

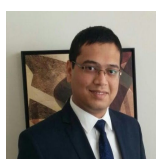
A Deep Dive into the Concept of DEMPE - A New Perspective for Intangibles

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In a highly competitive market, innovations stand out and provide better competitive advantage in terms of profit for a business that is one step ahead of the other competitors in terms of technology. The fourth industrial revolution around the disruptive technologies and trends, such as Internet of Things (IoT), Virtual Reality (VR), Artificial Intelligence (AI) and Machine Learning, all of which are rapidly changing the way we work and live and these are all heavily based on intangibles. Moreover, there are multiple other types of intangibles, such as marketing intangibles (trademarks, brand names, logos, etc.), data processing related intangibles (software, copyrights, etc.), engineering related intangibles (industrial design, trade secrets, drawings, etc.), customer related intangibles (customer lists, contracts, relationships, etc.), and many more, which act as key value drivers for a business.

The Transfer Pricing (TP) aspects of the intangibles is a very vexed issue, where, there could be challenges on identification of the entity which really contributes to the constructive development of the intangibles, the entity which should be considered as the real owner of the intangibles, the entity that should enjoy the profits and bear losses arising out of the exploitation of intangibles, etc. The typical structures deployed by the Multinational Enterprises (MNEs) are centralized, where, there is one entity which is the owner of intangibles (typically the headquarters) and the rest of the entities are identified as the contract service providers, which are remunerated with routine profits on their costs for such services. The Revenue Authorities across the world then come up with the typical assertion on the substance vs form issue , challenging the legal ownership of the intangibles and the role played by the service providers in actual development of the intangibles. There was no elaborate guidance under the international taxation regime on the TP issues surrounding intangibles and hence this was leading to litigation and an era of uncertainty due to the detailed scrutiny by the Revenue Authorities across the world.

The Base Erosion and Profit Shifting (BEPS) Action Plan (AP) 8 by the Organization for Economic Cooperation and Development (OECD) has presented a framework (i.e. DEMPE) for identifying the members of the MNE Group that contribute in creation of valuable intangibles and determining the arm s length remuneration based on their contribution in the entire value chain.

This article aims to take a deep-dive into the concept of DEMPE , which is a new perspective for intangibles and this will get extensively explored during the upcoming discussions on the framework for TP remuneration within the MNE Group and by the Revenue Authorities also while conducting the scrutiny of the international transactions surrounding intangibles.

(A) Concept in brief:

At the outset, it is worthwhile to mention that the intangibles that are important to consider for TP purposes may not always be recognized as intangibles for accounting purposes or may not be registered as patents / copyrights, etc. Whilst identification of a particular asset as an intangible asset itself could be a significant exercise and the OECD has provided detailed guidelines for the same, we have not delved into identification of intangibles in this article, since the objective is to discuss the DEMPE concept.

Thus, for this article, we have proceeded on the assumption that intangible asset is already identified and endeavoured to discuss various aspects of arm s length remuneration to be earned by various entities from use or transfer of intangibles.

In TP cases involving intangibles, the determination of the entity or entities within an MNE Group, which are ultimately entitled to share the returns derived by the MNE Group from exploiting such intangibles is crucial. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the MNE Group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. In such situations, following pertinent questions arise:

(i) Whether the legal owner is entitled to retain the entire return from exploitation of intangible(s)?

or

(ii) Whether other members of MNE Group which have contributed to such intangible(s) should also be entitled to receive part of such return - over and above the arm s length return earned by them for their routine functions?

Above questions are more crucial when the facts of the case suggest that the legal owner of the intangible(s) is merely an owner and all other decision-making functions are performed by other members of the MNE Group.

The Revenue Authorities in various jurisdictions have observed that the tax advantage accruing to the MNE Group in case of legal owner being resident in low tax jurisdiction have resulted in prevalence of structures designed to centralise the global or regional ownership of intangibles. There was a consensus amongst the Revenue Authorities of various countries that such structures may have resulted in loss of fair share of tax for the countries, wherein the actual contribution to the intangible takes place. A need was, therefore, felt for the guidance or framework for appropriate allocation of arm s length remuneration between the entities that have contributed to the intangible(s) instead of the fact that legal owner is entitled to all the residual returns.

Final report on OECD s BEPS AP 8-10 “Aligning transfer pricing outcomes with value creations , released on October 2015, has inter alia provided guidance on applying arm s length principle on intangibles, focusing on economic substance, risks/ control and corresponding rewards than merely focusing on the legal ownership. As the name suggests, the AP 8-10 provides guidelines that the entity which creates the value should be entitled to the commensurate returns. The framework of DEMPE was introduced vide this report that aims to ensure that entities contributing in creation of intangibles receive fair share of income i.e. a clear focus on substance for conducting TP analysis of Intangibles. The framework of DEMPE can be understood with the help of following diagram:

As per DEMPE framework, each respective entity which is engaged in **D**evelopment, **E**nhancement, **M**aintenance, **P**rotection and **E**xploitation of intangible(s) is entitled to the arm's length remuneration (after compensating other MNE Group entities for the activity performed by them) from the overall revenue generated from intangible instead of the erstwhile practice wherein only the legal owner of intangible(s) was entitled to the residual returns.

