



UNIVERSIDADE CATÓLICA PORTUGUESA

Intangible-related profit allocation:

**Increasing the resilience of
tax systems against BEPS**

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Master in Law

Law School of the Portuguese Catholic

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**To my parents, my sister Beatriz,
and Rudy**

“A better understanding of how BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments.”

OECD, BEPS Actions 8-10, 2015 Final Reports

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To God, for the opportunity and wisdom granted to me.

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Resumo

As mudanças introduzidas nas Diretrizes de Preços de Transferência em 2017 introduziram o acrónimo DEMPE no âmbito das regras de atribuição de lucro derivado da exploração de um intangível. DEMPE significa desenvolvimento, aperfeiçoamento, manutenção, proteção e exploração de um intangível. Trata-se de um dos acrónimos mais debatidos tanto na academia como nas sociedades de advogados e consultoras que se dedicam à temática dos preços de transferência, tendo ganho destaque também entre as autoridades fiscais. O presente estudo versa sobre as funções DEMPE e sua aplicação prática na alocação de lucros relativamente as transações entre multinacionais que envolvam intangíveis. Numa primeira fase, faremos uma contextualização do acrónimo DEMPE, procurando esclarecer o seu sentido, conteúdo e alcance e abordar os impactos do mesmo, particularmente em tempos de desaceleração económica. Seguidamente, percorreremos os seis passos da análise de uma transação envolvendo intangíveis. Os desafios que emergem na aplicação prática do acrónimo supramencionado serão clarificados ao longo da presente dissertação, através da citação de diferentes posições doutrinárias, apontando para as posições que nos afiguram mais sustentáveis. A presente pesquisa tem por objetivo responder à seguinte questão: Como imputar os lucros imputáveis a intangíveis de um modo que aumente a resiliência dos sistemas tributários domésticos contra o BEPS?

Palavras-Chave

Preços de transferência, Transações envolvendo intangíveis, Funções DEMPE, Alocação de Lucros, Criação de Valor.

Abstract

The changes introduced to the Transfer Pricing Guidelines in 2017 encompassed the DEMPE acronym into the scope of the rules for attributing profit derived from the exploitation of an intangible asset. DEMPE means development, enhancement, maintenance, protection, and exploitation of an intangible. It is one of the most discussed acronyms both in academia, law offices and consulting firms dealing with transfer pricing issues and has also gained prominence among tax authorities. The present study deals with the DEMPE functions and their practical application in the allocation of profits in relation to transactions among multinational enterprises that involve intangibles. In a first phase, we will contextualise the DEMPE acronym, seeking to clarify its meaning, content, and scope as well as to address its impacts, particularly in times of economic downturn. Next, we will go through the six-step analysis of a transaction involving intangibles. The challenges that emerge in the practical application of the acronym mentioned above will be clarified throughout this dissertation through the enumeration of different doctrinal positions, pointing to the positions that seem more sustainable to us. This research aims to answer the following question: How to input profits attributable to intangibles to increase the resilience of domestic tax systems against BEPS?

Keywords

Transfer pricing, Transactions involving Intangibles, DEMPE functions, Profit Allocation, Value Creation.

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Acronyms

AL	Arm's Length
ALP	Arm's Length Principle
BEPS	Base Erosion and Profit Shifting
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
FAR	Functions performed, Assets used, and Risks assumed
IP	Intangible Property
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD MTC	OECD Model Tax Convention
PCA	Process Contribution Analysis
PE	Permanent Establishment
PoEM	Place of Effective Management
RACI	Responsible, Accountable, Consulted and Informed
R&D	Research and Development
TP	Transfer Pricing
TPG	Transfer Pricing Guidelines
TPSM	Transactional Profit Split Method
VCA	Value Chain Analysis
UN	United Nations

1. Introduction

Multinational groups aim at being lucrative. They produce and commercialise products and services worldwide, exploiting each jurisdiction's comparative advantages at different levels.

The sales that a group entity obtains in a certain jurisdiction require efforts and investments that may be performed by other group entities located in a different jurisdiction. Such different taxable entities, although placed in different countries, are part of the same economic group and have the same interests. This may lead them to – contractually – agree on prices which would not be those that independent parties would agree to and, consequently, distort the allocation of the MNE's taxable base across the globe.

This practice has become a huge concern to tax authorities, which have been facing a set of increasingly more sophisticated cross-border transactions between associated entities, especially given to the advances in technology. Those transactions aim at maximising profit and may lead to erosion of tax bases and to the (artificial) shifting of profits to low or non-tax jurisdictions. Consequently, it has been internationally recognised the relevance of transfer pricing rules and of their continuous enhancement.

Tackling base erosion and profit shifting caused by multinational groups was, and has been for a couple of years, the key topic on the international tax policy agenda. The OECD has performed extremely significant work seeking to address the issue, particularly through the publication of the BEPS 15 Actions Project. Currently, the same concerns lead to the development of the so-called Pillar One (aiming at the introduction of a global minimum tax rate on corporate profits of large MNEs), and Pillar Two (focusing on the reallocation of profits - and in turn, taxes - from where economic activities are conducted to where the markets/customers are).

