment measures; and
- the stringent regulation of pharmaceutical marketing activities regarding content and promotional channels,<sup>[7]</sup> complemented by industry- and country-specific codes of conduct.

In addition to health imperatives such as access to medicines, the multiple regulations and intermediations in the pharmaceutical market stem from the fact that medicines can be characterized as experience goods, where patients may not be able to reliably evaluate the product attributes until after consuming the good, or as credence goods, where the quality of the product may still be difficult to evaluate after consumption. Health authorities pre-qualify the products based on efficacy and safety, significantly narrowing the asymmetry, and physicians – who are insulated from the sale of the product to avoid agency problems<sup>[8]</sup> – act as informed experts/agents for the patient.

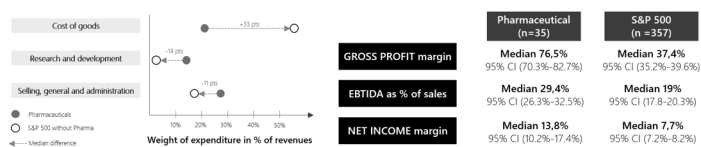
Because the information on drugs is not fluid or consolidated, physicians rely on approval documents, congresses, key opinion leaders and on the information provided by pharmaceutical manufacturers. Hence the importance of the regulation of pharmaceutical marketing and the necessity for pharmaceutical MNEs to ensure the optimal degree of fluidity of information, which includes reaching a large volume of healthcare practitioners and providing multiple updates.

## 2.2. Financial aggregates

The above-average profitability of the pharmaceutical industry when compared with other industry segments has been established in several studies.<sup>[9]</sup> In one of the most recent studies, Ledley et al. (2020)<sup>[10]</sup> conducted a statistical review of financial aggregates (gross profit, EBITDA (earnings before interest, tax depreciation and amortization) and net income) from 2000 to 2018 for 35 pharmaceutical companies and compared them to average and other industry segments of the S&P 500.<sup>[11]</sup>

The study reported the median values and median differences between pharmaceuticals and the S&P 500, as shown in Figure 1.

**Figure 1 – Financial indicators, pharmaceuticals v. the S&P 500**



**Note 1: Charts derived from values in F.D. Ledley et al., Profitability of large pharmaceutical companies compared with other large public companies, JAMA (American Medical Association 2020), p. 4.**

**Note 2: Please note that profitability derived from the sum of median cost of goods sold (COGS), research and development (R&D) or selling, general and administrative expenses (SG&A) differ from the median of EBITDA and net income (sum of medians is not equal to the median of the sum).**

When comparing expense levels by macro-category, the significant median gap on cost of goods sold (COGS) (32.6%) between pharmaceuticals and the index is partially offset by higher levels of median expenditure in terms of research and development (R&D) and selling, general and administrative expenses (SG&A). The study identifies a gap of 10.4 and 6.1 points respectively at EBITDA and net income levels between pharmaceuticals and the S&P 500. When controlling for variables such as company size,<sup>[12]</sup> such gaps fall to 8.6% and 4.1% respectively but remain significant.

While corroborating the fact that the pharmaceutical industry is the most R&D-intensive industry, highlighting the role of innovation (and therefore of intellectual property) in the value creation of life science firms, the study shows that SG&A expenditure in pharma – expressed

5. For the approval of products and for continuous safety monitoring.

6. See section 3.3.

7. The most notorious feature is the forbidding of direct-to-consumer advertising for prescription drugs, which only occurs in the US and New Zealand markets.

8. L. Balafoutas & R. Kerschbamer, *Credence goods in the literature: What the past fifteen years have taught us about fraud, incentives, and the role of institutions*, 26 *Journal of Behavioral and Experimental Finance* (2020).

9. See for example: United States Government Accountability Office, *Drug industry: profits, research and development spending and merger and acquisition deals*, GAO-18-40 (Nov. 2017).

10. F.D. Ledley et al., *Profitability of large pharmaceutical companies compared with other large public companies*, JAMA (American Medical Association 2020).

11. Excluding pharmaceuticals, composed of 357 companies.

12. Given the fact that the 35 pharmaceutical companies in the sample were large multinational enterprises (MNEs).



as a percentage of revenues – was higher than the S&P 500 median by almost 11 points, reaching 28.2% as opposed to 17.5% in the S&P 500, fuelling the idea that pharma is driven more by SG&A (including marketing) than by R&D. Such is the pharma paradox.

In a subsequent study, Sood et al. (2021)<sup>[13]</sup> reviewed the 2013-2018 financial data of pharmaceutical and biotech companies to assess the level of excess returns – calculated as the difference between the return on invested capital and the expected returns given risk (weighted average cost of capital) and compared the results of the pharmaceutical industry to the S&P 500 values. Unadjusted measured excess returns were 4.7% for pharmaceuticals and 4.2% for other S&P 500 values.

The authors also calculated adjusted excess returns treating R&D expenses as investments (instead of expenditure). Adjusted excess returns for the pharmaceutical segment for the period were around 1.7%, compared to the S&P 500 rate of 3.6% (respectively 4.7% and 4.2% unadjusted excess returns). Biotech-adjusted excess returns were 9.6% (13.1% unadjusted) but were significantly more volatile (below the S&P 500 in 2017 and above by 13 points in 2015),<sup>[14]</sup> emphasizing the key role of R&D on the economics of pharmaceutical MNEs.

The weight of SG&A expenditure on sales (“excess spending”) has constantly fuelled transfer pricing controversy on the role of marketing in the value chain and the role of the local marketing and distribution affiliates of pharmaceutical MNEs. Two objective observations can be formulated based on financial metrics:

- based on Figure 1 data, pharma spends 37% of its gross profits on SG&A, whereas the S&P 500 spends an average of 40%.<sup>[15]</sup> As such, it could be argued that pharma spends proportionally less in SG&A than the average S&P 500 company, in terms of the percentage of its available commercial cash-flows; and
- calculations made by the author<sup>[16]</sup> suggest that the ratio of SG&A to R&D expenditure for the pharmaceutical segment was 1.6 (and 0.8 for the Biotech segment), significantly below other industries<sup>[17]</sup> (average ratio for total industries without financials of 5).

The pharma paradox is partially explained by the fact that MNEs spend on average 15/20% of their revenues in developing a limited number of candidates globally, have large global functions that can account for between 5% and 8% of their revenues<sup>[18]</sup> and allocate between 20% and 23% of their revenues to promote a large number of products in a very large number of jurisdictions, a magnitude that is not abnormal based on the features described in the previous section.

### 3. High-Level Value Chain in the Pharmaceutical Industry

Value chain analysis usually revolves around three pivotal functions: R&D, manufacturing and marketing. There is a case in the pharmaceutical industry for the introduction of a fourth segment to account for the value proposition of the products. See Figure 2.

**Figure 2 – High-level value chain in the pharmaceutical industry**



Indeed, when compared to other industries, the typical end-to-end pharmaceutical value chain has at least two main idiosyncratic features. The first one is that there is a large ecosystem of agents of critical importance operating outside the multinational as a result of the market intermediation described in section 2.1. The second particularity stems from the highly regulated environment in which pharmaceutical companies operate. Such features have generally prompted the roll-out of highly centralized global functions, and more specifically functions in charge of the value proposition definition and management of products, to ensure global alignment – during the life cycle of the product, from development to maturity – when addressing the multiple external stakeholders.

The globalization of pharmaceutical markets and the increased interconnection between markets<sup>[19]</sup> has fostered the necessity for a globally managed value proposition. Hence the inclusion of this segment in the value chain within the commercialization and marketing cluster.

13. N. Sood, K. Mulligan & K. Zhong, *Do companies in the pharmaceutical supply chain earn excess returns?*, International Journal of Health Economics and Management 21, pp. 1-16 (2021).

14. Such approach is in line with A. Damodaran, *Research and development expenses: Implications for profitability measurement and valuation*, NYU Working Paper No FIN-99-024 (1999): “[i]n firms where R&D expenses have been increasing rapidly over time, reclassifying R&D can push up operating income significantly and can make return on capital a much higher number. In mature firms, where R&D expenses have been stable over time, the return on capital may decrease when R&D is reclassified”.

15. Respectively  $(28.2/(100-23.5))$  and  $((28.2-10.7)/(100-(23.5+32.6)))$ . Calculations are proposed as an illustration of aggregates; they are not included in Ledley et al.

16. Based on Prof. Damodaran's global data set of financial metrics by industry segment, available at [https://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datacurrent.html](https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datacurrent.html) (accessed 2 Oct. 2022).

17. Ratios were for example of 1.9 for systems and applications software, 2.1 for computers and peripherals, 3.3 for online retail, 3.7 for healthcare products and healthcare IT, 5 for diversified chemicals or 6.2 for machinery.

18. Based on this author's observations.

19. Linked, for instance, to international reference pricing.

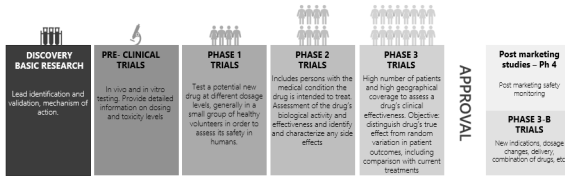
### 3.1. R&D and intellectual property (IP)

R&D spending in the pharmaceutical industry covers a variety of activities, including the following:

- invention, or research and discovery of new drugs;
- development, or clinical testing, preparation and submission of applications for regulatory approval, and design of production processes for new drugs;
- incremental innovation, including the development of new dosages and delivery mechanisms for existing drugs and the testing of those drugs for additional indications;
- product differentiation, or the clinical testing of a new drug against an existing rival drug to show that the new drug is superior; and
- safety monitoring, or clinical trials (conducted after a drug has reached the market) that the FDA may require to detect side effects that may not have been observed in shorter trials when the drug was in development.

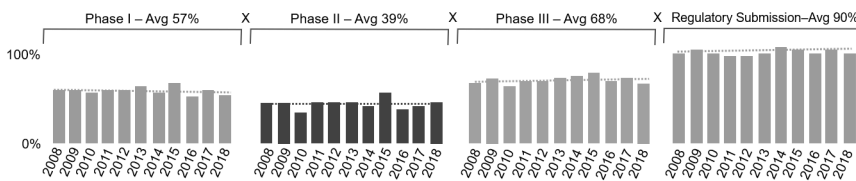
Clinical trials are extensively regulated to ensure the safety of patients and to properly evaluate the clinical benefit of a given drug. The process is illustrated in Figure 3.

