ASSET MANAGEMENT AND TRANSFER PRICING

Complexity and risk

The asset management industry is subject to constant change and increasingly faced with competition from new market entrants, alternative investment opportunities and developing client requirements. The result is increasing structural and operational complexity.

In addition, a myriad of regulation applies to investment products and investment vehicles, much of it without global reach/alignment but applicable domestically or regionally – examples being those issued by the SEC and EU directives.

The tax and transfer pricing environment

Multilateral action led by the G20 and OECD aimed at setting new international standards to close tax loopholes perceived to be exploited by some multinationals, and to create a more cohesive and transparent international tax framework, gave rise to the OECD's recommendations on Base Erosion and Profit Shifting ('**BEPS**').

'**Transparency**' is one of the three pillars that the BEPS actions have focused on, and, from a TP perspective, has led to the new '**master file**' and '**local file**' documentation standards, the introduction of '**Country-by-Country reporting**' for tax and the automatic exchange of tax rulings between tax administrations.

'**Substance**' is the second of the pillars. This has particular importance for asset management with its emphasis on '**Presence**' via people on the ground performing functions.

The OECD's recommendations emphasise that '**transfer pricing outcomes shall be aligned with value creation**', with contractual arrangements being put aside for transfer pricing purposes where they do not reflect commercial and economic reality, and contractual allocations of risk being respected only when they are supported by relevant decision-making and the capacity to bear risk.

The result is that asset managers are confronted with a huge number of new tax-related rules and compliance requirements.

Why is it so important for asset managers?

Asset managers commonly outsource certain functions, like

- Investment management
- Investment advice
- Fund distribution
- Fund administration.

Such outsourcing will often occur between related parties.

That is where transfer pricing comes into play and where tax authorities will pay close attention to verify whether the '**arm's length principle**' is followed – meaning that the prices and other terms and conditions agreed between related parties need to be the same (or at least similar) to what unrelated third parties agree or would have agreed under the same or similar circumstances.

Asset managers should be aware that some of the structures they have used in the past are now at greater risk of being disregarded as not being arm's length (especially contractual allocations of risk that lack economic substance).

Nonetheless, recent experience indicates that different tax authorities still have different – and often diverging – views about the basis on which income from asset management activity in an intra-group context should be taxed and how the arm's length principle shall be applied in practice. This places greater emphasis on being well-prepared to support and defend your transfer pricing policies.

Tax authorities like to challenge

With all the new rules and reporting requirements already in force, or in the process of being established, tax authorities are now better equipped than ever to identify behaviours that do not comply with the arm's length principle.

But even complying with the arm's length principle may not be sufficient to avoid challenges by tax authorities if asset managers are not able to provide the evidence that their related party transactions are '**at arm's length**'. Besides third party benchmarking, it is also important to ensure that appropriate intercompany agreements are in place and gaps/inconsistencies in the transfer pricing documentation are addressed.

Non-compliance (and the absence of necessary documentation as evidence of compliance) may result in

- Double taxation or taxation of income in a jurisdiction with a higher tax rate
- Late payment interest and penalties
- Qualification of the entity accounts by the auditor.

Severe cases may even trigger personal sanctions against the individual(s) having signed-off the related tax declarations.

Potential side-effects

'**Arm's length**' is not only a concept relevant for corporate tax purposes, it is also relevant for accounting purposes and subject to financial audits as such (see IAS 24, for example). In either case, the way transfer prices are managed affects financial performance and regulatory risk of an asset manager.

There are also legal considerations for directors in performance of their duties, which oblige them to act in the interest of the company they represent, not in the interest of the shareholder or of a related party.

What can be done in practice?

Where asset management is structured with a local manager subcontracting advisory, sales and back-office functions to related parties performing the respective activities in different jurisdictions, questions arise regarding the appropriate pricing methodologies and the appropriate basis for benchmarking the pricing of the outsourced functions.

Historically, many fund managers with international operations preferred the application of cost-based approaches, with a certain mark-up on cost as a profit element. Such approaches were favoured due to their conceptual simplicity and they were often regarded as easy to implement and maintain.

However, cost plus as a pricing methodology will often not be representative of the basis on which pricing for financial services transactions would be agreed between independent parties.

For activities that are complex or risky, or both (distribution/marketing and sub-advisory activities would be obvious examples), remuneration based on assets under management or on a split of profits may be more appropriate than cost plus. Profit splits in particular have become increasingly favoured by tax authorities, but determining the value contribution of each function and developing an arm's length share of profits (or losses) out of it has its own challenges.

What should asset managers do?

Asset managers should perform a thorough and accurate analysis of whether they are adequately placed to deal with current and future transfer pricing challenges.

Aspects that should typically be considered by the asset management industry are as follows:

- Does the existing transfer pricing policy reflect post-BEPS principles (and, in particular, the structure and substance of the operations) and is it compliant with the local transfer pricing rules in each of the jurisdictions concerned?
- Is there sufficient substance/presence to justify the (contractual) allocation of functions and risks?
- Are significant people functions/key entrepreneurial risk-taking functions remunerated in the same way as routine functions? If so, such remuneration may need to be revisited, as cost plus as a methodology for pricing may not be appropriate.
- Is the transfer pricing documentation complete and up to date – both in terms of business structures and transfer pricing policies?
- Are adequate processes and procedures in place, and are resources available, to manage the next transfer pricing audit?
- If asset management operations are located in offshore jurisdictions – check each of the above once again!

It should not be forgotten that transfer pricing audits can be intense and detailed and take considerable time to resolve. The resources, costs and ongoing uncertainty created by an open transfer pricing enquiry mean that it pays to think about this issue pre-emptively.

BDO is here to help

BDO has not only the knowledge, but also has experience in advising a wide range of asset managers in transfer price planning, policy design, documentation and defence. We can also assist with advance pricing agreements with tax authorities.

We can help with the preparation of transfer pricing documentation and at any stage of the analytical process, whether with value chain analyses (to assess the relative value of activities for the entire asset management operations) or the identification of market data for an objective analysis of what might be supportable as an arm's length reward for each asset management activity.

For any further guidance on this topic, please do not hesitate to contact one of the members of BDO's international Financial Services Transfer Pricing Steering Committee:

Daniel McGeown
BDO Canada
+1 (0) 416 369-3127
dmcgeown@bdo.co.uk

Michiko Hamada
BDO United States
+1 (0) 212 885-8577
mhamada@bdo.com

Ben Henton
BDO United Kingdom
+44 (0) 207 034 5820
ben.henton@bdo.co.uk

Anton Hume
BDO United Kingdom
+44 (0) 207 893 3920
anton.hume@bdo.co.uk

Natalya Marenina
BDO Australia
+61 2 8264 6649
natalya.marenina@bdo.com.au

Ilona Orbók
BDO Hungary
+36 1 2353010
ilona.orbok@bdo.hu

Jürgen Raab
BDO Luxembourg
+352 45 123-618
juergen.raab@bdo.lu

or your local BDO Member Firm
www.bdo.global

www.bdo.global