

The post Base Erosion and Profit Shifting world

The impact of tax policy and BEPS
on life sciences companies

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Summary points

- National tax policy decisions are having a major impact on the competitiveness and market valuation of life sciences businesses, which is why so many companies have structured themselves to take advantage of the lower tax rates offered by many jurisdictions.
- These structures are often criticized in the public arena. In response to this pressure the G20 has tasked the OECD to consider the issue of Base Erosion and Profit Shifting (BEPS).
- The OECD has responded with a 15 point Action Plan which aims to explore the issues and aims to produce final recommendations by December 2015.
- Some of the proposals could significantly impact the post-tax profitability of life sciences companies, which may alter funds available to invest in essential research and development (R&D).
- Businesses need to review their current operations to ensure that the true value generated from each location and activity is fully recognized and remunerated.

The four major impacts on life sciences companies:

Impact 1:

Life sciences companies which rely on the use of representative offices or third parties as their in-country representative may have to adapt their structure if the OECD recommends a change to the exemptions surrounding the creation of a permanent establishment.

Impact 2:

It may be necessary to demonstrate a stronger association between the owner of an intangible asset and any activity which has a material effect on the value of that intangible. In theory, activities including (but not limited to); the control of budgets, the control of strategic decisions and the control of research programs, may need to be linked to the place of ownership of the intangible

Impact 3:

The need for more transparency in transfer pricing documentation and the request for country-by-country reporting may result in more tax audits and potential disputes over where profit should be allocated for tax purposes

Impact 4:

The collection and use of structured and unstructured patient data may begin to constitute an intrinsic value generating intellectual property in the country in which it is collected; this may result in a taxable nexus.

Executive summary

This report is intended as a factual description of the issues arising as a result of the complexities of the international tax systems and their impact on life sciences businesses. It is not an attempt to judge practices that may arouse public interest on both sides of the Atlantic.

The Organisation for Economic Co-operation and Development (OECD) Action Plan on Base Erosion and Profit Shifting (BEPS) is designed to prevent multinational businesses achieving non-taxation on profits or artificially shifting profits across borders to exploit lower corporate income tax rates.

The principle of national tax sovereignty allows individual countries to set their tax policy without consideration of the rates and tax policy set by other countries. This

has led to a large variation in corporate income tax rates. There is a 27.5 percent spread between the lowest and highest corporate income tax rates in OECD countries and there is a 24 percent spread in effective corporate income tax rates between the top 20 life sciences companies.

These variations often compel companies to treat corporate income tax as a 'cost' to the business; minimizing the corporate income tax liability increases post tax earnings.

This is particularly pronounced in the US where their system of worldwide taxation is coupled with one of the world's highest corporate income tax rates. The current US tax law permits a deferral of taxation of overseas profits until repatriation and the life sciences sector has been active in implementing corporate inversions in an attempt to achieve a permanent deferral, on these profits. They also frequently push intellectual property exploitation rights into cost sharing arrangements with low tax jurisdictions. Companies often view these practices as necessary to achieve a competitive effective tax rate.

In Japan, on the other hand, tax planning is considered less culturally acceptable, despite the high domestic corporate income tax rate.

European life sciences companies are generally more restricted in their ability to shift profits across borders due to robust Controlled Foreign Corporation (CFC) laws, and place a relatively greater reliance upon research and development (R&D) tax credits or tax incentive programs that reward innovation such as royalty/patent boxes (see page 9 definition).

The potential impact of BEPS

The BEPS Action Plan tries to address the arbitrage between different tax rates and different interpretations of tax principles which arise as a result of tax sovereignty. The aim is to produce a revised set of guidelines to help eliminate non-taxation and ensure that profits are correctly allocated to the functions or activities that give rise to them. This will maintain the objective of minimizing double taxation and reduce the unnecessary burden of compliance on tax payers. Life sciences companies will need to review their use of lower tax subsidiaries in the management and exploitation of intellectual property. Currently the management of intangible assets is focused on cost sharing and economic risk, whereas one likely impact of the BEPS Action Plan will require a closer alignment of actual 'value generation' (profit) to 'economic activity.'

