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This article examines new guidance from the OECD in the context of Japan’s transfer pricing regulations and consider how ownership of intangibles should be managed in practice.

The OECD has been developing revised guidance on transfer pricing of intangibles since 2010; it issued its final report on transfer pricing under actions 8-10 of the base erosion and profit-shifting project on October 5, 2015. The report, “Aligning Transfer Pricing Outcomes With Value Creation,” contains an entirely revised Chapter VI of the OECD transfer pricing guidelines (Special Considerations for Intangibles).

The new OECD guidance covers the ownership of intangibles and transactions involving the “Development, Enhancement, Maintenance, Protection, and Exploitation” (DEMPE) of intangibles. The guidance indicates that legal ownership and the funding of the development of an intangible — without performing and controlling all of the functions — would not establish entitlement to the returns derived from the exploitation of those intangibles.

The focus on the performing and controlling elements in these DEMPE functions to identify ownership is one of the key differences between the previous iteration of the OECD transfer pricing guidelines and the new guidance.
Japanese transfer pricing regulations have for some years recognized the importance of the performance of some of the key functions for identifying ownership of intangibles. For example, the Commissioner’s Directive on the Operation of Transfer Pricing (transfer pricing guidelines), initially published in 2006, clearly states:

(when examining licensing transactions of intangible properties, it shall be noted that not only the legal ownership of the intangible properties but also the degree of contribution of a corporation or a foreign-related person to the activities for the formation, maintenance or development of the intangible property ... need to be taken into account.

In this article, we compare the new OECD guidance with the Japanese transfer pricing regulations, drawing on our experience in Japan to help identify ownership of intangibles in practice following the implementation of the new guidelines.

DEMPE Functions in New OECD Guidance

One of the key trends that triggered an increased focus within the BEPS project on intangibles was the perceived misalignment between asset returns and value creation activities for intangibles. In the OECD’s view this was caused by the distinction between legal ownership and economic ownership, and it led to a mismatch between companies’ businesses and intangible assets strategies. Because of this perceived misalignment, the following transactions have been under increased transfer pricing scrutiny around the world in recent years:

- development of marketing intangibles;
- royalty payments for the use of trademarks or brand names and know-how;
- business or industrial franchises;
- contract research and development arrangements;
- enhancement of intangibles; and
- transfers of intangible assets as a part of a business’s reorganization.

To resolve these issues, the new OECD guidance focuses on DEMPE functions regarding intangible assets to identify who is eligible for the returns derived from the exploitation of intangibles.

The new guidance clearly states that there is no automatic return on account for mere legal ownership of an intangible. To achieve entitlement to the returns from intangibles, an entity is required to perform directly – or to control the performance of – DEMPE functions and related risks regarding the intangibles. Further, the returns that an entity retains in a multinational group depend on the contributions it makes through DEMPE functions to the anticipated value of the intangible, relative to contributions made by other group members.

According to the new OECD guidance, functions that have been determined to have special significance when undertaking a functional analysis to arrive at the arm’s-length compensation include:

- design and control of research and marketing programs;
- management and control of budgets;
- control over strategic decisions regarding intangible development programs;
- important decisions regarding defense and protection of intangibles; and
- ongoing quality control over functions performed by independent or associated enterprises, which may have a material effect on the value of the intangible.

In contrast to the importance of performing DEMPE functions, return on intangible development funding alone may be limited to a risk-adjusted, forward-looking return on capital. As discussed above, we have seen movement away from the concept of ownership toward adopting a “transactional approach,” with a clear focus on “substance” when conducting a transfer pricing analysis of intangibles under the new guidance.
Ownership of Intangibles in Japan

Japanese regulations define “intangible property” as “copyrights, rights to industrial property ... as well as customer lists, items of important value such as sales networks, etc.,”\(^1\) with further stipulation that rights to industrial property include innovation to improve operation or production efficiency and unique ideas regarding production technologies, recipes, and related know-how.\(^2\)

In Chapter 2-11 of the Japanese transfer pricing guidelines (Intangible Properties to Consider in Examinations), the Japanese tax authorities further clarify that when considering the degree to which intangible property contributes to the income of a corporation or a foreign related party, the following should be taken into account:

- patents and trade secrets derived from technical innovation;
- know-how derived from the experience of employees and other human resources through business activities such as management, front-office operations, production, R&D, and sales promotion; and
- production processes, negotiation procedures, and development, distribution, and financing networks.

