Rome, 15 June 2022

Via e-mail: taxcommittee@un.org

UN Tax Committee

Comments on transfer pricing work streams

Dear Sirs,

I would like to thank you for the opportunity to submit my comments on the work streams outlined in the Co-Coordinator's report document CRP. 13 issued on 17 March 2022 (the "Report").

I appreciate the work plan on topics in relation to transfer pricing as it considers unresolved issues that need to be addressed for developing countries.

I have limited comments on some general issues. In this respect, please find hereinafter my observations, focused on some of the specific aspects outlined in the Report.

- **Industry / sector guidance for primary products**

-Value chain of the industry

A value chain analysis can alternatively be a valuable and complementary methodology for determining adequate transfer pricing. Its main purpose is to determine where and how value is created in business operations.

It is worth considering that one important characteristic of primary products (agriculture and agro-food) is a significant level of concentration, particularly in most advanced sectors in terms of technology and marketing, such as ultra-fresh dairy products. Outside of MNEs a number of businesses worldwide exist on the market. The large majority of these are small and very small businesses with local products. The main drivers of this concentration are competitiveness and food safety. The food system operates under the influence of standards (e.g. the International Food Standard, British Retail Consortium Global Standards, Global Gap). It is obligatory for agro-food companies to adhere to these standards, which involves a considerable expense. In addition, such concentration ensures the

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financing of intangible investments (innovation and communication), which enables companies to gain market share due to the advantage effect derived from size.

With the rise of globalization, MNEs are facing challenging economic circumstances and an increased level of competition, which oblige them to review their supply chain models to achieve strategic objectives. The main objectives are the creation of operational benefits and cost reduction.

Procurement is one of the focus areas, as it plays a significant role in driving corporate performance. In particular, central procurement has become an important area of focus for MNEs. Raw materials, packaging materials and services need to be available in the right place and at the right time to allow the enterprises to manufacture their products. Enterprises are highly dependent on the supply of raw and packaging materials and services. Any major disruption due to natural events or a change in the macroeconomic context, resulting in input price volatilities and/or capacity constraints, could potentially affect an entity's financial results. In addition, enterprises are also exposed to contract risk, as they rely on third-party commodity suppliers. Any termination or material change to the contract arrangements, or any failure of the supplier to meet its contractual obligations, could have a significant impact on production, distribution and sale of their products and, consequently, on operations, cash flows and financial conditions. Efficient relationships with suppliers are key to the company's short-term financial position and long-term competitive power. Global and/or regional procurement operations have been created, and centralized in one or more group entities in order to manage the above-mentioned risks. These central entities, which have key strategic decision responsibilities in relation to the overall procurement function, are a critical element of the overall supply chain of these organizations. The advantages associated with such centralized global and regional sourcing operations relate primarily to savings from economies of scale; in addition, they significantly improve an MNE's bargaining power on the market and ensure that the group can source materials at a lower price and even at a higher quality.

The three most common types of procurement operating models are: a decentralized operating model, a lead-buyer operating model; the centralized sourcing and procurement operating model (a central entity is fully responsible for developing and executing the procurement strategy and directly interacting with independent suppliers. The central entity can either: negotiate with suppliers and enter into framework agreements. The affiliates will then purchase from suppliers under these framework agreements, benefiting from the terms and

conditions negotiated by the procurement entity; or enter into procurement agreements directly with suppliers and purchase goods in its own name. The procurement company will then sell the goods and materials to the affiliates).

The procurement risks to be analysed, among others are: market risk, supply risk, commercial capacity risk, contractual risk, quality/reputational risk. Another key element is the analysis of the main assets employed in a procurement model, e.g. supplier relationships, systems and tools used to enable efficient sourcing, and the creation of know-how.

The adoption of an organizational model has consequences on transfer princing and comparability analysis.

Considering comparability factors, the guidance should explore, among the others, the role of group synergies within MNEs. It is important to identify the role that these group synergies play in generating procurement value. It is also important to identify which associated entities contribute to these synergies in order for them to be appropriately compensated. Joint efficiencies are an essential attribute of MNEs. Depending on the type of procurement operating model, different types of benefits can be obtained. In a decentralized operating model, the benefits generated are more like the benefits of "passive association". In the lead-buyer operating model, there are "deliberate concerted group actions". This operating model may give an MNE an advantage or disadvantage in the marketplace over market participants that are not part of the MNE and are involved in comparable transactions. In the centralized sourcing and procurement operating models, the incremental group benefits would be synergistic and non-synergistic. In these cases, the transfer pricing policy should take into account that the central entity is executing key value adding activities.