For these reasons the proposals have the potential to significantly impact the bottom line of a large number of life sciences companies by increasing their overall effective corporate income tax rates. Or, they may merely achieve a concentration of 'substance' in those jurisdictions offering the most competitive effective corporate income tax regime. Ultimately this could lead to a race to the bottom in terms of corporate income tax rates.

We recommend multinational life sciences companies should review their organizational structures and perform scenario planning to assess the likely impacts of the BEPS work-streams. In particular, focus should be given to how the existing structures would be viewed should information regarding the supply chain and taxes paid in each country be made available to the public.

The history behind corporate income tax rates

Barely a day goes by without a news story criticizing multinational companies for structuring their operations to avoid paying their 'fair share' of corporate income tax. Politicians are weighing in with their own judgements, encouraged by an indignant public.

However, the primary cause of this controversial issue is the interpretation of international tax rules and the lack of coherence between the setting of national tax policies, which gives rise to the possibility of double taxation and tax avoidance.

Tax sovereignty enables countries to develop and implement their own domestic tax rules, without having to consider the effects of other countries' rules. Consequently, rates can differ widely around the world, with businesses taking advantage of these variances resulting in their profits suffering zero or nominal levels of corporate income tax. These issues are not new and were one of the drivers behind the development of international tax treaties started by the League of Nations in the 1920s. Which gave rise to the original international double taxation conventions.

The principles and structures within these original treaties, such as the concept of a permanent establishment (PE), were defined at a time of relatively scarce international trade and slow communication methods.

In today's digital global economy many companies have embraced technology to enhance their operations and drive cost out of the value chain. By fragmenting functions across national borders, the spectre of double taxation and tax avoidance are starting to recur. Digital trade, for example, allows firms to do business in a country in which they have no PE or physical presence.

With multinational businesses increasingly accused of manipulating existing rules to artificially shift profits across borders and take advantage of lower tax rates, the question has been raised whether the principles established by the League of Nations are still fit for purpose. The G20 has charged the OECD to consider the issue of Base Erosion and Profit Shifting (BEPS) and it has responded by developing a 15 point Action Plan to explore issues and come up with recommendations within an extremely aggressive timetable set to end in December 2015¹.

Some of the proposals could significantly impact the post-tax profitability of life sciences companies, which may impact funds available to invest in essential R&D. Therefore businesses need to review their current operations to ensure that the true value generated from each location and activity is fully recognized and remunerated.

The plan will attempt to more closely align the location of where value is created with the resources needed to produce that value.

¹ Source: www.oecd.org/ctp/BEPSActionPlan.pdf

Permanent establishment (PE) A corporate income tax PE is created where there is a fixed place of business through which the business of an enterprise is wholly or partly carried on, or where a dependent agent acts on behalf of an enterprise and habitually exercises an authority to conclude contracts in the name of the enterprise.

The corporate income tax landscape for life sciences companies

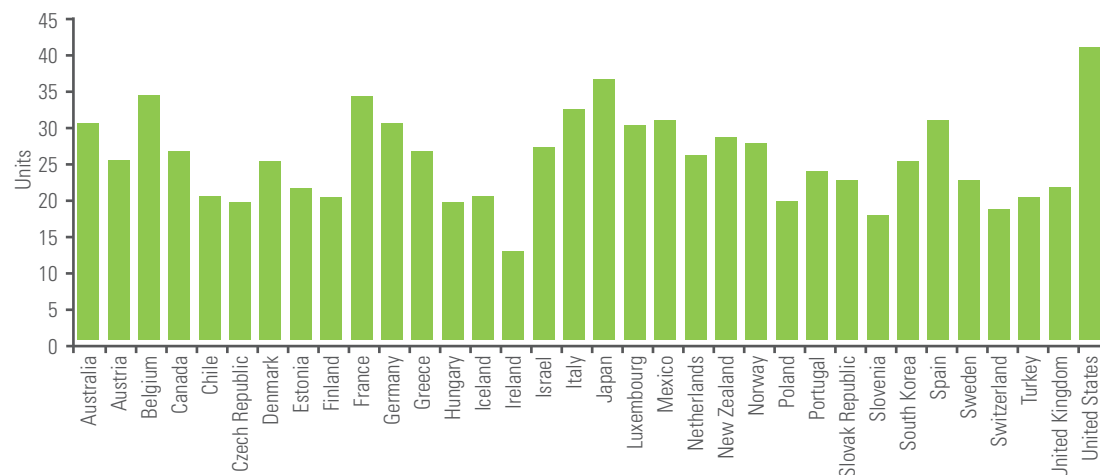
The variations in corporate income tax rates among OECD countries

A simple comparison of headline corporate income tax rates demonstrates the challenges faced by business and tax authorities.

