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Practical DEMPE Analysis—
Designing, Defending and Documenting Your TP Policy

Insight in Economics™

Objectives

- **Share practical experience with respect to the use and implementation of DEMPE in the Transfer Pricing context**

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I. Context

1. Intangibles and Transfer Pricing— What does the BEPS Outcome Tell us?

Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

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Chapter VI compliant analysis with respect to intangibles:

1. Identification of intangibles

2. Identification of Functions, Funding and Risks relating to intangibles

Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

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Definition of an intangible:

- Is not a physical asset or a financial asset,
- Is capable of being owned or controlled for use in commercial activities, and
- Whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances

- Patents
- Know-how and trade secrets
- Trademarks, trade names and brands
- Rights under contracts and government licenses
- License and similar limited rights in intangibles

Other: Goodwill and ongoing concern

NOT intangibles

- Group synergies
- Market-specific characteristics (e.g., location savings, consumer purchasing power)
- Assembled workforce

Source: OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables

Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

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1. Ownership

- **Ownership**

2. Functions (perform/control)
Funding (provide)
Risks (control/bear)

- **Development**
- **Enhancement**
- **Maintenance**
- **Protection**
- **Exploitation**

Source: OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables

Steps to Analyze Intangibles Under Revised Chapter VI of the OECD Guidelines

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The table below identifies companies within the MNE which perform and exercise control over DEMPE; provide the necessary funding and other assets; and bear and control the various risks associated with the intangible.

Intangible XYZ	**Functions** (perform/control) *"important functions"*		**Risks** (control/bear)	**Funding** (provide)
	Perform	Control		
Development				
Enhancement				
Maintenance				
Protection				
Exploitation				

Source: OECD / G20 BEPS—Guidance on Transfer Pricing Aspects of Intangibles—Action 8: 2015 Deliverables

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I. Context

2. Risks and Transfer Pricing— What does the BEPS Outcome Tell us?

Steps to Delineate Risks
Revised Chapter I of the OECD Guidelines

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In its Transfer Pricing Guidelines, the OECD introduces a six-step process to analysing risks

1. Identify economically significant risks in the relevant relational context

2. Determine how risks are contractually assumed

3. Determine which enterprise(s)
   - Perform(s) control functions and risk mitigation functions,
   - Encounter(s) upside or downside consequences of risk outcomes, and
   - Have(s) the financial capacity to assume the risks

Steps to Delineate Risks
Revised Chapter I of the OECD Guidelines

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4. Determine whether the contractual assumption of risks is consistent with the ***conduct*** of the parties by analysing whether
   - The associated enterprises follow the contractual terms; and
   - The party assuming risk exercises ***control over the risk*** and has the financial capacity to assume the risk

5. Where the party assuming risk does not control the risk or does not have the financial capacity to assume the risk, allocate risk to the entity exercising the control and having the financial capacity to assume the risk
   - In case of multiple entities that both exercise control and have the financial capacity, allocate risk to the entity(ies) having the most control

6. Price the transaction taking into account the financial and other consequences of risk assumption

"BEPS Impact" on Guidelines

- BEPS has lifted the analytical focus in transfer pricing ***from transactions to the context of commercial and financial relations***
- Therefore, a more complete and realistic approach to risk is imperative—with direct consequences for the identification of intangibles, ownership thereof and entitlement thereto
- Post-BEPS, the company-wide transparency on functions, assets and risks can only make sense and be managed on the basis of an understanding of what drives value in the enterprise, ***i.e., of a value contribution analysis***

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II. DEMPE Analysis within the framework of Value Contribution Analysis

General observations

- The ***value contribution analysis*** is the underlying analytical framework for i) determining the contribution of different functions and intangible categories towards consolidated group value chain related profits and ii) determining which party contributes what share towards intangibles returns

- The ***DEMPE analysis*** is the core analytical element of the second part only, it focuses on slicing the intangible return for one group of intangibles into the different DEMPE contributions of the parties involved

- Practical considerations will usually require that a DEMPE analysis is applied towards a ***bundle of intangibles***, where DEMPE contributions of the different parties involved are usually the same for every single intangible element

NERA Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

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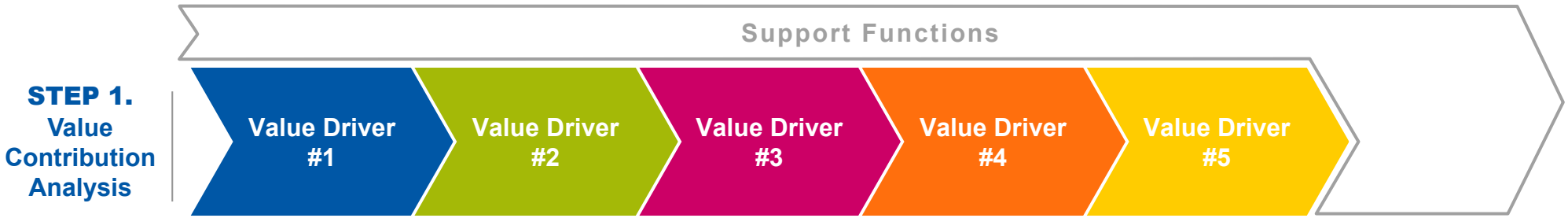
A Four-Step Process
Step 1—Value Contribution Analysis



