An industry perspective: Financial services, life sciences and automotives

Post-BEPS, TP controversy has affected all industries. Deloitte's Ralf Heussner, Aydin Hayri and Juan Ignacio de Molina explore the impact on the financial services, life sciences and automotive industries.

Transfer pricing (TP) controversy in the post-BEPS world can affect all industries, but the changes affecting financial services, life sciences and the automotive industry has been particularly interesting. In financial services, actors have had to contend with the addition of tax and regulatory rules. In life sciences, the industry must now integrate 'marketing intangibles', while in the automotive sector, the industry must now assess the viability of traditional TP methods in the face of greater business integration and more global operations.

The common ground for all these industries is that tax controversy management must now begin well before the start of any tax audit. It must begin with establishing defensible TP policies that are aligned with BEPS, continues to their proper implementation, and monitors and documents the management of actual tax audits.

Given the heavy reliance on centralised operating models in today's world, it is important for both taxpayers and tax authorities to address potential tax risks upfront to avoid an increase in the number of tax audits, and any subsequent controversies that may arise.

Financial services

One of the key questions to have emerged from the BEPS initiative is about how to best reconcile different notions regarding the allocation of risks, from an economic and regulatory point of view. BEPS also introduced greater disclosure requirements, with more transparency through country-by-country reporting (CbCR), a master file concept, and sector-specific reporting obligations. Taken together, it seems like an ideal recipe for a wave of tax controversies across the banking, asset management and insurance sectors.

Interaction between the tax and regulatory environment

It should not be a surprise that financial regulation often influences the set-up of operating models in the financial sector. Common examples include centralised booking models for global trading in banking (to encourage the efficient use of regulated capital), or underwriting with a regulated insurance carrier across different jurisdictions using a framework of passporting.

The common denominator is their reliance on a centralised operating model, where one regulated entity engages with a number of related (or unrelated) parties across a range of jurisdictions.

Interestingly, the sector that tends to rely even more heavily on centralised operating models than insurance or banking is the asset management sector. The introduction of the Undertakings for Collective Investment in Transferrable Securities (UCITS) and Alternative Investment Fund Managers Directive (AIFMD) regimes resulted in the creation of so-called cross-border distribution models, whereby a regulated management company (ManCo) became responsible for the production, distribution and management of investment funds.

In practice, the ManCo delegates some or most of the core and non-core activities, including: risk management, portfolio management, investment advisory and research services, distribution and capital raising, fund marketing support, fund administration, and other support activities to related or third parties.

It is possible that ManCos delegate activities to related parties in 10, 20, 30 or even more jurisdictions on a number of different transactions, depending on the size and international footprint of the asset manager. This may result in thousands of intragroup relationships between the ManCos and their foreign-related parties that are subject to potential TP scrutiny.

Various tax authorities have already started scrutinising transactions in the asset management sector, mainly on how to remunerate distribution or advisory-related activities based on cost plus or fee split related approaches. Given the number of countries and transactions involved, the number and magnitude of potential tax assessments, and the resulting controversy cases that could affect the ManCo location, it is daunting.

It is becoming essential for both taxpayers and tax authorities to address the management of potential tax audits and resulting controversies, considering that a large part of the asset management industry is relying on similar delegation models.

The status quo of tax authorities and regulators

Until recently, tax authorities had relied on rather formalistic criteria (whether reasonable efforts were made to document the arm's-length nature of transactions, the failure to document certain transactions, the non-recognition of a permanent establishment, or the lack of sufficient cooperation under audit) as basis for their assessments, as a result invoking presumptive taxation.

Other tax authorities have decided to focus on less complex transactions, such as the provision of intragroup services. This is likely to change in the future because tax authorities have increased teams and resources and have more information at hand (for example, CbCR).

Given the potential impact of tax audits and the resulting controversy in light of centralised operating models on the asset management sector, both tax authorities and financial regulators are focusing on tax as a governance topic. Tax authorities are requesting information as part of (or outside) regular tax audits, to gauge the readiness of asset managers to address the controversy challenge.

Practical implications in financial services

Taxpayers will need to respond to the controversy challenge by considering the following:

- Do TP policies exist, and are they consistently implemented/monitored;
- Does TP documentation exist, and is it aligned with the messaging of the regulatory position;
- Are TP policies defendable in light of BEPS and recent changes in the asset management sector (one-sided approaches that rely on pricing individual transactions relative to two-sided approaches that rely on testing the splitting of fees);
- Is the ManCo involved in the process of setting the tax strategy and managing potential tax audits/controversies, considering that the ManCo would be involved as counterparty under a centralised operating model;
- How are tax audits being managed to avoid potential inconsistencies;
- Is management aware of the options available to manage tax audits and controversies ranging from domestic appeals, mutual agreement procedures (MAPs) and/or advance pricing agreementS (APAs)? For example, lighthouse APAs that can be used to support the TP positions toward tax authorities in other jurisdictions; and
- How can existing TP and legal documentation be improved as a first line of defence against upcoming tax audits?

Life sciences

In many ways, TP controversies for life sciences companies were precursors to the wider debate around OECD/ BEPS initiatives. By its very nature, profitability in life sciences is driven by long, drawn-out research, and subsequent clinical development that precedes the commercialisation of successful products.

For successfully approved products, the current year's income statements would show significant levels of profitability, because they would not include past R&D expenses, nor would they show the R&D expenses related to failed products that never reached the market.

Furthermore, in many cases, taxpayers would centralise R&D development (and therefore intellectual property (IP) ownership) in a few key jurisdictions, leaving other jurisdictions with functional returns. Hence, the concerns by the non-IP owning jurisdictions that they are not getting a fair share of the taxable income.