Figure 1 shows that, in 2014, the corporate income tax rate on trading income varies widely across the OECD, from Ireland at 12.5 percent to the US at 40 percent. Interestingly, only four of the 34 OECD member states have a corporate income tax rate above 30 percent, while 19 (56 percent) are at 25 percent or lower, suggesting an increasing tendency to reduce corporate rates.

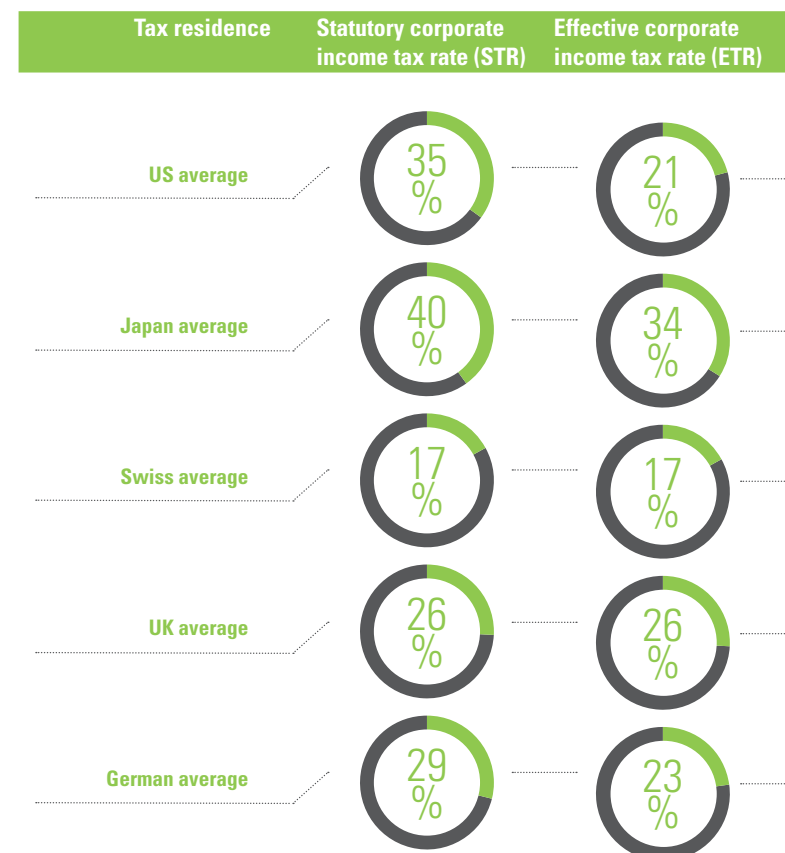
The 27.5 percent variation between the highest and lowest corporate tax rate in OECD countries has had a big impact on life sciences businesses' structures and operations, as evidenced by the significant variance in 5-year average effective tax rates, as seen in Figure 2.

Fig1: OECD countries



Source: OECD country table from KPMG Corporate Tax Rate Survey 2014

Fig2: Five year average tax rates of the top 20 life sciences companies



Source: Taken from the most recent publicly available financial filings, calculated on a 5-year average effective tax rate

Between 2009 and 2013, the 5-year average statutory corporate income tax rate for the various holding company locations ranged from 14 percent in Switzerland to 41 percent in Japan; a spread of 27 percent. This means that a Swiss-based multinational could potentially have considerably more income or free cash available for investment into R&D, compared to a Japanese company. National tax policy decisions are having a major impact on the competitiveness and market valuation of life sciences companies. To counteract the effect of these variations many companies have structured themselves to take advantage of the lower rates offered by some jurisdictions around the world. Nevertheless, the table on page 7 shows that there is still a 24 percent variance between the 5-year average effective corporate tax rates, with the average being 24 percent. This gives some companies a significant competitive advantage.

