

Intangibles and DEMPE analysis: on tax authorities' radars worldwide

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Federico Vincenti and Alessandro Valente of Valente Associati GEB Partners/Crowe Valente highlight the increasing importance of DEMPE analysis and the challenge this presents for courts in applying the OECD Transfer Pricing Guidelines.

Tax administrations worldwide (including Italy) are paying increasing attention to intra-group transactions involving intangible assets. It is indeed a hot topic.

In particular, tax authorities are focusing on the correct allocation of profits deriving from the exploitation/use of intangible assets, which must take place according to the functions performed, the assets used, and the risks assumed by the companies involved in the transactions.

Mere ownership of the intangible is not sufficient to allow retention by the legal owner of the benefits derived from its exploitation.

Although the legal owner of an intangible may receive profits from its exploitation, other entities of the same multinational entity (MNE) group may have performed functions, used assets, or assumed risks that may have contributed to the value of the intangible. Such entities should be remunerated for their contributions at arm's length.

DEMPE functions

In the above cases, as stated in Chapter 6 of the OECD Transfer Pricing Guidelines, 2022, it is necessary to analyse the so-called development, enhancement, maintenance, protection and exploitation (DEMPE) functions (and associated risks), with the aim of identifying which entity involved in the transaction performs these functions.

- Development – refers to all activities and strategies associated with the conception and creation of the related products, including R&D activities.
- Enhancement – refers to all activities aimed at strengthening the brand(s), understood as recognisability by the customer, externally, and efficiency enhancement of the production process and its supporting technologies, internally. These activities allow the intangible asset to be guaranteed as having successful performance over time and be subject to constant improvement.
- Maintenance – covers all activities carried out to ensure the continuity and profitability of the business. Among other things, the function ensures the maintenance and control of product quality standards.
- Protection – refers to initiatives aimed at maintaining the value of products, in terms of legal protection of intangible assets.
- Exploitation – refers, in a broad sense, to the way in which intangible assets are used to generate benefits.

As such, tax administrations will only recognise the deductibility of the cost of a royalty if:

- The taxpayer succeeds in demonstrating through the DEMPE analysis the allocation of functions and risks between the companies involved in the intra-group transactions; and
- The taxpayer paying the royalty succeeds in demonstrating the financial benefits derived from the exploitation of the intangible asset. For example, the recognition of a royalty due for mere group membership or use of the group's corporate name is frequently challenged by tax administrations.

Similarly, if the group company owning the intangible decides not to charge royalties to the associated properties because the latter contribute to increasing the value of the intangible by performing DEMPE functions, it is advisable to document the analysis performed in order to avoid a potential challenge by the tax authorities.

Case law

The increase in recent case law confirms the importance of DEMPE analysis for MNE groups and a non-uniform approach by courts (sometimes).

Italy is not an exception. In recent case law, tax authorities have used DEMPE analysis in the context of a valuation of intangibles.

In this regard, reference is made to three unpublished decisions issued by the same Turin Court of First Instance, which decided differently on identical cases, albeit with reference to different tax years.

The main issue at stake was the relationship between the parent company of the group (an Italian company) and its foreign subsidiary (an American company). The Italian Revenue Agency challenged the fact that the Italian company, as exclusive owner of a trademark, had not accounted for, or reported, any royalties with reference to tax years 2014, 2015 and 2016.

The company challenged the three tax assessment notices (*Avvisi di Accertamento*), considering that the prerequisites for the charging of royalties by the Italian parent company to the US subsidiary were absent. In addition, the company referred to Article 6.81 of the Transfer Pricing Guidelines, which provides that: "As a general rule, no payment should be recognised for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership."

The court of first instance upheld the Italian company's appeal for 2014 and 2015, ruling that the American subsidiary:

- Had been completely independent from the Italian company for many decades;
- Was not linked by any legal or shareholding relationship, because it was only a sister company and belonged to the same group; and
- Did not benefit from any support from the Italian company for the development of the brand on American territory.

The judges of first instance ruled out the possibility that this case could constitute a transaction of a transactional nature between the Italian company and the American affiliate, given that:

- The US subsidiary's complete IT, managerial and production autonomy;

- The substantial irrelevance of the trademark (i.e., group name) in supporting the marketing of its products; and
- The lack of connection between the production activity of the American company and the reference to the group name.

Contrary to what was decided regarding the other tax years, the first-instance judges rejected the appeal concerning 2016, having considered that the documentation showed continuous attention by the Italian parent company to the protection of its trademarks and products worldwide.

Furthermore, contrary to the rulings for 2014 and 2015, the judges held that the use of the word trademark resulted in the US subsidiary being charged the relevant royalties.

The discrepancy between the three rulings' outcomes and approaches is evident: the first two applying fully the OECD Transfer Pricing Guidelines (in particular, paragraph 6.81) and the last one not assessing any of the factual and legal circumstances alleged by the party.

A difficult question

From the above, it is clear to see the difficulty of the courts and the Italian tax authorities in applying the OECD's transfer pricing principles with reference to the remuneration of intangibles through the application of DEMPE analysis.

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