**Figure 3 – Pharmaceutical research and development**



R&D and IP generation is one the most critical business risks in the pharmaceutical industry. Not only does it involve very significant (monetary) at-risk investments combined with state-of-the-art science, but the approval process is sequential, long and most importantly, has limited probabilities of success.

**Figure 4 – Transition probabilities in development (data from 2008 to 2018)**



**Note: IQVIA, The Changing Landscape of Research and Development (Apr. 2019).**

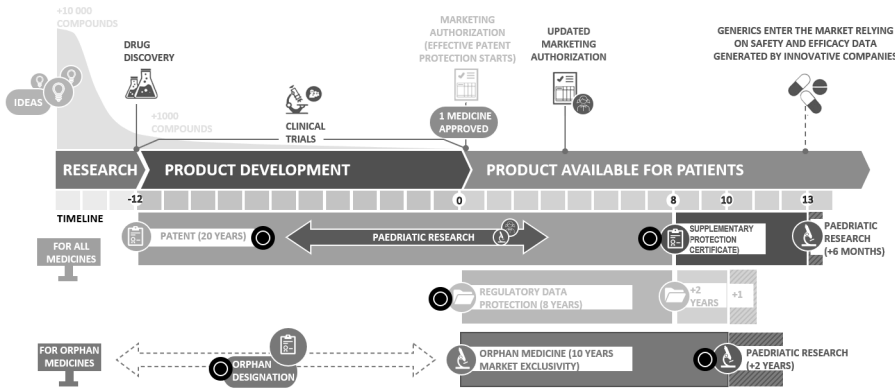
Figure 4 therefore indicates the transition rates: the probability that a drug in phase 1 trials enters phase 2 trials was on average 57% for the 2008-2018 period. The probability of a drug being approved in phase 1 is therefore the multiplication of all the transition rates: around 13%. The appraisal of risk also requires the consideration of the length of the development process, which has on average taken between 10 and 14 years from the launch of the first phase 1 study to the regulatory approval. Studies equally suggest that the total time from phase 1 to regulatory decision, regardless of product failure or success,<sup>[20]</sup> has increased 26% since 2010.<sup>[21]</sup> Phase 3 trials are by far the most expensive trials to conduct, hence the importance of the proof of concept (in phase 2) given the investments and risks at stake.

Once approved, pharmaceutical MNEs enjoy a limited period to recoup the investments made during the 10-plus-year development phase and generate profits to be reinvested in subsequent R&D programmes. Most jurisdictions have implemented similar regulations regarding

20. At the regulatory level.  
 21. IQVIA, *The Changing Landscape of Research and Development*, IQVIA Institute for Human Data Science (Apr. 2019).

the exclusivity of IP rights on pharmaceutical drugs based on patents, data exclusivity and regulating the entry of generic drugs in the market. See Figure 5.

**Figure 5 – Protection and exclusivity for a typical compound**



**Note: EFPIA, The Pharmaceutical Industry in Figures (Key Data 2021).**

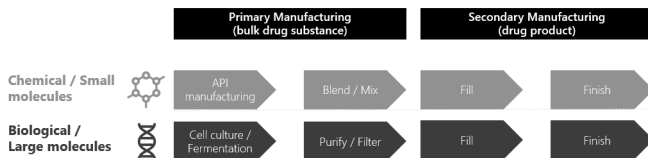
The competition<sup>[22]</sup> for a newly approved compound can typically take the following forms:

- existing proprietary drugs (Rx) in the same therapeutic segment: drugs that are still protected by patents, exploited by the originator company that gained approval before the newly approved compound. This is referred to as “between patent” competition, based on the clinical cost/benefit determined by the different stakeholders;
- generics: drugs that have the same active pharmaceutical substance (or a combination of substances) and the same form of administration as the original patented medicinal product, and are entering the market after the originator product. In many countries, generics (Gx) can be substituted for proprietary products either at the moment of prescription or at the point of distribution (pharmacy for example); or
- biosimilars: a biosimilar is a biological medicine highly similar to another biological medicine already approved (usually called the “reference medicine”) in terms of structure, biological activity and efficacy, safety and immunogenicity profile (the intrinsic ability of proteins and other biological medicine to cause an immune response). Depending on the jurisdiction, biosimilars may or may not be substitutable for originator drugs.

### 3.2. Manufacturing and supply chain

In the pharmaceutical industry, chemistry and biology are at the heart of manufacturing. Manufacturing advances are necessary to cope with the sophisticated enhancements embedded in these fundamental processes. A new molecule may for instance require new know-how and processes to synthesize the molecule, the scaling up of production (for biologicals) or improved facilities and equipment with significant upfront investments. See Figure 6.

**Figure 6 – Overview of manufacturing in the pharmaceutical industry**



<sup>22.</sup> Please note that this article does not address the specific issues of counterfeiting and parallel trade, and the impact of the latter on operational transfer pricing aspects.

Most small molecule drugs are manufactured through organic or inorganic chemical synthesis, whereas large molecule (biologic) drugs are manufactured through live cellular expressions. To produce small molecule drugs, the manufacturer combines specific chemical ingredients to make the drug substance or active pharmaceutical ingredient (API). To produce large molecule (biologic) drugs, however, the manufacturer uses live microbial cells (plant- or animal-sourced cells) to synthesize a biological drug substance or API. The resulting biologic is a very large, complex molecule (often 200 to 1,000 times as large as a small molecule and usually comprised of proteins).<sup>[23]</sup> Given the size and complexity of such large molecules, manufacturers often face substantial manufacturing challenges and risks.

The manufacturing function is highly regulated: current good manufacturing practice regulations outline the minimum quality standards for the manufacturing of drugs, including biologics, and are established to ensure that products are safe and effective for human use. The definition and management of manufacturing processes are therefore key to maintaining quality standards and ensuring the scale-up capabilities of the manufacturing network of pharmaceutical MNEs. Specifically on biologics, immunogenicity, adverse events and efficacy can all be affected by even the slightest process change because a biologic is defined by its process. As such, industrial processes need to be robust enough to ensure that the same output is obtained when it is run for the first time or the hundredth time.

Finally, pharmaceutical supply chains have become global and complex and must deal with three major imperatives: avoid disruptions, ensure traceability and manage temperatures (cold chains). With more outsourcing, new modalities and novel ways to reach patients, it's critical to ensure that they can withstand shocks to avoid product shortages that can have severe consequences for patients and society. Pharmaceutical supply chains span across continents and involve many actors: material/API suppliers, manufacturers, wholesalers, traders, pharmacies and hospitals. To remain effective, supply chains need to ensure high standards in terms of connectivity, data management and traceability to minimize product losses and ensure the safety of the patients.

### 3.3. Promoting and marketing an intangible: From value proposition to distribution

While a product approval is a critical milestone for pharmaceutical companies, it does not constitute a guarantee of success, as significant risks are embedded in the commercialization phase of a newly approved compound. A 2020 study<sup>[24]</sup> has for instance suggested that about half of all products launched over the past 15 years have underperformed pre-launch consensus forecasts by more than 20% and that a missed product launch can be challenging to overcome, especially as competition continues to intensify across most disease areas.

To put it simply, value propositions in the pharmaceutical industry are composed of two core elements with variable degrees of correlation: clinical benefits to patients and society (quality and efficacy), and price/cost.

Because of the nature of the product, customer and stakeholder engagement in the pharmaceutical industry requires the deployment of content-based marketing strategies (on validated clinical attributes of the product). Moreover, treatment decisions are increasingly co-governed by payers, who influence doctors' behaviour through drug formularies and therapeutic guidelines. Finally, patients – through access to a higher volume of information through digital tools – play an increasing part in the prescription process. These trends have led pharmaceutical companies over the last decade to deploy more customer-centric organizations and progressively depart from the traditional detailing model largely based on detailing through sales representatives' visits to healthcare professionals.

The value proposition of novel products needs to produce a market-shaping impact through the generation of compelling evidence to ensure a proper level of disease understanding and the maximization of market access by integrating real world evidence generation strategies into the process. Increasingly, the value proposition includes the identification with customers and stakeholders of solutions to optimize care pathways for patients. The value proposition in the industry also aims at activating demand through advocacy (for example key opinion leaders) and through a superior patient experience (patient communities, education, support programmes). Finally, it involves a deeper integration of the MNE in an ever more complex healthcare ecosystem.

The first component of the value proposition is therefore aimed at fostering market acceptance of a new therapeutic solution (once it is approved and once the market authorization is granted). An acceptance that can also be affected by pricing. The methodologies for the pricing of pharmaceutical products are usually defined by the health administrations of jurisdictions. Additional stakeholders can be involved in the price setting and price evolution, depending on funding systems in a given country and distribution channels (insurance companies, pharmacy benefit managers in the United States, etc.). One of the most common pricing methods is external referencing, which consists in using the price of a pharmaceutical product in one or several jurisdictions to derive a benchmark or to set a reference price. Pricing systems can also be based on markup regulations across the supply and distribution chain,<sup>[25]</sup> or on internal referencing,<sup>[26]</sup> or simply on negotiations (including through tenders).

23. Deloitte, *Advanced Biopharmaceutical Manufacturing: An Evolution Underway* (2015), available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/life-sciences-health-care/us-lshc-advanced-biopharmaceutical-manufacturing-white-paper-051515.pdf>.

24. P. Rosenom et al., *Biopharma Launch Trends — Lessons Learned From L.E.K.'s Launch Monitor*, XXII L.E.K Insights 87 (Dec. 2020).

25. A percentage or fixed mark-up could be specified at any point along the supply chain (e.g. ex-factory mark-up; and incorporating fee-for-service remuneration such as fees for dispensing or service quality). Other types of price regulation, such as direct price controls, could be set at any point along the supply chain, with a view to specifying the maximum prices, also referred to as price caps or price ceilings.

26. Using the prices of a set of pharmaceutical products that are therapeutically comparable and interchangeable to derive a benchmark or reference price for the purposes of setting or negotiating the price or reimbursement rate of a product.