US

The US applies a worldwide taxation system, unless a company triggers an application of the US controlled foreign corporation (CFC) rules, then any taxation on its foreign subsidiaries foreign income is deferred until repatriation. The reductions in Effective Tax Rates (ETR) achieved by US companies are primarily attributable to lower foreign taxes paid, with Ireland, Switzerland and Puerto Rico playing an important role in US multinational group structures (all have Statutory Tax Rates (STRs) below 15 percent). US companies have also adopted corporate restructuring to remove non-US income from the US tax net, by entering into 'corporate inversion' transactions, where the company's headquarters are moved to a non-US location.

Figure 3 on page 9 shows an overall increase in the number of life sciences companies inverting out of the US over the last 10 years (although this trend declined temporarily in 2011 following targeted anti-inversion regulation which has since been re-defined). This trend is exacerbated by the fact that most countries in the OECD are implementing corporate income tax regimes to attract investment, via lower headline corporate income tax rates, dividend exemption on foreign earnings, and favorable regimes such as intellectual property/patent boxes. When considering corporate income tax in isolation, therefore, the US appears increasingly unattractive.

Since 2005 Japan and the US have shown little or no reduction in corporate income tax rates, whereas most European countries have had an incremental decline in rates.

Japan

The decrease in Japanese life sciences companies' ETRs – compared to their STRs – is mainly due to R&D tax credits, which account for a 10 percent average reduction. Lower foreign taxes on non-repatriated earnings also help to bring down the ETR. Despite Japan's high corporate income tax rate, the use of low tax subsidiaries (e.g. for managing intellectual property rights) as a way of reducing STRs is uncommon. It has been suggested that one reason for this is that some Japanese businesses may view corporate income tax as a civic duty rather than a 'necessary evil.'

Corporate inversion:

This is when a corporation moves its headquarters (typically) to a jurisdiction with a lower rate of corporate income tax, while retaining material operations and significant management roles in its higher-tax country of origin. Corporate inversions are used by companies that receive a significant portion of their income from foreign sources, and which are taxed on their worldwide income or on repatriation to the parent company territory.



Source: Taken from the most recent publicly available financial filings, calculated on a 5-year average effective tax rate

A Swiss-based multinational located in a canton where the average Swiss statutory corporate income tax rate is 14.5 percent will have approximately US\$40 of additional income available per US\$160 earned, when compared with a Japanese multinational, which has to pay tax at over 40 percent. This income would be available for investment or as free cash to use to grow the business.

Robin Walduck
Head of International Tax and Treasury
KPMG in the UK

Fig 3: Since 2006, 20 life sciences companies have performed inversions from the US



Source: Corporate income tax rate is sourced from KPMG's corporate tax rates table

European countries

Compared to other regions, many European headquartered life sciences companies do not appear to rely on moving income rights to lower tax regions to reduce their ETR. This is partly due to more developed CFC laws in the European economic area, which make it harder for companies to artificially move profits through operations in lower tax regions; and a lower headline rate offered together with intellectual property (IP)/patent box regimes. The resulting ETR is sufficiently competitive, with less need for further structuring to take advantage of lower tax rates elsewhere.

IP and patent box regimes:

Allow a reduction in the corporate income tax rate on profits derived from a qualifying product that incorporates patents. The net benefit for claiming companies is likely to be several percentage points off their corporate earnings.

R&D incentives

Across the top 20 life sciences companies, basic R&D incentives only reduce the average tax rate by around 3 percent in any one year, while the Japanese provide the highest reductions, of up to 11.5 percent.

This reflects the fact that such incentives are designed to encourage broader employment in R&D rather than to cut the tax burden. Preferential tax regimes such as IP/patent boxes offer significantly lower rates of corporate income tax on qualifying income, and encourages employment in R&D activities. However, the reduced scope and additional qualifying requirements in most IP/patent box regimes suggest a desire to link the active management of IP to the same location in which income is recognised for tax purposes.

As Chris Stirling, Global Head of Life Sciences, KPMG in the UK, comments, rising R&D costs, longer development cycles, and declining prospects for blockbuster drugs are putting pressure on margins. Cost advantages in production, salary or taxes paid are therefore more important than ever, putting pressure on multinationals based in high tax countries. Any R&D incentives are therefore very welcomed.

