INTERNATIONAL

Legal Ownership of Intangible Assets versus Economic Substance: OECD Perspectives – BEPS Action Plans 8-10

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Introduction

Because of mounting public and political pressures, the G20 countries asked the Organisation for Economic Co-operation and Development ("OECD") to develop an action plan on base erosion and profit shifting ("BEPS") limiting opportunities for multinational enterprises ("MNEs") to shift profits to jurisdictions with a lower tax rate. The 15 BEPS action plans the OECD produced are broad in nature and coverage. From the transfer pricing perspective, there are four action plans, Action Plans 8, 9, 10 and 13. Action Plans 8-10 predominantly address the issue of profit shifting by MNEs through the use of a transfer pricing policy. On the other hand, Action Plan 13 deals with transfer pricing documentation, amongst which an MNE may need to prepare and submit to the relevant tax authority a country-by-country report, a master file, and a local file if certain thresholds are met. One item that would need to be analysed and disclosed in the master file and local file deals with value-chain analysis, which would help the MNE and the relevant tax authority to formulate an approach to identify the key value drivers, including intangibles, in order to allocate the MNE's profits accordingly.

This article aims to discuss in more detail the OECD's approach to the allocation of profits from the creation and exploitation of assets, in particular intangible assets. It also identifies practical approaches that can be used to assist in understanding the significance of various functions and their relevance to the determination of the allocation of profits among different entities that contribute to the creation and exploitation of intangible assets. The transfer pricing documentation under Action Plan 13 is not discussed. The article also discusses China's position with respect to intangibles.

OECD's Approach to Substance and China's Responses

The key aspects of the OECD's approach to intangibles are as follows:

1. The definition of intangibles is being broadened, the term "marketing intangibles" being adopted.
2. Mere legal or "economic" ownership is no longer the driver of the rights to intangible income.
3. Intangible returns should be allocated to the entities that perform intangible activities, these activities being development, enhancement, maintenance, protection, and exploitation (the so-called "DEMPE functions"), and manage and control the risks associated with the performance of intangible activities as well as the financing of the intangible activities, including the ability to bear the financial risks associated with the financing activities. This is in reality the heart of the OECD's approach, in that it is important to understand an MNE's value chain and to identify the functions performed by the various entities in the value chain that are critical to the creation and exploitation of intangible assets. Under the OECD's transfer pricing documentation process, the analysis on the value chain is to be disclosed in the master file and the local file.
4. In identifying the key DEMPE functions, the OECD noted that certain functions can be outsourced, but control over critical risk-bearing decisions must rest with the entity that outsources these functions. The definition of control is also defined.

Definition of an "Intangible"

The new definition of an "intangible" is given in the OECD's 2015 final report on Action Plans 8-10:

"An intangible …. that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers." [1]

The final report goes on to give examples of what may be considered as intangibles.

Legal Ownership and the DEMPE functions

More specifically, the final report addresses legal ownership and rights to the economic returns of assets as follows:

"While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration…. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed….

It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide funding and other assets, and which member(s) assume the various risks associated with the Intangible." [2]

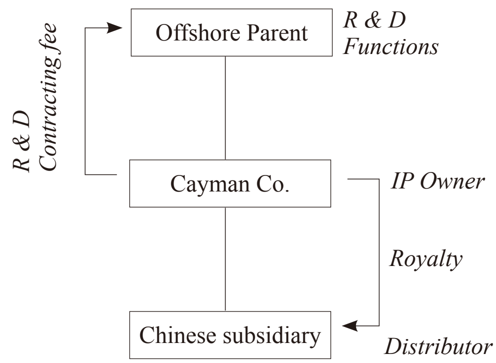
China's Position

China's position generally aligns with the above OECD rules with some localised modifications. Its position is stated in the recently issued 2017 Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures ("Bulletin 6"). In Articles 30-32 of the Bulletin, the State Administration of Taxation (SAT") adds location specific advantages ("LSAs") as an additional comparability factor in a transfer pricing analysis and adds "promotion" to the above-mentioned DEMPE functions in determining the parties' contribution to the creation of an intangible.

Whereas the OECD provides that the contributions of MNE group members to the value of intangible assets are to be evaluated by examining the DEMPE functions, the SAT would require an evaluation based on DEMPE + P functions, the additional "P" being "promotion". In the view of the China tax authorities, promotional efforts are often carried out by the Chinese party, which takes on the associated risks, and these promotional efforts contribute to the value of an intangible in China. Essentially, LSAs refer to location savings and market premium as comparability factors, and the efforts to promote the intangible in China and to build up Chinese consumers' product awareness are important value drivers for marketing intangibles. The Chinese entity in the value chain should be allocated additional profits due to these LSAs. Location savings refer to the cost savings made by having the manufacturing operation in China. Market premium refers to the specific advantages provided by the Chinese market, such as its large population and growing middle class and the Chinese people's liking for foreign products.