However, the trend has been a move towards value and evidence-based pricing, which is an approach that aims to set prices for pharmaceutical products based on the value or worth that patients and healthcare systems attribute to the pharmaceutical products.<sup>[27]</sup> The shift over the last decade to value-based and evidence-based pricing has put an emphasis on real-world data and real-world evidence, increasing the importance of globally managed health economics and outcomes research, medical and market access departments with responsibility for generating evidence of the value of new interventions for reimbursement agencies and local healthcare payers with the aim of managing and securing the product's acceptance, approval and authorization.

While it can be acknowledged that in certain jurisdictions reality can be more complex: (i) in general, price negotiations tend to occur within price tunnels that are globally defined; (ii) promotion is performed through the communication of the clinical value proposition of the product; (iii) products are approved by regulatory bodies and defined by chemical or biological attributes; and (iv) the place of dispensing is highly regulated for prescription drugs. Hence the fundamental distinction that can be made between the functions involved in the definition of the value proposition and those ensuring that it is effectively and efficiently disseminated.

It could be legitimately argued that such an assertion is mainly valid for large products or franchises in MNEs, whilst the commercial management of mature portfolios or tail products is more decentralized. Industry statistics on 16 large pharmaceutical and biotech MNEs<sup>[28]</sup> nevertheless illustrate that the top three products account for around 40% of their revenues, and probably a more significant share of profits. This suggests that even if such a model were only applicable to the top ten products of a firm, it would remain a relevant business feature for transfer pricing purposes.

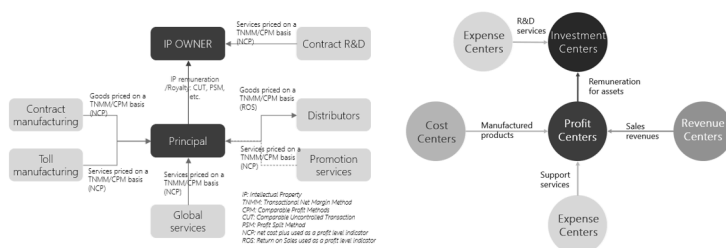
## 4. Typical Intercompany Transactional Model in the Pharmaceutical Industry

### 4.1. The rationale for centralized models

The rationality of the transactional models implemented within multinationals can be appraised through at least two prisms that tend to be intertwined: (i) a managerial view on the different functions and (ii) the existence of market templates.

The figure below illustrates the most common transactional framework observed in large pharmaceutical MNEs. Variations of this model include the presence of regional/specific principals operating in defined geographic areas or in a specific business area (e.g. a therapeutic area or industry sub-segment).<sup>[29]</sup> In addition, in some cases, the principal – acting as an operations and commercial entrepreneur – can also be the owner of the intellectual property of the products.

**Figure 7 – Commonly observed centralized transactional framework in pharmaceutical MNEs**



The management control system framework can be a simple and useful tool to analyse the functions/roles outlined in Figure 7 and described in section 3. For instance, in cost centres<sup>[30]</sup> the performance measurement requires the specification of standard quantities of direct labour and materials required for each unit of output, and managers are responsible for minimizing the variance between actual costs and standard costs on a yearly basis. Such features correspond to how manufacturing and services are managed within pharma MNEs.

Revenue centres would be units in which managers are responsible for maximizing sales volumes while respecting a budget commitment on expenses but not having the authority to significantly lower prices to increase volumes.<sup>[31]</sup> Within the pharmaceutical industry, distribution and promotion entities would typically fit the revenue centre characterization, given the lack of control they have in the product portfolio, and the formation and the management of the selling price in many jurisdictions where prices are directly or indirectly regulated and globally managed. Under such a model, the effect of the transactional model is to allocate residual profits to profit and investment

27. For more details on pricing, see WHO, *WHO guideline on country pharmaceutical pricing policies*, Web Annex B, Evidence-to-decision tables (2nd ed., World Health Organization 2020).

28. V. Patel et al., *How Business Strength Varies Across The Top Pharma Companies*, S&P Global Ratings (27 Aug. 2020).

29. Such would be the case for instance for a principal dedicated to prescription drugs or specialty care, and another one operating in generics and biosimilars or on consumer healthcare.

30. Or standard cost centres.

31. R.F. Vancil, *What Kind of Management Control Do You Need?*, Harvard Business Review (Mar. 1973).



centres who make cross-functional and integrative decisions as well as capacity decisions (on resources and asset investments that commit the organization over time). Note that a unit can be a profit and an investment centre, either fully acting as both, or in the context of cost-sharing agreements.

The rationality of such a model can also be corroborated by market templates in the pharmaceutical industry. In the area of R&D, pharmaceutical companies have for a long time resorted to clinical research organizations (CROs). The clinical trials segment of the CRO market is estimated to have reached USD 32 billion in 2021.<sup>[32]</sup> Similarly, pharma MNEs have outsourced a significant part of their manufacturing to contract development and manufacturing organizations. The contract development and manufacturing organization (CDMO) market was estimated at USD 90 billion in 2019,<sup>[33]</sup> 12% of which accounts for manufacturing services towards clinical development activities and the rest to commercial manufacturing. In addition, it should be noted that the market for contract packaging is deemed to match the size of CDMO (circa USD 60 billion). While less mature than the CRO and CDMO markets, contract commercialization outsourcing (estimated at USD 27 billion in 2019)<sup>[34]</sup> embeds sales activities (external sales force, key account and key opinion leader management) and medical, market access and marketing services.

It could therefore be concluded that the centralized transactional framework depicted in figure 7 reflects the transactions pharma MNEs engage in with third parties. Moreover, absent any specific competitive advantage, the result is that remuneration policies based on costs for manufacturing and service provider operators and based on sales for distribution and promotion entities generally fit the management control systems framework. As such, the model embeds a reasonably high level of economic rationality.

It is worth noting that one of the business benefits of such a transactional model is to accommodate the integration of acquisitions with a fully automated transactional model in which the individual segments of the acquired business can be linked to the appropriate transactional module.

The review of market templates in the pharmaceutical industry is also likely to evidence the particular role of capital-based transactions. Over a decade, transactions such as royalty securitization or venture capital funding targeting specific portfolios of development programmes have been on the rise. They evidence that in this industry, capital investments – at risk – can attract remunerations based on third-party sales without a major control over DEMPE (development, enhancement, maintenance, protection and exploitation) functions.

## 4.2. Entitlement to residual profits

Given the weight of intangibles in pharmaceuticals, their remuneration and the determination of the entities within an MNE group that are entitled to the revenues rising from the exploitation of intangibles is critical. As specified by the OECD Guidelines,<sup>[35]</sup> the exploitation of an intangible includes both the transfer of the intangible or rights in the intangible and the use of the intangible in commercial operations.<sup>[36]</sup> There are two critical stakes:

- the allocation of the R&D risks and expenditure – 15% of the MNE's annual sales – and their effective deduction; and
- the allocation of residual operating profits<sup>[37]</sup> derived from commercialized compounds: around 30/35% of third-party sales. Note that a 2-to-3-point impact from OECD's Pillar One<sup>[38]</sup> would only marginally reduce the relevance of this issue.

Thus, the contribution of the 2017 OECD Guidelines<sup>[39]</sup> on the entitlement to residual profits, through the analysis of DEMPE functions and the effective control over risk, require particular attention in the pharmaceutical industry. These ideas can be considered some of the most intrusive transfer pricing measures in the sense that they require an in-depth analysis of how MNEs are run with limited guidance.

When launching such an analysis, one suggestion is to reverse-engineer the process, starting with the identification of significant economic and operating risks. If the degree of exposure to certain risks can vary from MNE to MNE, the review of the risk management sections of annual reports yields a rather uniform list of risks among which DEMPE-related risks can be identified:

- patient safety monitoring;
- R&D success and portfolio regeneration;
- manufacturing quality standards;
- continuity of supply: supply shortages and other disruptions risks;

32. K. Brookes, *CRO Industry Market Report*, Contract Pharma (6 July 2022), available at [https://www.contractpharma.com/issues/2022-06-07/view\\_features/cro-industry-market-report/](https://www.contractpharma.com/issues/2022-06-07/view_features/cro-industry-market-report/) (accessed 11 Oct. 2022). Including early research, lab support and analytics, the market is deemed to be worth between USD 50 and 60 billion.

33. K. Bottomley & A. Newrzella, *Outsourced Pharmaceutical manufacturing 2020, Current Trends and Future Prospects*, Results Group LLP (22 Nov. 2019).

34. *Pharmaceutical Contract Sales Outsourcing Market Size, Growth, Trends, Forecast 2021-2030*, BioSpace (10 Aug. 2022), available at <https://www.biospace.com/article/pharmaceutical-contract-sales-outsourcing-market-size-growth-trends-forecast-2021-2030/> (accessed 11 Oct. 2022).

35. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), Primary Sources IBFD [hereinafter *OECD Guidelines* (2022)].

36. *Id.*, at para. 6.32, footnote 3, p. 255.

37. Solely for the purpose of illustration, we will assume an EBIT (earnings before interest and tax) of 25%, therefore a pre-R&D EBIT of 40% of third-party sales, where 5% are allocated to distributors/markets, 3% to manufacturers and 2% to diverse service providers, with therefore a residual profit of 30% of sales.

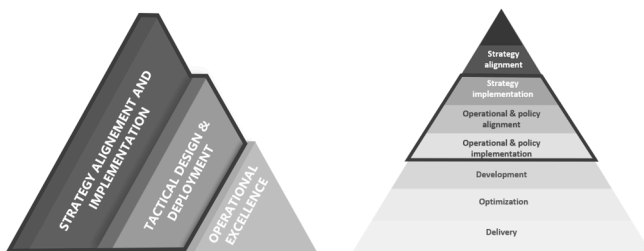
38. Example: 25% x ((between 20% and 25%)-10%), bearing in mind that Pillar One metrics apply on adjusted net income, not EBIT.

39. And included in the *OECD Guidelines* (2022).

- integration and success of acquisitions and alliances;
- managerial and operational efficiency;
- risks arising from the increased digitalization of operations;
- reliance on third parties;
- market competition: patent protection and generic/biosimilar entries;
- pricing and reimbursement policies/cost containment measures;
- international operations with a large footprint;
- credit risk;
- ethics: respect of codes of conduct through the value chain;
- environmental, social and governance matters; and
- reputational risks.