- **Value Contribution Analysis**: Understand, in addition to an analysis of functions, how value is created in the Enterprise
  - Identify the key value drivers as part of a company's value chain which influence the most the **Critical Success Factors** of the Enterprise within its industry
  - Identify the key value drivers in the value chain which can be held accountable for the Enterprise's **major risks** within its industry and its chosen business model

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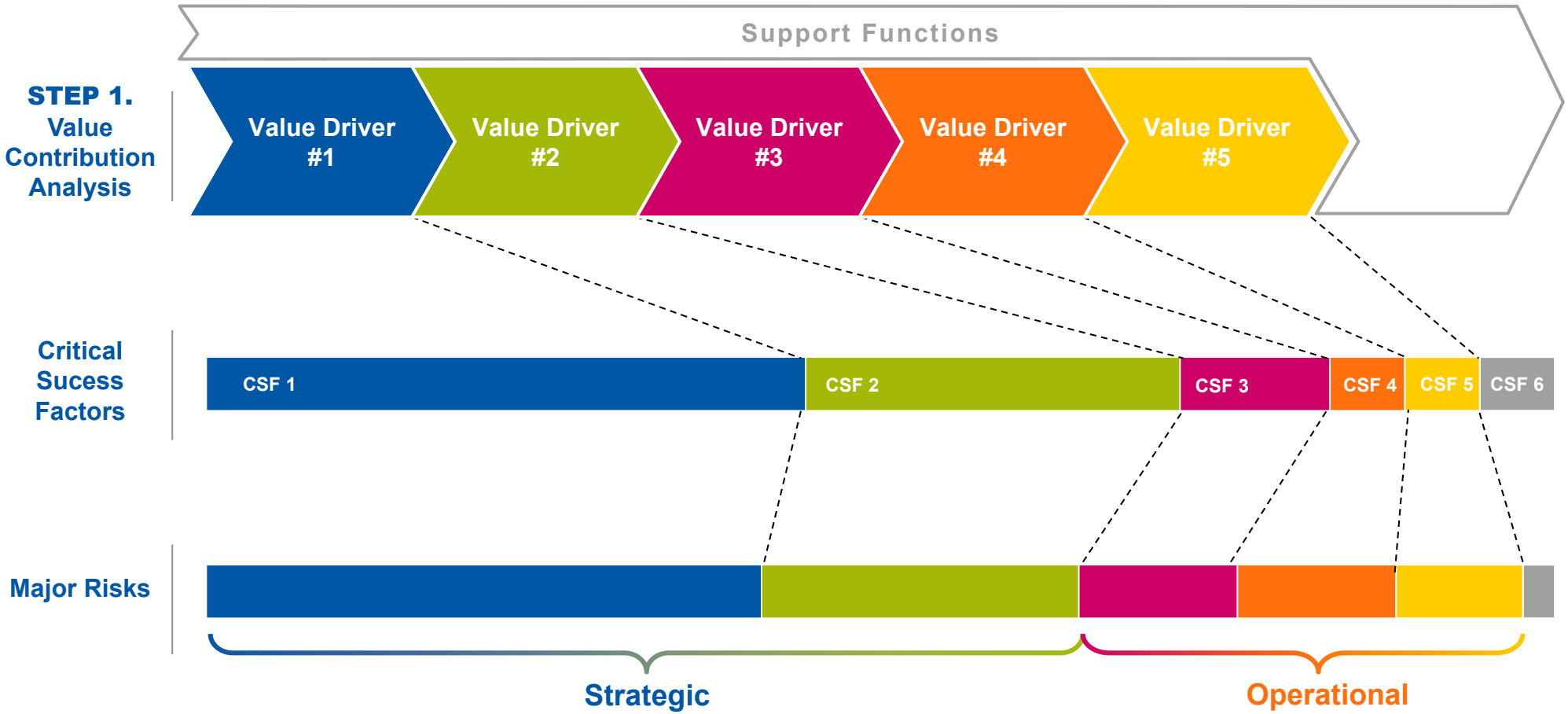

