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A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: India and South Korea

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In this article, the sixth 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 India and South Korea. Comments or questions about transfer pricing rules in Korea may be directed to Young-Ho Lee, a partner at KPMG Korea.

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In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing as part of base erosion and profit-shifting actions 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. This article focuses on India and South Korea.[1]

India

The Indian tax authority, also called the Central Board of Direct Taxation (CBDT), applies the transfer pricing rules according to the section(s) 92A-F, Income Tax Act, 1961, and relevant rule(s) 10A-E of the Income Tax Rules, 1962.[2] India is not a member of the OECD, and its transfer pricing rules do not explicitly recognize the direct applicability of the OECD guidelines, meaning domestic regulations take priority. India's laws broadly align with the OECD guidelines, which are often used by the regulators as a reference point on an as-needed basis. Though no updates were made to explicitly incorporate the BEPS guidance, including the control of risk framework or DEMPE, into Indian domestic regulations, many of the concepts around control of risk framework and DEMPE have been included in the tax authority's circulars and in arguments made by the CBDT.

[1] For 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; 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; Julia Bürkle et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Germany, the Netherlands, and Sweden," *Tax Notes Int'l*, June 26, 2023, p. 1743; Carlos Pérez Gómez et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Mexico and Canada," *Tax Notes Int'l*, July 17, 2023, p. 251; and Sophie Lewis et al., "A Global Survey on the Application of the Control of Risk and DEMPE Frameworks: Australia and China," *Tax Notes Int'l*, Aug. 28, 2023, p. 1083.

[2] This section was written in conversation with Priyam Singhania and Kishore Nair of BSR & Co. LLP in India.

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U.N. Developing Country Transfer Pricing

India included some key thoughts on the control of risk framework and DEMPE in the "India — Country Practices" section of the Practical Manual on United Nations Transfer Pricing for Developing Countries.[3] India notes (in the manual) that reviewing the risk assumed (and which entity bears the economic risk) is not an independent element in a transfer pricing analysis but must be analyzed in conjunction with the functions performed and assets employed; meaning that India believes that a transaction must be viewed holistically — not just analyzing which entity funds the project. To analyze which entity controls the risk, it is also important to review core functions, key responsibilities, who is conceptualizing and designing the research, who is monitoring the day-to-day work, key decision-making and levels of individual responsibility for the key decisions. Further, India believes that if an entity performs core functions and makes strategic operational decisions, it controls a substantial portion of the risk.

Circular 3 and Circular 6 — R&D Service Providers

CBDT has been focused on (and will continue to focus on) transfer pricing issues surrounding the large number of foreign parented firms with Indian development/research and development operations.[4] The heart of the debate between the Indian tax authorities and taxpayers is whether those centers are entrepreneurial (and should earn nonroutine returns) or instead limited risk (and should earn routine returns). This focus is present at both the audit level and in mutual agreement and advance pricing procedures.

An amendment to circular 3 released in 2013 clarified the Indian tax authority's position on the factors to be considered to characterize a development center as an R&D service provider bearing limited risk.[5] According to the circular, a limited risk R&D service provider does not assume or have any economically significant realized risks and works under the direct supervision of the foreign principal. In other words, the foreign principal performs most of the economically significant functions and exercises control over the associated risks. Also, the limited risk R&D service provider has no ownership right (legal or economic) on the outcome of the R&D because that ownership is with the foreign principal. However, if the foreign principal is located in a low- or no-tax jurisdiction (a country or territory where the minimum tax is less than 15 percent), CDBT often presumes that the principal would not have the ability to control the risk. However, the taxpayer may be able to rebut this presumption based on the specific facts and circumstances of the case.

Contract R&D Service Provider Controversy

Taxpayers have encountered a number of scenarios in which Indian R&D operations are classified as being a low-end limited risk R&D service provider with the foreign parent reimbursing the Indian affiliate for their costs plus a profit component; however, the CBDT classifies that entity as more than being just a low-end limited risk service provider based on the contractual terms in the intercompany agreement, number of patents registered, activities of the provider, actual conduct of the parties, and so forth.

In one example, an Indian subsidiary of a foreign company was engaged in rendering software development services and information technology enabled services. The Indian subsidiary adopted the transactional net margin method to benchmark its activities based on its classification as a routine low-end software developer engaged in writing and testing codes under the direction of its parent company and charged out its services at a cost-plus markup basis. Further, the intercompany agreement stated that the Indian subsidiary would render services requested and approved in writing by the parent company and the output of the Indian subsidiary's performance of R&D work (if any) would be owned by the parent company.

The Indian tax authority asserted that the taxpayer was providing high-end software development services and, accordingly, rejected

[3] United Nations, "Practical Manual on Transfer Pricing for Developing Countries" (2021).