Our research shows that there are at least nine countries currently offering IP box regimes. They each have different qualifying conditions to benefit from the reduced tax rate.

It should be noted that the EU Commission is currently assessing all EU IP/patent box regimes to ensure that they are not anti-competitive. In the future they may be much stricter in the way 'substantial activity' is defined in the IP/patent box legislation and this may result in significant changes to the way in which these various regimes operate. Life sciences companies which rely on these regimes to deliver significant reductions in corporate income tax rates need to review their current arrangements and perform scenario planning to assess how these may be impacted.

Fig 4: Intellectual/patent box regimes overview

	The corporate tax of qualifying income	Profit quantification
Belgium	6.8%	80% of qualifying income
China	15%	All income
France	15.5%	The net income derived from the licensing costs
Hungary	5% and excess at 9%	Gross royalty income taxed and associated expenses are ignored
Luxembourg	5.84%	The net income derived from the licensing
Netherlands	5%	Generally transfer pricing related principles apply
Spain	12%	Reduction in 60% in net income derived from IP
Switzerland	8.8%	Net licence income
UK	10%	Prescribed formula approach

Rising R&D costs, longer development cycles, and declining prospects for blockbuster drugs are putting pressure on margins. Cost advantages in production, salary or taxes paid are therefore more important than ever, putting pressure on multinationals based in high-tax countries. Any R&D incentives are therefore very welcomed.

Chris Stirling
Global Head of Life Sciences
KPMG in the UK

Source: IP 'BOX' regime overview comparator, April 2014 – KPMG in the UK

Contribution of corporate income tax to total tax revenue

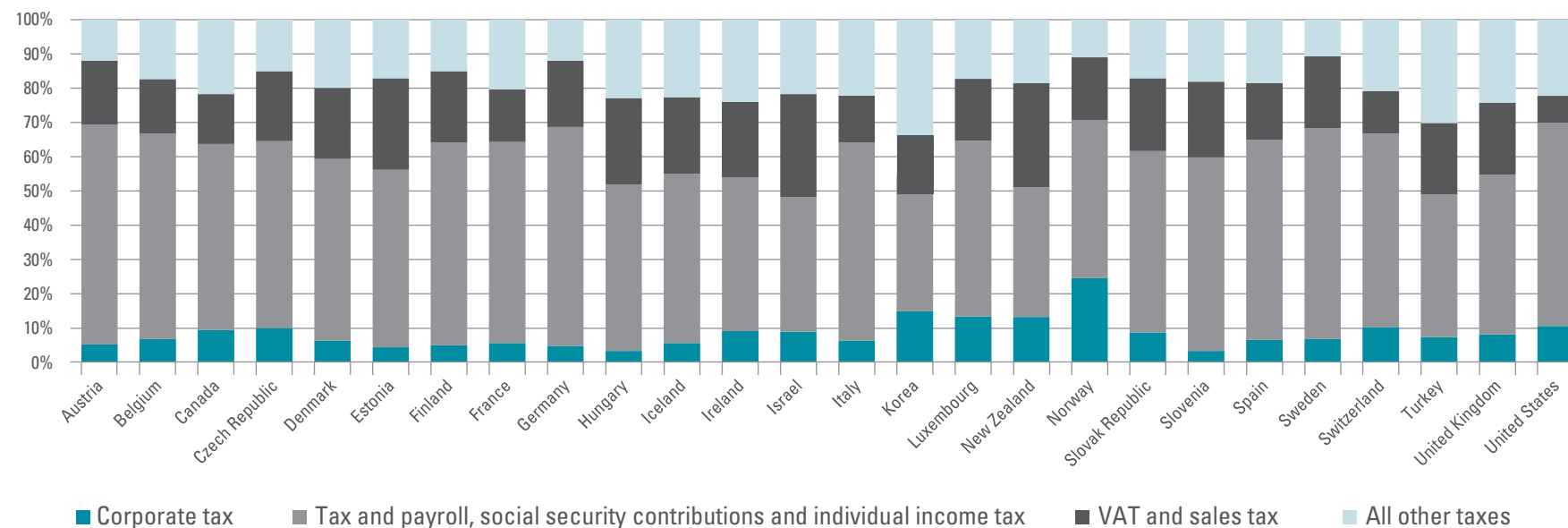
Although the media tends to focus on corporate income tax paid in a particular territory, such headlines mask the complexity of running a global business, where tax laws vary widely and corporate income tax is only one of the ways in which governments raise funds (along with personal tax/social security and VAT/goods and services

taxes). In most jurisdictions the corporate income tax has been the smallest contributor to total tax revenues over the past 10 years.