Looking briefly at some key points in the analysis of transfer pricing methods, the comparable uncontrolled price (CUP) method would generally be the most appropriate transfer pricing method for commodity transactions. In addition, the use of quoted or publicly available prices, as a particular application of the CUP method, has been used by MNEs in order to determine the arm's length price of their related party transactions affecting commodities. It should be helpful in the guidance to suggest standardization of the sources of information that should be used for the application of this method. In many cases, the use of quoted prices is a very good starting point for a transfer pricing analysis supplemented with comparability adjustments where required. Certain commodities, however, are not priced through agreements, but priced on a transactional basis. In these cases, for documentation purposes, flexible approaches recommended to tax

administrations to validate the arm's length nature of these transactions, in order to eliminate excessive administrative burden for businesses.

-Environmental regulation

Sustainability and environmental, social and governance (ESG) issues affect how companies do business. In recent years, more companies are recognizing sustainability as a strategic priority that significantly involves business risks and opportunities. However, few companies have already implemented organizational structures that are designed to consider sustainability as a business issue and are in the process of redefining operational structures to achieve their ESG policy.

The Subcommittee industry guidance on primary products should explore how the ESG integration into the business strategy and processes influences MNEs organizational structures in order to consider the transfer pricing aspects of actions that groups assume in order to align their business models and organizational processes with ESG targets.

As a consequence, ESG impact on transfer pricing issues may require MNEs to revise their transfer pricing policies. A detailed analysis and accurate delineation of potentially new functions, risks and assets should be done. It may also be that new transactions evolve within groups.

Some of the ESG transfer pricing issues include:

– changes and/or adaptions of the business model;

– major product costs and/or savings (e.g. energy costs, cooling costs);

– development of new products and processes;

– impact on new or existing brand value;

– creation or enhancement of intellectual property assets;

– changes to the supply chain and operating models (e.g. improving flexibility of the supply chain);

– participation in new regulatory regimes;

– profit changes that reflect new environmental costs, new products or new processes.

To address all these issues, MNEs' transfer pricing policies and procedures may need to be adapted.

ESG drivers and risks are crucial for primary products. The industry guidance should contemplate possible changes to the supply chain.

To give some examples of transfer pricing implications, it may be that manufacturing steps are insourced and manufacturing entities assume additional production functions. This may be the case where groups have non-compliant suppliers with which they cannot come to terms on monitoring arrangements or ESG commitments. The functional risk and asset profile of the manufacturing entity changes and the transfer pricing method applied may need to be adjusted. In other cases, ESG may have an impact on the whole group, and on the single group entity's cost structure. A last example of ESG-driven changes of the functional profile is the centralization of the management of supplier agreements to ensure that these are compliant with the group's ESG criteria and reporting obligations. Similar to the centralization of logistics, functions relating to supplier relationships, including negotiation and contract management, may be centralized if these functions imply significant ESG risks for a multinational group.

- **Industry / sector guidance for the pharmaceutical industry**

-Value chain of the industry

When describing the value chain of the pharmaceutical industry, the UN Subcommittee should consider differences existing between innovative and generic drugs in order to outline their consequences on transfer pricing functional and risk analysis. They are usually developed by different companies or different segment/divisions of a multinational group so they correspond to specific value chains.
Focusing on generic drugs one should consider the following aspects:

- generic drugs have a much easier development process, as companies must only prove their bioequivalence to the originator drug in order to receive the marketing authorization.
- in the generic drugs industry, companies have to submit the registration dossier to demonstrate the bioequivalence of the product. Neverthless, the investment required and the time spent on its compilation is not comparable to a dossier filed for innovative drug.
- the approval of a generic drugs does not create any legal exclusivity.
- if the product receiving the approval is the first generic on the market, sales and profits will be higher than when other generic players have already launched their products.
- the patent cliff does not exist for generic drugs and sales are usually driven by demand and competition between the different players.
- as a result, the value of the dossier is lower than it is for patented products.

