

A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden

by Julia Bürkle, Franklin Hundscheid,
Karolina Viberg, Maria Andersson, Jessie Coleman,
Alistair Pepper, and Nicolas A. Karolewicz

Reprinted from *Tax Notes International*, June 26, 2023, p. 1743

A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden

by Julia Bürkle, Franklin Hundscheid, Karolina Viberg, Maria Andersson, Jessie Coleman, Alistair Pepper, and Nicolas A. Karolewicz



Julia Bürkle



Franklin Hundscheid



Karolina Viberg



Maria Andersson



Jessie Coleman



Alistair Pepper



Nicolas A. Karolewicz

Julia Bürkle (jbuerkle@kpmg.com) is a partner in KPMG Germany's global transfer pricing services practice. Franklin Hundscheid (hundscheid.franklin2@kpmg.com) is a partner in KPMG Netherlands' global transfer pricing services practice. Karolina Viberg (karolina.viberg@kpmg.se) and Maria Andersson (maria.andersson@kpmg.se) are partners in KPMG Sweden's global transfer pricing services practice. Jessie Coleman (jessiecoleman@kpmg.com) is a principal and Alistair Pepper (alistairpepper@kpmg.com) is a managing director in the economic valuation services group of the Washington National Tax practice of KPMG LLP.

Nicolas A. Karolewicz (nicolaskarolewicz@kpmg.com) is a tax associate in the economic valuation services practice of KPMG LLP.

In this article, the third 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 Germany, the Netherlands, and Sweden.

Copyright 2023 KPMG LLP.
All rights reserved.

In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing,¹ as part of base erosion and profit-shifting actions

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

8-10. It can be difficult to get a comprehensive global view of how different tax authorities are applying this guidance. KPMG has surveyed its member firms from around the world to better understand how local tax authorities are approaching the control of risk and development, enhancement, maintenance, protection, and exploitation (DEMPE) frameworks. In this article,

the third in a series, we focus on Germany, the Netherlands, and Sweden.²

Germany

Germany's administrative principles governing transfer pricing³ incorporate the OECD guidelines by reference.⁴ The administrative principles state that the German tax administration (Bundesministerium der Finanzen, or BMF) "refers to the OECD Transfer Pricing Guidelines for orientation, within the framework of the applicable national law, regardless of whether the case involves a situation that is subject to" a double taxation agreement.⁵ This reference gives the German tax administration a legal basis to apply both the DEMPE framework and the revised guidance on control of risk.

The administrative principles include a subsection on DEMPE functions in a section on intangibles, which states that "the allocation of income from intangible assets should generally be based on the assumed functions and risks and the measures for managing them, and does not therefore depend solely on who is the owner or holder of the intangible assets."⁶ The guidance also highlights the importance of the control of risk framework, which is described as a "key element" of a function and risk analysis.⁷

The DEMPE framework is usually proactively referred to by the German tax administration in an inbound context, where the returns allocated to local distribution or manufacturing entities are relatively low. For example, a business that operates in Germany through a limited-risk

distributor earning a relatively low operating profit margin could be challenged by the tax administration based on the distributor performing DEMPE functions that are not appropriately recognized in the returns it is allocated. In these cases, the tax administration will typically seek to increase the return allocated to the German entity.

The guidance on control of risk has regularly been used to challenge transfer pricing arrangements that result in German entities being allocated losses. In simple terms, when the realization of losses is a consequence of playing out a given risk, the German tax administration may try to argue that the risk that resulted in a loss is controlled outside Germany. In this scenario, the German tax administration would likely argue that this loss should be allocated to the nonresident entity that controls this risk. For example, if a German manufacturing entity incurs a loss because its production facilities are underused, but a nonresident entity is responsible for capacity management, then the German tax administration may argue that the manufacturer's losses should be allocated to the nonresident.

In Germany, state tax officials are responsible for audits of small and medium-size multinationals, but additional tax officials of the Federal Tax Office (Bundeszentralamt für Steuern) in Bonn are involved for audits of larger multinationals. Mutual agreement procedures and advance pricing agreements are also the responsibility of the Federal Tax Office in Bonn. The DEMPE framework and guidance on control of risk can be applied by officials at both state and federal levels. It is expected that MAP and APA submissions include a detailed discussion of both DEMPE functions and the control of risk guidance.