In this context, special attention should be given to intangible assets. Transfer pricing has been in the foreground of international tax issues in the last two decades, particularly due to the increase in the relevance of intangibles in the global economy. The “new economy” of the 21st century has seen business enterprises, especially associated entities, divesting themselves from tangible assets and turning to intangible assets. This is done to enhance their

position in a world focused on technological innovation.¹

Intangible assets are often the most expensive assets to deal with, and their valuation is frequently extremely difficult to assess. That is due to an obvious reason: as they have no physical form, they cannot be simply or easily converted into cash. Besides that, misallocation of the profits generated by valuable intangibles has heavily contributed to base erosion and profit shifting. The main challenge has been establishing the best way to determine the fair share of profit allocation deriving from the real performance of functions related to intangibles.

In order to address that challenge, the OECD proposed in 2015, through the publication of Actions 8-10, the DEMPE acronym. DEMPE stands for development, enhancement, maintenance, protection, and exploitation of an intangible. It was proposed as part of the solution to allocate remuneration (and taxation) to the place where value is created.

Several scholars and practitioners have different views on the interpretation and on the value of the guidance provided by the OECD on DEMPE, often with a view that diverges from the Organisation's intentions but also raises some critics related to it.

Departing from such divergent interpretations, this dissertation proposes to analyse and, as far as possible, clarify and eventually suggest solutions by pointing to the positions that seem more sustainable in the doctrine. The research question of this thesis could be summarised in the following sentence: How to input profits attributable to intangibles in a way that increases the resilience of domestic tax systems against BEPS?

The present study is structured in three parts.

The first part provides an overview of the historical context of the DEMPE acronym, starting with a brief contextualisation of the intangibles and their increasing relevance, going through the DEMPE's advent and objectives, also covering its impact on the beneficial owner concept. In addition, it brings a definition to each of the DEMPE functions, reflected in a practical scenario through a case study. Finally, it addresses the impact of times of economic downturn, especially the COVID-19 pandemic, on transfer pricing of intangibles to acknowledge the recent developments by the OECD on this matter. This part of the work also aims at understanding whether the economic crisis can trigger the existence of a permanent

¹ Ayeni E. (2020), *Transfer Pricing of Intangibles: Empirical Study of Transfer Pricing and the Intangibles: Why Tax Authorities must look beyond methodology*, chapter two, PhD.

establishment (PE) or a change of the company tax residence by virtue of the displacement of employees to “home offices”.

The second part dedicates to the study of the OECD’s six steps for analysing transactions involving intangibles, providing an explanation for each of them.

The third part of this dissertation focuses on raising the key challenges and issues emerging in the practical application of DEMPE, elucidating different views and understandings found in the doctrine, also caused by different interpretations of the OECD standards on how intangible transactions should be evaluated.

Lastly, the second part of chapter four seeks to address each of the highlighted issues, trying to find ways that facilitate the application of the DEMPE acronym so intangible-related profits are allocated among multinational groups in a way that increases the resilience of tax systems against BEPS.

2. DEMPE Functions

2.1 Contextualisation

All over the world, German bread is valued for its unique diversity. The knowledge of raw materials, baking procedures and the awareness of tradition is passed on from generation to generation by the master and journeymen to the apprentice. In the baking craft, centuries-old traditions are united with the latest insights and practices.

UNESCO, Inventory of *Intangible* Cultural Heritage for Germany²

If one assesses these bread (commercial) transactions seriously, one shall conclude that along the transaction of the bread itself, one has also to consider the baking techniques, the recipes, and the knowledge altogether. The traditional bakeries profit from their long traditions and expertise and, therefore, benefit from the existence of valuable intangibles.³

That finding applies not only to bread (or to the traditional bakeries) but also to the multinationals that trust in valuable intangibles as sources of a sustainable profit and of a market share. Thus, the value of several MNEs has been increasingly attributed to the ownership and exploitation of brands, patents, know-how, and trademarks, for instance. For that reason, the importance of intangible assets within the global economy has significantly

² UNESCO (2014), *Nationwide Inventory Of Intangible Cultural Heritage For Germany*.

³ H Bjorn H. et al. (2021), *Intangibles in the world of transfer pricing: Identifying - Valuing – Implementing* (English Edition), (1st ed. Springer).

grown.

The increasing relevance of intangibles from a business perspective has resulted in a growing focus on intangibles in the world of transfer pricing. This has been one of the main topics on the agenda of international tax organisations such as the OECD, the UN, and of many governments.

At the OECD level, it has been discussed whether the concept of intangibles should be interpreted broadly or narrowly. This discussion lasted for many years, and the most important development in this area was the acronym proposed in 2015 with the BEPS Action Plans 8-10.⁴ Here, intangibles were defined as all non-physical or financial assets that are capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated in a transaction between independent parties in comparable circumstances⁵, irrespective of whether they are subject to legal registration or protection, or regardless of whether they are classified as an intangible for accounting purposes. Therefore, a definition was introduced deriving directly from the arm's length principle and its 'comparability' nature.

The previous versions of the TPG contained a quite limited indication of specific items being classified and exemplified as intangibles. The later edition made it broader and no longer divided them into categories such as trade and marketing intangibles. Instead, it illustrated what items are usually considered in a TP analysis involving intangibles. It also amplified the definition and considered concepts such as goodwill and ongoing concern value that may or not constitute an intangible, as well as group synergies and market-specific characteristics that were clearly defined as not constituting intangibles. Besides that, the new version made it clear that the definition of intangibles, as predicted therein, is only relevant for the purposes of transfer pricing (not for accounting purposes).⁶

The 2017 version of the TPG not only updated the intangibles definitions but also introduced the DEMPE functions acronym. In order to discuss this new feature, it is first necessary to understand the context in which it was introduced.