The guidance should consider the central role of intangibles (patents, marketing authorisation, registration dossier, marketing intangibles) in creating value and their impact on the transfer pricing analysis. It could be useful considering their feature as unique and valuable intangibles or in some case of hard-to value-intangibles. The pharmaceutical industry involves different types of intangibles, which, in combination, may be extremely valuable. Interactions between these intangibles, as well as the relative contribution to value creation where different companies hold rights to the intangibles used, are very significant in performing a transfer pricing analysis with regard to the intangibles.
The dossier (and its submission for registration) is commonly regarded as the underlying intangible asset supporting patents and marketing authorization received from the different countries' health authorities and, as such, as the unique intangible being the source of the future economic value of the medicine.
Particular attention should be given to the role of marketing intangibles that are often closely integrated with location specific advantages.

When dealing with intangibles some of the key issues concern determination of the arm's length rate of royalties, allocation of the cost of development of the market and brand in a new country, remuneration for development of marketing and R&D intangibles, their use, transfer pricing of co-branding, etc. The main challenge in determining the arm's length royalty rate is to find comparables in the public domain with sufficient information for comparability analysis. Difficulties have been encountered in determining the rate of royalty charged for the use of brands and trademarks in certain cases. The use of valuation techniques as an alternative is a feasible option.

The guidance should also analyse the importance of market specific characteristics for developing countries such as location advantages, market accessibility, large customer base, market premium. Subsidiaries of multinational group often performs substantial marketing activities relating to marketing, market research and market development in developing countries market, which have resulted in some cases in creation and development of local marketing intangibles like customer lists and dealer networks. In any case these activities usually add value to intangibles such as brands, trademarks and trade names owned by parent companies located in developed countries or in low tax jurisdictions.
Developing countries taxpayers incur these expenses for and on behalf of their parent companies, and these expenses promoted the brands/ trademarks that are legally owned by the overseas associated enterprises. The functions carried out, which are in the nature of development of the relevant intangibles, deserve compensation. The awareness about the trade intangibles owned by the associated enterprise, is enhanced by the marketing efforts made by the local companies, thus adding value to the intangibles. This practice also creates a platform for the associated enterprise when it launches new products in the local markets.

One feature of the pharmaceutical industry is that primary brands are mainly in the hands of multinational companies. This is due, among other reasons, to (i) the fact that multinational companies hold the preponderance of patents on the main pharmaceutical products and (ii) the restraints imposed by governments to ensure quality control of pharmaceutical products.

In some cases, local subsidiaries using the technical know-how of their parent company have incurred significant costs to customize such know-how and to enhance its value by their R&D efforts. An example that should be considered is the co-branding of a new foreign brand owned by the parent MNE (a brand which is unknown to a new market) with a popular local brand name. Whether the local subsidiary has developed a valuable brand in the domestic market over a period of time, incurring large expenditure on advertisement, marketing and sales promotion, it should be entitled to an arm's length remuneration for contributing to increasing the value of the little-known foreign brand by co-branding it with a local.

Another issue to examine is that manufacturing, marketing and distribution activities, though also very relevant for the success and profitability of a drug, are, at least from a valuation perspective, usually considered as routine activities not as critical as the R&D functions.
In developing countries the manufacturing process is mainly secondary manufacturing, which involves processing active pharmaceutical ingredients (APIs) so that they can be used as a drug.

-Transfer pricing risks

In addition to the level of uncertainty and the resultant business risk, pharmaceutical companies are faced with major economic, regulatory and political risks particular to the industry. Peculiar economic risks of these companies are the result of their research and development programmes being subjected to fortuity about the outcome of new diagnostics and/or drugs.
As another difference between generic and innovative drugs, even if such a new product has been secured through all pharmacological and toxicological testing and various clinical trials, companies marketing a new medicine may be faced with the risk resulting from unexpected side-effects to be detected only with the broader use of the product under the conditions of daily life.

Various regulatory interventions provide for significant risks in pharmaceutical companies, as they are limiting their managements' ability to exercise entrepreneurship. Government interventions may preclude or limit the enterprises' opportunity to effectively utilize the marketing authorization granted, for example by health economic or pharmaco-economic studies not being accepted in support of sufficient market prices.

Pharmaceutical companies are also faced with considerable political risks (e.g. activities of non-governmental organizations and initiatives of institutional investors that severely impact the business decisions of the enterprises).

In general, there is an apparent lack of distinction between social and commercial responsibility. Research-based pharmaceutical and biotech enterprises shoulder each type of responsibility.

-Government intervention

Government intervention into the determination of market prices, reimbursement levels, or even the limitation of access to pharmaceutical products is sometimes justified by the fact that such governments are the principle customers of the industry.