Unlike the OECD's final report, the SAT has not provided detailed guidelines on how to examine intangible activities and the management and control of operational and financial risks.

The concept and China's position can be illustrated by the following example:



Under Bulletin 6, the royalty amount being paid by the Chinese subsidiary would be compared with the benefits derived and the contribution made by the Chinese subsidiary. Indeed, there would be contributions made by the Chinese subsidiary to the marketing of intangibles by virtue of its local marketing efforts. Thus, excess royalty would be denied as a deduction. On the other hand, from the perspective of Action Plans 8-10, only the royalty received by Cayman Co. would be split between the entity and the offshore parent company according to the principles stipulated under these action plans. The difference in approaches could lead to double taxation.

Cash Box Entity

It is noted by the OECD that the legal owner of an intangible could still be entitled to a return even if it does not perform any DEMPE functions, as long as it provides financial capital and bears financial risks. The term used to describe such an entity is "cash box". In the above example, Cayman Co. could receive compensation if it provides the financial capital and bears financial risks (i.e. if it is the "cash box entity").

The principle given by the OECD in its final report is that the return to a cash box entity which controls and bears financial risk is limited to a risk-adjusted return to a fund provider. Generally, it is compared to a return on marketable bonds with ratings comparable to the associated risks. On the other hand, if the cash box entity does not control the financial risk, the entity should only be entitled to a "risk-free" return (e.g. return on treasury bills).

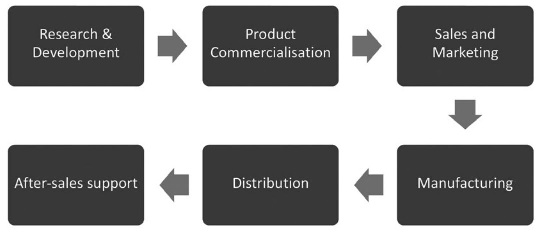
This principle is consistent with China's position as stipulated in Article 6 of Bulletin 6.

DEMPE Functions

As stipulated by the OECD, rights to the economic returns from an intangible asset will depend on which entity performs and controls the DEMPE functions. To accurately identify the DEMPE functions and the entities that perform each of these activities, an MNE needs to identify and categorise all of its intangible assets, taking into consideration the new definition of marketing intangibles adopted by the OECD. This is illustrated in the example above, in that the offshore parent company is the entity performing the R & D activities, thus creating an intangible (i.e. the know-how and the technology), and the China subsidiary is the entity providing the local marketing activities, thus contributing to the marketing intangible. Both the parent company and the China subsidiary should be entitled to a return based on the respective DEMPE functions (DEMPE + P in the case of China) they performed. Cayman Co., while it is in the legal owner of the IP, should only be entitled to a risk-free return.

Once management has a complete catalogue and understanding of all of the MNE's intangible assets, the next step is to obtain an understanding of the MNE's operational value chain.

This can be illustrated in the following traditional value chain for a tangible goods business:



For each business process along the value chain, one should explore and understand the functions that are performed to transform inputs into outputs, along with the critical success factors and the use of intangible assets, in order to identify the drivers of the MNE's profits. Management should, as part of the value-chain analysis, ask themselves questions that relate to the identification of value drivers, including the following:

1. What are our critical success factors?
2. What makes us stand out from our competitors?
3. Do we have processes and/or know-how that allow us to produce product more efficiently and/or at reduced costs compared to our competitors?
4. Do we have a unique position in the market?
5. Do we have supplier contracts with favourable terms compared to those of our competitors?
6. Do we have a strong client base?
7. Do our relationships with our clients matter, or is the sale of the produce purely driven by price and thus commoditised?

With a good understanding of the MNE's intangible assets, value drivers, and critical success factors, management can start to identify the important DEMPE functions for the intangible assets (control over the strategic direction of R & D functions, development of process know-how, etc.) performed within each business unit of the MNE's value chain.

The next step of the DEMPE analysis is to identify which persons within the MNE group of entities perform each of the DEMPE functions. This analysis effectively creates a road map summarising which entity performs which of the DEMPE functions that drive profitability along the value chain. Once the road map is complete, one can start the process of allocating returns from exploiting the intangible assets relative to contributions made by the group members.