NERA Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

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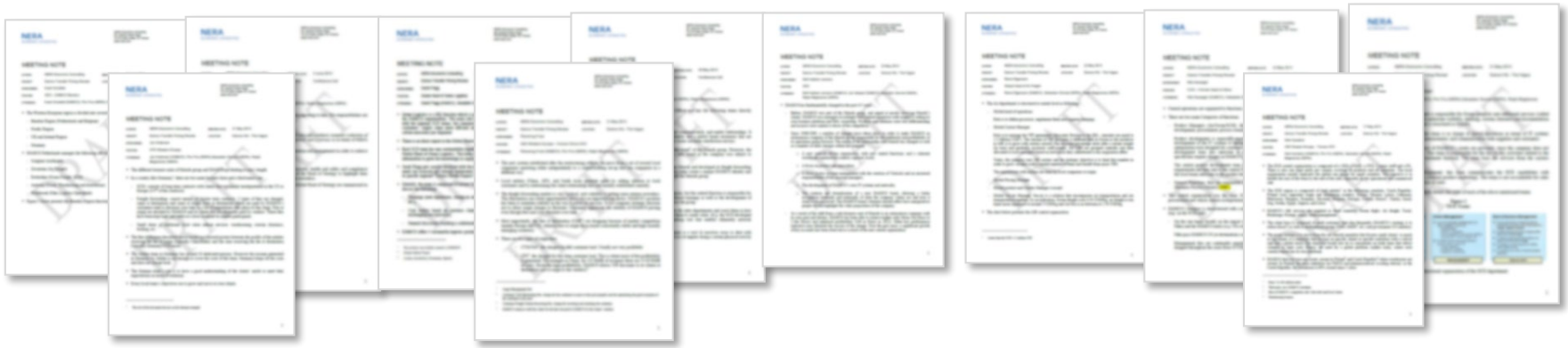
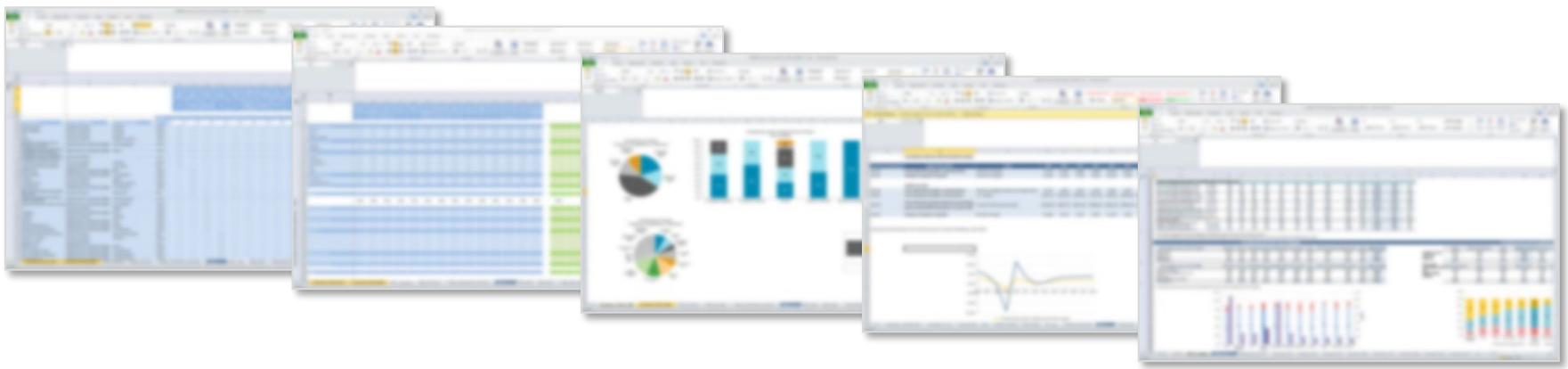
A Four-Step Process
Step 1—Value Contribution Analysis

Treatment of Data and Information

External surveys and Survey Style Interviews



Statistical Treatment



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Value Creation, Functional Analysis and Roles and Responsibilities

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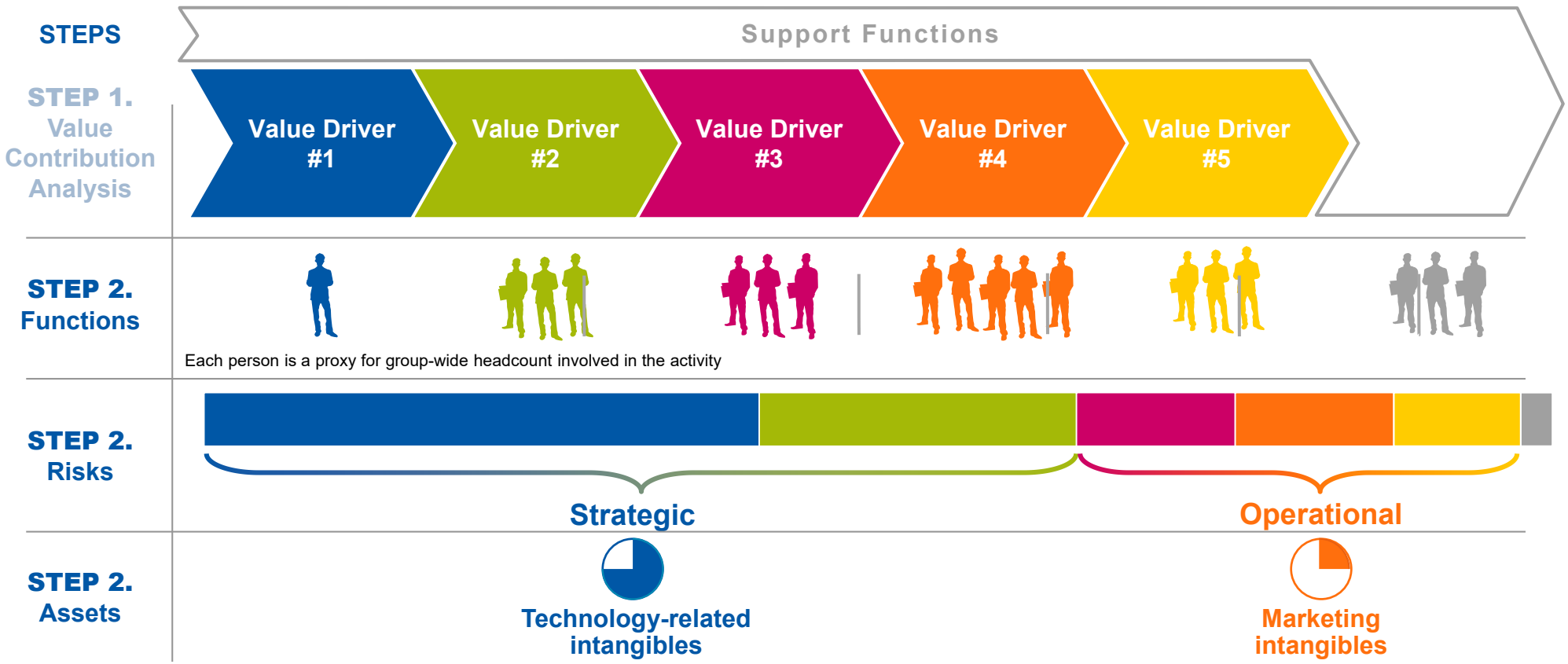
A Four-Step Process
Step 2—Mapping of the Enterprise Functions, Assets and Risks with Value Creation