Given this relatively modest figure, potential (but unlikely) solutions could be to either abolish corporate income tax

altogether and increase the other tax measures, or to set an internationally agreed range of 'acceptable' corporate income tax rates.

Fig 5: Total tax revenue by type of taxes (% of total tax revenue), 2014 for all OECD countries



Source: <http://stats.oecd.org/Index.aspx?DataSetCode=REV>

How BEPS could impact life sciences companies

Fig 6

The BEPS workstreams		
Coherence	Substance	Transparency
Hybrid Mismatch Arrangements	Preventing Tax Treaty Abuse	Methodologies and Data Analysis
Interest Deductions	Avoidance of PE Status	Disclosure Rules
CFC Rules	Transfer Pricing (TP) Aspects of Intangibles	TP Documentation
Harmful Tax Practices	TP/Risk and Capital	Dispute Resolution
	TP/High Risk Transactions	
Digital Economy		
Multilateral Instrument		

Source: OECD secretary-general report to the G20 finance ministers and central bank governors, 19-20 July 2013

Coherence

When considering the actions grouped under coherence, the life sciences sector is no different to any other industry sector and so has no defining features that would warrant special considerations. That said, the focus on hybrid mismatch arrangements, limiting base erosion via interest deductions and CFC laws is likely to have a profound impact on the use of debt funding and entity recognition for tax purposes that will warrant a full review of funding arrangements to ensure that they remain tax efficient. Indeed, consideration should be taken prior to the introduction of any initiative arising from BEPS to ensure

that existing structures are not prevented from being unwound in an efficient manner. The focus on countering harmful tax practices will likely result in an increased need for substance and activity, and therefore a review of how existing preferential regimes are utilized within the business should be performed as a matter of urgency to assess any operational changes that may be required.

Substance

Given the importance of intangible assets to the life sciences sector, the changes proposed under the BEPS Action Plan could fundamentally impact the way that companies organize and exploit their intangibles.

Restoring the full effects of international standards

The life sciences sector in general has not relied on conduit arrangements with little substance to help manage the effective tax rate and therefore should not be unduly impacted by any strengthening of treaty provisions to prevent the inappropriate granting of treaty benefits. However, any changes to the definition of a PE introduced to prevent the avoidance of PE status may have a dramatic impact on the industry's historic use of wholly owned representative offices or third party representatives, both of which under current PE guidelines are likely not to create a PE for the non-resident. Any reduction in the current exemptions from the creation of a PE will likely require greater transparency on the function and risks performed and the value attributed to such activities thereby increasing the corporate tax burden in those countries.

We would recommend that all life sciences companies perform a review of their current PE status and model how changes to the preparatory and auxiliary or independent agent exemptions could impact their corporate income tax position.

Aligning income recognition with value creation

Historically, the owner of the intangible received returns under a residual profit split, with many of the functions within the value chain treated as routine, with comparatively low arms length returns. This often resulted from a cost-sharing arrangement, where marketing and distribution rights were granted through a cost share of R&D activities. Under the new proposals, if the cost-sharing activity is limited to purely bearing a funding risk, then the return allocated to the funder would simply be a risk-adjusted rate of anticipated return on the capital invested. In addition, there will be more importance attached to where and who is responsible for the following: design and control of research and marketing programs; management and control of budgets; control over strategic decisions about intangible development programs; important decisions on defence and protection of intangibles; and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

Companies need to review how they manage their IP development, ownership and exploitation, documenting fully who the significant decision makers are and where they are based. To give future certainty, unilateral or bi-lateral/multi-lateral Advanced Pricing Treatments (APA) should be considered.

