Ten Questions on the OECD’s DEMPE Concept and Its Role in Valuing Intangibles

The author explores the DEMPE concept introduced by the OECD—“development, enhancement, maintenance, protection and exploitation” of intangibles—and its place in the broader framework for analyzing related-party transfers of intangibles.

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The Organization for Economic Cooperation and Development first referred to the “development, enhancement, maintenance, protection and exploitation” of intangibles in guidance developed under Action 8, one of the transfer pricing items in its Action Plan on Base Erosion and Profit Shifting (BEPS). The acronym DEMPE seems to have taken off sometime after the release of the final BEPS reports in October 2015 and has since become part of the global transfer pricing lexicon—for better or for worse. This article explores the concept of DEMPE and its context in the overall transfer pricing analysis through 10 questions.

1. What is the relevance of DEMPE?

The OECD’s BEPS Action Plan was foreshadowed by tax authorities’ concerns that multinational companies were artificially shifting income to low-tax jurisdictions by transferring their valuable intangibles to affiliates in those jurisdictions. In these situations, the multinational often didn’t have much operational activity in the low-tax jurisdiction but claimed to earn significant profits there by virtue of its intangibles ownership. One approach the OECD took to addressing this particular concern was to include specific operational requirements, which in its view mirror arm’s-length behavior, for an entity to reap the economic benefits of owning intangibles.

The starting premise of the OECD’s approach is that all members of a multinational company should receive appropriate compensation—that is, compensation consistent with the arm’s-length standard—for the functions they perform, the assets they use and the risks they assume in connection with the intangibles. The approach then presumes that important functions related to the development, enhancement, maintenance, protection, and exploitation—DEMPE—of an intangible contribute to the creation of the intangible’s value. The OECD’s approach, therefore, concludes that in order for the legal owner of an intangible to be entitled to the returns from the intangible, it must perform important DEMPE functions. Legal ownership alone doesn’t generate a right to all (or indeed any) of the intangible return. In this way, the OECD’s guidance on DEMPE is in-
tended to prevent companies with no employees or with minimal operational activity from earning significant intangible-related returns.

2. What are some examples of important DEMPE functions?

The nature of the important DEMPE functions in any specific case will depend on the facts and circumstances.

For self-developed intangibles, or for self-developed or acquired intangibles that serve as a platform for further development activities, these important functions may include, among others, design and control of research and marketing programs, direction of and establishing priorities for creative undertakings, including determining the course of “blue sky” research, control over strategic decisions regarding intangible development programs, and management and control of budgets. For any intangible (that is, for either self-developed or acquired intangibles) other important functions may also include significant decisions regarding defense and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

For a fully developed and currently exploitable intangible purchased from a third party, the important functions may be the selection of the most appropriate intangible on the market, the analysis of its potential benefits to the multinational group, and the decision to take on the risk-bearing opportunity through purchasing the intangible.

3. Do the ‘important’ functions related to an intangible have to relate to DEMPE?

It is possible that an important function related to an intangible doesn’t fit neatly into one of the DEMPE categories. For instance, when a fully developed intangible is acquired from a third party, as noted above, an important function related to the intangible could be the selection of the most appropriate intangible on the market based on an analysis of its potential benefits to the multinational group. This “important” function isn’t easily categorized as development, enhancement, maintenance, protection, or exploitation, but nevertheless should be entitled to returns from the intangible. Thus, while, in general, the important functions related to intangibles are likely to fall readily into one or more of the DEMPE categories, it is up to the taxpayer to establish what the “important” functions related to an intangible are and whether those can be straight-jacketed into a DEMPE category. For ease of exposition and in keeping with the common parlance of transfer pricing, this article simply refers to the important functions related to an intangible as important DEMPE functions, or more simply, DEMPE functions.

4. How does DEMPE fit into the OECD’s framework for analyzing transactions involving intangibles between associated enterprises?