In the area of health care, it appears to be easier for governments to develop measures for controlling the supplyside, rather than to emphasize the demand-side. On the supply-side, governments control access, prices, volumes, costs and profits by means of requiring, amongst others, the determination of the product's "clinical excellence", the approval of pharmaco-economic studies, the demand of price reductions, paybacks, budget limitations, the enforcement of reference pricing, tiered pricing, generic substitution, parallel imports, limitations to certain levels of costs, reimbursements, and "allowable profits".

The extent and nature of government intervention in the pharmaceutical industry is, in fact, its distinguishing feature. Regulation and legal frameworks can affect the ease of market entry in several ways. There are understandable reasons why governments regulate the entry of a drug into the market and the manner of its manufacture and sale, but such regulation undeniably adds to the costs and burdens of companies in the industry. An importation permit may require separate compensation, which may add costs to the global operation if the importation permit is owned by an entity other than the company responsible for manufacturing and distributing the pharmaceutical products. On the other hand, health permit restrictions on ownership of pharmaceutical products with the same API for companies with so-called second-brand strategies may add complexity to the operational structure, which must therefore be properly evaluated. On this basis, regulatory restrictions should be analysed as a factor determining comparability.

-Potential changes to the industry stemming from the COVID-19 pandemic

The guidance should consider the transfer pricing consequences of allowing developing countries access to cheap medicines also beyond some agreed disease

e.g. HIV/AIDS, tubercolosis and malaria and also COVID -19 if need through compulsory licensing.

- **CO2 certificates**

The Subcommittee guidance should consider as a starting point that the green agenda is a global commitment, and activities in one entity of a MNE group may create costs and benefits for part or all of the group. This impacts functions, risks and assets across a multinational group and may change intragroup transactions or creates new value transfers that must be considered from a transfer pricing perspective.

The most important impact of the green agenda is the incorporation of environmental costs of doing business that have been avoided or undervalued by some companies. The green agenda's need to both limit and provide incentive is driving new mechanisms for taxes and tariffs to ensure that the polluter pays. Fundamental among these are cap-and-trade schemes for carbon and other emissions, which allocate credits up to a cap, then require the purchase of other companies' surplus credits if that cap is exceeded, which creates a cost for emissions.

The creation of active markets in emissions credits places a value on them. However, the regional nature of cap-and-trade schemes, as well as market fluctuations, creates differences so that these values can be both variable and volatile. The sharing of carbon or emissions credits between associated enterprises will not only require an appropriate pricing mechanism for a group's transfer pricing policy, but will also create challenges and opportunities in identifying an arm's-length price because of the impact on cost. In addition, beside price fluctuations, the transfer pricing policy should consider regional market values and different values in various parts of the business. The understanding of this will require consideration of existing transfer pricing policies, supporting documentation, and benchmarking.

Moreover, losses or low profits resulting from adoption of a green agenda will need support from the enterprise's transfer pricing policy. Development costs of new technologies, products, and processes may also contribute to start-up losses. Because these costs may create intellectual property, they need to be provided or licensed to group users at an arm's length price or rate. Business models are also changing through the increased involvement of central offices or the realignment

of logistics around local hubs. These changes represent the greatest opportunity to integrate transfer pricing planning and commercial opportunities.

Looking at investments, care is required around levels of debt and thin capitalization defense as finance, profit, and asset levels change. The changes to business models and the creation of investments in new businesses and technologies will always generate risks and opportunities.

Green agenda will cause several transfer pricing issues. That agenda is not fixed, but it changes according to a range of drivers including regulation, innovation, new market conditions, and shocks. To start integration of the green agenda into a group transfer pricing policy, the following issues should be explored:

- which entities benefit from the adoption of green agenda initiatives;
- which entities take the risk; whether it is a new asset created or an existing asset improved;
- who bears the cost and who benefits from additional income;
- what are changes in the value chain characterization;
- which is the location of functions, assets, and risks in the supply chain.

In general, one should illustrate the transfer pricing implications of moving carbon credits around the group and which is the best entity to purchase credits taking into account any available tax losses.

By doing this analysis, flexibility is needed to find solutions that take into account business objectives and transfer pricing linked to carbon credits across the value chain.

- **COVID-19 / economic downturn**

The guidance on COVID -19/economic downturn should be coupled with the analysis of short and medium period effects of Russia-Ukraine war on developing countries.