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Value Creation, Functional Analysis and Roles and Responsibilities

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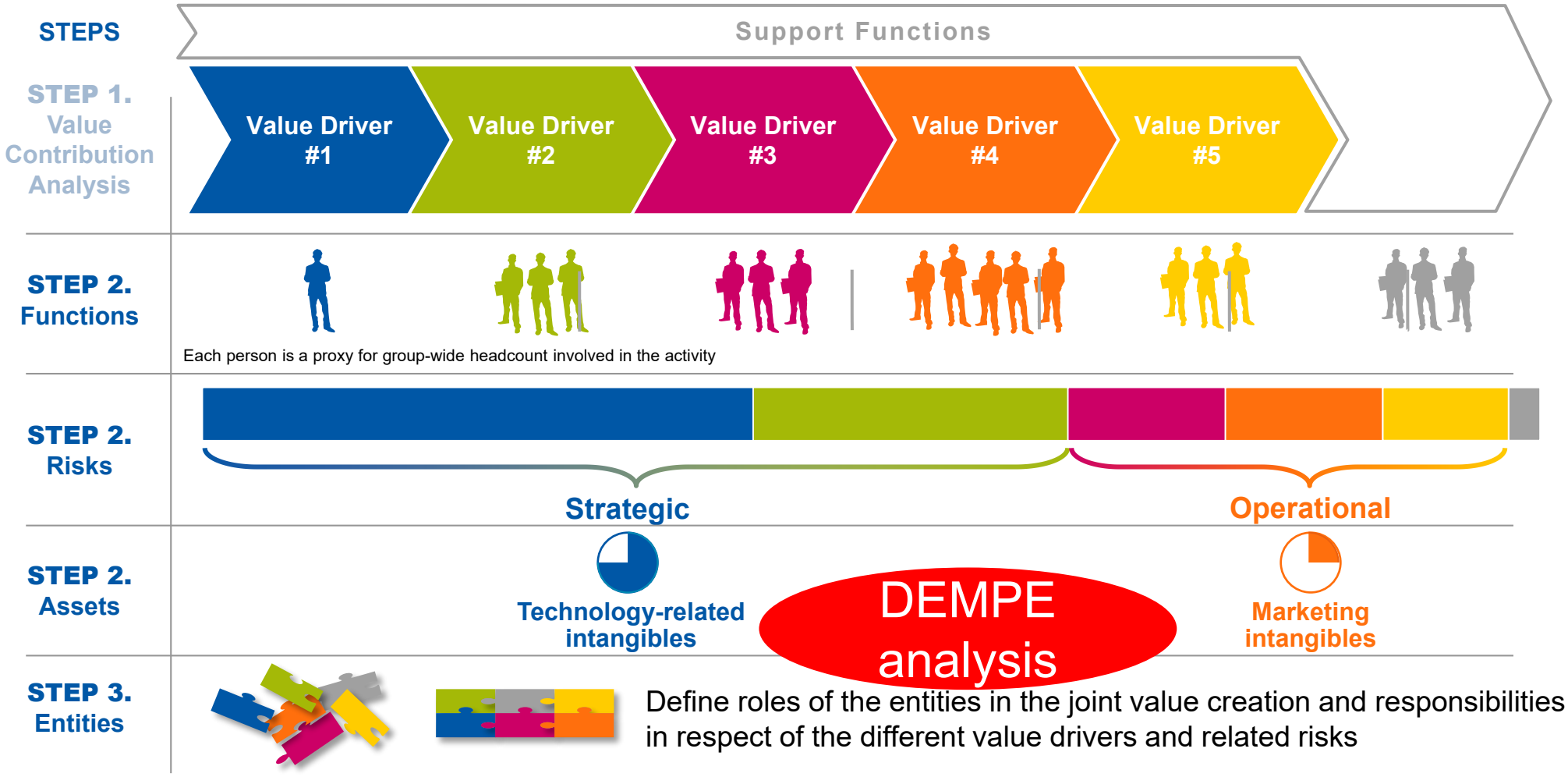
A Four-Step Process
Step 3—Role, Responsibilities and Control of the Individual Group Entities



Define roles of the entities in the joint value creation and responsibilities in respect of the different value drivers and related risks

NERA Analytical Framework
Value Creation, Functional Analysis and Roles and Responsibilities

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A Four-Step Process
Step 4—Relational Dynamics and transactions

- Step 4 involves the definition of how the relevant parties, now properly identified and assessed in terms of their role in the total set of relationships in the enterprise, can expect to be rewarded—**transactions are the expression of the relationships**
- This step includes **analysis of how prices are set**—***ex ante*** and *ex post*
- Risk being the impact of volatility, the responsibilities of group entities for different risks drive the dynamics in establishing the final remunerations for those entities—***ex post* outcomes can only be understood and explained in view of those responsibilities**
- For this reason, it is important to understand how prices are set for the intercompany transactions—reference should be how independent parties behave in **similar relationships**

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III. Practical DEMPE Analysis

