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In this article, the first in a series, the authors summarize their findings from a KPMG member firm survey of how tax authorities around the world are applying the OECD control of risk framework and the transfer pricing guidelines on development, enhancement, maintenance, protection, and exploitation of intangibles. This installment is focused on the United States and the United Kingdom.

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In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing[1] as part of the base erosion and profit-shifting actions 8-10. This has transformed how tax authorities around the world approach transfer pricing.[2]

The formal title of BEPS actions 8-10 was "Aligning Transfer Pricing Outcomes With Value Creation," and, in broad terms, its objective was to give tax authorities more powerful tools to counteract arrangements that shift profits to low-tax jurisdictions that performed limited activities. The concepts introduced in BEPS actions 8-10 — like the six-step control of risk framework for analyzing transactions involving intangibles and development, enhancement, maintenance, protection, and exploitation (DEMPE) functions — are now core to the practice of transfer pricing.

It has taken a while for the impacts of BEPS actions 8-10 to work their way through the system. Countries (as well as companies) took time to get up to speed with these new concepts, and most tax authorities, sensibly, did not seek to apply the new guidance retroactively (though there have been exceptions). Now, seven years after these actions were released, we are finally seeing a more complete picture of what has changed. It has not always been pretty. As several recent articles have highlighted, BEPS actions 8-10 have a number of conceptual limitations, particularly as tax authorities have become increasingly aggressive in their interpretation of the guidance.

Obtaining a comprehensive view of how different tax authorities are applying core concepts of the control of risk and DEMPE is not easy. The transfer pricing world is rife with rumor, and there is no clear objective data on applying concepts that are inherently subjective. Even within tax authorities, different departments (and

[1] OECD, "Aligning Transfer Pricing Outcomes With Value Creation, Actions 8-10 — 2015 Final Reports" (2015), included guidance related to intangibles, risk, capital transfers between group entities, and other high-risk transactions.

[2] In 2017 this was formally incorporated into the OECD transfer pricing guidelines.

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even different individuals) may have different views.

For businesses, understanding how specific tax authorities are actually applying the control of risk framework and DEMPE paradigm is critical to manage transfer pricing risks. To square this circle, KPMG has surveyed its member firms from around the world to better understand how their local tax authority is approaching the concepts of control of risk and DEMPE. We will summarize the findings from that survey and identify some common trends and themes in this series of articles.

What Questions Did We Ask?

Discussions with KPMG member firms were wide-ranging, but we asked each four questions:

- Does your country's domestic legislation or regulations incorporate the changes made to the OECD transfer pricing guidelines by BEPS actions 8-10? And if yes, does it apply this guidance to periods before the relevant legislation or regulations were amended?
- Does your country's tax administration typically apply the revised guidance on the control of risk and DEMPE framework simultaneously or separately?
- How frequently and in what circumstances does your country's tax administration apply this guidance?
- Within your country's tax administration, who most frequently applies this guidance?

These questions were designed to capture information on some key issues:

- First, we wanted to understand the legal basis (if any) on which tax administrations apply the BEPS actions 8-10 guidance and whether they try to apply it retroactively (before it was officially incorporated into domestic law).
- Second, we wanted to understand whether tax administrations are applying the revised guidance on control of risk and DEMPE framework to specific cases, or whether they were adopting a "kitchen-sink approach" — using all possible arguments regarding arrangements that they do not like.
- Third, we wanted to understand what activities, industries, or fact patterns were most frequently leading to tax administration challenges.
- Finally, we wanted to understand who within tax administrations was applying this guidance, which again is relevant for taxpayers when thinking about their transfer pricing risks.

Below, we focus on the contrasting experiences of the United States and the United Kingdom.

The United States

The U.S. Treasury has long taken the position[3] that its transfer pricing regulations under section 482 are "wholly consistent" with its treaty obligations and the OECD transfer pricing guidelines.[4] It continued to take this position after the 2015 BEPS deliverables were finalized; hence, its stance was that no updates were needed to the IRC or the Treasury regulations to incorporate the changes from the OECD BEPS guidance.

However, U.S. practitioners generally agree that the 2015 BEPS deliverables (and resulting 2017 and 2022 OECD transfer pricing guidelines) differ in many respects from section 482. Some key examples of the differences as they relate to control of risk and DEMPE are:

- *Legal ownership of intangibles*: Section 482 indicates that the legal owner of an intangible will be considered its sole owner unless the ownership is inconsistent with economic substance.[5] This is in marked contrast to the control of risk and DEMPE concepts in the OECD transfer pricing guidelines.
- *The treatment of contracts*: While a written agreement to set forth the terms and conditions of intercompany transactions is not required under section 482, in practice, U.S. regulations place a premium on having prior written contractual arrangements in place. Contractual terms, including the allocation of risks, that are agreed to in writing before the associated transactions occur will be respected by the IRS if the

[3] AM 2007-007.