(B) Legal ownership vs economic ownership:

The AP 8-10 has moved away from concept of legal ownership and has adopted an approach of looking at who is contributing to the value-chain for the development and management of intangibles. Further, the report also emphasised that legal ownership of intangibles by itself does not confer any right ultimately to retain returns derived by the MNE Group from its exploitation. Accordingly, the legal owner is entitled to economic returns only in case where it also performs DEMPE activities. However, in case the legal owner does not perform any of the key activities within the DEMPE approach and barely holds legal title in an intangible, it may not be entitled to any profits other than the arm's length return for administration of intangibles.

For example: In case where Entity A is undertaking all the relevant functions in relation to DEMPE, while Entity B (legal owner) is providing all the necessary assets including funding for these activities and is also assuming financial risks. In this case as per the DEMPE framework, Entity B would be entitled to a risk adjusted return on its funding commitment and ability to bear financial risks and Entity A would be entitled to all the residual returns generated from exploitation of intangibles.

(C) Importance of undertaking appropriate Functional, Assets and Risks (FAR) analysis in relation to the intangibles:

The OECD has prescribed a six-step framework to identify commercial or financial relations in the context of intangibles. This six-step framework emphasises the following three key principles:

â€¢ Identification of the intangible property used or transferred in the transaction under consideration

â€¢ Undertaking an appropriate FAR analysis

â€¢ Accurate delineation of the transaction based on the actual conduct of the parties rather than being driven merely by the contractual terms agreed between the parties

The FAR analysis is one of the most important constituents in transfer pricing analysis since it forms foundation of economic analysis. The AP 8-10 has given emphasis on value creating functions of DEMPE over the legal ownership and contractual arrangements. Accordingly, the OECD's guidance on DEMPE is intended to prevent companies who do not have enough economic substance from earning significant intangible related returns.

Further, the guidance also provides for confirming consistency between the terms of the contractual arrangements and actual conduct of the parties to determine whether the party assuming the risks related to DEMPE also controls those risks and has capacity to assume those risks. An entity is considered to have control over a risk if it performs decision-making functions related to accepting or declining risk-bearing opportunity and responding to the risk. If the legal owner neither controls nor performs the functions related to the DEMPE of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions. The relative value of contributions under the principles of DEMPE for intangibles varies depending on the facts of the case and such contributions can be decided by undertaking robust FAR analysis. Depending upon the FAR, the relative contribution/ arm's length compensation would be determined after considering certain comparability factors such as exclusivity, extent of legal protection and duration, geographical scope, stage of development, useful life, expected future benefits, etc.

To accurately delineate the transactions and relative contributions / functions of the parties engaged in a transaction, the FAR analysis will now require robust understanding and documentation of roles and responsibilities of the parties. This will also require the identification of entities which are controlling the DEMPE functions, as opposed to performance of such functions. Such a requirement may need a more

detailed description and documentation of the responsibility assignment matrices, requiring the identification of the depth of such responsibilities, may be by way of a RACI chart, i.e. the role played by each of the entity against the functions in the value chain, such as Responsible, Accountable, Consulted and Informed.

[D\) Click here to read more about the DEMPE approach adopted by the Chinese Tax Authorities and its recent debut in Indian TP litigation](#)

(E) Availability of significant information to IRA through Country-by-Country Reporting (CbCR) and Master File (MF):

In view of the CbCR and MF regulations that are already implemented in India, significant information would be available with IRA in terms of overall strategy and transfer pricing policy of the MNE Group around intangibles, list of intangibles and their legal owners, entities engaged in R&D, inter-company arrangements, etc. This would enable the Centralized Risk Assessment Unit (CRAU) set-up under the Director General of Risk Assessment (DGRA) to conduct effective tax TP BEPS risk assessment.

(F) Practical challenges in DEMPE: illustrative list:

Whilst the AP 8-10 provides guidelines for delineating the transactions and provides that the compensation earned from use or transfer of IP should be divided between various contributing entities based on the principles of DEMPE, we have outlined below certain real-life illustrative situations wherein undertaking the DEMPE analysis and consequent determination of arm's length price could be tricky and cumbersome:

1. For a software product development project, multiple entities - let say Four entities, from different jurisdictions are engaged in rendering software development services and the same are integrated by a separate entity, let say Fifth entity. Post such integration, such Fifth entity performs certain value-added work on it and the final product is owned and exploited by the Parent entity of the Group.

In such scenarios under DEMPE analysis, it could be tricky to arrive at the relative contribution of each of initial Four entities to overall project (specifically around Development, Enhancement and Maintenance) since they have performed the services under the broad bucket of software development services.