The OECD provides a six-step framework for analyzing transactions between associated enterprises involving intangibles, consistent with the framework for identifying the commercial or financial relations between associated enterprises provided in the OECD transfer pricing guidelines.

Step 1. Identify the intangibles with specificity and the specific, economically significant risks associated with the DEMPE of the intangibles.

Step 2. Identify the contractual arrangements between the associated enterprises related to the intangibles.

Step 3. Identify the parties performing functions, using assets, and managing risks related to the DEMPE of the intangibles.

Step 4. Confirm the consistency between the terms of the contractual arrangements and the conduct of the parties, and determine whether the party assuming risks related to the DEMPE of the intangibles controls those risks and has the financial capacity to assume those risks.

Step 5. Delineate the actual controlled transactions related to the DEMPE of the intangibles given the steps above.

Step 6. Determine arm’s-length prices for the transactions consistent with each party’s contributions of functions performed, assets used, and risks assumed, unless the accurately delineated transaction isn’t recognized under the guidance of section D.2 of Chapter 1 of the OECD guidelines.

Note that step 4 requires a comparison of the conduct of the parties with the contractual arrangements. Given the OECD’s presumption that the entitlement to returns from an intangible requires the performance of important DEMPE functions, if an entity that doesn’t perform such functions is contractually assigned ownership of the intangible, then the accurate delineation of the transaction in step 5 and the arm’s-length pricing in step 6 will assign the economic benefits of the intangible away from this contractually identified owner of the intangible.

5. How does DEMPE for intangibles relate to the principles of Chapter 1 of the OECD guidelines?

Chapter 1 of the OECD guidelines provides guidance on accurately delineating the actual transaction between related parties. An important facet of the accurate delineation of a transaction is identifying the parties assuming economically significant risks. Under the principles of Chapter 1, the party assuming an economically significant risk must have control over it and must have the financial capacity to assume it. An entity is considered to have control over a risk if it performs decision-making functions related to accepting or declining the risk-bearing opportunity and responding to the risk. When multiple parties exercise control over a specific risk, the contractual allocation of risk to one or more of those parties will be respected.

As with intangibles, tax authorities have also expressed concern that multinationals were artificially shifting income to low-tax jurisdictions by shifting risks contractually to group companies in those jurisdictions with limited activity. The OECD’s approach on allocation of risks is similarly intended to prevent companies with no employees or with minimal operational activity from earning significant risk-related returns.

The guidance in Chapter 1 provides a framework for analyzing risk in a controlled transaction in order to accurately delineate the actual transaction with respect to that risk. As noted above, this framework is similar in structure to the six-step framework for analyzing trans-
actions between associated enterprises involving intangibles.

Further, the OECD guidelines note that risk management and DEMPE shouldn’t be thought of as necessarily encompassing different functions. Section D at paragraph 1.62 states, “Risk management should not be thought of as necessarily encompassing a separate function, requiring separate remuneration, distinct from the performance of the activities that optimise profits. For example, the development of intangibles through development activities may involve mitigating risks relating to performing the development through the performance of the development function itself.”

In other words, important DEMPE functions will generally encompass significant risk control functions related to an intangible. Under the principles of Chapter 1, DEMPE risks and the excess profits associated with those risks should be attributed to the entity controlling them—that is, performing “important” DEMPE functions.

To summarize, a reasonable interpretation of the guidance in Chapter 1 on risks and Chapter 6 on intangibles is that the two chapters prescribe the same principles for delineating the actual transaction between associated enterprises. An underlying principle of the two chapters is that only an entity performing key decision-making functions related to the key income generators for the multinational company—be it risk assumption or the development of intangibles—could earn the income related to those key income generators. If multiple entities perform these decision-making functions then contractual assignments of rights to one or more of those decision-making entities will be respected. (However, see the discussion below on possible sources of controversy.)