⁴ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

⁵ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, paragraph 6.6.

⁶ Dziwinski K. (2022), *The DEMPE Concept and Intangibles: Definition, Practical Approach and Analysis in the Context of Licence Model*, (Wolters Kluwer), paragraph 1.6.2.3 and supra n. 4, paragraph 9.55.

Previously, the TPG were commonly misinterpreted as indicating that the legal owner of an intangible asset should be entitled to all the returns from its exploitation, even if associated parties performed functions or assumed risks related to it. Such interpretation allowed situations where a “shell company”, the legal owner of an intangible, located in a tax haven but with no employees undertaking activities or taking significant decisions, would be allocated with all the profits related to that intangible.

This is because intangibles are, by definition, mobile. Therefore, they may lead to a misallocation of profits and, thus, to base erosion and profit shifting.⁷

Tax Authorities raised their voices and expressed their concerns about structures in which MNEs would artificially shift their income to low-tax jurisdictions. The OECD addressed this phenomenon directly by identifying the BEPS issues arising from such transactions.

As mentioned above, as part of the OECD/G20 BEPS Project⁸, the DEMPE acronym was introduced in the final Actions 8-10 Reports⁹, released in October 2015. More specifically, it aims at differentiating legal ownership of intangible assets from the appropriate remuneration due to the contributions to an intangible, regardless of whether they are made by the legal owner or by others. This is because several entities (beyond the legal owner in the group) may, and often are, involved in the creation of value of an intangible. They may have performed functions, assumed control over the risks, and had financial capacity in connection with the key DEMPE functions.

In other words, DEMPE was designed to provide both taxpayers and tax authorities with an accurate assessment of the transactions, being this analysis a step to identify the ideal remuneration of each entity based on their relative contributions in earning the profit. The relative value of each party’s contribution to the achievement of profit is based on the functions performed, the risks assumed, and the resources employed in the business activity that contributes to the generation of profits.

In particular, in order to provide guidance on determining the pricing in accordance with the actual conduct of related parties, one of the most significant developments was to ensure

⁷ OECD (2015), Actions 8-10, *Transfer Pricing*.

⁸ OECD (2016), *BEPS Project Explanatory Statement: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

⁹ *Supra* n.4.

that the legal ownership of an intangible by an associated enterprise itself is not determinative to retain the full amount of intangible-related profits.

Specifically, in terms of ownership, the BEPS Actions 8-10 state that only where no legal owner is identified (under applicable law or contracts) will the member of the MNE group that controls decisions regarding the exploitation of intangible and that has the practical capacity to restrict others from their usage be considered the legal owner of such intangibles for transfer pricing purposes.¹⁰ The legal owner of intangibles will be entitled to retain all *ex ante* returns derived from the exploitation of such intangibles only if it: Performs and controls all of the DEMPE functions; provides all assets necessary for the DEMPE functions; and assumes all risks related to the DEMPE functions.¹¹

Such emphasis on the functional value creation does not mean that the legal owner must perform all the DEMPE functions on its own to be entitled to all (or portion) of the return derived by an MNE group from the exploitation of intangibles. However, it is expected that the legal owner is able to exercise control over the risks and has the financial capacity to undertake the related risks.¹²

2.2 Defining DEMPE Functions

2.2.1 Introduction and case study

Depending on each industry and its activities, some functions may be more important than others. Following this line of thinking, the OECD's list of functions related to the intangibles is decisive in the ultimate allocation of intangible-related returns.¹³

It is worth analysing each of the DEMPE functions separately. To better acknowledge its meaning and objectives, the author provides below a detailed explanation based on a practical case scenario.¹⁴

Consider the following illustration. A premium Turkish tea company has entities in

¹⁰ Pankiv M. (2016), *Post-BEPS Application of the Arm's Length Principle to Intangibles Structures*, 23 Intl. Transfer Pricing J. 6, (IBFD), paragraph 2.2.2, and also supra n. 5, paragraph 6.40.

¹¹ Supra n. 4 p 84; supra n. 5 paragraph 6.71 and supra n. 10.

¹² Idem.

¹³ Supra n. 5, paragraph 6.32.

¹⁴ The case study is inspired by Kestutis R. (2018), *DEMPE explained*.

Turkey, France and Portugal. The group produces blended black tea. The Turkish entity was responsible for the development of the brand GoldÇay, being the owner of it. The Turkish entity also purchases the machinery and acquires the area licenses that are needed for tea cultivation. The French entity then blends the black tea to the highest standards in France, which entails using extensive proprietary know-how to mix the various teas to blend with the unique tastes appreciated by the customers of the GoldÇay group. The French entity also packages and distributes the black tea and put in place a new website where the clients can access and place their orders. The brand stands out in the market through its website for its excellent customer service and support. In the meantime, the Portuguese entity is in charge of updating and revising the information available on the website, as well as marketing it, in order to reach a greater number of customers.

Therefore, different DEMPE functions are performed by the Turkish, French and Portuguese entities, each contributing to the value of the GoldÇay group brand.

2.2.2 Development

The development of an intangible relates to the creation of ideas for the brand and products, and putting them in place.¹⁵ In the present case, several different ideas were put in place for the creation of the GoldÇay brand by the Turkish entity. Each entity was responsible for several parts of the development process. For instance, the Turkish company was responsible for the first brand development. At the same time, the French entity established quality standards for the customer services and support by setting up an online sales process, which refined the client experience on the website. In the same way, the Portuguese entity played a key role in establishing marketing strategies for improving brand visibility.