[4] Amendment of Circular No. 3/2013 — Clarifications on functional profile of development centers engaged in Contract R&D services with insignificant risks — conditions relevant to identify such development centers.

[5] Circular No. 06/2013 [F No. 500/139/2012] (June 29, 2013), an amendment of Circular No. 3/2013 (Mar. 26, 2013).

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most of the comparable companies proposed by the taxpayer. The Indian tax authority introduced new companies to the comparable set that significantly increased the arm's-length range, requiring a transfer pricing adjustment to be made. This case ultimately went to the Indian tax court, which concluded that the subsidiary was a high-end contract R&D service provider that bore limited risk and should be remunerated accordingly. The tax court held that the Indian subsidiary satisfied all the guidelines mentioned in the circular to be characterized as a contract R&D service provider. Of key interest in the court's decision was that all the patents that came out of the contract R&D functions were owned by the United States.

The above provides insights into the Indian tax authority's growing emphasis on determining where the value is created. Multinational enterprises with limited-risk development/R&D operations in India should regularly review the functions performed to understand and confirm actual conduct of the parties, and these functions should be well documented in the intercompany agreements and transfer pricing documentation.

Advertising, Marketing, and Promotion Controversy

The DEMPE framework has also been discussed and relied upon by the Indian tax authorities and courts when considering whether the advertisement, marketing, and promotion (AMP) expenses incurred by the Indian subsidiary to promote brands owned by its parent create a marketing intangible.

For example, an Indian subsidiary of a foreign company was engaged in manufacturing cosmetic products and distributing cosmetic products imported from its group companies. The Indian subsidiary incurred AMP expenses to develop its market and increase sales in India.

The Indian tax authority argued that the Indian subsidiary incurred excessive AMP expense to promote the brand that was owned by the foreign parent. They further considered that because the Indian subsidiary undertook DEMPE functions for its foreign parent, it should have been compensated for the services provided (on a cost-plus basis) and thus proposed a transfer pricing adjustment on that basis.

The case eventually went before the Indian tax court, which determined that the domestic AMP expenses did not necessarily mean that DEMPE functions were present in India and that the marketing intangibles were all owned by the parent. The court further noted that there was no formal arrangement between the taxpayer and its foreign parent for incurring AMP expenses — meaning there was no transaction that required compensation. Also, the mere fact that the Indian subsidiary was permitted to use the brand name of its parent would not automatically lead to an inference that any expense the subsidiary incurred toward AMP was only to enhance the brand of its parent. Based on this conclusion, the Indian tax court withdrew the transfer pricing adjustment.

MNEs with manufacturing/distribution operations in India should review their domestic AMP expenses and, to the extent those are material, be able to demonstrate through documentation whether those spends are routine or nonroutine (like brand-related campaigns or sponsorships). Of note, sometimes the Indian taxing authorities at the lower level may assert AMP expenses incurred by the Indian subsidiary should result in a profit split. MNEs should also ensure that not only the intercompany agreements, invoices, debit notes, and so forth are aligned with the functions, assets, and risks adopted in conducting the comparability analysis but that they also sync up with the actual conduct of the parties involved.

South Korea

The South Korean National Tax Service (NTS) applies the transfer pricing rules according to the Law for Coordination of International Tax Affairs, which was originally enacted on January 1, 1996.[6] South Korea is a member of the OECD, and its domestic legislation has been amended to be mostly consistent with the OECD guidelines. The NTS domestic legislation incorporated changes made under the BEPS guidance, including concepts surrounding the control of risk framework and DEMPE in 2019 when the amendment to the Presidential Enforcement

[6] Tai-Joon Kim, formerly of KPMG Korea.

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Decree and Enforcement Rule to the Law for Coordination of International Tax Affairs was finalized.

Application in an Outbound Context

In practice, the NTS frequently applies their interpretation of the control of risk framework and DEMPE in audits — often performing their own DEMPE analysis to support transfer pricing adjustments. Regarding South Korean headquarter companies, the NTS often asserts that — because of the performance of DEMPE functions — the headquarters should charge a royalty to its subsidiaries. The NTS has made the royalty assertions in terms of technology as well as brand and marketing intangibles.

In one example, a Korean company manufacturing chemical materials set up a Chinese manufacturing operation to expand its sales to the global market, including China, and the Chinese subsidiary purchased semifinished materials from the Korean headquarters in the manufacture of the same chemical materials for sale to the China market. In audit, the NTS noticed that the Chinese entity earned high profit. The NTS asserted that the Korean headquarters performed all the important DEMPE functions developing technology and creating trademark without receiving any payment from the Chinese subsidiary for the use of technology and trademark owned by the Korean headquarters, and the NTS made transfer pricing adjustments accordingly. In this case, the NTS thoroughly reviewed why the Chinese entity earned such a high profit in terms of its low functional/risk profile and how the Korean headquarters supported the Chinese entity based on its DEMPE analysis.