The subsequent step is – within the identified functions managing the selected DEMPE risks – to determine the adequate level of analysis. Focus could be placed on architectural competencies<sup>[40]</sup> and integrative or combinative capabilities<sup>[41]</sup> that can provide meaningful guidance on how MNEs preserve and develop their competitive advantage, enabling the generation of significant residual profits, as opposed to component competencies that are essential for day-to-day problem solving at a local or component level.

**Figure 8 – Illustrations of the proposed level of functional analysis for the allocation of residual profits**



As depicted in Figure 8, within the DEMPE functions, a priority could be given to high to intermediate levels of management, focusing on strategy implementation and operational alignment, where those architectural competencies might be captured. An analysis carried out solely at the strategy alignment level might not provide enough guidance on control over risk aspects, as such a level might be mainly devoted to strategic decision making.

From a practical standpoint, in large MNEs, a starting point could be the governance bodies that oversee key aspects of IP generation, launch and commercialization. Typically, such bodies are cross-functional bodies that supervise the IP R&D pipeline, prepare the clinical evaluation of the projects and govern resource allocations of the R&D functions, including but not limited to the committee that approves development phase transitions or project prioritization. From a commercial standpoint, functions such as launch excellence, market access and pricing, and medical evidence generation could be the centre of attention.

Further guidance on the nature of functions and the identification of significant risks could be sought from the increasingly complex collaboration agreements between pharmaceutical operators, but also from simpler licence agreements when the DEMPE analysis is only carried out on IP. Sophisticated alliances that involve a continuous collaboration between parties on key aspects of the development, manufacturing and commercialization of a drug are likely to provide deeper evidence of how functions are allocated, and of how risks are managed between third parties in a collaborative environment, pursuing common and particular interests. Indeed, governance through the delineation of joint committees could allow practitioners to (i) focus on the relevant DEMPE (those that are agreed with third parties), and (ii) to provide market templates to tax administrations on allocations of functions and risks that can take different forms. Similar analysis can subsequently be duplicated, with the same set of functions and risks, within the MNE, to substantiate (or to test the substance) of the transactional framework of the MNE.

40. T. Chi & J. Zhao, *Equity Structure of MNE Affiliates and Scope of Their Activities: Distinguishing the Incentive and Control Effects of Ownership*, *Global Strategy Journal* (2014).

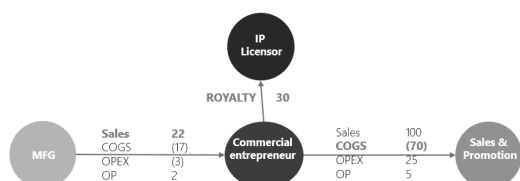
41. R. Henderson & I. Cockburn, *Measuring competence? Exploring firm effects in pharmaceutical research*, *Strategic Management Journal* 15, pp. 63-84 (1994).

DEMPE and control over risk in the review of residual profit allocations could become one of the most important challenges for the pharmaceutical industry, and evidence from third-party behaviour might be the most reliable way to document the level of granularity of the analysis, as well as the relevant functions and risks.

### 4.3. Operational transfer pricing

While operational transfer pricing is not an issue specific to the pharmaceutical industry, it is of great importance given the centralized transactional framework depicted in section 3.1 and the magnitude of the margins embedded in transfer prices, and more specifically in transfer prices to distribution and promotion entities.

**Figure 9 – Illustration of transfer pricing transactions in a centralized model**



In this example,<sup>[42]</sup> the implementation of transactional net margin method (TNMM)-based policies for manufacturing and sales and promotion functions generates a high intensity intercompany framework where for 100 third-party sales, intercompany transactions of 122 are necessary. One of the specificities in pharmaceutical (and in general to intangible-intense segments such as high-tech products<sup>[43]</sup> or luxury) is the relatively reduced number of API or drug substance manufacturing sites, which tends to maximize the impact of such a model in terms of intercompany activity.<sup>[44]</sup> The complexity can be increased by dedicated primary and secondary manufacturing sites that need to transact before the acquisition by the licensor (in this example).

The exposure within pharmaceutical MNEs is high, commensurate with the intensity of its transactional framework, thus increasing the stakes related to compliance on taxes that are pegged to transactions, such as VAT and customs duties. The sensitivity of the matter is finally augmented by the high number of SKUs (stock keeping units) in large pharmaceutical MNEs, which is driven by several factors such as several dosages per drug and important regulatory constraints (labelling, drug information). Such intricacies explain the fact that pharma MNEs have tended to be early adopters of technology and processes for operational transfer pricing.

In the implementation of transfer pricing policies, and more specifically in the case of TNMM/comparable profit method (CPM), for promotion and distribution companies, the question of the granularity of the calculation is often raised: on a product-by-product basis, or on a portfolio basis. The portfolio basis is the most encountered approach for the determination of transfer prices, as it is on a par with the actual management of distribution affiliates,<sup>[45]</sup> with a likelihood of having relevant financial data for the transfer pricing calculations that is therefore increased. With the metrics of Figure 9, assuming that the 100 is now generated by a portfolio of products, the transfer prices would be calculated to generate a gross margin of 30% for the affiliate.

Mechanically, it implies that regardless of their maturity (launch phase, mature), the products could yield the same gross margin, and as such, the prices of individual products become highly interdependent. If such approach is retained, it should be supported by evidence on how the business is effectively run from a managerial standpoint, and most importantly, properly documented in the intercompany supply agreement. These are both factors that can be of assistance when entering discussions with tax or customs administrations on individual pricing. Moreover, there are markets in the pharmaceutical industry that have implemented regulated margin systems,<sup>[46]</sup> whereby import prices are expressed as a fixed percentage and transactional models need to be adapted.

Finally, particular attention should be paid to TNMM/CPM-based transfer prices on active ingredients sold to distribution affiliates that are equally in charge of secondary manufacturing. This particularly applies to prescription drugs that are no longer protected by patents and for which analogues could be traded in the free market. There are many valid reasons to deviate from analogue prices, based on comparability criteria such as quality, purity, concentration and embedded intangibles or economic attributes (such as selling price differentials in the market), provided they can be documented and quantified. The difficulty remains with TNMM policies based on portfolio approaches, given the interdependency of transfer prices between products that can impact the pricing of specific APIs imported by pharmaceutical MNE affiliates.

42. Using metrics derived from Figure 1, and using a 10% net cost plus mark up for manufacturing and a 5% return on sales solely for illustration purposes.

43. For high-tech components.

44. In comparison with industries that have large webs of manufacturing sites to supply local markets.

45. Even if in some cases, promotion and distribution entities can be managed by therapeutic business units.

46. Not for tax or transfer pricing purposes (unlike Brazil, for instance).

## 5. Selected Transfer Pricing Issues in the Pharmaceutical Industry

### 5.1. Can benchmarking still make the cut for intangible valuation in pharmaceuticals?

Between January 2018 and May 2020, a median monthly number of 55 licensing deals were concluded in the pharmaceutical industry.<sup>[47]</sup> Business-oriented<sup>[48]</sup> databases<sup>[49]</sup> are widely used by pharma operators for the calibration of their in- and out-licensing transactions and can contain up to more than 100,000 data points. Large databases are therefore able to accommodate granular searches according to therapeutic area (if relevant), development phase or geographic scope criteria. Despite the liquidity of the market, tax administrations have expressed serious concerns about the use of the comparable uncontrolled price (CUP) method for the valuation of IP assets in the pharmaceutical industry.

Two main shortcomings are usually invoked on the application of the CUP method: (i) the uniqueness of the assets which prevent the satisfaction of comparability criteria; and (ii) unaccounted differences in profit potential between assets which can alter the comparison.

However, given the large number of observations in the market, benchmarking could still be the foundation of the delineation of relevant metrics, if it is not based on the sole contractual royalty rates of third-party licence agreements. Indeed, elements such as tiered royalties, upfront payments and development and/or commercial contingency payments (milestones) are ubiquitous in the pharmaceutical licensing agreements. The first step should therefore be the computation of an effective royalty rate, which can be achieved through financial modelling involving sales curves that can be pegged to sales triggers of milestones and can also embed profitability assumptions to derive proxy levels of profit split metrics. In practice, wide ranges could be indicative of comparability issues and their relevance could be discarded by tax administrations.

The best alternative means to overcoming data-related limitations is the review of internal comparables, for which the MNE (as a licensor or a licensee) has prepared contemporaneous data sets reflecting the expectations of the parties. Such data sets should allow the transfer pricing practitioner to narrow the external benchmark range through more accurate economic adjustments, or – beyond the royalty rate – to establish arm's length profit-split ratios that could substantiate the selection of a point in the benchmark range or drive the modelling of options realistically available to the firms.

Benchmarking could as such remain a powerful starting point for the valuation of intangibles in the industry, provided the results are corroborated by a secondary method, usually a profit split method, where internal comparables or alternative financial valuation methods play a critical role.

One significant limitation is related to the fact that a large share of third-party licensing deals are concluded at either pre-clinical or phase 2, with a lower number of transactions for approved drugs. It is also worth noting that the CUP method can prove difficult to apply to transversal assets such as technology platforms, where the value is derived from the ability of the licensor to combine those assets with its own assets or the functions owned or performed by the MNE.

### 5.2. Projections v. actual results on intangible valuations: Adjustments?

Regardless of the method used for the determination of the remuneration of an intangible asset – CUP/comparable uncontrolled transaction (CUT) method, discounted cash flows, profit splits, Monte Carlo simulations, real options – financial projections are of the utmost importance, as they represent the expectations of parties at the inception of the transaction.<sup>[50]</sup> It applies in the context of a straightforward licensing or in a more complex structure such as cost sharing or cost contribution agreements. Because those transactions are usually entered into for long periods, and spread over several audit cycles, the comparison of the initial projections and the actual outcomes are often a point of tension between tax administrations and taxpayers, with a high potential for hindsight. The asymmetry of information that exists between third parties in third-party deals is replaced on intercompany transactions by an information asymmetry between the taxpayer and the tax administrations.