2.2.3 Enhancement

The enhancement consists on the continuing work on aspects of the intangibles and ensure that it will be constantly improved.¹⁶ The enhancement was split mainly between the French and Portuguese entities in the practical case. The French entity contributed to enhancing the brand's image in the market by improving the client shopping experience, while the Portuguese entity enhanced brand recognition by adopting advertising campaigns.

2.2.4 Maintenance

¹⁵ Idem.

¹⁶ Idem.

The maintenance of an intangible involves making all possible efforts to assure that the intangible will continue to perform accordingly and will be able to generate revenue for the business.¹⁷ The case scenario contemplates the maintenance through the effort of ensuring that the customers were satisfied with the service and with the extremely high quality of the brand product. Most of the maintenance function was performed by the French entity, which is responsible for creating a great relationship with the clients by monitoring their satisfaction in after-sale calls and for ensuring quality control. The French entity guaranteed that the shopping experience was unique. The Turkish entity was responsible for maintaining the brand's legal license agreements. The Portuguese entity kept on promoting and monitoring the brand's well-being but also performed constant updates on the platform.

2.2.5 Protection

Brand protection is relevant to assure that the value of the brand's assets remains strong. It involves securing IP legal rights, ensuring nobody can copy the ideas, and monitoring competitors' activities.¹⁸ The protection of GoldÇay's brand was essentially performed by the Turkish and the French enterprises. The Turkish entity was in charge of enforcing brand protection, legally registering the brand (through trademark), and granting the brand license to the other group entities. The French entity protected the brand reputation by creating online customer service systems and tracking the competition, whereas also dealing with patenting the business' blending know-how and ensuring client privacy protection.

2.2.6 Exploitation

Lastly, the exploitation of an intangible refers to how it is used to generate profits.¹⁹ For the case at hand, the main entities responsible for the brand's exploitation were the French and the Portuguese entities, which were: inserting the brand into the market, making a connection with customers and helping them benefit from the products, but also marketing the brand.

2.2.7 Concluding remarks

The practical case shows that the three entities added value to the brand differently.

In a pre-BEPS context, one could interpret that all the residual profits created from the

¹⁷ Idem.

¹⁸ Idem.

¹⁹ Idem.

activities performed in relation to the intangible would be allocated to the Turkish entity as the legal owner of the brand.

With the implementation of DEMPE, each entity performing functions related to the development, enhancement, maintenance, protection, and/or exploitation of the intangible will be entitled to receive a proportional share of the residual profits.²⁰

The OECD still outlines that, in considering the AL compensation for functional contributions of different entities of the group, specific functions arising from the DEMPE acronym will have a special significance, such as the direction of and establishing priorities for creative undertakings, including determining the course of “blue-sky” research; control over strategic decisions regarding intangible development programmes; design and control of research and marketing programs; management and control of budgets; conducting ongoing quality control over functions performed by independent or associated enterprises that may have material effects on the value of an intangible; and making important decisions regarding defence and protection of intangibles.²¹ Nevertheless, each situation is particular and is subject to a case-by-case analysis before deciding what the important functions are.

Although the DEMPE acronym seems to be purely related to the performance of functions, it also reflects the employment of assets and assumptions of risks.²² The guidelines provide that entities physically performing a full set of DEMPE functions and assuming the DEMPE-related risks will undoubtedly be entitled to a full (or predominant) amount of returns.

In contrast, the guidelines ensure that bearing branding-related costs does not, in itself, create an entitlement to intangible-related returns²³. However, it is important that the party entitled to the returns bears the corresponding costs. If the party bears only intangible-related costs but does not perform or control important functions or does not control important risks associated with the funding activities, it will only be remunerated restrictively and not in the same way as the parties that do the full scope.²⁴

2.3 Impact in Times of Economic Downturn

Not for the first time in history, the markets, tax administrations, and especially MNE

²⁰ Idem.

²¹ Supra n. 5, paragraph 6.56.

²² Supra n. 5, paragraph 6.32.

²³ Supra n. 5, paragraph 6.59.

²⁴ Idem.

groups are significantly affected by an economic crisis. The Covid-19 pandemic and other recent developments brought, among other consequences, the decrease in client demand, interruptions in supply chains, and uncertainty and volatility in financial markets. Such circumstances have also drastically affected the way companies do business. Multinational enterprises were obliged to restructure their supply chains and to implement modifications to assure the sustainability of their business. Moreover, investments in innovations and in patenting have decreased, while debt and risk levels have risen substantially.²⁵

Whereas several experts have considered how Covid-19 affected the profitability of entities member of a MNE group, the true consequences will reach much further. This is because all these transformations will have a long-term effect as the transfer pricing analyses for 2020 and the years to come will be impacted by these new circumstances.²⁶

This chapter analyses the impact of the Covid-19 crisis on transfer pricing of intangibles. It will take into account OECD's guidance on this matter. It is worth noting that a transfer pricing analysis is an "all facts and circumstances analysis"; therefore, a change in the facts also changes the analysis.²⁷

One of the first and biggest impacts caused by the COVID-19 pandemic is the fact that MNE's employees have been forced to work from their homes, initially due to closed offices and travel restrictions, which in several cases did not correspond with the company's tax residence country. This resulted in functions (comprising DEMPE functions) being performed in a different jurisdiction.²⁸ For the purposes of this thesis, this matters as employees may perform functions related to intangibles.