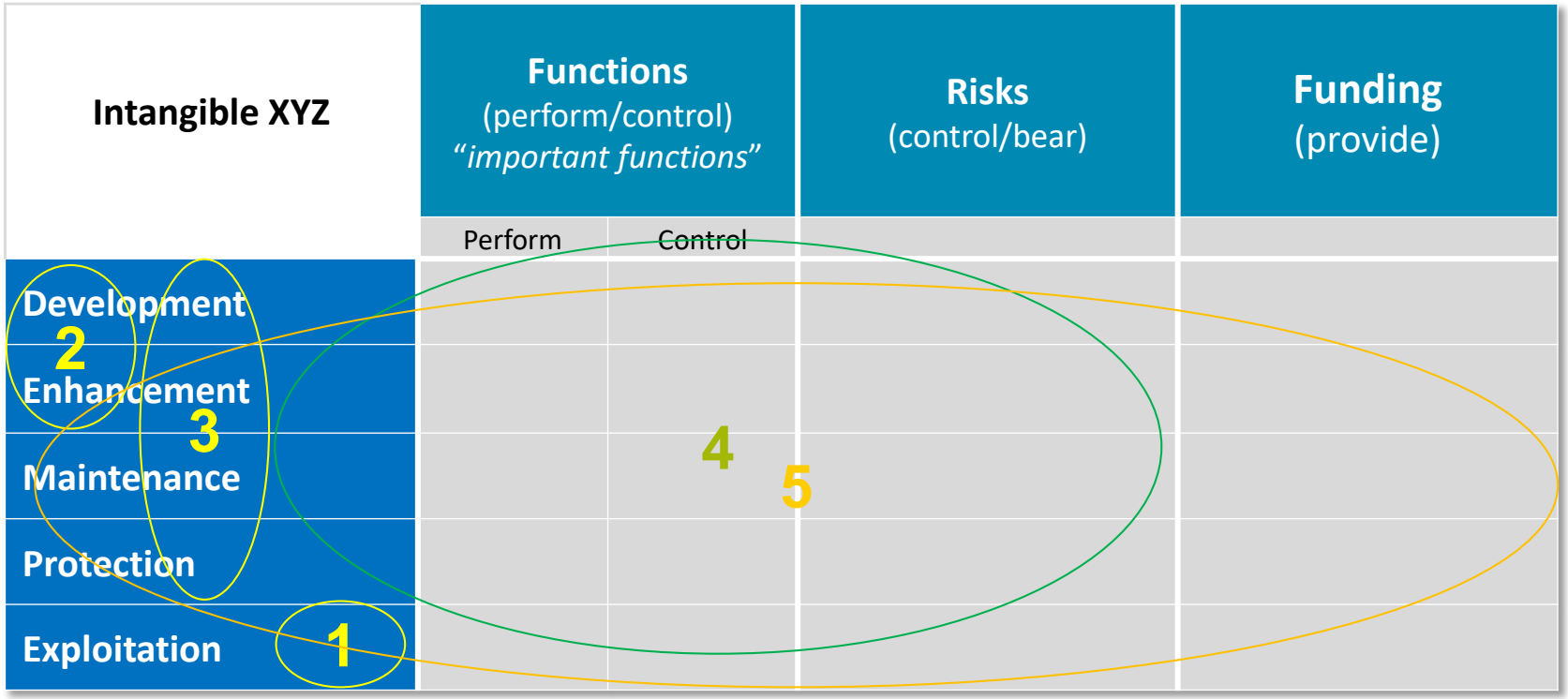
General Remarks

- A ***DEMPE analysis*** for a bundle of intangibles does not necessarily mean that a profit split analysis will be the necessary outcome to remunerate the value contributions of all parties involved

- On the contrary, the economic analysis of the ***DEMPE contributions*** would ideally identify that many local intangible contributions are of limited ***entrepreneurial value***; such contributions could still be determined through application of traditional one-sided TP methods

- Insofar a sophisticated DEMPE analysis can be used in many cases to ***corroborate existing traditional TP solutions***

Slicing the DEMPE analysis into pieces



Steps 1-3 will determine the relative importance of the 5 DEMPE pillars in intangible profit attribution

The considerations of the steps 4 and 5 will impact on the profit attribution between the contributing entities

1 Understanding the relevance of Exploitation

- Exploitation is linked to the usage of the intangible for commercial terms (e.g. license manufacturer, distributor)

- The ***pure exploitation should not entitle to a share of the intangible return*** if the exploiter has no further DEMPE contribution (e.g. then distributor should get a routine return if there is no valuable DEMP contribution to marketing intangibles)

- The exploiter may exploit the defined intangibles (e.g. technical ones) in conjunction with other intangibles from another category (e.g. self-developed marketing intangibles)
  - In such case, the distributor would still not be entitled to a share of technical intangibles-related profit
  - However, the distributor may earn a marketing intangible related return

2 The development & enhancement dimension

- Development & Enhancement are the ***most creative DEMPE elements*** and in most cases the most valuable as they really contribute to market distinction and USPs

- The relative importance of the two depends on the individual case at hand

- Original developments per se may no longer be valuable after some time and only enhancements & updates will allow to generate income (example: tech / industrial equipment)

- Development activities may contribute to ***platform IP*** which, even when no longer protected, is key for developing and commercialising cost-effective high-margin enhancements (example: Braun & Philips electric shavers)