The US tax administration (Internal Revenue Service, IRS) and more recently the OECD have provided guidance on how tax administrations and taxpayers should assess the relevance of significant divergences between initial projections and actual results for intangible valuations: the periodic adjustment sections in US Treas. Reg. §1.482<sup>[51]</sup> and the hard-to-value intangibles section in the OECD Guidelines (2022).<sup>[52]</sup> While the use of actual results to question ex ante projections is an appealing concept, it is questionable from an economic standpoint.<sup>[53]</sup> The main reason would be the resulting gap in the appraisal of risks (including R&D, technology, commercial or

47. Torreya, *Biopharmaceutical Sector Update on the Financing and Deal Environment*, Torreya (29 May 2020).

48. Non transfer pricing-driven.

49. Examples: current agreements, Cortellis Deals Intelligence, IQVIA Pharma Deals, DealForma.

50. A specific difficulty has been noted on previously mentioned transversal assets such as technology platforms, for which financial valuations are particularly difficult to elaborate. Alternative appraisal methods, such as Shapley values, could be pursued. See V. Hahn et al., *Shapley Value: A Fair Solution to the Value Creation Puzzle in Transfer Pricing?* (18 Oct. 2021), reprinted from Tax Notes International (18 Oct. 2021, pp. 291-306) with permission from Tax Analysts, available at: <https://ssrn.com/abstract=3969517> (accessed 11 Oct. 2022).

51. Treas. Reg. §1.482-4(f)(2) for intangible valuation and Treas. Reg. §482-7(i)(6) for cost sharing agreements.

52. Ch. D-4, paras. 6.186 to 6.195 *OECD Guidelines* (2022).

53. P. Penelle, *The OECD Hard to Value intangible guidance*, *Intangibles*, p. 13 (3rd ed., *International Tax Review* 2016).

macro-economic risks). Indeed, ex ante projections embed assumptions on risks and proxies to control for those risks in the valuation, whereas actual profits are by nature de-risked.

A candid interpretation of the periodic adjustment mechanisms would be to evaluate whether actual numbers that significantly depart from projections are indicative of an obvious (or deliberate) distortion at the inception of the transaction. If the comparison could trigger a reasonable doubt on assets for which no IP generation is involved, the impact of the probability of success on – for example – a portfolio of developed and in-development assets that are licensed, cost-shared or sold, is such that it could render the exercise tremendously perilous for taxpayers.

While there are many differences between the IRS and OECD approaches, to properly rebut the presumptions on initial projections or to adequately engage with tax administrations, it is necessary that taxpayers devote significant efforts to substantiating the main assumptions behind the financial projections. In the pharmaceutical industry this could be achieved through the documentation of the following items:<sup>[54]</sup>

- patient-based models: documentation of the prevalence of the disease, population, treatment per day and dosages;
- competition landscape: expected market shares, existing and anticipated competition and pricing assumptions and impact on revenue curve;
- pricing assumptions per main territory (usually the United States and the rest of the world);
- review of the probability of success rates if development activities are involved with proper internal or external benchmarks;
- expected weight of COGS and operating expenses (OPEX) (avoiding normalized rates if possible);
- segmented profit and loss statements (P&Ls), where significant differences in profitability exist between territories;
- decay assumptions when reaching the loss of exclusivity (price and volumes); and
- the word on the street: corroboration by external financial analyst notes or consensus.

The main value of the clear definition of such parameters would be to provide the ability to derive different valuation scenarios when establishing the arm's length conditions of licensing, to delineate the risks borne by each party and to illustrate on an ex ante basis the entitlement to profits of each party based on the materialization of certain assumptions.

Significant variances between projections and actuals can stem from single events (failure of an indication, accelerated approval, adverse events) or from a larger number of smaller impact events. Taxpayers ought to properly be prepared to bridge the gap between actuals and projections and establish that the latter were established in good faith and delineate the variances that are part of the normal conduct of business for each party to the transaction. This shall be the case whether third parties would have renegotiated the terms or not, which can also be documented through the review of internal or external comparables.

### 5.3. Pharma(s)

So far, this article has addressed pharma as a single business segment, whereas the industry is composed of several sub-segments that can have economic attributes that can influence the economic analysis of the different operators of the value chain.

The main segments that can be mentioned are the following (bearing in mind that operators in the market can be diversified or specialized):

- prescription drugs (Rx): the biopharma segment is composed of traditional pharma MNEs increasingly present in biologicals, as well as pure biotech players at different stages of development. While some groups are increasingly leaning towards specialty care, some smaller companies remain active mainly on primary care;
- generics account for the vast majority of volume in the pharma industry. They are mainly present in small molecules, a quality- and volume-driven business where capital expenditure, R&D and marketing expenditures are lower than in biopharma. The rise of biosimilars is generating different market patterns (higher investments and hence lower price decreases when reaching the market); and
- unlike the previous segment, consumer healthcare products (over the counter, OTC) are not prescribed products, with prices that are less (or not) regulated, with significantly less investment in R&D and a higher reliance on branding. They nevertheless share similar distribution channels with the other segments.

The main question that arises is whether the economic attributes of the different segments differ in such a magnitude that they would require a significant overhaul of the transfer pricing framework of prescription drugs. The most important differences are the weight of R&D and intellectual property on the value chain (even if for biosimilars – depending on the approval route that is taken – significant studies need to be carried out) and that R&D is also performed for OTC products, though to a much lesser degree. However, it should be

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54. In addition to general financial elements such as the discount rate.



noted that all categories of products require a formal approval process<sup>[55]</sup> – although less complex than Rx drugs – and rely on a market authorization delivered by a regulatory body to ensure the safety of the patients and the quality of the products.

The main differences could be related to the marketing function, given the differences that exist in terms of pricing dynamics and promotion intensity. For instance, the progressive deregulation of OTC distribution (allowing the distribution of products outside pharmacies) combined with free pricing could shift the segment closer to fast-moving consumer goods. Generics evidence a different marketing profile, as they rely significantly less on promotion, and more on volume and quality to ensure a proper substitution of off-patent branded drugs. This is a substitution at the point of sale that is often encouraged by health authorities or may even be mandatory.

As such, differences exist, because the value chains tend to differ between the segments. The main issue is related to the lack of homogeneity in the Gx and OTC markets, driven either by different consumer behaviours and/or regulations. In the European Union, the regulatory framework with articles dedicated to promotional activities and advertising of medicinal products is regulated by Directive 2001/83/EC of the European Parliament and of the Council of 6 November 2001 on the Community code relating to medicinal products for human use, applicable to OTC products. In the United States, the FDA regulates the labelling of non-prescription drugs, but it does not regulate the advertising; that responsibility largely rests with the Federal Trade Commission, except for certain OTC drugs approved under new drug applications. In addition, there is not a harmonized classification of Rx/OTC products, and in some countries, OTC products can be both prescribed and available on pharmacy shelves.

Rather than developing a whole new framework for OTC and generics, a sound recommendation could be to ensure that at the very least promotion and distribution benchmarks include OTC and Gx products. But again, because in many countries they follow the same distribution routes as Rx products, this approach also has its limitations, as local operators tend to be involved in several market segments.

## 5.4. Benchmarking (other than intangibles)

As suggested by section 4.1., an important number of market templates exist for clinical research and manufacturing functions. Despite the ongoing consolidation and the vertical integration in both segments, databases shall continue to yield rational results for the benchmarking of both functions. The difficulty of the exercise can nevertheless be more connected to evolutions within the pharmaceutical MNEs, with more agile and interconnected R&D models and with the ever-increasing prevalence of biological manufacturing, for which market templates are rarer and for which risks tend to diverge from chemical manufacturing.

For the promotion and distribution function, adequate benchmarking can be problematic as market templates are scarcer, reducing the number of hits returned by databases for certain territories once certain filters are applied for the search, to exclude operators with high R&D-to-sales ratios or agents with insufficient OPEX-to-sales ratios.<sup>[56]</sup> The number can be further reduced during qualitative reviews regarding the pharmaceutical segment they operate in to ensure a minimum alignment with the activities carried out by the tested party. In many instances, the searches are likely to yield a limited number of comparable companies, unless criteria is loosened, either on the operating sub-segment or on the geographical scope. Both elements in many cases lead to difficult discussions with tax administrations.

The relative lack of comparables in the market is likely to lead to objections on the use of TNMM/CPM methods and encourage the use of the profit split or residual profit split methods, with the OECD's Pillar One being only the most structured attempt to generalize the concept through the allocation of a portion of "excess profits".<sup>[57]</sup> Another approach would be to normalize returns for promotion and distribution entities in the industry (Amount B within Pillar One to some extent) or to encourage/incentivize MNEs through pre-established metrics. The Australian Taxation Office, for example, has partially addressed the matter through the issuance of its Practical Compliance Guideline's risk assessment framework for life science distributors in its territory<sup>[58]</sup> where – for risk assessment purposes – ranges of operating profits have been disclosed depending on the functions undertaken by the local affiliate.

From a practical standpoint, the question remains how compliance through benchmarking can be enhanced for the promotion and distribution function, after<sup>[59]</sup> or without<sup>[60]</sup> Pillar One's implementation. Several leads could be taken into consideration:

- broad categories of markets could be defined based on the economic attributes that could impact the economic return of an independent distributor, through pricing, market structure, the reimbursement system, wholesaling practice (or margin distribution between wholesales, pharmacies, etc.). To be efficient, such an approach would need to yield quite a limited number of categories;
- more meaningful results could be yielded through a broader functional scope in benchmarking: in line with the remarks in section 5.3., it could be that a larger number of companies that might differ in the sub-segment in which they operate would yield a more meaningful

55. For example, in the US territory, the review of over the counter (OTC) products is handled by the US Food and Drug Administration's Division of Drug Information (CDER), the Office of Drug Evaluation and the Nonprescription Drug Advisory Committee. These bodies assess and review OTC ingredients and labels. A drug monograph is established for each class of product. The monograph is composed of acceptable ingredients, doses, formulations and labeling. New products that are in conformity with existing OTC drug monographs can be launched in the market without further review. Those OTC products that do not must obtain an approval through the FDA's New Drug Approval System.

56. Or with revenue thresholds to avoid size distortions.

57. To avoid confusion with the term "residual", which is used in a different manner for transfer pricing purposes.

58. ATO Practical Compliance Guideline, PCG 2019/1, transfer pricing issues related to inbound distribution arrangements: not specific to the life science industry but containing specific guidance for certain industries including life sciences.