This condition raises some questions from a tax perspective, including, for instance, whether such functions, now performed in a different country, trigger the existence of permanent establishment (PE). Questions are also raised when that leads to a change of the company tax residence by virtue of the displacement of the company's "place of effective management" (PoEM).²⁹ Both mentioned scenarios lead to serious tax consequences, as a PE

²⁵ Petruzzi R. (2020), *Dealing at Arm's Length in Times of Social Distance: A Case Study*, (Tax Notes).

²⁶ S. Prasanna & G. Capristano Cardoso (2020), *Developing a Transfer Pricing Policy Framework for the Current Economic Crisis and Beyond*, 27 Intl. Transfer Pricing J. 5, (IBFD).

²⁷ J. García Berdonce, V. Chand & X. Ditz (2021), *Answering Eight Key Questions about Transfer Pricing during the COVID-19 Era*, 28 Intl. Transfer Pricing J. 4, (IBFD), p. 215.

²⁸ M. Martin, M. Horowitz & T. Bettge (2020), *INSIGHT: Transfer Pricing Substance in Flux—DEMPE, BEPS 2.0, and Covid-19*, Bloomberg Tax (31 July).

²⁹ Criteria widely used, particularly in civil law jurisdictions and main criteria used in bilateral tax treaties (patterned under the OECD MC) for the tie-break of companies with double residence. One should note that,

would allow the State of its location to tax all profits attributable to it, whereas the shift of the company's tax residence would allow worldwide taxation in that State.

The OECD clarified its understanding of these issues in the note "*Analysis of Tax Treaties and the Impact of the Covid-19 Crisis*".³⁰ In an attempt not to break with the existing rules, this note refers extensively to guidance already included in the 2014 and 2017 versions of the commentaries to the OECD model – and tries to explain how that guidance applies to this new scenario.³¹

Regarding the impact of Covid-19 on the creation of PEs, it is important to analyse which entities of the group perform DEMPE functions and assume the relevant economic risks related to the intangibles – in order to determine the intangible's correct remuneration and allocation.

Let us focus on the following example: Before Covid-19, a key employee was responsible for exploiting a certain intangible and performed such function in the entity's office in South Africa. Due to the pandemic, the employee moved close to his family and now works from his home office in Spain. In this case, there should be no fundamental impact on the group's functional analysis. Although the employee would perform DEMPE functions in a different part of the world, he would still be working on behalf of the entity that performs the DEMPE functions, regardless of his remote location. This employee could, however, trigger a PE risk for their employer, but the OECD has clarified that such risks are minimal, in several circumstances, for employees working from home.³² Accordingly, the pricing and allocation of an intangible would not change.

Contrastingly, in cases where the business has been restructured, and another entity of the group (located in a different jurisdiction) is now performing a specific DEMPE function as a result of the Covid-19 pandemic, proper corrections to the transfer pricing documents and intra-group contracts are needed. Consequently, the profits (and costs) resulting from the DEMPE functions must be allocated to the entity actually performing such functions and assuming the corresponding risks within the group.³³

after 2017, the OECD formula additionally requires a mutual agreement procedure between the competent authorities of the involved contracting States.

³⁰ OECD (2020), *Secretariat Analysis of Tax Treaties and the Impact of the COVID 19 Crisis*.

³¹ OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, OECD, Paris.

³² OECD (2021), *Updated guidance on tax treaties and the impact of the COVID-19 pandemic*, paragraphs. 14-19 OECD, Paris, and supra n. 26.

³³ Supra n. 26, p. 335.

The determination of the intangible remuneration must follow the proper application of the Arm's Length Principle (ALP), regardless of whether the DEMPE functions are now performed elsewhere. In case where a PE has been considered, either due to (i) the (new) physical location of the employees of the original responsible entity, or (ii) further elapse of time of presence of the employee in the other Contracting State; the profits assigned to the PE should also take into consideration the remuneration of the DEMPE functions performed in the PE state.³⁴

Furthermore, in Covid or post-Covid landscape, certain MNEs may not find it worth to continue putting effort into additional research and development (R&D) activities (as it generally involves bearing a high cost without a guarantee of an effective return compensating said cost). Therefore, they may only engage in routine research and development required to continue with the business activities.³⁵

In these cases, there may be a revision of the entities performing DEMPE functions and their contributions to functions related to the group's intangibles. As stated by the OECD TPG, determining which entities are performing DEMPE functions allows acknowledging the contributions of each one and, therefore, determining which are entitled to the returns from intangible's exploitation.

Finally, another significant impact of COVID-19 involving intangibles relates to the increase in digitalisation. The rendering of digital services and replacing people with newly created IPs. Such innovations require MNEs to review their intangible policies with adequate record keeping, allowing the recognition of the DEMPE functions performed by the various entities of the group.³⁶

3. Analysis of a Transaction Involving Intangibles and the Assessment of Intangible-Related Contributions

3.1 Introduction

As previously explained, Actions 8-10 of BEPS require that all the members of an MNE

³⁴ Idem.

³⁵ RSM (2020), White Paper: *Analysis of Impact of COVID-19 on Transfer Pricing* (27 April).

