INSIGHT: Transfer Pricing Substance in Flux—DEMPE, BEPS 2.0, and Covid-19

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The OECD’s Base Erosion and Profit Shifting (BEPS) project has brought about significant developments in the role of substance in transfer pricing, and it isn’t done yet. The Final Report for BEPS Actions 8-10, relating to transfer pricing, provides that “the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles . . . is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles,” and these principles have been incorporated into Chapter 6 of the OECD’s transfer pricing guidelines. The rules concerning development, enhancement, maintenance, protection, and exploitation—better known by the acronym “DEMPE”—are impacting taxpayers in both direct and indirect ways. Separately but similarly, the Final Report on Actions 8-10 provides that risks (and the returns associated with those risks) should be allocated to entities that both exercise control over the risk and have the financial capacity to assume it.

Yet as tax authorities around the world begin to implement these substance concepts, the OECD is already looking beyond them. A flurry of recent developments stemming from prior work on BEPS Action 1, relating to the taxation of the digital economy, have resulted in what some are calling “BEPS 2.0.” These developments fall into two categories, or “pillars”—Pillar One, which involves the allocation of taxing rights, and Pillar Two, which concerns global minimum taxation. Importantly, BEPS 2.0 will not necessarily be limited to digital businesses: the Unified Approach agreed to by the Inclusive Framework on BEPS (Inclusive Framework) would apply broadly to consumer-facing businesses as well as to automated digital services. One component of the Unified Approach under Pillar One seeks to allocate income taxing rights to local markets, regardless of a company’s presence in the relevant jurisdictions. In doing so, it moves beyond current substance concepts like headcount and functions.

Yet it is less clear what it is moving towards. As of the date of writing, a set of guiding principles underlying Pillar One had yet to be agreed on. It is possible to see its reallocation of income and taxing rights as espousing a more holistic view of substance that takes into account not only what a company does, but the value-creating features of the company’s markets and users. At the same time, it is possible to read the Unified Approach as a compromise solution that is agnostic as to substance concepts, and is simply intended to facilitate political agreement. How BEPS 2.0 progresses will have important consequences for substance and the role it plays in the international tax system.

Substance Under the OECD Guidelines: DEMPE and Risk

The current DEMPE rules envision that DEMPE functions should be considered when allocating the returns derived from an intangible, as well as costs connected with it, among related parties. While ownership may receive a return in connection with its exploitation of the intangible, the OECD Guidelines provide that mere legal ownership—while respected for transfer pricing purposes—“does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may
initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible.” Instead, the return to which the owner is entitled depends on its DEMPE functions, if any, relative to those of its affiliates. DEMPE is thus a substance requirement: entitlement to returns from an intangible cannot be shifted with the transferance of contractual rights, but rather depends on the functions, assets, and risks connected with the intangible.

The OECD Guidelines likewise require an analysis of risk. Like the ownership of intangibles, risk is subject to contractual manipulation, and a consideration of risk that did not look beyond the four corners of the applicable contract could lead to the allocation of risks—and the associated profits—to entities that neither control those risks nor have the financial capacity to bear them. While the OECD Guidelines do not ignore contractual assumptions of risk, they respect such contractual assumptions only where the party assuming the risk both controls the risk and has the financial capacity to assume it. For a party to possess adequate control over a risk for this purpose, it must (1) possess the ability to decide whether to take on, decline, or lay off opportunities that involve risk, and whether and how to respond to such risks, and (2) actually engage in such decision making. However, for an assumption of risk to be respected, the party assuming the risk need not perform day-to-day risk mitigation activities (e.g., quality control) itself. Rather, these may be outsourced, though any such activities performed by a related party must be appropriately compensated.

**Tax Authorities’ Use of Substance**

Because these substance concepts were developed by the OECD, and involve both explicit changes to the OECD Guidelines as well as changes in how the Guidelines are interpreted, they may play an active role in transfer pricing examinations in countries which implicitly or explicitly incorporate the OECD Guidelines, or whose laws are based on the Guidelines. The OECD released the Final Report on Actions 8-10 in 2015, and transfer pricing audits related to these concepts are now well underway. We have seen a number of audits in Europe (e.g., in Sweden, Denmark, and Germany) specifically focused on DEMPE or similar concepts, often in connection with a restructuring or acquisition. These audits can involve very large amounts at issue, as DEMPE gives tax authorities a tool to challenge the allocation of profit associated with valuable intangibles.

Intriguingly, the IRS (including exam teams, the Transfer Pricing Practice, and the Advance Pricing and Mutual Agreement program) has begun to make arguments based on these OECD substance rules, or at least consider these issues. This is despite the fact that the U.S. Treasury regulations under tax code Section 482 have remained unchanged, so as a technical matter any changes to the OECD Guidelines or discussion drafts should not affect the interpretation or application of Section 482. At least for the moment, U.S. transfer pricing law contains no analogue to the DEMPE rules, and continues to respect contractual assumption of risks except in extreme cases.

**Complying With Substance Rules**

Most taxpayers are trying to thoughtfully address these issues within the confines of their existing structures and business needs. That is, they are increasing their substance and aligning it with their transfer pricing to the extent possible, and are also improving their governance practices and policies to make substance clearer and document the activities being conducted in the various jurisdictions. Any changes to a company’s tax and transfer pricing structure must now take substance concepts into account.