59. After for those pharmaceutical MNEs that are not in the scope, mainly due to the revenue threshold or profitability threshold in the case of emerging MNEs.

60. Because it is very likely that without Pillar One implementation the trend towards residual profit split or profit split methods will only increase, fostered by the analysis carried out by the OECD and in the Inclusive Framework.

statistical result than a benchmark on a reduced number of observations. Across business sub-segments, the similarities (distribution channels, point of sale, regulatory environment) should bear a sufficient weight to partially neutralize product differences (promotion to consumers for OTC, pricing). Undoubtedly, additional evidence would be necessary to corroborate such an assumption;

- SG&A-to-sales ratios are likely to require adjustments should the comparable companies yield significantly lower or higher ratios. As noted in section 2.2., SG&A to sales ratios are significant in the industry and need to be accounted for. While it could be argued that large deviations could be indicative of functional differences, an economic adjustment for the differential of SG&A/OPEX could be an interesting alternative to resorting to bilateral methods; and
- if the three previous steps can contribute to partially cope with the difficulties of benchmarking in the industry, they still do not address the lack of comparables in emerging economies, which prevents a balanced discussion between tax administrations and pharmaceutical MNEs. An interesting option to consider could be derived from the roll out of country risk adjustments<sup>61</sup> on globalized benchmarks.

The crux of the issue is that in a post-BEPS, pre-or-post-Pillar One environment in a complex and exposed industry like pharmaceuticals, there will be a growing need to provide additional evidence of the rationality of the benchmarking exercise. Failing to do so might just contribute to accelerating the proliferation of non- or less-than-arm's-length-based solutions and transfer pricing controversy.

## 6. Conclusions

There is no doubt that the pharmaceutical industry is highly exposed from a transfer pricing standpoint, with high stakes associated with the high profitability of the industry.

Such exposure can be associated with:

- a lack of understanding of the economics prevailing in the industry and the lack of homogeneity of certain pharmaceutical markets or segments. This can lead either to the overemphasis or underestimation of the impacts of markets and/or segment differences on transfer pricing policies;
- its high reliance on the complex generation and exploitation of intangibles: generating multi-year exposure with often multifaceted valuation aspects that need to be at the same time technically accurate and fit for discussions with tax administrations;
- complex business models with either vertically integrated MNEs or niche operators, specialized MNEs or highly diversified companies. Such models can generate a significant data constraint for transfer pricing practitioners that needs to be factored when designing transfer pricing policies; and
- a transfer pricing-intense transactional framework to ensure an adequate allocation of high system profits on a large spectrum of jurisdictions: transfer pricing in pharmaceuticals is a pull system, where profits are pulled from markets for upstream reallocation, creating a high-risk environment in many jurisdictions.

In line with the 2017 and 2022 OECD Guidelines, transfer pricing policies within the industry need to be increasingly sustained by real world evidence, stemming from business operations, market templates (third-party behaviour) and grounded economic and financial analysis. It is only through such efforts that transfer pricing models, policies and methods will be able to overcome the next generation of changes in the value chain, as well as the functional and economic analysis arising from the digitalization of pharmaceutical MNEs.

It is nevertheless necessary to mention that industry practitioners face a large spectrum of challenges: complex and technical challenges (US cost-sharing regulations, intangible valuations, DEMPE functions tests) in a limited number of jurisdictions, while in many emerging markets basic issues such as disagreements on value chain (marketing mainly), industry-specific facts and circumstances or a lack of comparables can lead to substantial controversy.

In this respect, the work initiated by the UN Subcommittee on Transfer Pricing with the release of the Practical Manual on Transfer Pricing for Developing Countries in 2021, and the future work on industry-sector guidance on pharmaceuticals, could prove key in setting a common ground between pharmaceutical MNEs and the tax administrations of emerging countries.

61. B. Steens et al, *Transfer pricing comparables: Preferring a close neighbor over a far-away peer?* Journal of International Accounting, Auditing and Taxation 47 (2022).

## International

**Caroline Silberstein and  
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# Does Intangible Ownership Move with the People That Perform the DEMPE Functions?

In the context of globalization and accelerated by the COVID-19 pandemic, recruitment pools are becoming global, remote team working becomes common, and employees performing significant value adding functions may be located in different jurisdictions, not always in the country of the head office or of the entity that owns the group's valuable intangibles. While the identification of significant people functions has been a critical point in transfer pricing analyses for more than 25 years, its precise significance in the OECD Guidelines has evolved in successive waves. The greater emphasis on people functions raises questions on the impact that workers' or functions' mobility can have on the allocation of intangible ownership and return.

## 1. Introduction

For many multinational enterprises, the recruitment pool is becoming global, especially in the areas that are deemed compatible with remote team working, and competences are hired where they are found. This trend was facilitated by globalization and accelerated by the COVID-19 pandemic and the new working habits that derived from it. As a consequence, employees performing significant value adding functions may be located in different jurisdictions, not always in the country of the head office or of the entity that owns the group's valuable intangibles. Further, these employees may be relocated over the years – internal mobility being a significant feature of many multinational enterprises' human resources management; or a function may be relocated upon the recruitment of a new employee in a country different from the one in which the predecessor was based. Situations where a multinational enterprise has its complete management team sitting in the same building are becoming exceptional.

This raises important questions in the area of transfer pricing as greater emphasis is put nowadays on the location of people functions. This article focuses on the evolution of this concept in OECD guidance over time, in an attempt to clarify the impact that workers' or functions' mobility can have on the allocation of intangible ownership and return.

## 2. Definition of Intangibles for Transfer Pricing Purposes and Their Significance

The definition of intangibles for transfer pricing purposes in the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* [hereinafter *OECD Guidelines*] is the following: “the word ‘intangible’ is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.”<sup>[1]</sup>

On the one hand, this definition is relatively broad given it does not provide for an exhaustive list but rather uses a negative formulation, i.e. something which is not a physical or financial asset and not limited to the legal or accounting definitions. On the other hand, the OECD in this definition carefully narrowed and delineated the scope of intangibles for transfer pricing purposes, stating that intangibles are “capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”. In other words, not everything that is not a physical or financial asset consists in an intangible: in particular, location-specific advantages are not intangibles but comparability factors.

Intangibles do not all have the same impact on value creation and on the selection of the most appropriate transfer pricing method. Some are characterized as “routine”, others as “unique and valuable intangibles”. The latter encompass “intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would

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1. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022) para. 6.6., Primary Sources IBFD [hereinafter *OECD Guidelines*]

be expected in the absence of the intangible.”<sup>[2]</sup> For instance, it can be expected to be the norm in a given industry for distributors to have sufficient commercial know-how and clientele to perform their distribution activities (otherwise, they would not be hired as distributors in the first place); such commercial know-how and clientele would likely be regarded as routine, i.e. not unique, if they can reasonably be expected to be present in similarly situated independent parties. The identification of “unique and valuable intangibles” has consequences on the selection of the most appropriate transfer pricing method and determination of arm’s length prices for transactions involving the use of intangibles alone or in connection with sales of goods or the performance of services.

### 3. Evolution of the OECD Thinking in Relation to People Functions: From “Functions (Taking into Account Assets Used and Risks Assumed)” to “Assets Used and Risks Assumed (Taking into Account Functions Performed)”?

While the identification of significant people functions has been a critical point in transfer pricing analyses for more than 25 years, its precise significance in OECD Guidelines has evolved in successive waves.

The 1995 OECD Guidelines provided, as part of the functional analysis, that “compensation usually will reflect the *functions* that each enterprise performs (*taking into account* assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, comparison of the functions taken on by the parties is necessary. This comparison is based on a functional analysis, which seeks to identify and to compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. For this purpose, particular attention should be paid to the structure and organization of the group. It will also be relevant to determine in what juridical capacity the taxpayer performs its functions”. [Emphasis added]<sup>[3]</sup> Thus, the identification of significant functions (taking into account assets used and risks assumed) already played a prominent role in the 1995 OECD Guidelines.

In 2008 and 2010, as part of its Authorised OECD Approach (AOA) for attributing profits to permanent establishments<sup>[4]</sup> (PE), the OECD introduced the notion of significant people functions in order to “[...] attribute to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE.” The relevant significant people functions can “vary from business sector to business sector [...] and from enterprise to enterprise within sectors”.<sup>[5]</sup>

The rationale for this approach whereby risks and assets follow functions in an intra-entity setting was precisely the lack of legally binding agreements between two parts of the same legal entity, hence the impossibility to rely on contractual allocation of intangible rights and risks between a head office and its foreign permanent establishments:

The factual, legal position in a PE context [...] is that there is no single part of an enterprise which legally ‘owns’ the assets, assumes the risks, possesses the capital or contracts with separate enterprises. The legal position is thus unhelpful in a PE context, since Article 7(2) requires the PE to be treated as if it were a distinct and separate enterprise, performing its own functions, assuming its own risk and owning or using assets on its own. It is therefore necessary under the arm’s length principle of Article 7 to develop a mechanism for attributing risks, economic ownership of assets and capital to the hypothetically distinct and separate PE, for associating with the hypothetically distinct and separate PE the rights and obligations arising out of transactions between separate enterprises and the enterprise of which the PE is a part and for recognising and determining the nature of the “dealings” (i.e., the intra-enterprise equivalents of separate enterprise transactions) between the hypothetically distinct and separate PE and other parts of the enterprise of which the PE is a part.<sup>[6]</sup>

It was expressly stated that this approach, developed to deal with the specific challenges of attributing profits to a PE in a single entity context under article 7 of the OECD Model Tax Convention, was not intended to apply under article 9 of the OECD Model Tax Convention for allocating profits between associated enterprises that are distinct legal entities where reliance on intragroup contracts is possible – subject of course to those contracts to reflect the economic substance of the transaction and to comply with the arm’s length principle : “between unrelated enterprises, the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts or other ascertainable legal arrangements. Similar considerations apply to associated enterprises *providing those contracts or legal arrangements reflect the underlying reality* and meet the criteria in Chapter I of the Guidelines. [...] Similarly, in a separate enterprise context no issues generally arise over determining which enterprise possesses the capital.” [Emphasis added.]<sup>[7]</sup>

In the 2010 OECD Guidelines (which apply to transfer pricing between legally distinct associated enterprises), a new chapter related to the transfer pricing aspects of business restructurings was introduced. In this chapter, noting the critical importance of intragroup allocations of risks and intangibles return in the context of business restructuring, the OECD aimed at strengthening its framework to determine whether a particular risk allocation or reallocation is arm’s length. The OECD concluded that “Unlike in the AOA that was developed for

2. OECD Guidelines (2022), para. 6.17.

3. OECD Guidelines(1995), para. 1.20.

4. For almost a century, the work of the OECD has oscillated between an assimilation or a differentiation of subsidiaries and permanent establishments.