In another audit case, the NTS asserted that a South Korean-headquartered food and beverage company should have charged a royalty to overseas manufacturing subsidiaries based on a NTS-performed DEMPE analysis. The NTS focused on the R&D activities performed by the parent and noted that the charge-out for certain technical services to overseas manufacturers was insufficient based on the value provided. The taxpayer performed their own DEMPE analysis, rebutted the NTS claims, and argued that the technical service charge was sufficient. Ultimately the taxpayer and NTS agreed that a royalty was appropriate but that it should be reduced by the technical services payment.

In another example, in audit, the NTS challenged that no royalty was paid by affiliates of a Korea-headquartered television parts company that manufactured and shipped products to related parties abroad. The NTS argued that the subsidiaries were using valuable intangible property developed in Korea. In this case, the taxpayer performed its own DEMPE analysis that demonstrated that the historical R&D performed by the Korean headquarters was obsolete, that there were no valid patents, and that the headquarters no longer performed R&D. The NTS withdrew their adjustment.

Application in an Inbound Context

For inbound distributors, the NTS frequently considers DEMPE in terms of exploitation to understand if marketing activities in-country rise to the level of requiring nonroutine returns. Accordingly, the NTS tends to target limited risk distributors that incur significant advertising and marketing expenses with moderate profitability and assert that these local marketing activities may assist the intellectual property owner to develop local marketing intangibles.

In one example, in audit, a local distributor (a Korean subsidiary) importing toys for resale to the Korean market had a difficult time demonstrating to the NTS that, as the limited risk distributor, the local entity did not bear any significant business risk although it incurred significant marketing spending. The NTS asserted their strong belief that performing these marketing functions meant the entity bore significant risk. For this reason, the NTS aggressively challenged which party controlled the risk and requested the local distributor to submit very detailed information on who develops the global and local marketing plans and strategies, the detailed DEMPE roles for employees at the global headquarters, how the global approval process for each marketing budget was conducted, whether the local distributor decided how local marketing expenses were made, and whether the local distributors had specific marketing/sales teams for local needs. The audit was scheduled to end within

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three months, but the audit period was extended by an additional three months. During the audit, the company provided detailed explanations about the marketing efforts made and advertising plans/brand development strategies developed by the foreign headquarters. While the NTS ultimately accepted that the entity was low risk, the audit process was challenging because it took significant time and effort to gather information from global headquarters and persuade the NTS about the reasonableness of the global headquarter functions.

In another example, in audit, the NTS noted that the Korean subsidiary who distributed home repair tools incurred significant advertising expenditure to make the brand well-known in the Korean market as part of the locally developed marketing plans. Based on its DEMPE analysis, the NTS asserted that the local distributor performed valuable marketing activities in excess of a limited risk distributor (for example, facilitating brand advertisement on the top of the backboard in the baseball stadium) and argued that these advertisements were for brand awareness, not for the promotion of goods in Korea, meaning these advertising expenses should be borne by the global brand owner. Eventually, the local distributor agreed with the NTS position, and a transfer pricing adjustment was made accordingly.

When South Korean manufacturers remit royalties abroad, the NTS often uses DEMPE to argue that royalty rates should be lower or are inappropriate. In some audit cases, taxpayers in South Korea have proactively used the DEMPE concepts to rebut NTS adjustments.

In one example, in which the NTS looked at DEMPE concepts, a South Korean subsidiary of a global gaming company performed promotion and marketing services of video games and support activities for game users located in South Korea. Given its limited functional profile, the South Korean subsidiary was remunerated on a cost-plus basis. At the audit level, the NTS asserted a deemed permanent establishment because the South Korean subsidiary performed important and significant functions for the group's global value chain. In this case, the NTS considered the South Korean subsidiary to be an independent game distributor rather than a limited-risk entity and proposed a large tax assessment calculated on both a revenue-based commission scheme and the profit split method. The taxpayer was able to effectively demonstrate the soundness of the South Korean subsidiary's current transfer pricing policy by emphasizing the critical R&D (and DEMPE functions) undertaken by the foreign parent. The NTS accepted this argument and removed their proposed adjustment.

In the gaming industry,[7] the NTS often expects the taxpayer to use a profit-split method using a DEMPE analysis to allocate profits between the global game developer and the affiliate game publisher.[8] ■

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[7]Game developers are responsible for computer programming and designing game characters, and they actually develop the game, whereas game publishers take care of marketing, distribution, and strategic decision-making for the sale of the game in the market.

[8]The following 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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