For example, some of the negative consequences of the crisis include a decrease in consumer demand, interruptions in supply chains and uncertainty and volatility, all of which can have reflections in financial markets. In particular, certain economic sectors (e.g. pharmaceutical, medical or technological services) have not been impacted as negatively as other sectors, and some have even experienced

growth during the COVID-19 era. Although the COVID-19 crisis has impacted the global economy, not all countries and economic sectors have been affected equally. There are also significant business changes to consider e.g. the introduction of direct-to-consumer businesses.

During the COVID-19 the first measures implemented by MNEs to ensure the continuity of their businesses have mainly been focused on: guaranteeing that supply chains are functioning, reorganizing resources to improve the MNE group's efficiency, and mitigating risks arising from the COVID-19 crisis. In some cases, it may require a modification to the MNEs' business model. Consequently, changes to the transfer pricing policy of an MNE group may also be required in light of the new circumstances. Regarding changes made to an MNE group's business model, two critical aspects must be considered: temporality and the applicability of these measures, if these changes will affect all of the MNE group's entities or only some of them. Lasting changes implemented in the MNE group's business model that affect all or most of the group's entities will most likely require modifications to the transfer pricing policy of the MNE group. While the circumstances caused by the pandemic are extraordinary, in the event of modifications to the MNE group's business model, the relevant changes may be applied globally that requiring an effort to maintain consistency in the group's transfer pricing policy. The main problem that MNEs will face upon implementing these changes to their business model consists of determining the arm's length conditions regarding the new intercompany transactions that will be carried out; or the intercompany transactions that the MNE group was carrying out until now but that will be changed in order to adapt them to the current market circumstances.

It is plausible that the effects of the pandemic are allocated to multinational groups along the entire value chain. New business models may arguably need new transfer pricing approaches, and important starting points are value creation and

market references. In their analysis to evaluate the economic downturn effects on transfer pricing MNEs sould explore the following aspects:

- Are key drivers of value in the business still the same?
- Is profit still recognized where value is created in the business?
- Where are key decisions being taken?
- Have risk and/or data management capabilities been transferred abroad?
- How would third parties agree to international remote working and under what terms?

In general, the COVID-19 crisis has negatively impacted the supply chain of many MNEs. As a consequence of lockdowns, the closing of international borders, the scarcity of materials, and the inability of workers to perform activities, MNE groups may consider a restructuring of their business models, which means a shift in activities from one country to another in order to adapt to the circumstances of the crisis. During the lockdowns, a lot of MNE groups will address their business models to remote-servicing business models, leading to possible business restructuring consequences. In some cases, restructuring transactions have been made to achieve a centralization of functions.

The Subcommittee guidance should highlight that Governments all over the world have implemented various support mechanisms to help companies manage the impact of COVID-19. The government assistance may have transfer pricing implications as these public support measures could impact intercompany transactions. In this context, there may be situations of non-uniformity in the use of public subsidies between the parties involved in the intercompany transaction because these extraordinary support measures depend on local governments' measures. Government assistance should be treated as local market feature often relevant in affecting the price of a controlled transaction.

The guidance should also indicate in details supporting transfer pricing documentation. The documentation should describe which entity of the group made decisions relating to the management of risks relating to COVID-19, the amendments in the intercompany agreements, in light of COVID-19 (with the evidence that independent parties in comparable circumstances would have revised or modified their existing contractual arrangements); specific government assistance programs and government intervention measures that involve the company and the pricing of intercompany transactions with related parties, and specific analysis of how the company's sales volumes, operational costs, capacity utilization and profitability have changed during COVID-19. The documentation

should also include the market reports and the official statistics that describe the impacts of the economic crisis on the sector in which companies operate; changes to the search strategy of the benchmark analysis; the impacts on the value chain and the effects of the crisis on the functions, risks and assets employed by the related companies.

In benchmark analysis, it should be considered the use of flexible solutions e.g. adjustments to the search strategy or adjustments to comparables in order to address the lack of reliable comparable data or applying term-testing over 3 years for the years 2020 and 2021 involved in the pandemic instead of annual testing.

Particular attention should be paid to the accounting treatment of the economic effect of government grants both in the tested parties and in the comparable companies used as a reference in order to assess the arm's length nature of the intercompany transaction under analysis.

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I hope to have other occasions for contributing on these important issues over the next several months.

Sincerely,

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