5. Paras. 18 and 19 of the OECD (2008) and (2010), *OECD Report on the Attribution of Profits to Permanent Establishments*, Primary Sources IBFD.

6. Id., at para. 17.

7. Id.

Article 7, the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it. [...] However, [...] a tax administration is entitled to challenge the purported contractual allocation of risk between associated enterprises if it is not consistent with the economic substance of the transaction.”<sup>[8]</sup>

Hence, in determining whether an allocation of risks is arm’s length, the existence of comparables remains critical, in accordance with the overarching arm’s length principle. The 2010 OECD Guidelines stated that “where data evidence a similar allocation of risk in comparable uncontrolled transactions, then the contractual risk allocation between the associated enterprises is regarded as arm’s length. [...]”<sup>[9]</sup> By contrast, “[...] where no comparables are found to support a contractual allocation of risk between associated enterprises, it becomes necessary to determine whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances. [...] In the absence of comparables evidencing the consistency with the arm’s length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances.”<sup>[10]</sup>

Control “should be understood as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions.” Importantly, subcontracting the performance of some functions does not lead to a reallocation of risks: “when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.”<sup>[11]</sup>

The OECD again emphasized that “The reference to the notions of “control over risk” and of “financial capacity to assume the risk” is not intended to set a standard under Article 9 of the OECD Model Tax Convention whereby risks would always follow capital or people functions. The analytical framework under Article 9 is different from the AOA that was developed under Article 7 of the OECD Model Tax Convention.”<sup>[12]</sup>

Thus, in the 2010 OECD Guidelines, the performance of risk control functions and the financial capacity to assume risk were relevant, although not determinative factors in assessing the compliance with the arm’s length principle of risk allocations: they do not trigger an automatic (re-)allocation of risks, by contrast with the standard under the AOA (according to which, in an intra-entity set-up, risks follow functions).

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8. OECD Guidelines (2010), paras. 9.11-9.12.

9. OECD Guidelines (2010), para. 9.18.

10. OECD Guidelines (2010), paras. 9.19-9.22.

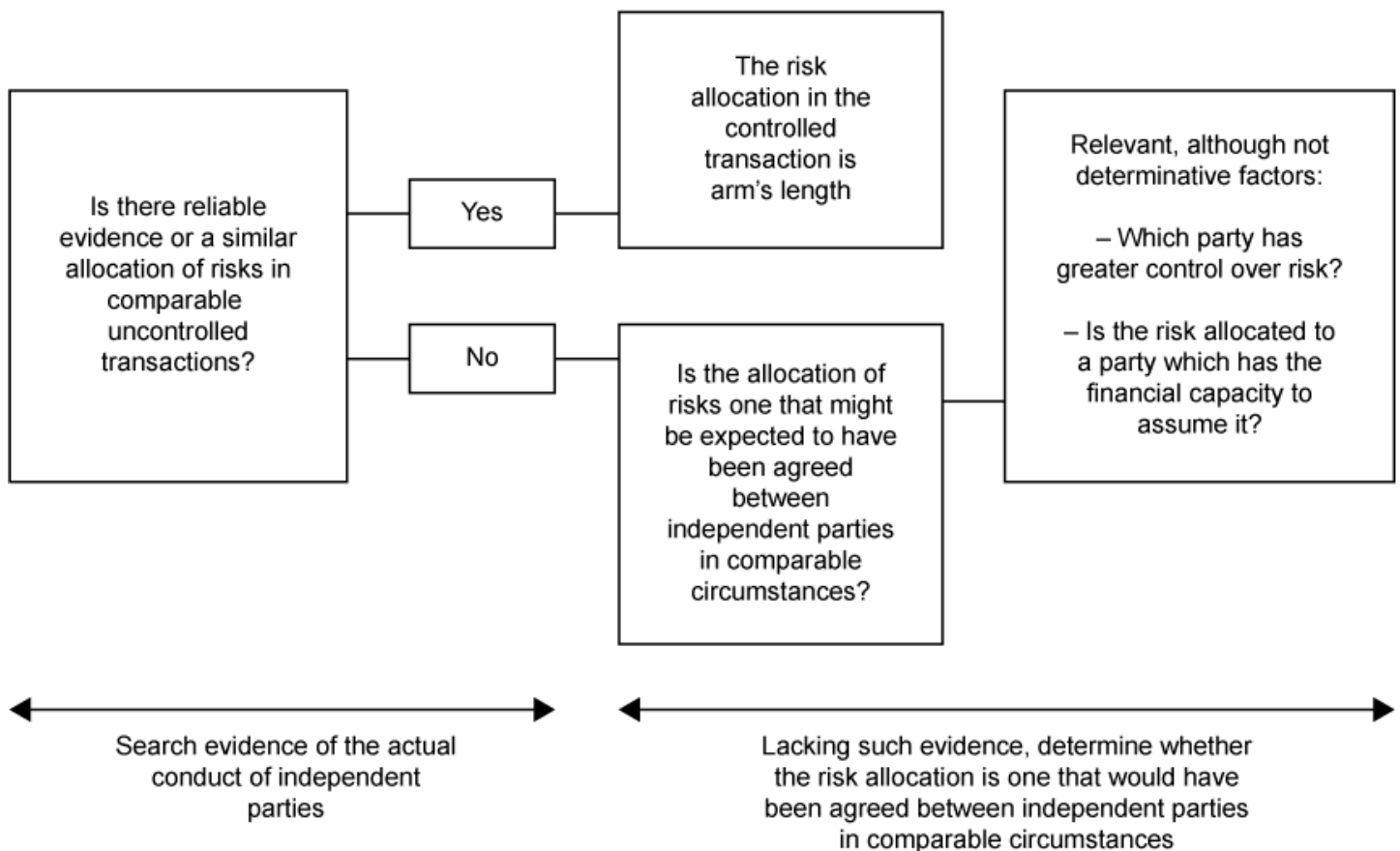
11. OECD Guidelines (2010), para. 9.23.

12. OECD Guidelines (2010), para. 9.21. In the 2017 Guidelines, this language was revised, stating at para. 9.7 that “This chapter only covers transactions between associated enterprises in the context of Article 9 of the OECD Model Tax Convention and does not address the attribution of profits within a single enterprise on the basis of Article 7 of the OECD Model Tax Convention, as this is the subject of the Report on the Attribution of Profits to Permanent Establishments.”



Further, these two factors remain subsidiary to the overarching arm's length principle: where comparables exist that evidence a similar risk allocation between independent parties, these tests are not needed or relevant. This whole reasoning was illustrated in the 2010 OECD Guidelines with the following diagram <sup>[13]</sup>

**Figure 1 – Determining whether the allocation of risks in a controlled transaction is arm's length**



In the case of intangibles, the type of functions that the owner would be expected to perform in order to be allocated the development risk and return was illustrated as follows:

As [an] example, assume that a principal hires a contract researcher to perform research on its behalf. Assume the arrangement between the parties is that the principal bears the risk of failure of the research and will be the owner of the outcome of the research in case of success, while the contract researcher is allocated a guaranteed remuneration irrespective of whether the research is a success or a failure, and no right to ownership on the outcome of the research. Although the day-to-day research would be carried on by the scientific personnel of the contract researcher, the principal would be expected to make a number of relevant decisions in order to control its risk, such as: the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher. Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, e.g. at predetermined milestones. The principal would be expected to be able to assess the outcome of the research activities. The contract researcher's own operational risk, e.g. the risk of losing a client or of suffering a penalty in case of negligence, is distinct from the failure risk borne by the principal.<sup>[14]</sup>

This notion was further elaborated in the 2017 Guidelines:

When funding is provided to a party for the development of an intangible, the relevant decisions relating to taking on, laying off or declining a risk bearing opportunity and the decisions on whether and how to respond to the risks associated with the opportunity, are the decisions related to the provision of funding and the conditions of the transaction. [...] The higher the development risk and the closer the financial risk is related to the development risk, the more the funder will need to have the capability to assess the

13. OECD Guidelines (2010), para. 9.33. This diagram was removed in the 2017 version of the OECD Guidelines.

14. OECD Guidelines (2010), para. 9.26.

progress of the development of the intangible and the consequences of this progress for achieving its expected funding return, and the more closely the funder may link the continued provision of funding to key operational developments that may impact its financial risk. The funder will need to have the capability to make the assessments regarding the continued provision of funding, and will need to actually make such assessments, which will then need to be taken into account by the funder in actually making the relevant decisions on the provision of funding.<sup>[15]</sup>

#### 4. Recharacterization of Transactions or Delineation of Actual Transactions

Importantly, in its 1995 Guidelines, the OECD stated that disregarding or recharacterizing a transaction should remain exceptional: “A tax administration's examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises *as it has been structured by them*, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. *In other than exceptional cases*, the tax administration should not disregard the actual transactions or substitute other transactions for them. *Restructuring of legitimate business transactions* would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured.”<sup>[16]</sup> [Emphasis added.]

This guidance, far from giving a blank check for taxpayers to organize transactions that lacked economic substance, already provided for a substance over form and a commercial rationale test. It was, however, expected that cases of recharacterization would remain exceptional; the OECD affirmed that for legitimate business arrangements, taxpayers had the freedom to organize their affairs as they deemed appropriate. However, when developing the 2010 OECD Guidelines, some OECD countries considered that this guidance was too restrictive in practice, especially since there was no clear consensus concerning what kind of situations would be concerned with the lack of commercial rationale test. The 2010 OECD Guidelines therefore included several examples of business restructurings to illustrate the above reasoning and its relationship with recharacterization, especially in the case of restructurings involving a transfer of intangible rights.<sup>[17]</sup>

The post-BEPS 2017 OECD Guidelines reflect a notable evolution in this respect. With the introduction of the concept of “accurate delineation of the *actual* transaction” in Chapter I of the Guidelines, as an essential component of the comparability analysis, the OECD suggests that tax authorities may recharacterize transactions (or reallocate risks or intangible returns in a given transaction) without having recourse to the exceptional circumstances criteria (substance over form and commercial rationale tests discussed above), by reallocating risks in cases where the entity to which risk is contractually allocated does not perform the risk control functions and does not have the financial capacity to assume risk.