The Netherlands

The Dutch State Secretary for Finance published a transfer pricing decree in April 2018⁸ that was replaced by a new transfer pricing decree in June 2022,⁹ incorporating the changes made to the OECD guidelines by BEPS actions 8-10 into

²For previous installments in this series, see Mark R. Martin et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: The U.S. and U.K.," *Tax Notes Int'l*, May 8, 2023, p. 705; and Olivier Kiet et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: France, Italy, and Spain," *Tax Notes Int'l*, June 5, 2023, p. 1327.

³BMF-Schreiben, "Verwaltungsgrundsätze Verrechnungspreise – Grundsätze für die Korrektur von Einkünften gemäss Sec. 1 AstG," IV B 5 – S 1341/19/10017 :001 (July 14, 2021), which was replaced by BMF-Schreiben, "Verwaltungsgrundsätze Verrechnungspreise – Grundsätze für die Korrektur von Einkünften gemäss Sec. 1 AstG," IV B 5 – S 1341/19/10017 :003 (June 6, 2023).

⁴This section was written in conversation with Julia Bürkle of KPMG Germany.

⁵BMF 2023, *supra* note 3, at para. 2.2.

⁶BMF 2023, *supra* note 3, at para. 3.53.

⁷BMF 2023, *supra* note 3, at para. 3.5.

⁸Verrekenprijsbesluit no. 2018-6865 (Apr. 22, 2018).

⁹Verrekenprijsbesluit no. 2022-0000139020 (June 14, 2022).

Dutch law.¹⁰ The 2018 and 2022 decrees clarify that the Dutch State Secretary for Finance's view is that, to the extent the changes to the OECD guidelines further clarify the application of the arm's-length principle, the amendments also apply to years before these changes were published. This approach is consistent with the emphasis the Dutch tax authority has historically given to substance in the transfer pricing area. The Dutch tax authority has adopted a targeted approach to applying the DEMPE framework and revised guidance on the control of risk framework to different types of transactions.

The Dutch tax authority uses the DEMPE framework and revised guidance on the control of risk framework to determine whether the Dutch taxpayer receives an arm's-length remuneration and whether the Dutch taxpayer can deduct costs. It scrutinizes deductions of costs regarding materialized risks by analyzing whether it was the Dutch taxpayer or rather a foreign group entity that exercised control over the risks, made the decisions, and had the financial capacity to assume the risks.

The Dutch tax authority has historically emphasized the performance of development and enhancement activities, viewing the "D" and the "E" as particularly important DEMPE functions. According to the 2018 and 2022 decrees, in general the development and enhancement functions will be given more weight in the assessment of the relative contribution to the value of the intangible asset than the maintenance, protection, and exploitation functions. The 2018 and 2022 decrees do not consider that this may differ from industry to industry. One area of focus for the Dutch tax authority is intellectual property jointly developed by two or more parties that are residents of different jurisdictions. A participant in a cost contribution arrangement that assumes risks should also exercise control over these risks and have the financial capacity to bear the downside effects of these risks. A participant in a cost contribution arrangement that provides only the financing and exercises control only over risks related to that financing — not the risks regarding the other activities within the arrangement — is

generally entitled to only an arm's-length financing compensation considering the financing risk (risk-adjusted rate of return). The participant is entitled to risk-free compensation only if they do not control the risks related to the financing.

Another scenario that the Dutch tax authority is likely to scrutinize is a group performing DEMPE activities in the Netherlands but paying a royalty or license fee to a nonresident entity for the rights to use certain IP, like brands or trademarks. The Dutch tax authority will analyze both sides of the transaction, with a focus on the DEMPE activities performed in the Netherlands and by the nonresident entity. In cases in which the nonresident's DEMPE activities are limited, the Dutch tax authority may argue that the royalty or license fee paid by the Dutch entity should be reduced, or in more extreme cases, that the nonresident entity's activities should only be remunerated with a cost-plus service fee. For this reason, it is particularly important that taxpayers prepare two-sided transfer pricing documentation for their most material transactions with Dutch entities.

Sales support services remunerated on a cost-plus basis are increasingly subject to audit. The Dutch tax authority wants to understand the role played by local staff in the sales process and is likely to consider an operating profit margin return to be more appropriate when the local staff has a role in negotiating prices and driving sales. Similarly, while it was previously common practice to remunerate head office functions with a high return on cost, the Dutch tax authority is revisiting this position and, in some instances, arguing for even higher returns or claiming that the profit-split method may be more appropriate.