2 The development & enhancement dimension

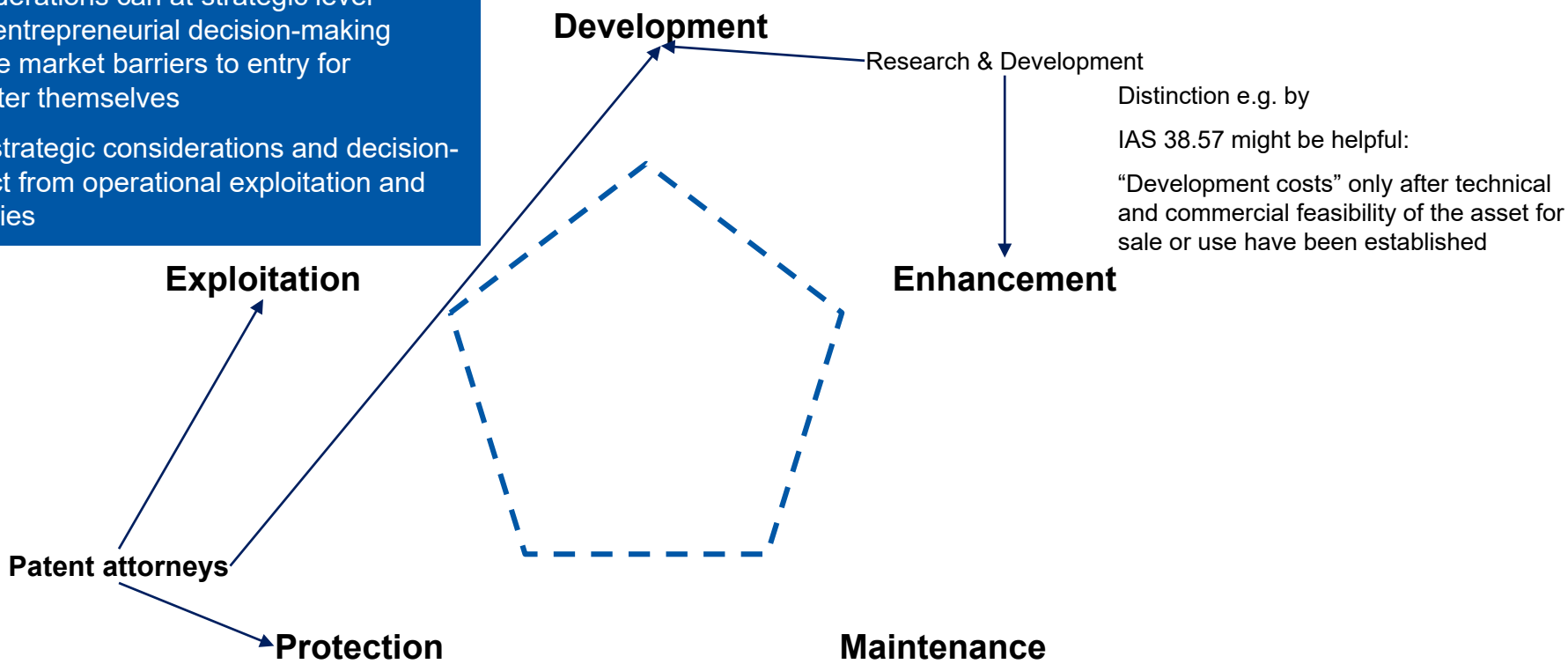
- Economic approaches to value relative importance
  - Capital cost analysis / intertemporal investment patterns in consideration of fairly distinct risk patterns
  - Marginal contribution analysis to costs, prices and revenues
  - Customers surveys on customer decision drivers
  - Organizational, cost center and personnel remunerational analysis
  - Comparable uncontrolled transactions (contractual clauses in 3rd party license agreements are often explicit on DEMPE activities)
- Critical aspects
  - Is original development still proprietary? Can it easily be replaced?
  - Has an originally developed platform IP transformed into a different type of intangible category (example: is the original construction & design of Braun & Philips electric shavers that have been preserved over decades of enhancements now a brand-building marketing intangibles?)

3 The relative importance of Maintenance & Protection

- Maintenance and protection will often be judged to be of lesser importance than development & enhancement
  - Outsourcing to technical service units which have no entrepreneurial decision-making power
  - Such functions can often be outsourced and reasonable external comparables are likely to exist
- While in many cases it may be justified to determine the remuneration of M&P activities through one-sided cost plus methods, this outcome can not be generalized
  - In some industries, M&P decisions may have a strategic dimensions
  - Notable cases in the pharmaceutical and tech industry
  - However, this may be unrelated to operational M&P activities

Differentiating DEMPE Functions
Pharmaceutical product intangibles

- In the pharmaceutical industry, exploitation and protection considerations can at strategic level become critical entrepreneurial decision-making aspects to create market barriers to entry for competitors / enter themselves
- However, such strategic considerations and decision-making is distinct from operational exploitation and protection activities



