

Intangibles, DEMPE and corporate reorganisations: what to watch out for in transfer pricing

Sponsored by



By *Federico Vincenti, Alessandro Valente* March 17, 2023



Federico Vincenti and Alessandro Valente of Valente Associati GEB Partners/Crowe Valente set out the transfer pricing complexities that can result from different forms of corporate restructuring.

Corporate reorganisation operations are frequently challenged by tax authorities in order to assess their potential tax implications (i.e., exit tax, changes in functional profile impacting transfer pricing policies, configuration of a permanent establishment, etc.).

Indeed, corporate reorganisations may involve the transfer of functions, risks and assets between associated companies and the termination or renegotiation of bilateral agreements, among others.

It is important that agreements relating to the reorganisation or reallocation of economic activities comply with the arm's length principle, if the transfer of functions, assets, risks or a going concern takes place abroad (exit scenarios) or in Italy (entry scenarios).

The reorganisation of multinational groups and changes in integrated business models, even when based on sound economic reasons, often entail the 'difficulty of reasoning' in an arm's length manner (considering the members of the multinational group as independent entities).

Transfer pricing issues

The optimisation of the value chain is one of the main motivations for multinational entities to proceed with a corporate restructuring. Such transactions may give rise to transfer pricing issues, including the following:

- Reallocation of functions, risks and assets between group companies (it is essential to understand the expected new functional role of the companies within the group);
- Redefinition of intercompany flows (functional analysis of the entities involved in each transaction);
- Identification of the transfer pricing method (in the event that the method selected in the pre-reorganisation period does not prove to be the most appropriate for the new circumstances of the case) and its application; and
- Preparation of suitable documentation (transfer pricing documentation illustrating the changes that have occurred in view of the reorganisation, and intercompany agreements relating to the intercompany transactions).

Furthermore, corporate reorganisations often involve the centralisation of intangible assets and risks, and the related potential profit, through the following operations:

- The conversion of fully fledged distributors into limited-risk distributors (i.e., commission agents) for a foreign associated enterprise which can operate as a principal;
- The conversion of fully fledged manufacturers into contract manufacturers for a foreign associated enterprise acting as a principal; or
- The transfer of ownership rights to intangible assets to a centralised entity (i.e., the so-called IP company) within the group.

The last scenario envisages, for example, the transfer of the group's brand by the company that historically owned the intangible to a centralised entity based in a different tax jurisdiction and the continued use of the assets by the transferor in another legal capacity (for example, as a licensee of the transferee or through a contract that includes the possibility of exercising rights over the intangible itself).

In such a case:

- The arm's-length remuneration will have to take into account the significance of the functions performed, the assets used, and the risks assumed by the parties in relation to the intangible asset, and analyse, in particular, the control of the risks borne and functions performed in relation to the development, enhancement, maintenance, protection and exploitation of the intangible asset (DEMPE functions); and
- In the context of the tax audit, the administration will examine the entire commercial agreement between the parties to determine whether the transaction complies with the arm's length principle.

Therefore, the DEMPE analysis will make it possible to assess whether, following the legal transfer of the intangible asset, the transferor has retained control over the DEMPE functions and related risks, or whether the functional profile of the companies involved has also changed as a result of the reorganisation.

Such an analysis – of absolute relevance – should be carried out before the assessment of the transfer pricing policies' compliance with the arm's length principle, for those that were adopted following the reorganisation.

Consider the following example:

- Company A, resident in Italy, transfers its trademark to Company B, resident in a foreign country;
- Company A continues to perform all DEMPE functions with the exception of the legal protection of the trademark, which is performed by Company B;
- Following the transfer of the trademark, Company A pays royalties to Company B for the use of the trademark.

In the above case, Italian tax authorities analysed in detail the royalty transaction between the two companies and deemed the deductibility of the royalty cost incorrect because the DEMPE functions are mainly performed and controlled by the Italian company.

In fact, the payment of the royalty will only be accepted if it can be proven that there is a benefit for the licensee in incurring such cost and if this entity is remunerated for the functions performed and risks assumed.

That said, to define a transfer pricing policy adaptable to the case at hand, it is necessary:

- To perform a detailed analysis of the intangible at stake in the transaction (including brand awareness in the market);
- To perform a detailed DEMPE analysis to understand which entities perform and control the DEMPE functions (and assume the associated risks);
- If a royalty is due, it is necessary to prepare a quantitative analysis to define the arm's length royalty rate, which also takes into account the DEMPE functions performed by the licensee; and
- To evaluate the presence of additional intra-group transactions that may be linked to the exploitation of the intangible asset (for example, the sale of products with the brand name that is the subject of the royalty transaction).

The application of DAC6

From an Italian point of view, the application of the DAC6 legislation to the following transfer pricing cases should be considered:

- The presence of unilateral safe harbours;

- Transfer of hard-to-value intangibles; and
- Transfer of functions, risks and assets.

With reference to the last case, the legislator does not require the reporting of all business restructuring transactions but only those that had a significant effect on the transferor's profit and loss account.

In fact, the following transactions are relevant for DAC6 purposes: transactions for which the annual forecast of the transferor's, or transferors', earnings before interest and taxes (EBIT), in the three-year period following the transfer, is less than 50% of the annual EBIT forecast of the transferor(s) if there was no transfer.

TAGS **SPONSORED** **TRANSFER PRICING** **GLOBAL**

CROWE VALENTE/VALENTE ASSOCIATI GEB PARTNERS



Federico Vincenti

PARTNER Crowe Valente/Valente Associati GEB Partners



Alessandro Valente

LAWYER Valente Associati GEB Partners