The Dutch tax authority has historically had a principled approach to transfer pricing. Dutch taxpayers should be prepared for the Dutch tax authority's focus on the DEMPE and control over risk functions performed by Dutch taxpayers and foreign group entities and its scrutiny of the profit and deduction of costs of Dutch taxpayers in this respect.

Sweden

The Swedish Income Tax Act (Inkomstskattelag) does not explicitly refer to the OECD guidelines or

¹⁰ This section was written in conversation with Franklin Hundscheid of KPMG Netherlands.

contain any detailed transfer pricing regulations; hence no updates were made to incorporate the BEPS guidance.¹¹ However, Swedish case law refers to the OECD guidelines as an appropriate framework to interpret the arm's-length principle. This case law gives the legal basis to apply the OECD guidelines, including those incorporated under actions 8-10.

The Swedish tax administration frequently and simultaneously applies the DEMPE and control over risk frameworks. The Swedish tax administration applies these frameworks widely, including in cases involving local marketing and distribution, local manufacturing, and local research and development activities. The challenges based on DEMPE and control over risk are raised by the Swedish tax administration's audit teams. After the OECD finalized the 2015 BEPS guidance, the audit teams immediately began applying these frameworks, including retroactively for cases before 2015. We have observed several examples in which non-Swedish groups acquired Swedish companies and the Swedish tax administration asserted that — because of a reduction in Sweden of DEMPE and control over risk functions — a deemed transfer of intangible property for transfer pricing purposes occurred. Also, the Swedish tax administration is relatively aggressive in asserting that Swedish groups without legal ownership of intangible property would be entitled to nonroutine returns because of DEMPE or control over risk functions in Sweden.

For example, in 2013 a U.S. company acquired the shares of a smaller Swedish technology group. Following the acquisition, the parties entered into a sale and distribution agreement in which the U.S. company was granted the rights to market and distribute the products developed by the Swedish company. The U.S. company agreed to pay the Swedish entity 25 percent of net profits for those rights.

Based on discussions with company employees, public disclosures, and the transfer pricing documentation, the Swedish tax administration claimed that upon the acquisition in 2013, (i) there had been a deemed transfer of

significant risk control functions and economic ownership of intangible assets to the United States; and (ii) third parties would have structured this as a sale, not an ongoing license arrangement. As support for this position, the Swedish tax administration noted that all DEMPE and control functions had moved from Sweden to the United States. For example, the head of sales was no longer in Sweden, the product development strategy for new products was set in the United States, and the U.S. entity made stop-go decisions on all new products. The Swedish tax administration claimed that the intercompany agreement did not reflect the transactions that were actually occurring between the two parties, and that a restructuring had occurred post-acquisition.

The Swedish tax administration made an adjustment based on the comparable uncontrolled price method — asserting that a one-time lump sum payment should have been made from the U.S. entity to the Swedish entity based on the 2013 acquisition price, less a routine return for the ongoing activities performed in Sweden. The Swedish tax administration was ultimately successful in its approach, and the Swedish Administrative Court of Appeal supported this position formally on March 24, 2020.

There are other types of examples in which the Swedish tax administration has maintained that Swedish operations are not compensated appropriately for their DEMPE or control of risk functions. In one example, a Swedish-parented pharmaceutical company had structured its operations with a Luxembourg company, which legally owned the group's intangible property. The Swedish parent entered into an agreement to distribute the rights for selling the drugs in its territory, receiving a routine operating margin for its distribution functions, while the residual profits flowed to the Luxembourg company.

The Swedish tax administration insisted that the investment risk made by the Swedish parent was the main DEMPE risk function and was ultimately controlled by the group CEO employed by the Swedish parent. Further, the Swedish tax administration believed that other group entities had contributed to the control over risk, and it applied a profit split to remunerate these contributing entities. According to the

¹¹This section was written in conversation with Karolina Viberg and Maria Andersson of KPMG Sweden.

Swedish tax administration, the Luxembourg company did not control any of the risk related to investments in new intangible property rights; therefore, its remuneration should be limited to a risk-free return on invested capital and a cost-plus compensation for its routine services. Ultimately, the Administrative Court ruled in favor of the company based on the Swedish tax administration's failure to question the current distribution agreement between the Swedish and Luxembourg entities. The administration had also not properly delineated a new transaction to be adjusted. The Swedish tax administration has

appealed this case to the Administrative Court of Appeal.¹² ■

¹²The 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.

Copyright 2023 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.