[4] This section was written in conversation with Mark R. Martin and Joshua D. McConkey of KPMG US.

[5] Reg. section 1.482-4(f)(3).

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terms are consistent with the economic substance of the underlying transactions.[6] In contrast, the OECD transfer pricing guidelines note that the agreement provides only a "starting point"[7] for understanding how the transaction was intended to be structured.

- *Cost-sharing arrangements*: The U.S. qualified cost-sharing arrangement[8] (for the joint development of intangibles by related parties) and the cost contribution arrangement, which is discussed in Chapter VIII of the OECD transfer pricing guidelines, have noticeable differences — one is that under an OECD cost contribution arrangement, the participants need to perform management control functions and have the financial capacity to assume those risks.[9]

Generally, in its examination process, the IRS does not place the same emphasis on DEMPE as other countries that have incorporated the BEPS actions 8-10 guidelines into their domestic law. However, in accordance with the 2019 memorandum "Interim Guidance on Mandatory Issue Team Consultations With APMA for Examination of Transfer Pricing Issues Involving Treaty Countries,"[10] large business and international exam teams are now required to consult with the IRS advance pricing and mutual agreement program when auditing transfer pricing transactions that involve counterparties in jurisdictions that are U.S. treaty partners. While the 2019 memorandum does not specifically mention DEMPE, as a practical matter, APMA would consider DEMPE arguments raised by treaty partners and advise examination teams on that basis. However, in our experience, it is extremely rare for DEMPE arguments to be made at the exam level.

In the fall of 2022, several IRS officials made public comments to indicate that the IRS was placing increased importance on the economic substance doctrine. Section 7701(o) defines this as the common law doctrine under which certain tax benefits are not allowable if the transaction does not have economic substance or lacks a business purpose. The IRS public comments, in combination with the April 2022 IRS removal of the executive approval requirement for applying this doctrine and asserting the economic substance penalty, have made taxpayers concerned the IRS will use it to recharacterize intercompany transactions. While the economic substance doctrine differs significantly from control of risk and DEMPE, many view it as DEMPE-adjacent because it emphasizes the overall substance.

For cases that are in the competent authority process where the treaty partner has adopted and applied the DEMPE framework, practitioners have seen APMA assert that the United States should be attributed a portion of the nonroutine returns from intangible property stemming from the performance of DEMPE functions in the United States, even though the intangible property was never owned or funded by the United States. In these cases, the United States attributes value to each component of DEMPE — that is, to assess valuation creation that would lead to nonroutine returns.

In one example, a company is pursuing a bilateral advance pricing agreement between the United States and a European jurisdiction. The APA seeks to address the inbounding of intangible property into the United States coupled with a transition from a European principal structure to a U.S. principal structure to better align with the firm's current and ongoing structure. The company has employees in Europe performing legal and marketing functions; in DEMPE terms, only the "P" for Protection is performed in Europe. As part of the APA discussions, APMA has been highly focused on DEMPE issues with the current structure and is considering if a reduced payment by the United States for the intangible property is warranted given that most of the DEMPE functions have historically occurred in the United States.

[6] Reg. section 1.482-1(d)(3)(ii)(B).

[7] OECD transfer pricing guidelines (2022), section 1.42.

[8] Defined in reg. section 1.482-7.

[9] Jeroen Dijkman and Prita Subramanian, "Evaluating the Equivalence of Cost-Sharing and Cost Contribution Arrangements," *Tax Notes Int'l*, Mar. 13, 2023, p. 1473.

[10] IRS, "Interim Guidance on Mandatory Issue Team Consultations With APMA for Examination of Transfer Pricing Issues Involving Treaty Countries," LB&I-04-0219-001 (Feb. 19, 2019).

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In another example in the APA/APMA realm, practitioners have seen APMA focus on control of risk and DEMPE functions to establish economic ownership. In this case, a U.S.-headquartered technology company (U.S. HQ) acquired a Japanese company (Japan Co.) holding valuable intangible property. On the acquisition date, the legal and economic ownership of the acquired technology was in Japan, and no formal transfer of intangible property occurred following the acquisition. Residual profits remained in Japan immediately after acquisition; however, these profits gradually transitioned to U.S. HQ over several years, even though legal ownership of the technology was never formally transferred. As of the start of the APA period, the research and development team at Japan Co. reported to someone at U.S. HQ who had the correct skill set to manage the research and development team. U.S. HQ also determined compensation and bonuses. APMA was able to establish — because of its performance of DEMPE functions — that U.S. HQ was the entrepreneur and the economic owner of the Japanese intangible property; hence Japan Co. was a service provider, with U.S. HQ receiving the residual returns.