After defining intangibles, the guidelines go on to state in Chapter 2-12 (Contribution to the Formation, Maintenance or Development of Intangible Properties) that:

> [when examining licensing transactions of intangible properties, it shall be noted that not only the legal ownership of the intangible properties, but also the degree of contribution of a corporation or a foreign-related person to the activities for the formation, maintenance or development of the intangible property ... need to be taken into account.]

Even before 2006, cases involving the Tokyo Regional Tax Bureau supported Japan’s long-held view that contribution to key functions is of critical importance in determining the value attributed to intangibles. Also, the transfer pricing guidelines (Reference Case Studies on Application of Transfer Pricing Taxation) include several cases that explain how the functional contribution to R&D would be taken into account to identify ownership of intangibles.

Case 13 of the reference case studies (contributions to creation, maintenance, and development of intangible properties) illustrates the differences between the legal owner of intangible properties and the parties contributing to their creation, maintenance, and development. This particular case study explains that it is important to “take into account the functions performed by the corporation or foreign-related person in decision-making and risk management in R&D, as well as the actual provision of services and burden of costs.”

It further clarifies that “decision-making” would include “the formulation and direction of concrete development strategy and preparatory work, such as information gathering,” and that “risk management” would consist of “the comprehensive identification of risks inherent in activities such as the creation of intangible properties, and the management of these risks in an integrated fashion through overall and continued control of progress.”

In Case 14 of the reference case studies (treatment of companies that only bear the cost of creation of intangible properties), one of the parties has no R&D operations but bears some of the costs of R&D undertaken by another party who makes all the strategy decisions while managing the related risks. In this case study, the Japanese tax authorities explain that “it is not possible to simply treat the cost borne by one party as its contribution to the creation, maintenance, and development of intangible properties” and conclude that the level of contribution of the party who merely bears the R&D costs is low.

Turning to exploitation functions, our experience in Japanese inbound cases is particularly pertinent. Since the exploitation of intangibles might not be as easy to control centrally by the legal owner (or the controller of the functions) as the other DEMPE functions, exploitation functions are often not just performed, but also controlled, by an entity that is close to the markets. Owing to the nature of exploitation functions, it was a clear intention of the Japanese tax authorities to recognize higher returns (even under a transactional net margin method (TNMM) framework) for distributors with a foreign parent.

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1. Special Taxation Measures Law Circular 66-4, (3)-3-(Note) 1.
2. Basic Circular 20-1-21.
Conclusion

Now more than ever, the OECD is changing its approach to entitlement to profit from intangibles by focusing on “functions.” Japanese transfer pricing regulations have long considered that functions are of critical importance in determining who should earn returns from intangibles. Given our experience in Japan and the OECD’s new direction, we may start to see how tax authorities around the world will respond.

Significantly, to achieve activation of the DEMPE functions, it is important to maintain consistency between bearing the costs of DEMPE functions and the decision-making and risk management related to them. The new OECD guidance allows that the legal owner of intangibles could outsource the DEMPE functions as long as an entity performing those functions will operate under the control of the legal owner. Given that the “controlling” element would necessitate active decision-making regarding risk management, the legal owner—who not only pays the costs of DEMPE functions but also makes decisions and manages the related risks—would likely be entitled to benefits attributable to the DEMPE functions under the new guidance.

Conversely, for the exploitation of the DEMPE functions, it might not be as easy for the legal owner (or the controller of the functions) to achieve central control as it is when executing the other functions. Therefore, we expect that local entities located close to large markets such as China and India would be challenged by their local tax authorities on the existence of intangibles. Although there is no easy way to reduce risks posed by challenges presented by local authorities, our experience in Japanese inbound cases indicates that giving higher returns to local distributors, even in a TNMM framework, might reduce some of those risks. Given the OECD’s increased focus on “substance” when undertaking a transfer pricing analysis of intangibles, all multinational enterprises will have to review their ownership structures to determine whether there is adequate capability and authority at the legal owner level (or the controller of DEMPE functions) for the intangibles, and whether all contributions by other entities are sufficiently remunerated.

3 If an entity other than the legal owner of the intangibles performs such control functions of DEMPE functions related to the intangibles, the entity performing control functions should be compensated on an arm’s-length basis.
4 As we have already seen in the draft Chinese rules, functions such as collection and analysis of marketing intelligence, establishment of sales channels, management of customer relationships, and brand promotion activities are referred to as important functions contributing to the value of intangibles.

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