

Intangibles in a post-BEPS world

The framework for analysing intercompany transactions involving intangibles is examined by [Hendrik Blankenstein](#) and [Caterina Colling Russo](#) at [Tax Partner AG – Taxand Switzerland](#). Does the new DEMPE analysis benefit MNEs and tax authorities or simply confuse matters, resulting in an increase of intangibles-related disputes?

On October 5 2015, the OECD delivered a final package of reports providing recommendations and guidance in connection with the 15-point action plan to address base erosion and profit shifting (BEPS).

The 186-page final report, which covers BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 Final Report* (in this article referred to as the Report) offers guidance on a multitude of transfer pricing topics, most importantly guidance for applying the arm's length principle (focusing on economic substance, risks/control and corresponding rewards) and on intangibles.

The Report replaces various sections of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 (TPG). For countries that formally subscribe to the TPG, the new guidance offered by the Report takes the form of agreed amendments to the TPG. These amendments will become part of the TPG after they have formally been adopted by the OECD Council.

Within the Report a strong emphasis is placed on the accurate delineation of the actual intercompany transaction by making use of pre-determined analytical frameworks (para. 1.60, p. 22 and para. 6.34, p. 74) offering taxpayers and tax authorities a stepped approach on how to achieve an accurate delineation of the transaction under review.

Paragraph 6.34 of the Report provides a specific analytical framework for analysing intangibles in controlled transactions. Within the prescribed analytical framework, multinational enterprises (MNE) need to focus on the DEMPE functions (development, enhancement, maintenance, protection and exploitation) with a view to determining which group entities in the MNE undertake and more importantly control these functions.

In this article, we will discuss the framework for analysing intercompany transactions involving intangibles and, in particular, whether the newly introduced DEMPE analysis benefits the MNEs and tax authorities in their analysis or whether it will merely confuse matters resulting instead in an increase of intangibles-related transfer pricing disputes.

Framework for analysing intercompany transactions involving intangibles

The steps of the analytical framework will lead to a DEMPE analysis of the transaction aimed at providing the MNE with all the ingredients to correctly delineate the transaction before determining the intercompany pricing.



Caterina Colling Russo

Tax Partner AG, Zurich

Tel: +41 44 215 77 56
caterina.collingrusso@taxpartner.ch

Caterina Colling Russo, a senior adviser with Tax Partner, has more than 10 years' full-time experience in transfer pricing consulting. Caterina has previously held specialist transfer pricing positions within global international tax and transfer pricing firms. She has worked in Amsterdam, London and Rome.

Caterina has extensive experience in tax planning/restructuring projects and has performed transfer pricing studies for clients in a wide variety of industries including apparel, banking, luxury goods, oil and gas, commodities, fast-moving consumer goods and pharmaceutical. Caterina has provided assistance to clients developing strategies for the conclusion of APAs as well as tax audit defence in multiple European countries. Her technical skills include valuation of intangibles, and transfer pricing aspects of business restructuring. Moreover, she provides advice relating to inter-company financial transactions, ranging from guarantee fee and interest rate projects (transfer pricing policy and benchmarking) to providing transfer pricing solutions for intermediate finance companies as well as for captive insurance companies.



Hendrik Blankenstein

Tax Partner AG, Zurich

Tel: +41 44 215 77 54
hendrik.blankenstein@taxpartner.ch

Hendrik Blankenstein is a partner of Tax Partner AG and leads its transfer pricing team. From 1989 to 1995, Hendrik was an international tax consultant at Big 4 firms in both the US and the Netherlands, from 1996-2004 he worked as an in-house international tax and transfer pricing counsel at Nestlé's HQ in Switzerland, and from 2005 to 2015 as a Swiss based partner in globally operating transfer pricing boutique consultancy firms.

Hendrik has been providing transfer pricing advice to Swiss and foreign multinational clients in a variety of industries, covering design of transfer pricing systems, preparation of masterfile/local file documentation, negotiation and conclusion of unilateral/bilateral APAs, successful management of complex transfer pricing audits and setting up transfer pricing risk management frameworks.