6. What role does funding play in the DEMPE framework?

General economic theory indicates that economic activity requires both funding (or capital) and people who use that funding to create economic output. In particular, for risky economic undertakings, such as developing intangibles, funding is an important contributor to economic output. Further, the output of a firm is distributed between the providers of funding and the people working for the firm for their contributions to the firm’s output.

The OECD’s presumption is that funding of the intangible in itself has little or no claim on the returns from the intangible, if that funding is not provided by an entity having people controlling that funding and making important decisions related to the DEMPE of the intangible: “Where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted return on its funding,” the OECD states in Section B of Chapter 6. Further, the summary to Chapter 6 of the OECD guidelines notes that “funding of the development, enhancement, maintenance, protection or exploitation of an intangible by an entity that does not perform any of the important functions in relation to the intangible and does not exercise control over the financial risk will generate no more than a risk-free return.”

In this, the OECD appears to take a somewhat asymmetrical view of funding and decision-making functions. While funding without decision-makers associated with that funding gets little or no return, the guidance is less clear on whether an entity with important DEMPE functions, including control over DEMPE risks, but without funding can claim the returns from the intangible.

The OECD guidance refers to the “financial capacity to bear risks” in numerous places as a necessary condition for assuming risks (which could include DEMPE risks) without providing a description of what that financial capacity looks like. According to Chapter 1 of the OECD guidelines, financial capacity to assume risk can be defined as “access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises.” But there is no explanation of what “access to funding” means. Is it the opportunity to raise funds or does it mean that the entity already has the funding or capital? The opportunity to raise funds can be very different before and after the realization of risk. An entity might have easy access to funding before the realization of a risk but if it doesn’t actually obtain that funding and an adverse outcome of risk is realized, the access to funding could decline quickly.

The presumption in the OECD guidance appears to be that funding per se is not necessary for an entity to earn the returns from an intangible (including the returns to DEMPE-related risks) but the “access to funding” is. There seems to be a further presumption that an entity with the decision-making functions related to the intangibles (including key risks related to the intangible) should have “access to funding.” Thus, the OECD guidance may appear to allow an entity with important DEMPE functions, including control over DEMPE risks, but without funding to claim the returns from the intangible.

7. How can DEMPE functions be identified?

The exercise of identifying DEMPE functions will vary by company. An important common step in any evaluation of DEMPE functions will be a functional analysis, which can include interviewing relevant personnel in the multinational company, reviewing the group’s management organizational structure, identifying the key intangibles used in the business, and reviewing the company’s human resources data on employee locations, titles, and roles. Industry and other public sources can also provide useful information on “important” functions related to an intangible.

8. Does the guidance on DEMPE preclude the existence of contract R&D arrangements?

No. Contract research and development arrangements can still be used. That is, R&D activities could still be outsourced to related parties. However, a key question is whether what has traditionally been considered a distinguishing feature of contract R&D—namely, its lack of claim on intangible risks or residual returns from intangibles—is still feasible. The OECD guidelines note that if “the contractual arrangement between the associated enterprises is a contract R&D arrangement that is respected . . . remuneration for risk mitigation functions performed through the development activity would be incorporated into the arm’s length services
payment. Neither the intangible risk itself, nor the residual income associated with such risk, would be allocated to the service provider.”

Under the guidance in Chapter 1, for the contract R&D arrangement to be respected and the contract R&D service provider not to be entitled to returns from the intangible, the contract R&D service provider either:

- must not perform any important DEMPE functions (including control of DEMPE risks), or
- if it does perform some of those functions, then there must be other entities performing important DEMPE functions (including controlling DEMPE risks) and there must be intercompany contracts assigning rights to the intangibles and associated risks to one or more of the other entities. (The section below discusses the ambiguity of OECD language on this point and potential sources of controversy.)

Further, if the contract R&D provider doesn’t perform DEMPE functions (including controlling DEMPE risks) then under the Chapter 6 guidance, it shouldn’t be entitled to excess returns from the intangible.