Transparency

One concern identified under the BEPS review is inadequate information provided by tax payers to tax administrations. It is looking at developing rules on transfer pricing documentation to enhance transparency, including country-by-country reporting. Intangibles in

this sector are often legally owned by a limited number of entities, reducing the time required to manage and protect intangible rights. The rights to market intangibles and derive income may sit in a number of legal entities, with responsibility for marketing or R&D situated elsewhere in different legal entities or virtual management committees comprising individuals from a variety of locations.

If the need for substance in a particular entity were necessary, so that income would fall within a preferred tax regime such as an IP/patent box, this may require major operational restructuring, with no tangible benefit for tax authorities. A more holistic approach should be adopted to ensure that, within a specified territory, the substance requirements may be met (although not necessarily within a single entity).

In an ideal world, information on the supply chain and transfer pricing, together with country-by-country reporting would be kept within the relevant tax authorities and not published more widely. Such data may be commercially sensitive and can be subject to misinterpretation by individuals unfamiliar with international tax concepts. That said, it must be accepted that with current public sentiment, it is highly probable that information will end up in the public domain.

Companies therefore need to understand what country-by-country reporting means for them, understand how they would articulate their tax affairs in the public domain, including the structure of their operating models, the funding strategy they have, where the IP is owned and managed, etc.

Digital economy

Big data

Life sciences companies are on the cusp of an explosion in patient-centric data. As the industry moves towards more personalized medicine and companies become more involved in care pathways, patient information will drive the development of medication. For example, does unstructured or unanalyzed data have any intrinsic value? And are the generators of such data (i.e. the patients) creating valuable intellectual property in the country where the data is collected, creating a taxable nexus (PE)? The impact of a 'yes' response to either of these questions is still unclear, and the full recommendation of the working group on BEPS due in September 2015. Regardless of the specific outcomes of this group, it is clear that there is an increasingly strong focus on the collection, manipulation and potential value of data.

Going forwards life sciences companies need to consider the value that may be attributed to the data they collect.

Companies need to review how they manage their IP development, ownership and exploitation, documenting fully who the significant decision makers are and where they are based. To give future certainty, unilateral or bi-lateral/multi-lateral APA's should be considered.

Russell Hampshire
Global Head of Tax, Life Sciences
KPMG in the UK

Corporate income tax in a post BEPS world

If the sector's main players want to gain greater certainty over their future tax liabilities, and maintain a flow of funds for essential R&D, they need to reconsider their organizational and legal structures, and quantify the value of intellectual property and intangible expenditure such as marketing.

Although full equality of corporate income tax and tax incentives around the world is unlikely, there could be a degree of convergence as a result of the BEPS Action Plan. This could actually simplify the rationale behind choice of location for production, distribution, R&D and sales and marketing, as commercial and logistical benefits would be the driving force, rather than the need to optimize the corporate income tax position.

In order to reduce uncertainty over transfer prices, companies can make better use of advanced pricing agreements, which establish an agreed pricing formula for a set period of time, and minimize the prospect of costly legal challenges. Life sciences companies should also embrace the move to greater transparency, as this creates better relationships with tax authorities, and enables more dialogue on tax planning.

The outputs from the BEPS Action Plan are rapidly taking shape. Businesses that understand the implications and adapt their business model in line with the direction BEPS is going should minimize the impact of inevitable inefficiencies in the system caused by a lack of certainty as to which markets adopt which recommendations. In the medium term, this should give them the best possible chance to maximize the availability of R&D funds, in order to gain innovation leadership.

The four actions life sciences companies should consider taking

Action 1:

Review the use of the representative offices within global business operations, quantify the impact that a change in the definition of a permanent establishment may have and consider restructuring to reduce the potential impact on post tax revenues.

Action 2:

Assess the relationship between the owner of all intangibles across the business and measure the relationship between business activities ensuring that they are commensurate to the revenues generated in the place of ownership.

Action 3:

Establish a robust transfer pricing documentation system so that exposure to audit and transparency demands will not result in a change to where profits are able to be allocated for tax purposes.

Action 4:

Develop a system which is able to measure the value of data that is collected through business activities enabling you to predict the potential of a data asset to become taxable and the amount of taxable profit which would be generated.



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