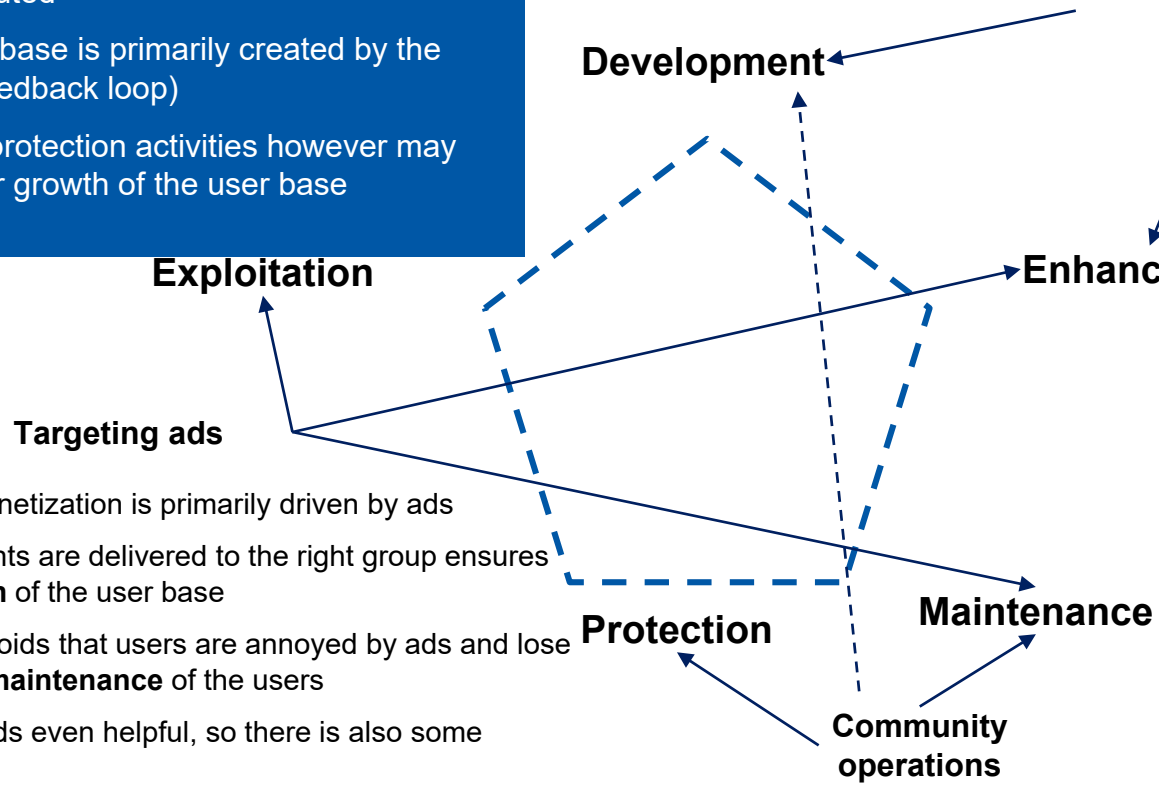
- Patents are increasingly used a strategic asset to be used in court against (potential) competitors. (Patent workarounds become enabler of business in pharma)
- Defendability of patents becomes of higher importance as pharmaceutical **development** becomes more cure-oriented and less ingredient-oriented. **Exploitation** becomes the start point for analysis whether a product should be developed at all.

Differentiating DEMPE Functions
Digital (social network) user base

- In the tech industry, the user base can be considered a distinct intangible, to which a share of the company value can be attributed
- However, the user base is primarily created by the platform (limited feedback loop)
- maintenance and protection activities however may facilitate the further growth of the user base

Platform (distinct intangible)

- Technological advantage over competitors necessary to attract users
- Feedback loops might run from e.g. technology to users or from user base to itself