³⁶ Supra n. 27, p. 227.

group receive appropriate compensation for any functions performed, assets used or risks assumed in connection with the development, enhancement, maintenance, protection and/or exploitation of intangibles. The actions mentioned above highlight that the MNE must determine, by means of a functional analysis, which group constituents perform – and exercise control over – the DEMPE functions. The MNE should also determine which entities provide funding and other assets and which members assume the various risks associated with the intangible. Regardless of whether the identified group constituents are the legal owners of the intangible.³⁷

The above-referred actions provide three concepts for the analytical framework in which it is established, namely (i) the taxpayer’s contractual arrangements, (ii) the legal ownership of intangibles and (iii) the conduct of the parties.³⁸ As with any other transaction, the analysis of a transaction involving intangibles must consider all relevant facts and circumstances, and price determination must reflect the realist alternatives of the relevant group members.³⁹

The TP intangible analysis requires an “extensive risk analysis”, which is explicitly identified at the beginning of chapter VI of the TPG as one of the key elements for TP transactions involving the use or transfer of intangibles. It is worth noting that previously, the risk analysis was mostly used in business restructurings.⁴⁰

3.2 The six-steps analysis

The OECD’s six steps for analysing a transaction involving intangibles, and briefly explained below and are as follows: i) identifying the intangibles and the risks within a particular transaction; ii) identifying the contractual arrangements relating to the transaction under analysis; iii) identifying which parties performed DEMPE functions, by means of a functional analysis; iv) determining whether the conduct of the parties was consistent with the contractual assumption of risk; v) delineating the actual controlled⁴¹ transactions relating to DEMPE; and vi) determining the ALP for the transactions.

3.2.1 Identifying the intangibles and the specific economically significant risks

³⁷ Supra n. 5, paragraph 6.48.

³⁸ Also provided by the 2017 TPG, paragraph 6.34.

³⁹ Supra n. 5, paragraph 6.43.

⁴⁰ Supra n. 5, chapter IX.

⁴¹ Controlled transaction means a transaction that takes place between associated enterprises (or related entities/parties). Uncontrolled transaction means a transaction that takes place between independent enterprises (or unrelated entities/parties).

Given that intangible assets contribute to the profit generation in intra-group transactions, any analysis of associated entities' transactions involving intangible assets must start by precisely identifying the assets being used or transferred in the transaction. This step should be carried out "with accuracy", and the definition of an intangible should be precise, as: i) on the one hand, interpreting a too broad definition could require acknowledging a compensation where no compensation would have been accepted between unrelated parties, and; ii) on the other hand, a too narrow definition could lead to the transfer or use of intangibles without compensation, when such use or transfer would have given rise to compensation in transactions between unrelated parties.⁴²

The first step also requires the identification of "specific, economically significant risks" associated with DEMPE in the transaction. The guidelines define 'risk' as the effect of uncertainty on the objectives of the business.⁴³

3.2.2 Identifying the contractual arrangements

As a second step, one should identify the contractual agreements regarding to the transaction under analysis. The TPG provides that written contracts for controlled transactions "reflect the intention of the parties at the time of the contract, including (...) the division of responsibilities, obligations and rights, assumption of identified risks, and pricing arrangements".⁴⁴ Furthermore, the guidelines require placing a special emphasis on determining the legal ownership of intangibles based on the terms and conditions established in legal arrangements, such as relevant registrations, license agreements, other contracts or any other indicia of legal ownership.⁴⁵ Once identified the legal owner of an intangible, any license relating to it will be considered different intangible for TP purposes, each having a different owner.⁴⁶

3.2.3 Functional analysis: functions, assets and risks

The third step concerns the functional analysis and aims to identify which parties performed functions, used assets and managed risks relating to the DEMPE within the controlled transaction. A group should determine which entities control any outsourced

⁴² Kestutis R. (2017), *DEMPE: Six steps for analysing transactions involving intangibles*; and supra n.5, paragraph 6.5 and 6.34.

⁴³ Idem and supra n. 5, paragraph 1.71.

⁴⁴ Supra n. 42 and n. 5, paragraph 1.42.

⁴⁵ Supra n. 42 and n. 5, paragraph 6.34. More detail on the identification of an ownership provided in the Section B.1.

⁴⁶ Supra n. 42 and n. 5, paragraph 6.41.

functions and control specific and economically significant risks. One of the core tasks is compensation, with a fair share of returns, the entities performing specific functions that significantly impact the value of the intangible. When such functions are outsourced by the legal owner to a related party, such party is entitled to obtain the respective returns gained from the intangible's exploitation. The functional analysis is therefore critical to identify the relevant intangibles, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed, and the specific risks assumed in connection with the DEMPE process of the intangibles.

3.2.4 Comparing the real conduct of the parties with contractual terms

In the fourth step, the real conduct of the parties should be analysed. The groups should assess whether the terms provided in the contractual arrangements (step 2) are consistent with the real conduct of the relevant parties. Also, it should examine how the responsibilities, risks and anticipated outcomes arising from the parties' interaction were intended to be divided at the time of contracting.⁴⁷ The objective of this step is to determine whether the parties that contractually assumed economically significant risks, actually control the risks and are financially able to assume the risks relating to DEMPE. When the parties comply with their contractual commitments and the real conduct is consistent with the terms provided in the contract, then the delineated transaction can be priced to correctly compensate for risk management functions (as step 6). When the party that commits to assume a specific risk does not actually control the risks, nor have the financial capacity to control it, then the risk must be allocated to the entity that does, as stated above.⁴⁸

3.2.5 Delineating the controlled transaction

The fifth step of the TP analysis involving intangibles is the so-called “delineation of the actual controlled transaction related to the legal ownership and DEMPE of intangibles” or “risk analysis”. It should be performed by considering control over risk and the financial capacity to assume the risk.⁴⁹ This approach is aligned with the (longstanding) recognition by the OECD TP Guidelines that a party assuming greater risk in a specific transaction shall be entitled to higher returns as compensation for assuming those risks.