##### The 2017-2022 OECD guidance on intangibles and DEMPE functions

A similar notion was introduced in Chapter VI of the 2017 OECD Guidelines with tax administrations being allowed to reallocate intangible return in cases where the legal intangible owner does not perform *any* of the so-called “DEMPE” functions (Development, Enhancement, Maintenance, Protection, Exploitation). However, the drafting of the OECD Guidelines in this respect remains carefully crafted:

The legal owner will be considered to be the owner of the intangible for transfer pricing purposes. *If no legal owner of the intangible is identified under applicable law or governing contracts*, then the member of the MNE group that, based on the facts and circumstances, controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner of the intangible for transfer pricing purposes. [Emphasis added.]<sup>[18]</sup>

But, while legal ownership is to be respected, identifying the legal owner is not the final step in a transfer pricing analysis:

For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed. <sup>[19]</sup>

“If the legal owner of an intangible in substance:

- performs and controls *all of the functions* [...] related to the development, enhancement, maintenance, protection and exploitation of the intangible;
- provides *all assets*, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the intangibles; and
- assumes *all of the risks* related to the development, enhancement, maintenance, protection, and exploitation of the intangible,

15. OECD Guidelines (2017), para. 6.64.

16. OECD Guidelines (1995), para. 1.36.

17. OECD Guidelines (2010), para. 9.190-9.194.

18. OECD Guidelines (2017), para. 6.40.

19. OECD Guidelines (2017), para. 6.42.

then it will be entitled to *all of the anticipated, ex ante, returns* derived from the MNE group's exploitation of the intangible." [Emphasis added.]

"It is not essential that the legal owner physically performs all of the functions related to the development, enhancement, maintenance, protection and exploitation of an intangible through its own personnel in order to be entitled ultimately to retain or be attributed a portion of the return derived by the MNE group from exploitation of the intangibles. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. A member of an MNE group that is the legal owner of intangibles could similarly outsource functions related to the development, enhancement, maintenance, protection or exploitation of intangibles to either independent enterprises or associated enterprises."

"To the extent that one or more members of the MNE group other than the legal owner performs functions, uses assets, or assumes risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible, such associated enterprises must be compensated on an arm's length basis for their contributions. This compensation may, depending on the facts and circumstances, constitute all or a substantial part of the return anticipated to be derived from the exploitation of the intangible." Similarly, "Where associated enterprises other than the legal owner perform relevant functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis for the functions they perform under the principles set out in Chapters I - III. The determination of arm's length compensation for functional contributions should consider the availability of comparable uncontrolled transactions, the importance of the functions performed to the creation of intangible value, and the realistically available options of the parties."<sup>[20]</sup>

Thus, the 2022 OECD Guidelines do not provide for a systematic proportional allocation of intangibles economic ownership based on the mere allocation of DEMPE functions, nor for a systematic profit split based on a value chain analysis. Rather, they (re)affirm that a legal owner must compensate at arm's length the functions performed by other group entities that contribute to the value of the intangibles. This can be for instance contract R&D entities or marketing entities, as the case may be.

Further, the OECD guidance indicates that where the legal owner neither performs nor controls any of the DEMPE functions, it would not be entitled to the ongoing return associated with the performance of those functions that it does not perform (as arm's length compensation for those functions should be allocated to the entity(ies) that perform(s) them); it does not exclude a remuneration for the mere ownership of assets, but only to the extent that the intangible owner "actually" uses them and/or actually bears the associated risks (see comments under item 4 above on the delineation of the "actual" transaction):

In extreme cases, "if the legal owner *neither controls nor performs the functions* related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions. Depending on the facts, the arm's length compensation required to be provided by the legal owner to other associated enterprises performing or controlling functions related to the development, enhancement, maintenance, protection, or exploitation of intangibles may comprise any share of the total return derived from exploitation of the intangibles. A legal owner not performing any relevant function relating to the development, enhancement, maintenance, protection or exploitation of the intangible will therefore not be entitled to any portion of such returns related to the performance or control of functions relating to the development, enhancement, maintenance, protection or exploitation of the intangible. *It is entitled to an arm's length compensation for any functions it actually performs, any assets it actually uses and risks it actually assumes.*"<sup>[21]</sup> [Emphasis added.]

Guidance on the relationship between the performance of risk control functions and the allocation of risks, including guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return in those situations where an associated enterprise is only entitled to any of those returns, is found in Chapter I of the 2022 OECD Guidelines.<sup>[22]</sup>

Finally, and very importantly, while the above guidance possibly restricts the ongoing return that an intangible owner would receive where it does not perform some of the DEMPE functions, it does not suggest a reallocation of sales proceeds in the event where the legal owner would dispose of the intangible. A long-established principle, confirmed in the most recent OECD guidance, is that in a transfer pricing analysis the options realistically available to each of the parties to the transaction should be considered. This is true also for transactions involving intangibles. In the view of many tax courts, whether a party has the legal option available to dispose of an asset is critical in the analysis.<sup>[23]</sup>

## 5. Conclusion

Identifying the significant people functions in a transaction has always been an important part of transfer pricing analyses since the 1995 OECD Guidelines. More recently, greater emphasis has been placed on people functions, first in the AOA for the attribution of profits to permanent establishments, as an alternative test in the absence of binding contracts within a single entity; then with the elaboration of the notions of control functions in relation to risks and of DEMPE functions in relation to intangibles, in the 2010, 2017 and 2022 OECD Guidelines.

20. OECD Guidelines (2017), paras. 6.51-6.52 and 6.71.

21. OECD Guidelines (2017), para. 6.54.

22. OECD Guidelines (2022), paras. 1.107-1.126.

23. See for instance the decision by the French Supreme Court, Conseil d'Etat n° 369814 of 7 December 2016, in the case of eBay France which held the legal registration on the ebay.fr domain name.

However, while the AOA provides that risks and assets follow functions within a single entity, the OECD Guidelines do not provide for the same between legally distinct associated enterprises. Despite some convergence, a clear distinction remains between the AOA under article 7 on the one hand, and the OECD Guidelines under article 9 of the OECD Guidelines on the other hand.

The key takeaways from the 2022 OECD Guidelines in relation to significant people functions and intangibles can be summarized as follows:

- There has been a subtle and progressive transition between the 1995 and 2002 OECD Guidelines from “functions (taking into account assets used and risks assumed)” to “assets used and risks assumed (taking into account functions performed)”;
- Further detailed guidance is provided as to what those important people functions are (the so-called DEMPE functions in relation to intangibles);
- A legal intangible owner is not required to perform all the DEMPE functions itself: it can use service providers (for instance contract R&D or marketing services providers) to the extent that it controls the risks associated with those subcontracted functions;
- DEMPE functions must be compensated at arm’s length, including in the case where these are performed for the benefit of a legal intangible owner which is a different associated enterprise;
- If the legal owner of an intangible neither controls nor performs the DEMPE functions related to the intangible it owns, then the OECD considers that it would not be entitled to any ongoing benefit attributable to the outsourced functions.

Thus, the OECD Guidelines do not suggest that the mere transfer of people functions, whether because of people performing these functions being relocating, or because the positions being filled by new personnel in a different country, would lead to economic ownership of the intangible also being relocated. Risks and assets do not follow functions in the case of separate legal entities. Rather, the OECD Guidelines clarify that the new entity hosting the functions should be compensated at arm’s length for the performance of the functions to the benefit of the intangible owner. Such remuneration may be a small or a large portion of the intangible return, as the selection of the most appropriate transfer pricing method and determination of the remuneration for these functions will depend on a factual analysis and in particular on the significance of those functions in value creation and the level of autonomy in decision-making of the functions transferred.

A different question is whether a relocation of functions may entail a transfer of workforce in place, which might be characterized as a transfer of “something of value” within the meaning of Chapter IX of the OECD Guidelines, and might (or not) attract profit potential. This “something of value” would, however, be distinct from the intangibles in relation to which the functions transferred are being performed. Similarly, depending on the circumstances of the case, the relocation of functions could lead to a termination or substantial renegotiation of certain intra-group contractual arrangements, that might warrant (or not) indemnification in accordance with guidance in Chapter IX of the OECD Guidelines.

One interesting development is the new emphasis put by the OECD, in the Pillar One proposal, on market jurisdictions, irrespective of the location of people functions : “Pillar One is focused on new nexus and profit allocation rules to ensure that, in an increasingly digital age, the allocation of taxing rights with respect to business profits is no longer exclusively circumscribed by reference to physical presence.”<sup>[24]</sup> For the OECD, “The existing international tax rules generally attach a taxing right to profits deriving from a physical presence in a jurisdiction. However, given globalisation and the digitalisation of the economy, businesses can, *with or without the benefit of local physical operations*, participate in an active and sustained manner in the economic life of a market jurisdiction, through engagement extending beyond the mere conclusion of sales, in order to increase the value of their products, their sales and thus their profits. Such participation is attributable to the nature of what is being supplied, how it is being supplied and the active interaction or engagement with market jurisdictions. This means that the allocation of taxing rights and taxable profits can no longer be exclusively circumscribed by reference to physical presence”. [Emphasis added.]<sup>[25]</sup>

It is amazing that this new market-based paradigm is being developed so shortly after the greater emphasis on people functions resulting from the BEPS Project. In allocating groups’ profits among jurisdictions, taxpayers and tax administrations may have to navigate between legal reality / contractual terms which many tax courts will consider as essential; location of people functions performed in an increasingly mobile environment, and, if Pillar One is implemented, location of customers. In June 2022, the OECD indicated that it is planning to review tax issues related to mobile work in a number of areas including tax treaties and transfer pricing rules in 2023 and beyond. Stay tuned!

24. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, para. 3 (OECD 2020).

25. Id., at para. 22.



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