China's position is in general consistent with the approach recommended by the OECD in its final report. The only difference is that China has added a sixth function, that is, promotion, such that the DEMPE functions have become DEMPE + P. As noted above, promotion was added because China is an advocate of LSAs. In preparing a value chain analysis that involves the Chinese market, it is important that an analysis be made as to whether the Chinese entity has performed local marketing efforts: for example, if a global marketing campaign was to be implemented, the Chinese marketing campaign should be funded and controlled by the overseas parent company if the MNE desires to take the position that there is no local marketing intangible in China.

Control

As discussed above, certain non-important DEMPE functions can be outsourced, either to a related party or an outsider, as long as the principal controls the functions. In the context of risk management, the OECD's final report defines "control" as the capability to make decisions to take on the risk associated with the outsourced function and decisions on whether and how to respond to, mitigate, and manage risks. Therefore, the entity controlling the risks must have people who have the authority to perform these functions and the ability to perform them effectively, including the competence to assess the performance of the outsourced function. [3]

The OECD's final report goes on to describe the important DEMPE functions, which include the following:

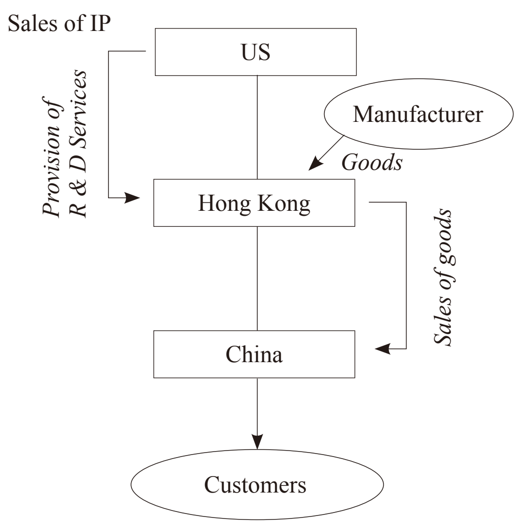
1. Design and control of research and marketing programmes
2. Direction and establishment of priorities for creative undertakings, including determining the course of blue-sky research
3. Management and control of budgets
4. Control over strategic decisions regarding intangible development programmes
5. Important decisions regarding the defence and protection of intangibles
6. On-going quality control over functions performed by independent or associated enterprises that may have a material effect on the value of an intangible[4]

The final report states that the above functions should not be outsourced by the principal if the profits from exploiting the intangible asset are to be attributed to the principal.

What Does the Above Mean?

This can be illustrated in the following examples.

Example 1:



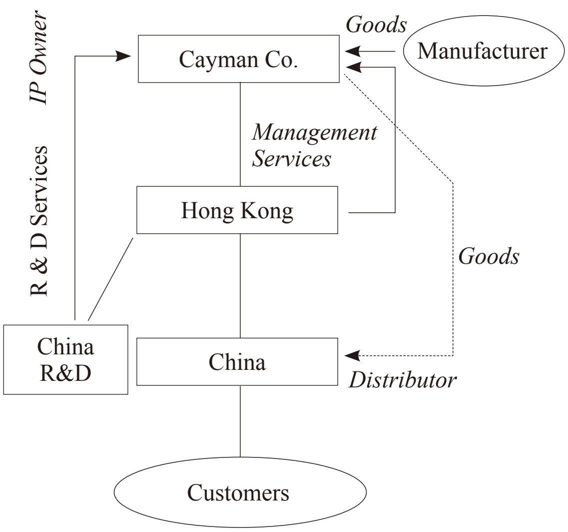
In Example 1, in order to beef up the entitlement of Hong Kong to a bigger share of the group's profit, the MNE makes efforts to make Hong Kong the owners of the original IP and the providers of enhancements to the IP. Therefore, Hong Kong purchases the IP from the US and enters into a contract R & D service agreement with the US for further development of the IP due to the fact that the development personnel are in the US. Hong Kong only has few people who oversee the manufacturers, which are arm's length suppliers. There are, however, a few regional sales and marketing personnel in Hong Kong who provide regular oversight of the China operation and other affiliates in the Asian region. The functions include approving budgets, marketing programmes, setting of sales targets, setting of price guidelines, and developing standard contracts which would be used by the Chinese subsidiary. The regional sales and marketing personnel report to the top management in the US. In essence, the regional sales and marketing personnel are not significant contributors to the selling efforts. Significant selling and marketing efforts are carried out by on the ground personnel in China.