Tax Partner AG, which currently comprises 12 partners and 26 tax professionals, has become a leading Swiss tax boutique firm, focusing on providing tax services such as international and national corporate tax, individual tax and VAT. Each of the 12 partners has their area of specialisation. With regard to related services such as legal, audit and accounting services, Tax Partner typically cooperates with local firms. For further information about Tax Partner, please refer to www.taxpartner.ch.

The framework for analysing transactions involving intangibles between associated enterprises requires taking the following steps:

Step 1: Identify the intangibles

The MNE has to define the intangibles at stake with specificity, in conjunction with the specific, economically significant risks associated with the DEMPE of the intangibles.

In order to support MNEs in performing this step, the Report includes a definition of intangibles only for transfer pricing purposes. Paragraph 6.6 defines intangibles as "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred between independent parties in comparable circumstances".

In addition, some guidance is given through examples of what can and cannot be defined as intangibles. The examples

are, however, only for illustrative purposes and not intended to be comprehensive. In this context, it is clarified that group synergies and market-specific characteristics are elements to take into account in a comparability analysis, but are not intangibles.

Intangibles used or transferred in a controlled transaction already under the existing guidelines needed to be identified with some specificity. What is new is the DEMPE analysis, i.e. the MNE has to identify which activities it classifies as development, enhancement, maintenance, protection and exploitation in relation to the defined intangible and analyse the intercompany transactions focusing on these activities.

Step 2: Identify the full contractual arrangement

It is recommended that the MNE maintains the documents necessary to derive the legal basis of their cross-border intercompany transactions involving intangibles, as these documents

form the starting point for any transfer pricing analysis. The terms of a transaction may be found in written contracts, public records such as patent or trademark registrations, or in correspondence and/or other communication among the parties. As mentioned in the Report at para. 6.35, contracts may describe the roles, responsibilities and rights of associated enterprises with respect to intangibles.

Step 3: Identify the parties performing functions, using assets and managing risks related to intangibles in relation to DEMPE

The MNE has, by means of the functional analysis, to review the conduct of the parties under a DEMPE analysis. In other words, MNEs have to clarify which group entities:

- perform the DEMPE functions;
- use the assets related to the DEMPE functions; and
- control the economically significant risks related to the DEMPE functions.

This analysis does not differ from the already well-known and widely applied concept of functional analysis, however, now from a DEMPE perspective. Therefore, MNEs are now required to identify specific activities for each DEMPE function and ascertain the relative importance of each DEMPE function. Such detailed analysis may be required not only involving group entities, which are currently involved in DEMPE activities, but also entities which performed DEMPE activities in the past.

The Report fails to define the DEMPE functions in much detail. It is clear that DEMPE may have a different meaning depending on the industry. In pharma, the several stages of R&D (and the importance of hard-to-value intangibles) may assume great relevance whereas in consumer goods, the focus may be more on brand value and the role of marketing and advertising. However, even in the same industry, MNEs may categorise activities – which are similar in nature – in a different way.

Step 4: Review the consistency between contractual arrangements and conduct of the parties through functional analysis (DEMPE)

Once the contractual arrangements and the conduct of the party/-ies have been reviewed within the DEMPE analysis context, the MNE has to confirm that there is consistency between legal and economic reality while determining whether the party assuming economically significant risks arising out of the DEMPE functions also controls these risks and has the financial capacity to assume them.

The conduct of the parties is leading. Only where the conduct of the parties and the legal reality of a transaction match will a transfer pricing effect be produced: being the legal owner of the intangible does not confer any right ultimately to retain returns, even though such returns may initially accrue to the legal owner as a result of legal rights.

The new guidance reaffirms and reinforces the necessity for alignment between the legal reality and the economic reality already present in the 2010 TPG and more importantly the prevalence of the economic reality, i.e. the conduct of the parties, over the legal reality (terms of the transaction). We refer in particular to paragraph 1.48 of the 2010 TPG “in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk.” Or paragraph 1.53 of the 2010 TPG: “The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties’ conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.”

The DEMPE analysis should be considered when drafting or reviewing intra-group agreements, specifically how the allocation of roles, responsibilities and risks are provided for.