The determination of which party assumes the risks shall be performed in line with what

⁴⁷ Supra n. 42 and n. 5, paragraph 1.42.

⁴⁸ Supra n. 42 and n. 5, Section D.1.2.1.5.

⁴⁹ Supra n. 42 and n. 5, paragraph 1.2.1.

is provided in Chapter I of the 2017 TPG⁵⁰ (regarding handling risk analysis in commercial or financial relations, as this guidance is not specific to any particular industry or sector).⁵¹ As set out in the guidance, six steps should be followed in order to determine the correct allocation of risk in a controlled transaction, which are: i) identification of the economically significant risks; ii) determination of how the parties assume those risks under the contractual terms of the transaction; iii) functional analysis to determine how associated entities operate in relation to those risks; iv) determination of whether the contractual assumption of those risks is consistent with the conduct of the associated enterprises; v) allocation of risks, if the contractual assumption of risk and the respective conduct of the associated entities are not consistent; and vi) pricing the accurately delineated transaction, considering appropriate compensation for the risk management functions performed.

At this phase of the analysis, it is possible to have a thorough comprehension of the controlled transaction and of which parties performed FAR in relation to the DEMPE of the group's intangible (s).

3.2.6 Determining the Arm's Length price

The last step of the analysis consists in determining the arm's length prices for the transactions. The TPG provides guidance on identifying suitable AL conditions and states that "the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances".⁵²

3.3 Additional remarks

In addition, the TPG also provides guidance on how the MNEs can identify the commercial or financial relations between associated entities (by understanding the industry sector of the MNE, the factors affecting the performance of the business operating in that sector, and identifying how each MNE operates – such as sale and productions), and accurately delineate the controlled transactions (by finding its economically relevant characteristics, through the five comparability factors, which are briefly characterised as follows: i) the contractual terms; ii) the functions performed; iii) the characteristics of property transferred or services provided; iv) the economic circumstances of the parties and of the market, and; v)

⁵⁰ Chap I deals with the Arm's Length Principle.

⁵¹ Supra n. 42 and n. 5, p. 47, footnote 1.

⁵² Supra n. 42 and n. 5, paragraph 1.143.

the business strategies).

All these steps are crucial to fairly and accurately determine the Arm's Length transfer pricing of an entity's controlled transaction involving intangibles.

3.4 Concluding Remarks

Prior to the amendments proposed by the BEPS Actions 8-10, the TPG could lead to occasions in which the allocation of profits was not adequately aligned with the economic activity that generated them. In fact, profits from assets were often eventually allocated to places where the actions associated with the attributed value were not carried out. As a consequence, the "return" on intangible assets could and was often taxed in low or no-tax jurisdictions. In reality, the arm's length concept allowed or, at least, did not comprehensively prevented/mitigated the contractual assignment of tasks, assets or risks at the expense of the parties' real economic behavior.⁵³

As explained above, as a response to it and in order to tackle artificial schemes where profits were shifted to jurisdictions with low or no taxation (and where no significant economic activity took place), the OECD introduced the concept of value creation through the idea of "align taxation with value creation".⁵⁴

4. How to allocate intangibles to increase the resilience of tax systems against BEPS

4.1 DEMPE-Related Practical Issues

The BEPS project aimed at avoiding base erosion and profit shifting. In what concerns transfer pricing, the Final Reports of Actions 8-10 aimed at aligning value creation with TP results, preventing tax planning schemes where profits, risks, or assets could be artificially shifted to low or no-tax jurisdictions. It did so by providing interpretative revisions to the previous guidelines and supplemental guidance on how to determine the arm's length

⁵³ Screpante M. (2019), *Rethinking the Arm's Length Principle and Its Impact on the IP Licence Model after OECD/G20 BEPS Actions 8-10: Nothing Changed But the Change?*, 11 World Tax J. 3, (IBFD); and Screpante M. (2018), *Garantizar que los resultados de los precios de transferencia estén en línea con la creación de valor en las operaciones con intangibles (Acciones 8-10): ¿el cambio que nada cambia?*, in Braccia (ed.), *Aspectos Relevantes de la Reforma Tributaria en Materia de Tributación Internacional*, (Thomson Reuters La Ley), p. 167-172.

⁵⁴ *Supra* n. 8, p. 4.

condition in transactions involving intangibles.

Despite the hard work and the various amendments introduced in 2017 to Chapters I and VI of the OECD TPG, the new guidance is viewed critically by both scholars and practitioners, which note that the current rules deliver results that do not actually match with its underlying rationale. This chapter is devoted to identifying and addressing the most relevant outstanding concerns and issues.

4.1.1 Does value creation actually prevent BEPS?

The first issue that should be raised is whether the value creation standard's implementation actually prevents the shifting of profits to low or no-tax jurisdictions. Screpante (2019)⁵⁵ sustains that the amendments introduced in 2017 were not substantial enough to allow that. According to her, the DEMPE has led to a new normative *functional-formula-based* standard that will only contribute to more transfer of profits to jurisdictions other than those where the real value is created.

