

## ***Implications of Base Erosion and Profit Shifting (BEPS) on the Pharmaceutical and Life Sciences industry***

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### ***In brief***

Pharmaceutical and Life Sciences (“PLS”) companies have traditionally set their transfer pricing strategy by trying to manage the expectations of multiple external stakeholders (regulatory bodies, income tax authorities, and customs authorities) and by staying abreast of industry trends. Nowadays, this task has become even more complex given the recent developments in the international tax and transfer pricing environment and the attention allocated by the media to the international tax practices of multinational companies. This news alert addresses some of the key highlights of the draft documents published by the OECD in the recent months and their anticipated impact for PLS companies.

### ***In detail***

#### ***Background***

The OECD, through its BEPS project, seeks to address concerns of the governments and general public with respect to reduced tax revenues stemming from tax planning aimed at eroding the taxable income base or artificially shifting profits to locations where they are subject to a more favorable tax treatment. Earlier in July, the OECD published its long awaited Action Plan regarding BEPS, which not only identifies areas of concern, but also provides both concrete actions and timelines to address double non-taxation. The 15 action points can be grouped into four general categories: (i) general actions directed at addressing BEPS, (ii) transparency and disclosure actions, (iii) treaty-related actions, and (iv) permanent establishment and transfer

pricing actions. This news alert will focus on the transfer pricing aspects of the Action Plan that would be relevant for PLS companies.

The OECD also acknowledges that businesses are now operating in a globally integrated manner and the current international tax rules were developed at a time when cross border transactions were not as prominent so they might inadvertently lead to double taxation or non-taxation. This statement is definitely applicable for PLS companies that, in response to shifting industry trends, a highly competitive marketplace and the evolving regulatory framework, have developed, organically or through M&A activity, complex global business models. Common attributes of PLS business models include multiple intercompany dealings with

respect to the development and use of intellectual property, manufacturing and supply chain operations, detailing and promotional activities, intercompany financing and shared services. In this light, PLS multinationals are likely to experience heightened attention in future tax audits given their international footprint and the various complexities entailed by their business models.

#### ***Transparency and Disclosure***

In the current economic environment, increased transparency has been called for by many stakeholders: the public, media, politicians, tax authorities and non-governmental organizations (NGOs). The concern with the current BEPS proposals on the increase of transparency and disclosure is that each stakeholder has a slightly different objective. Hence, the

selected proposal will need to be able to address a multitude of objectives that are not necessarily aligned. One can expect that it will be rather complex and costly for companies to comply with the disclosure requirements and to collect the requested data. There is also the question of whether commercially sensitive information will be safeguarded, which is a valid concern for any IP intensive sector such as the PLS industry.

As part of Action 13 of the BEPS Action Plan, the OECD released in October a memorandum on transfer pricing documentation and country-by-country reporting. This memorandum is concerned with identifying information that will enable tax administrations to accurately and efficiently assess transfer pricing risk. In this view, the OECD identifies the following headline information to be included in the country-by-country reporting template: (i) income, (ii) taxes paid, and (iii) other potential measures of economic activity such as: revenue by customer location, tangible and intangible assets by location, employment information, including location of senior management, research and marketing expenditure.

In complying with country-by-country reporting, PLS companies would have to disclose to local tax administrations details with respect to their global value chain and alignment of local income with value creating functions. It will no longer be sufficient to merely focus the discussion on local routine activities, but rather one would have to disclose the entire value chain allowing the local tax administration to assess whether there are any arguments that would qualify any local functions to be non-routine in nature or potentially creating intangible assets. It is therefore critical to have a robust

functional analysis that adequately addresses the discussion of functions, risks and assets in local intercompany dealings, as well as the overall value chain. Given the particularities of the PLS sector, it is also important to strategically frame and interpret the transfer pricing documentation in the context of industry developments and value drivers, as well as the regulatory framework.

### **Transfer Pricing Compliance**

Under the same umbrella of Action 13, the OECD also published a White Paper on Transfer Pricing Documentation, which is another step in urging taxpayers to provide more “qualitative information” on their intercompany transactions and a “clear big picture” overview of their transfer pricing policies. The paper acknowledges the importance of standardisation to reduce compliance costs for taxpayers, but equally puts emphasis on the role that transfer pricing documentation can play for enhanced transparency and improved audit risk assessment. The White Paper proposes a coordinated approach to documentation based on a two-tier structure consisting of a masterfile supported by country-specific documentation.