Step 5: Delineate the actual controlled transactions related to the DEMPE of intangibles

This step is the key outcome of the analytical framework. In this step, the MNE has, on the basis of the steps performed so far, access to all the key elements to accurately delineate the actual controlled transaction(s) related to the DEMPE of intangibles, hence offering the required basis for determining an arm’s length pricing of the delineated intercompany transaction (see next step).

Step 6: Pricing of the delineated transactions

The MNE, where possible, has to determine the arm’s length prices for the transactions under review consistent with each party’s contributions of functions performed, assets used and risks assumed.

Assuming a BEPS-proof DEMPE analysis has been conducted, a further and likely more far-reaching challenge will be to determine the pricing of the delineated transaction consistent with the respective contribution(s) of the group companies to each of the DEMPE functions.

The Report addresses the extreme, however not rare, cases of so-called “cash boxes”, in which an associated enterprise provides funding without either performing any functions relating to intangibles or control over the financial risk. For these cases, the cash box would only be entitled to a risk-free return, whereas in the presence of control over the financial risk it can expect a risk-adjusted return on its funding.

More challenging however, and still lacking clear guidance, are all those intercompany transactions where, often for operational reasons, the DEMPE activities are highly

fragmented amongst associated companies. The compensation for each party's contribution might not be easy to determine, especially in cases where the industry does not offer good availability of comparable transactions undertaken by independent parties. The authors expect that cases like these will probably lead to detailed price adjustment procedures and probably in some more frequent cases to the adoption of a profit split methodology.

Conclusions

In practice, the authors have observed that tax authorities have started to require the taxpayer in tax audits, in litigation, Advance Pricing Agreement (APA) and Mutual Agreement Procedures (MAP) to substantiate their position using the approaches laid down in BEPS Actions 8-10. Consequentially, MNEs can expect having to demonstrate through the prescribed frameworks, leading to a more detailed functional, risk and DEMPE analysis, that the intercompany transactions are delineated accurately and priced correctly.

Most steps in the framework for analysing intercompany transactions involving intangibles are not new. What is new is that – for intangibles-related transactions – MNEs need to focus on the DEMPE functions with a view to determining who in the MNE group undertakes and more importantly controls these functions. Whilst the concept of identifying value-adding functions and attributing returns based on the respective value added is understood, the new OECD guidance fails to define the DEMPE functions. The lack of definition of key terms of the new guidance will undoubtedly lead to increased uncertainty as the interpretation of a) which activities constitute which DEMPE function and b) what relative importance should be attributed to each function will likely lead to an increasing number of disputes between MNEs and tax authorities.

MNEs are required to ascertain the relative importance of each DEMPE function in their respective industry and value chain and identify specific activities for each DEMPE function in order to be able to undertake the detailed analysis, as required.

MNEs' burden of proof is expected to increase, and MNEs should not miss the opportunity to explain the necessary company and industry background underlying their transfer pricing policies as part of their transfer pricing documentation. This includes a detailed description of the group supply and value chain in the context of the intangibles-related transactions. This is key to support the taxpayer in performing a satisfactory DEMPE analysis.

In line with the refreshed concept of a transfer pricing master file, as contained in Annex I to Chapter V of the Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: Final Report – MNEs are now offered the opportunity to present their supply chain as well as all the relevant information needed to provide a blueprint of the group and ultimately to support and justify the selected transfer pricing policy.

Pricing intercompany transactions in light of a DEMPE analysis in some industries will favour the use of a profit split methodology, however guidance on profit split is still under review within the BEPS project.

The DEMPE analysis will put some pressure on defining the correct intercompany pricing and identifying comparable uncontrolled prices, especially for those intercompany transactions where, often for operational reasons, the DEMPE activities are highly fragmented amongst associated companies. In these cases, would the taxpayer be able to find comparable independent parties that have allocated the DEMPE functions in a comparable way? Again some industries will offer good availability of comparable deals undertaken among independent parties, where such comparables will not be available, assuming the transaction has been correctly delineated, this would certainly lead to detailed price adjustments procedures and probably in some more frequent cases to the adoption of a profit split methodology. Additional guidance on the use of the profit split method, hopefully including practical commercial examples for both businesses and tax authorities, is expected to be provided by the OECD in 2017.