Before the BEPS Action Plans 8-10 were introduced, Hong Kong might normally have taken up the big chunk of the group's profits, with the US earning only the R&D contracting fees and the China subsidiary earning only a small profit as a so-called "limited risk distributor".

After the implementation of BEPS Action Plans 8-10, and Bulletin 6 in China, the China tax authority may consider that certain DEMPE + P functions, notably the promotion function, were being performed in China. The Chinese subsidiary may not be considered as a "limited risk distributor" and should therefore earn a bigger share of the profits. While the US tax authority has not yet implemented the BEPS action plans, under the current transfer pricing rules and regulations, the US tax authority may consider that the control of the R & D is in fact in the US, including the risk of so-called "black-holed" R & D expenditures, and thus that the US entity should be entitled to more than an ordinary R & D contract fee based on a cost-plus basis. With respect to Hong Kong, the Hong Kong Government became an associate member of the OECD to join the inclusive framework for implementation of the BEPS action plans and indeed issued a Consultation Report on measures to counter BEPS in July 2017. It is contemplated that transfer pricing rules which would be consistent with the OECD's Transfer Pricing Guidelines will be codified for incorporation into the Inland Revenue Ordinance. Under the existing transfer pricing regime, relief from double taxation due to the transfer pricing adjustment initiated by the China tax authority could be sought under DIPN No 45 as long as the transfer pricing adjustment could be proved to be appropriate under the circumstances. Unfortunately, as Hong Kong does not have a double tax agreement with the US, such relief is not available to the extent that the US tax authority makes a transfer pricing adjustment with respect to R & D contract fees being paid to the US. In that transfer pricing adjustment, there would be double taxation.

The planning considerations to mitigate the above risks would include 1) shifting the control of R & D functions to Hong Kong, including the personnel who would control these functions; 2) building up the control and management of other important functions in Hong Kong; and 3) ensuring that the marketing and promotion functions are undertaken by Hong Kong, including the risks relating to such activities.

Example 2:



In Example 2, Cayman Co. has cash but no personnel. It buys goods from manufacturers which are arm's length suppliers and sells to the China distributor. Hong Kong provides management services, employing the president of the group, the CFO, the director of sales and marketing, and accounting personnel as well as the personnel who oversee the manufacturers. The president and the director of sales determine the type of products to develop and sell and the marketing strategy.

China R & D provides R & D services to Cayman Co. and receives strategic product development directions from the president and the director of sales based in Hong Kong. Such directions are however claimed to be provided by Cayman Co.

Before the OECD's Action Plans 8-10 and the issuance of Bulletin 6, the profits of the group were mostly allocated to Hong Kong.

Under BEPS Action Plans 8-10 and China's Bulletin 6, the China tax authority may require a full value chain analysis to be done to determine the respective contributions to the IP and the profit allocation. Cayman Co., as a cash box entity, should only be compensated on a risk-free return basis. In the worst scenario, Hong Kong may be considered as a mere service provider and thus would only be compensated for a routine service mark-up. China, including China R & D and the China distributor, may arguably be carrying out most of the DEMPE + P functions and may thus be allocated the residual profits after deducting the risk-free return to Cayman Co. and the routine service mark-up to Hong Kong. With respect to Hong Kong, relief could be sought under DIPN 45 to the extent that the China tax authority makes any transfer pricing adjustments to the related-party transactions.

To plan for future transfer pricing, it would be recommended that Cayman Co. be eliminated from the supply chain, with Hong Kong being considered as the entrepreneur, the one that is taking up the DEMPE + P functions. As long as the control of the R & D functions and the marketing functions are carried by Hong Kong, the position of China R & D and the China distributor, being considered as routine to be respectively the R&D service provider and the limited risk distributor, can be enhanced.

Conclusion

The OECD's broader definition of intangible assets and its approach to allocating profits from the creation and exploitation of assets between the legal owner of the intangible assets and other value-providing entities within the group will lead to increased scrutiny by tax authorities with respect to which entities are entitled to the profits from such assets and activities. It is important that the management of MNEs should assess the DEMPE (DEMPE + P in respect of China) functions of the group and identify which entity is carrying which of the DEMPE functions in order that a proper allocation of profits can be made. As shown by the examples in this article, some restructuring of the various entities and the functions may be necessary in order for a proper alignment to be achieved.

Endnotes

1. Organisation for Economic Co-operation and Development, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, 5 October 2015, para 6.16.
2. Ibid., at paras 6.42 and 6.48
3. Ibid., at paras 1.65 and 1.61.
4. Ibid., at para 6.56. T