2. In continuation of the situation at Sr No.1 above, the difficulty could arise in cases wherein multiple intangibles are being developed by multiple entities. In such case, DEMPE analysis would be required to be undertaken separately for each IP development project. Needless to say, role of each entity in every intangible development project could differ. Hence, this would warrant an exhaustive and extensive exercise to be undertaken by the MNE Group.

3. A trickier situation would arise in a case wherein a partially developed intangible is transferred by the MNE Group to an unrelated third party. In this case, whilst valuation methodologies could help in arriving at the compensation for transfer of intangible, the real difficulty could arise in determining the relative contribution of multiple entities in such partially developed intangible and subsequently the allocation of compensation received (by the owner of such partially developed intangible) between various entities contributing to the development of such intangible.

4. A practical situation which most of the MNE Groups could face is a case wherein a fully developed intangible is being transferred by One entity, Say A, to another Group entity, Say B. B could actually be an intangible owning company of the MNE Group which in fact carries the appropriate substance such as having qualified employees for protection of intangible, people who can take decisions regarding exploitation of intangible, ability to actually bear the risks in case there are disputes regarding such intangibles, etc. However, in practicality, there could be a situation where, along with B, all the above important functions under DEMPE are jointly performed by A as well.

In such case, a question to ponder upon would be on the methodology to be adopted for the allocation of profits from the exploitation of intangibles between A and B, after due consideration of the fact that A was remunerated at arm's length for performing certain important functions from DEMPE.

5. It is also observed in case of MNE Groups, certain legacy products (also termed as sunset products) are transferred by the intangible owning company to one of the Group entities, say Entity X, for all future maintenance and upgradations required in such products. Whilst intangible of such product is continued to be owned by the intangible owning company, all strategic decisions in relation to maintenance, upgradation, exploitation, etc are taken by Entity X. Even though, Entity X would be undertaking all strategic decisions on going forward basis – major contribution for DEMPE would already have been done by other entities.

In such case, it would be an interesting exercise to determine the relative contribution of Entity X in such legacy products and consequently to determine its share in the overall compensation received by such legal owner of intangible.

On a separate note, it would be even more interesting to see how the compensation earned by IP owning company from such legacy products would be bifurcated to arrive at the compensation towards maintenance, upgradation, etc by Entity X. This is due to the fact that the intangible owning company could claim that major portion of the revenue generated from exploitation of such intangible product is towards substantial DEMPE functions already performed by such company and arriving at a portion of compensation towards upgradation done by Entity X could be difficult, if not impossible.

(G) Parting remarks:

As mentioned at the outset, the intangibles are one of important profit drivers for the MNE Group. The AP 8-10 has clearly re-emphasized on the principle of substance over form i.e. the entity that creates value should receive its share from the compensation derived by the legal owner from exploitation of the intangibles.

In the context of Indian companies in India specifically in the service sector, one should appreciate that since the set-up of operations till date, the company might have moved up in the overall value chain. Hence, it is pertinent that a robust FAR is conducted to understand the role of Indian company vis-à-vis Group companies and a DEMPE analysis be undertaken if Indian company has added any value to the overall value chain. It becomes even more pertinent when the names of Indian employees are named as the co-inventors in the patents registered by the MNE Group.

It is a carving on the wall that the framework to accurately delineate the transactions surrounding the intangibles, i.e. DEMPE is here to stay and will need a threadbare description and documentation of the controlling functions performed by the respective parties to the transactions surrounding intangibles. It is also clear that the Revenue Authorities will explore the DEMPE framework to verify the substance over form for a transaction while undertaking the scrutiny the intercompany transactions relating to intangibles, not only for the TP scrutiny, which is a Specific Anti-Avoidance Regulation (SAAR), but also for evaluation of the arm's length nature of rights or obligations under the General Anti-Avoidance Rule (GAAR).

The MNEs may be required to take specific efforts on delineation of the roles and responsibilities of the Group entities engaged in transactions involving intangibles, review the appropriateness of their current pricing mechanism, adopt appropriate changes, if warranted, and document the FAR and DEMPE correctly in their TP documentation as well as the MF. The review of DEMPE, thus may require a more detailed FAR analysis and also a change in the MAM for computation of arm's length price, which may also include a Profit Split Method (PSM) in such cases.

In fit cases, the DEMPE should also be evaluated to explore implementation of a different business model, such as implementation of a variable royalty model or a franchise arrangement to achieve the implementation of PSM or even Cost Contribution Arrangements (CCAs) in cases where the DEMPE controlling functions are jointly performed by multiple MNE Group entities.

Last but not the least, considering the facts, risk evaluation, etc., the MNEs are bound to explore achieving certainty by applying for the Advance Pricing Agreement (APA) and that too under a Competent Authority proceeding, i.e. a bilateral or a multilateral APA, to avoid double taxation.

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