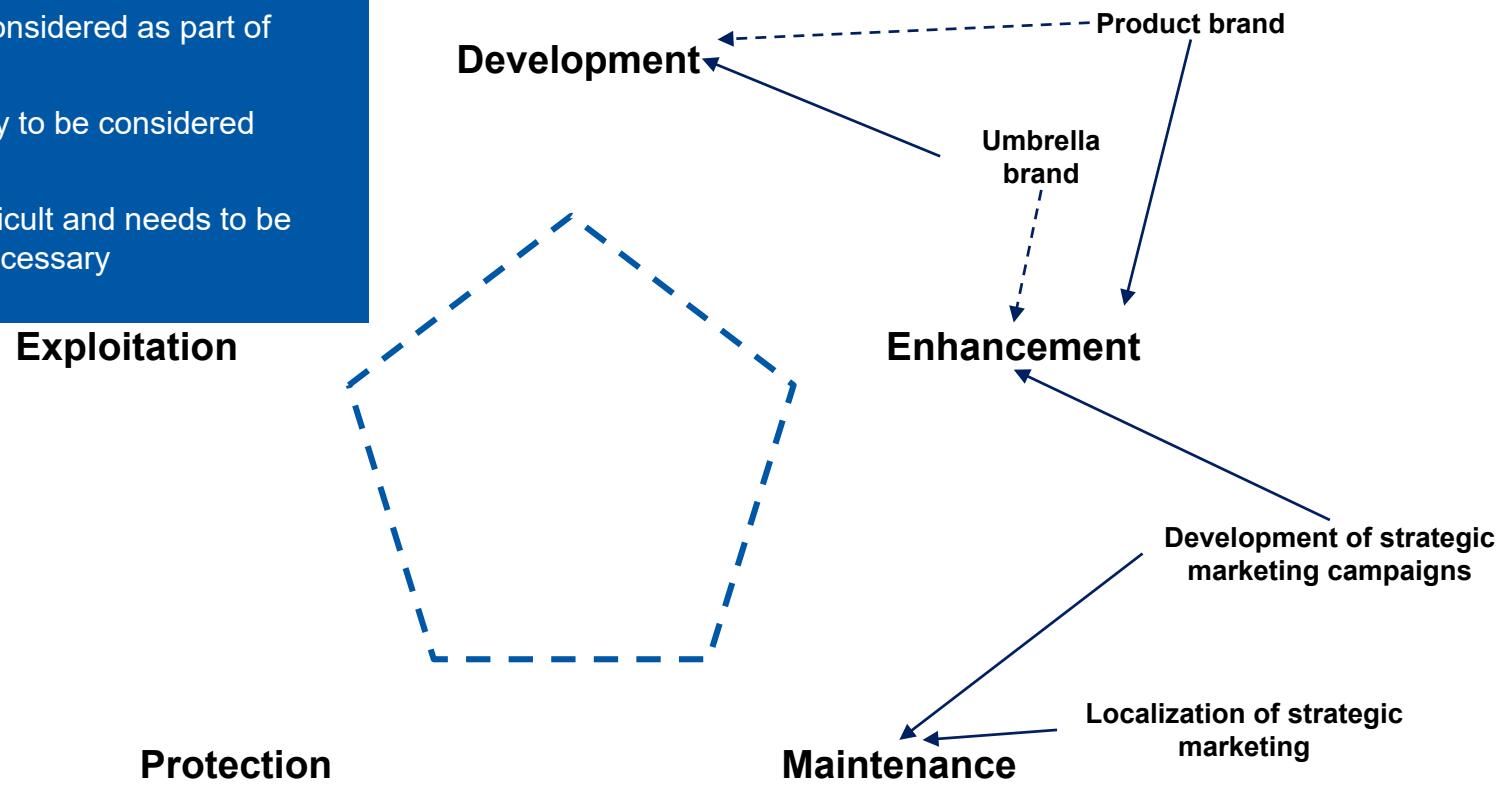


- In social networks, monetization is primarily driven by ads
- Ensuring advertisements are delivered to the right group ensures maximum **exploitation** of the user base
- At the same time, it avoids that users are annoyed by ads and lose interest, it thus helps **maintenance** of the users
- Some users find the ads even helpful, so there is also some **enhancement**

- The army of people cleaning user groups from hate mail, spam and fraud are one of the most important issues to keep the network going.
- A grey zone exists between **protection** and **maintenance**
- A distinction can be made by the level of outsourcability (traditional routine vs. non-routine) and employees' training in law

Differentiating DEMPE Functions
Consumer goods brand

- In Consumer goods, functions related to the umbrella brand are more likely to be considered as part of development
- Product brands are more likely to be considered enhancement
- However, the distinction is difficult and needs to be considered in detail, where necessary



Brand protection

- Internet phenomena such as “shit storms” might derail a brand quickly if protection measures are not taken immediately.
- The case of “Ritter Sport Schokolade” shows how important efficient brand protection can be.

4 The consideration of functional execution vs. functional control

- If spread across several entities, DEMPE activities will usually have a center of gravity (e.g. the HQ, a regional or BU principal)
- As a pure business necessity, this will usually translate into a spread between centralized business-decision-making & control and pure functional execution for many specialists involved
- While it should remain appropriate that pure functional execution in principle could be considered as a pure routine service, it remains true that high-value specialists in intangible-creating networks often contribute to enhancing the intangible value (for example, even by only preparing decisions)
- The post-BEPS challenge is how to distinguish acceptable solutions from legal organizational structures targeted by BEPS that involve the contractual centralization of risk and decision-making in certain limited substance principals

4 Transfer pricing solution approaches

- From the evolution of the business, robust evidencing why certain decision-making power should be concentrated in certain jurisdictions
  - e.g. in certain industries (like automotive) , it is plausible that central R&D decision making should be exercised in lead plant jurisdictions
- Evidencing of the limited decision-making power of local DEMPE activities in other territories through internal process documentation and robust industrial economics approaches
  - Even if it was assumed that all DEMPE contributors do collective decision-making, the economics of bargaining power and decision-making can evidence that territories with limited physical DEMPE contributions have no chance to impact on the actual decision-making
  - A headcount-based approach can justifiably be enhanced by the consideration of different hierarchies with group intangible networks, i.e. by giving senior layers of management more voting rights on collective decision-making

4 Implications for asymmetrical risk-taking and transfer pricing

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- BEPS is targeting “artificial” structures where risk control (and decision-making) is contractually allocated to low-tax jurisdictions for than tax planning reasons
- If the industrial economic analysis can evidence that a low DEMPE contribution entity has effectively no objective impact potential on decision-making, arm’s length behavior would imply that such entity would not be willing to bear risk, which it cannot control
  - It would voluntarily accept to become a low risk cost plus DEMPE service provider
- A profit split analysis to allocate intangible profits would be necessary only for the few more powerful DEMPE contributors
  - The actual transfer pricing solutions would still be consider asymmetrical risk allocation patterns, i.e. a licensee contributing to and exploiting marketing intangibles may bear higher risk than trademark licensors

5 The strategic role of funding in a DEMPE analysis

- Funding decisions and activities are normally considered to be shareholder-related and should have no impact on operational transfer pricing
- However, this would not be appropriate if funding was strategic, high-volume and high risk (e.g. funding of long-term start-up losses to develop new digital business models)
  - When such issues arise, group management becomes really involved at operational level more in the form of a PE investor than a pure shareholder / supervisor
  - It is reasonable HQ tax authorities will expect a significant payback in the form of later years' operational profits to accept the start-up losses - this should also be acceptable in the other jurisdictions since stand-alone these would not have the resources to finance the related risks
- Such strategic funding would normally not be feasible from a pure FinCo established in a low tax jurisdiction

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