Thus, when R&D strategy and direction for an intangible is determined in one entity and contract R&D is performed in another, the OECD guidance would seem to say that the DEMPE (including risk-control) functions and therefore the intangible-related returns belong in the former entity.

9. What are likely to be some sources of controversy related to DEMPE?

The language in the OECD guidelines is consensus language—that is, no participant to the BEPS project objected to the revised guidelines. Therefore, tax authorities with potentially different points of view needed to agree on the language in the revised guidelines. The end result was that at least some of the language in the guidelines is amenable to differing interpretations, which is likely to be a source of controversy.

For example, what one tax authority might consider an important DEMPE function, another might not. Similarly, tax authorities could have different views on what it means to exercise control over a risk—such as how closely involved or senior the decision-makers need to be.

If multiple entities perform DEMPE functions, a significant source of controversy is likely to be the entitlement of the different entities to the returns from the intangible for their DEMPE functions. One reasonable interpretation of the OECD guidelines, which tax authorities such as the U.S. may take, would be that in such a situation the contractual arrangement between the transacting parties should determine the entity entitled to the returns from the intangible, as discussed above. The OECD guidelines, however, don’t explicitly state this in Chapter 6. In fact, language in the guidelines muddies the issue:

The entitlement of any member of the MNE [multinational enterprise] group to profit or loss relating to differences between actual (ex post) and a proper estimation of anticipated (ex ante) profitability will depend on which entity or entities in the MNE group in fact assumes the risks as identified when delineating the actual transaction (see Section D.1 of Chapter I). It will also depend on the entity or entities which are performing the important functions as reflected in paragraph 6.56 or contributing to the control over the economically significant risks as established in paragraph 1.105, and for which it is determined that an arm’s length remuneration of these functions would include a profit sharing element. [Emphasis added.]

The term “profit sharing element” could be interpreted by some tax authorities as implying that important DEMPE functions should be entitled to returns from the intangible irrespective of contractual compensation terms.

Another source of controversy could be the attribution of DEMPE risks to entities that control them but that aren’t contractually allocated those risks. While an entity’s tax authority might not contest attributing positive returns to the entity arising from the resolution of a specific risk that is not contractually assigned to it, the tax authority might contest attributing the negative outcome of the risk to it.

See also the discussion below in the section on the U.S. view of DEMPE.

10. How does the U.S. view DEMPE?

In public pronouncements, U.S. government officials have said that the regulations under section 482 are consistent with the revised OECD guidelines. However, as noted above, the ambiguous language in the guidelines can mask significant differences in interpretation between the U.S. and other tax authorities.

For example, on the question of respect for contractual arrangements, the U.S. transfer pricing regulations respect contractual allocations of risk so long as they are consistent with the “economic substance” of the transaction. In considering the economic substance of the transaction, the following facts are relevant:

- whether the taxpayer’s conduct over time is consistent with the purported allocation of risk;
- whether the taxpayer has the financial capacity to fund losses; and
- the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized (in arm’s-length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control).

The U.S. rules on risk allocation, therefore, look similar to the OECD guidance in principle. However, unlike the OECD guidelines, the regulations under tax code Section 482 don’t prescribe the meaning of “managerial or operational control.” In practice, the Internal Revenue Service and U.S. Tax Court have generally respected contractual allocations of risk by the taxpayer. However, it is conceivable, and in fact is likely, that other tax authorities will interpret the same OECD guidance on risks to show much less respect for contractual allocations of risk by the taxpayer.

Further, in the case of intangibles development, regulations Section 1.482-7, on cost-sharing arrangements, permit intangible-related returns to cost-sharing participants without regard to operational control over DEMPE functions. While the rules on economic substance in regulations Section 1.482-1 described above still apply to cost-sharing arrangements, the IRS has not in practice insisted on economic substance in a cost-sharing participant in the form of managerial or operational control equivalent to the DEMPE functions or
risk control functions of the OECD guidelines in order for it to be entitled to returns from the intangible under development.

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