In this article, we specifically focus on distribution locations, but issues related to manufacturing and contract R&D locations are fairly similar to the ones discussed.

Initially, local tax administrations were concerned that the local distribution affiliates may not be so routine. They observed that life science companies spent a significant amount of their budget on representatives that visited doctors, as well as on promotional spending on the medical community and direct-to-consumer advertising.

The initial view advanced was that this direct-to-consumer advertising was an investment made to build up general market awareness, which was akin to an intangible. Hence the term "marketing intangibles".

For life science companies, the increasing TP scrutiny coincided with economic challenges arising from the so-called 'patent cliff': a large number of chemical blockbuster drugs discovered in the 1990s that were facing patent expirations. At the same time,despite increasing R&D spending, their replacements were not emerging as easily. Facing the patent cliff, and a drying pipeline of new drugs, life sciences companies embarked on significant cost- cutting measures, which included centralisation of financial and operation management in global and regional hubs, and outsourcing most business processes.

Against the backdrop of these business changes, taxpayers' response to 'marketing intangible' challenges were two-fold: on the one hand, they would point out the extensive outsourcing in the industry and challenge that the marketing and promotional expenses were anything but a routine cost of doing business.

On the other hand (and in line with their operational centralisation), they would point out that the financial responsibility for local sales and marketing expenditure was assumed elsewhere at the global or regional hub companies. Accordingly, even if marketing intangibles existed, they would not belong to the local distribution companies.

Tax administrations have had a two-prong response to outsourcing and centralisation trends. On the one hand, they have argued that an IP owner would need a local presence to be able to sell its products, and that this "market access" should have a separate return component.

On the other hand, they have made a variant of the important people argument, and pointed out that the local distribution companies may still have high-level executives who make key decisions on marketing and promotion spend, as well as on local pricing discussions with governments.

Such activities, they argue, cannot be "outsourced", and should therefore represent an additional quantum of value. Both "market access" and "important people functions" are used to argue that the local distributor returns should be over and above what is indicated by benchmarking under the transactional net margin method (TNMM).

The new control-of-risk paradigm and the potential bifurcation of returns for the control-of-funding versus control of operational risks introduced by the OECD TP guidelines may provide a fresh look for both taxpayers and tax authorities to re-evaluate these local distribution disputes.

Automotives

The automotive sector makes up the third area that has traditionally been at the forefront of tax authority interest. Many of the larger audits, MAPs, and APAs have featured multinational enterprises (MNEs) operating in these three industries.

Controversy in the automotive industry

Traditionally, original equipment manufacturer (OEM) automotive TP has concerned a TNMM operating margin for distribution activity, and a cost plus (at gross margin level) or cost plus as a profit level indicator at net margin level. The absence of independent distribution operations at the national market level has resulted in MNEs and tax administrations casting the net wider in search for comparables (for instance, looking at large- scale independent distribution operations who are themselves customers of the MNE).

The knowledge that national sales operations will be audited by tax administrations, and uncertainty over precisely how to benchmark operations in the absence of comparables, has kept APA programmes in the sector busy. An APA will remain the best way of managing TP risk in an industry that will always be of interest to tax administrations.

In an attempt to reflect the relative importance of the distribution arm when strategy and manufacturing are conducted (or managed at a centralised level), some automotives have attempted to quantify a reward based on changes in market share. Again, the difficulty in finding empirical data makes an APA discussion between the relevant tax administrations a wise choice.

Stepping away from these traditional approaches, however nuanced, it may be time to rethink automotive TP. At a macroeconomic level, a loss-making MNE (not rare in this industry) with a TP policy that effectively guarantees routine returns in manufacturing and distribution operations on the basis that they are so-called 'low risk', may no longer have a TP policy that best reflects the true economics of the overall business.

As always, much will depend on the facts. However, when a national sales company has significant input into the model mix, advertising and marketing, possibly even design elements, a characterisation as a routine distribution operation may not be the best way to proceed. In these cases, a methodology that requires the distributor to share in both the upside and the downside may be a better fit.
For example, this can be achieved by a sliding scale distribution margin based on pre-agreed success parameters. Again, depending on the facts, a highly integrated operation between manufacturer, distributor and brand owner may even necessitate consideration of a profit split methodology.

A combined national sales company (NSC) and manufacturing operation, for instance, may not be adequately rewarded by pricing those individual activities using traditional TP methods if some functions are somehow left out of the equation. Looked at another way, if (or when) attempting to apply a profit split there are no functions left to reward after routine functions had been rewarded, then the answer would have revealed itself and traditional methods would still be clearly better.

However, in cases in which rewarding routine functions still leave functions, assets and risks that have not been fully recognised, it may be time to consider a profit split methodology. Even if this means, in effect, an allocation of losses. It is a poignant moment to then consider the full OEM supply chain (design, brand, sourcing, manufacturing, logistics and distribution are increasingly related).

Capacity issues in manufacturing plants remain an issue that must be kept in mind. Recent tax audits in more than one country have attempted to (in essence) shift manufacturing losses back to the brand owner, irrespective of whether the brand is profitable. If an NSC is required to offer the full range of vehicles manufactured by the MNE, how should this be characterised from a TP perspective? Some types of vehicle will be more popular in certain markets compared to others. Not all OEMs would agree with the previously long-held orthodoxy that (loss-making or otherwise) halo models benefit all NSCs to the same degree.

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Ralf Heussner is a partner with Deloitte's Luxembourg member firm specialising in the financial services sector. Ralf worked for many of the key players in the asset management industry (ranging from traditional to private equity, real estate, and hedge funds), and the banking and insurance sectors during his prior tenure in Frankfurt, Hong Kong, and Tokyo.
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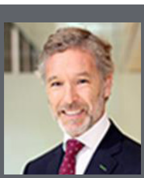

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