The United Kingdom

The OECD transfer pricing guidelines are incorporated into U.K. domestic law by reference.[11] This reference[12] was revised in 2016 to explicitly include the changes made to the OECD guidance by BEPS actions 8-10, effective for corporation tax purposes for accounting periods beginning on or after April 1, 2016. The United Kingdom was quick off the mark compared with some other countries in putting the new OECD transfer pricing guidelines on a statutory footing. HM Revenue & Customs has traditionally adopted an ambulatory interpretation of changes to the OECD transfer pricing guidelines, taking the view that any changes merely clarify how the arm's-length principle should always have been applied and therefore HMRC may consider new OECD guidance when reviewing periods that predate when that guidance was formally adopted in U.K. legislation. This is how HMRC views Chapter X on the transfer pricing aspects of financial transactions.

HMRC transfer pricing inquiries are taking longer to resolve. HMRC settled 175 inquiries during the 12 months ending March 31, 2022, and the average age of settled inquiries was two years and 10 months, similar to the previous fiscal year, but higher than the previous five years.[13] Longer inquiries are reflective of HMRC adopting a more evidence-based approach — we see more cases where HMRC determines it is necessary to conduct intensive fact-finding, often including conducting its own functional interviews with managerial staff, before moving on to discussing the correct pricing method for the controlled transactions under review. It is fair to say that HMRC wants to ensure that transactions are being accurately delineated, and the inquiries follow that approach — work out what you are pricing first (which includes analysis of risk control functions), then move on to the pricing issues.

HMRC's yield from transfer pricing inquiries was estimated at £1.4 billion in the year ending March 31, 2022. This was a reduction in the figure from 2021, but was in line with the figure for the period ending March 31, 2020.[14] The yield is lumpy, but the trend since 2016 is clearly upward. Two of the main drivers of this increase are the United Kingdom's diverted profits tax regime (introduced in 2015) and HMRC actively applying the changes to the OECD transfer pricing guidelines resulting from BEPS actions 8-10.

There are cases where HMRC challenges a taxpayer's accurate delineation of the transaction applying the control of risk framework, but more commonly, transfer pricing inquiries are settled based on transfer pricing adjustments that respect the taxpayer's delineation of the transaction. The risk control and DEMPE concepts are used in different cases, dependent on the underlying facts and circumstances, but with a focus on a limited

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[11] This section was written in conversation with Phil Roper of KPMG UK.

[12] Taxation (International and Other Provisions) Act 2010, Pt. 4, Ch. 2, section 164.

[13] HM Revenue & Customs, "Transfer Pricing and Diverted Profits Tax Statistics 2021 to 2022" (Feb. 7, 2023).

[14] KPMG, "HMRC Transfer Pricing and Diverted Profits Tax Statistics for Year Ended 31 March 2022" (Feb. 15, 2023).

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number of high-value cases in line with HMRC's "resource to risk" approach to transfer pricing.

For example, a group historically shared intangible development costs and residual profits between the United Kingdom and another European country where it had substantial DEMPE activities. Over time, the senior management roles located in the other European country declined, but there were still substantial DEMPE activities undertaken in that country. HMRC challenged this group's transfer pricing arrangements based on the DEMPE framework — arguing that the number and seniority of U.K. employees (relative to the other country) justified more profits being allocated to the United Kingdom, using a senior headcount-based contribution analysis.

In R&D-intensive industries where intangible property arises from large high-risk investments in prior years, care is needed when applying a current-year only analysis of DEMPE functions to determine entitlement to share the intangible-related returns derived by the group during that period. This approach may fail to recognize the significant value of historical contributions to development of the intangibles that are driving current profitability. This is a key argument that can be used to respond to tax administrations applying this type of approach.

Another important trend we see linked to the control of risk and DEMPE frameworks is that HMRC is scrutinizing arrangements that leave the United Kingdom with a cost-plus return (even quite high cost-plus returns) when senior leaders are located in the United Kingdom. This is particularly the case when those senior leaders are involved in managing the risks associated with development and commercialization of intangibles. In these cases, HMRC wants to assess if it would be more appropriate to test the United Kingdom's remuneration using a profit-split method.

Several cases in this space are handled through the United Kingdom's profit diversion compliance facility (PDCF). The PDCF was established in January 2019 and has focused on historic transfer pricing arrangements that are inconsistent with BEPS actions 8-10 guidance. Under the PDCF, HMRC sends "nudge" letters to groups that it considers potentially in-scope, giving them the option to register with the facility, and prepare a disclosure report setting out a proposal to settle any outstanding liabilities. In some instances, nudge letters have been sent to groups that are allocating significant returns to the United Kingdom. For example, a business that employed senior regional sales and marketing staff in the United Kingdom, which acted as regional subject matter experts and supported teams executing a global marketing strategy, was sent a nudge letter even though the relevant entity was allocated a relatively high cost-plus return. Again, this provides a clear example of HMRC zeroing in on senior staff titles and high pay, as a possible indicator that the United Kingdom is being under-remunerated. Country-by-country reporting data is also used as part of risk profiling U.K. taxpayers as part of the PDCF.[15] ■

[15]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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