In order to minimize disruptions to their business, some taxpayers may do the minimum they consider necessary to comply with DEMPE and risk requirements. Of course, the minimum necessary remains unclear, and will vary by jurisdiction, as these issues have not yet worked their way through dispute resolution systems. Time will tell whether companies have done enough, and how high the bar will be set factually in terms of interpreting these rules.

Moreover, some companies may be postponing any significant restructuring to comply with existing DEMPE and control of risk rules while awaiting the outcome of BEPS 2.0, which may also significantly impact substance requirements. The Inclusive Framework currently aims to reach agreement on key policy features of BEPS 2.0 at its October 2020 meeting, with a final report including technical details to follow by the end of 2020. However, the OECD has acknowledged that realistically, the challenges of coping with the Covid-19 pandemic may result in some aspects of a BEPS 2.0 solution being delayed until 2021.

**Substance and the Covid-19 Pandemic**

The recent disruptions due to Covid-19 have brought about new substance issues. Many companies have found that some employees are temporarily unable to work in the jurisdiction where they normally perform their functions. For instance, this may be the case where travel bans or guidelines cause employees to temporarily remain in a jurisdiction other than their home country, or where employees ordinarily live in one jurisdiction and commute to another but are temporarily unable to do so because of work from home policies.

Dislocated employees may result in many different tax issues at the company and individual level, such as tax residency and permanent establishment (PE) determinations. Several jurisdictions, including the U.S., the U.K., Ireland, and Australia, have released guidance addressing some of these issues, as has the OECD. However, we are not aware of any jurisdiction that has released guidance on how the activities of dislocated employees will be considered for transfer pricing purposes, e.g., when applying DEMPE and control of risk concepts.

Guidance from the OECD, the United States, and other jurisdictions on PEs should be helpful for determining whether dislocated employees’ presence in other countries should be ignored for transfer pricing substance purposes as well. After all, if a country ignores the presence of an employee for purposes of determining whether the employer has a taxable presence, it makes sense that the same rule should apply with respect to the allocation of income. However, sub-
stance issues may present different policy concerns from residency and PE issues, and may not be resolved in the same fashion. Moreover, countries may simply fail to provide guidance and safe harbors on these issues. Where the country in which an employee habitually performs his or her functions under normal circumstances and the country where that employee is dislocated both lay claim to the income associated with those functions, double taxation may result. To help guard against this, taxpayers should carefully document how their employees are affected, including the locations, durations, and rationales for their dislocation, as well as the functions they perform.

Beyond Substance?

What companies have to come to terms with is that we are in the early stages of a digital disruption. Moreover, as a result of the Covid-19 pandemic, it appears increasingly likely that there will be long-term changes to the supply chains of multinational enterprises. As developed economies continue to shift towards digitalization and rationalize their supply chains, and as tax authorities’ perspectives evolve, substance concepts will become increasingly important as a component of or potential adjustment to a traditional transfer pricing analysis. At the same time, the notion of substance itself will likely continue to evolve.

This is already happening. The DEMPE rules, as noted above, contemplate that all returns to an intangible should be allocated among the entities performing functions, using assets, and assuming risks associated with DEMPE. Yet the Unified Approach to Pillar One would allocate a yet-to-be-determined quantum of residual profit (referred to as Amount A) to market jurisdictions, notwithstanding the fact that those jurisdictions may perform no DEMPE functions. Similarly, as of the date of writing, it remains to be determined whether the minimum tax rules under Pillar Two will apply universally, or whether there will be substance-based carveouts. BEPS 2.0, as currently contemplated, clearly goes beyond and is inconsistent with the DEMPE and control of risk rules.

This does not mean that DEMPE and the BEPS risk rules are irrelevant: Pillar One would leave room for them with respect to the allocation of routine profits attributable to marketing intangibles, as well as some portion of non-routine profits. DEMPE and control over risk have not been superseded, but supplemented. BEPS 2.0 envisions an extra component that is layered onto the existing transfer pricing system, rather than a replacement of that system.

As the economy digitizes, substance concepts must likewise expand. In part, this is because traditional metrics of value creation and business activity in a jurisdiction, such as hard assets and headcount, will likely become less and less relevant. Under Pillar One, nexus and taxing rights might result even in the absence of anything that is currently considered “substance”—for example, as remarked above, there may be nexus for a company based on a market or customer base, even without any employees in a jurisdiction.

As another example, consider a company with primarily digital assets which are developed via teams dispersed over 40 countries. Its services or products are sold throughout the world, and the company has a handful of high-level management personnel in Country X, though the digital assets are owned in Country Y. Where should the income be taxed? If you change the location of the asset ownership or of the high-level management, should the jurisdiction(s) with taxing rights immediately shift with this change? In some ways, as digitalization increases, current DEMPE concepts may be a double-edged sword that can cut against both taxpayers and tax authorities. Increasingly, current substance concepts may not be important or necessary in finding nexus or allocating taxing jurisdiction, because BEPS 2.0 concepts—and the developments that will follow them—may apply different principles that apply a more expansive notion of substance, or set substance aside for the limited purpose of allocating Amount A.

Compliance with DEMPE and control of risk are increasingly critical, as tax authorities begin to focus on these concepts in high stakes audits centered on restructurings and large acquisitions. At the same time, it appears likely that current substance concepts, such as DEMPE, may be simply a bridge to a different substance standard, or a hybrid standard in which substance remains crucial for transfer pricing but plays no role in Amount A allocations. While remaining mindful of existing concepts, particularly as new developments may tease out what different countries consider an acceptable level of substance, taxpayers should follow the digital economy developments closely in the coming years, and should consider these developments when contemplating structural changes.

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