

Transfer pricing of pharmaceutical intellectual property

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Beyond statutory rates, the tax position of a pharmaceutical group depends above all on the allocation of profit among the countries in which it operates. That allocation is governed by transfer pricing rules based on the arm's length principle, which Switzerland applies in accordance with the OECD Transfer Pricing Guidelines although it has no comprehensive transfer pricing statute of its own.¹ For the Basel groups, the central transfer pricing question concerns intellectual property: who owns the patents, trademarks and know-how that generate the profits on blockbuster medicines, and how much of the profit should be attributed to the entities that discover, develop, manufacture and sell them.

Large pharmaceutical groups have traditionally organised their intellectual property in one of several ways. In a centralised model, the parent company or a principal entity owns the global rights to the group's patents and licenses them to manufacturing and distribution subsidiaries. In a cost-sharing model, two or more group entities share the costs of research and development and divide the resulting rights by territory, for example with one entity holding rights for the United States and another for the rest of the world. Under a contract research model, a principal company commissions research from affiliated laboratories, paying them a cost-plus remuneration while it retains ownership of the results.² The details of the structures used by Roche and Novartis are not public. Their annual reports describe the groups' effective tax rates and reconciliations to the Swiss statutory rate, but they do not disclose the internal allocation of intellectual property.

The BEPS reforms changed the economics of these models. Under the DEMPE analysis, an entity that legally owns intellectual property but does not control the development, enhancement, maintenance, protection and exploitation of it is entitled only to a limited return. Profits must follow the

people who make the key decisions. For the Basel groups, this requirement favoured Switzerland in one respect, because much of the strategic research management and decision-making of Roche and Novartis has always been located in Basel. It also strengthened the claims of the United States, where Roche's Genentech subsidiary and the research centres of Novartis in Cambridge, Massachusetts carry out a substantial part of the groups' research.³ The modified nexus approach of the Swiss patent box adds a further dimension, because the reduced rate applies only in proportion to the research expenditure incurred in Switzerland or commissioned from third parties.

Transfer pricing disputes in the pharmaceutical sector are frequent internationally, because tax authorities in large markets regularly challenge the remuneration of local distributors or the royalties paid to foreign owners of intellectual property. The resolution of such disputes takes place in mutual agreement procedures under double taxation treaties or through advance pricing agreements. Switzerland has a large network of treaties, some of them with arbitration clauses. On the Swiss side, the State Secretariat for International Finance within the Federal Department of Finance conducts the procedures.⁴ For a canton such as Basel-Stadt, the outcome of these procedures can have a direct budgetary effect, because an adjustment in favour of a foreign state reduces the Swiss tax base retrospectively.

1 Notes

1. Switzerland applies the arm's length principle through the general provisions of the DBG and StHG on business-justified expenses and hidden profit distributions, and through the administrative practice of the Federal Tax Administration, which refers to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (latest consolidated version 2022). To be verified. ↩
2. On intellectual property structures in the pharmaceutical industry, see the OECD Transfer Pricing Guidelines, Chapter VI (intangibles) and Chapter VIII (cost contribution arrangements), and the general literature on transfer pricing in the life sciences sector. To be verified. ↩
3. On the location of research activities of Roche (including Genentech in South San Francisco) and Novartis (including the Novartis Institutes for BioMedical Research, later Novartis Biomedical Research, in Cambridge, Massachusetts), see the annual reports of both groups and Part G, Chapter I. To be verified. ↩

4. On mutual agreement procedures and advance pricing agreements in Switzerland, see the guidance published by the State Secretariat for International Finance (SIF) and the annual OECD MAP statistics. To be verified. ↩

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