PLS companies are therefore strongly advised to review their transfer pricing compliance strategy to ensure they have adequate transfer pricing documentation, aligned to these evolving requirements, that appropriately presents their business model. It is key to pay particular attention to the description of the value chain and local functional analysis as these will be closely reviewed by the local tax authorities in an attempt to identify the “high-risk transactions and aggressive/tax avoidance schemes”. It is also highly recommended to prepare the country-specific documentation by having due

regard to local audit experience, frequent challenges by the tax authorities in the PLS industry and local interpretation of the grey areas of the domestic transfer pricing rules.

### **Intangibles**

Continuing its prior work on revisiting Chapter VI of the OECD TP Guidelines and under the framework of Action 8, the OECD also issued its Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles. The overarching part of the document provides guidance on the question of how to correctly allocate what may be described as the “return related to an intangible”, a question which is probably high on the agenda of any PLS company with an IP intensive portfolio of products.

The key message of this paper is that the legal owner of an intangible will be entitled to all returns attributable to the intangible only if, in substance, it performs and controls the important functions related to the development, enhancement, maintenance and protection of the intangible, as well as provides the assets necessary for the performance of these functions and bears and controls all of the associated risks. It is therefore clarified that legal ownership by itself does not confer any right to ultimately retain any return from exploiting the intangible. It is also stated that the mere funding of intangible-related costs without the assumption of any further risks, any control over the use of the funds provided or the actual performance of the funded activities will only entitle the funder to a risk-adjusted rate of anticipated return on the capital invested.

PLS companies are most often dealing with audit challenges related to their intangibles related returns. In particular, tax authorities have looked in recent years to address the observational trend that profit

resulting from locally-developed intangible property often goes untaxed in the local jurisdiction. In the PLS industry, intensely competitive market conditions and the strict regulatory environment have increased the importance of local sales and detailing activities, as well as the delivery of after sale complementary services. As such, PLS companies often come under scrutiny when it comes to the risk of creating local marketing intangibles. To avoid the transfer pricing pitfalls associated with marketing intangibles, PLS companies should consider the aspects of their operations that could impact this determination, such as relationships developed with local healthcare professionals and regulatory bodies, expertise of the local sales force, etc. Local Phase IV clinical trials may also present an area of concern as trials can be powerful tools in influencing prescribers of a product and could generate local marketing intangibles.

In addition to local marketing intangibles, PLS companies need to pay attention to several intangibles related matters such as: the potential for local market release authorizations to be viewed as an intangible given the market advantages that such regulatory permits could offer, the higher royalty rate that combinations of intangibles (patents, trademarks, market release authorizations) could command, circumstances when product or process improvements could be deemed intangibles

belonging to the contract manufacturer of the drug or the contract R&D service provider and the short term effects of M&A activity on the possibility to charge royalties for the use of trade names.

#### ***Expected next steps***

It is of critical importance that an international consensus is reached in terms of agreeing on the direction of the BEPS projects and any specific action items. Unless an international framework for future actions is agreed between the OECD members and support is also obtained by UN members, there is a risk of unilateral actions by individual governments. Such unilateral actions may not be helpful in comprehensively addressing the issues identified by BEPS and could potentially lead to increased regulatory complexity and double taxation.

#### ***Takeaway***

##### ***What does this mean for you?***

While the final proposals of BEPS remain to be announced, there are a number of factors that PLS businesses should be taking into consideration in the immediate short term. These include:

- Staying updated on the developments under BEPS, as the project is likely to lead to significant changes in the international tax and transfer pricing arena in the short to medium term;

- Develop a BEPS planning or assessment roadmap for addressing immediate tax and transfer pricing challenges that should highlight potential areas of concern, as well as a list of priorities requiring action.
- Identifying any situations where there is a heavy reliance on contractual structure as they may need to be reconsidered/revisited from a substance perspective;
- Considering whether the substance and legal form of transactions are always aligned, bearing in mind that substance is likely to receive increased focus;
- Reviewing levels of reward for intra-group transactions based on the actual substance of arrangements including looking at profitability per country, to identify any potential risk spots; and
- Reviewing the use of low tax or 'tax haven' jurisdictions, given it is likely these will be the focus of attention in the future.

***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact:

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