More specifically, it is defended that the shifting now remains through a “planned” change of development, enhancement, maintenance, protection, and exploitation functions. As these functions add value to the respective intangible, and taxation takes place where such value is created, the OECD's intention was that the higher the jurisdiction's degree of taxation, the more benefits would be allocated to it, based on (foreseeable) higher value-added by the functions performed therein (i.e. management or R&D functions). Thus, on the other hand, low-value-added functions, such as distribution and logistics, would be assigned to low-tax countries.⁵⁶ Practitioners state that the OECD did nothing but to reinforce the *status quo* of the allocation of residual benefits in favour of countries of residence or of high(er) taxation.⁵⁷

As a result, some consider that the underlying intentions were not achieved: Instead, the

⁵⁵ Screpante M. (2019), *Formulaic (or Formulary?!) Apportionment Wearing Value Creation Clothes: Is the Wolf Dressed in Sheep's Clothing?* (WU Vienna).

⁵⁶ Screpante M. (2022), *Pillar One and Pillar Two: A Confirmation of the Formulaic Apportionment and Anti-Avoidance Approaches of the Value Creation Functional DEMPE Formula Standard?*, 29 Intl. Transfer Pricing J. 1, (IBFD), and OECD (2013), *Addressing Base Erosion and Profit Shifting* p. 29: “From an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing or branding occurs. Knowledge-based assets, such as intellectual property, software and organizational skills, have become increasingly important for competitiveness and for economic growth and employment.”.

⁵⁷ Screpante M. (2022), *Pillar One and Pillar Two: A Confirmation of the Formulaic Apportionment and Anti-Avoidance Approaches of the Value Creation Functional DEMPE Formula Standard?*, 29 Intl. Transfer Pricing J. 1, (IBFD).

changes introduced by the BEPS project may contribute to a greater transfer of high-value benefits to low-tax jurisdictions, according to DEMPE, and following the same value creation standards that were intended to provide a different result. Furthermore, it is sustained that Actions 8-10 increase the risk that contractual arrangements, as the main criterion for profit-allocation, are negotiated precisely for the purpose of creating value in low or no-tax jurisdictions.⁵⁸

Thus, it is stated that the TPG could be viewed as effectively establishing a new functional regulation, which is a value creation standard based on a functional formula (DEMPE). This new functional regulation allows multinational enterprises to transfer their benefits to jurisdictions of low or no taxation since the value creation is, through the shifting of DEMPE functions to those jurisdictions.⁵⁹ Practitioners defending such an idea recognise that the value creation approach reinforces the alignment of the taxation of profits with the place where the real economic activities take place without, however, preventing profits from ending up being taxed at low rates.

Finally, some authors state that the OECD proposal has been just partially successful. This is so because the attempt was to create an objective approach based on specific relevant functional activities (such as DEMPE), with the objective to align value-generating activity and taxable income. However, and in fact, the value creation turned out to serve solely to support the transfer of profits, based on DEMPE functions, with the OECD approval. It creates a path in which profit can be shifted in such a way that arrangements can be seen as genuine since there is “substance” (DEMPE activities), and the capability to assume and control risks.⁶⁰

According to part of the doctrine, it remains unclear how the value of an intangible is “created”, as the guidelines provide no framework for determining it or how to discriminate between value created by different functions, assets, and risks, and therefore DEMPE is not enough to align taxation with value creation.⁶¹

In this sense, there has been a tendency, since the OECD has adopted the value creation approach, to apply transfer pricing rules with a focus on trying to determine the components of value creation that generate profits, rather than seeking to understand how independent

⁵⁸ Idem.

⁵⁹ Idem.

⁶⁰ Idem.

⁶¹ See, for instance, Screpante, supra n. 56 and Hickman A. (2021), *Arm's length principle mutations: control of risk in the OECD guidelines and variations in practice*.

enterprises, under comparable circumstances, would price their transactions.⁶² Such tendency leads to debates on how any value is effectively created and whether there is real value-creation in some DEMPE functions, such as decision-making or leadership.

The concern here consists in the fact that there are no agreed criteria to measure “value”. Therefore, jurisdictions will take distinct views about what is value and how it is created. However, such a debate that is not encouraged by the guidelines, and they were not made to solve it.⁶³

4.1.2 How should profits be allocated?

This leads us to the second point of concern raised by practitioners: the mapping of DEMPE functions does not answer the question of how profits should be allocated nor how to calculate its division. It is true that the TP guidelines provide some guidance on how to delineate the transactions that the functions relate to and how to find out how similar uncontrolled transactions are priced. However, in what concerns intangibles, the ALP is being applied as if the DEMPE functions and its control are of independent value.⁶⁴

As many multinationals have divergences in what regards the location of the intangible ownership and the location of management and control of DEMPE functions, one of their key concerns is how their transfer pricing practices should respect the intangible ownership and the location of the DEMPE functions if there are contradictions between the two. In other words, how to reconcile the mapping of the intangible’s ownership with the mapping of their control for DEMPE functions.⁶⁵

The OECD provides quite limited guidance on this topic. As explained above, the changes to the TPG in 2017 introduced new features to the BEPS project and clarified the difference between legal ownership and the right to profit from such intangibles. If the legal owner does not perform any relevant DEMPE function, it will not be entitled to any portion of the intangible returns. On the other hand, if the legal owner performs and controls all the DEMPE functions, provides all the assets and assumes all the risks related to the intangible, then it will be entitled to all of its anticipated returns. However, questions have been raised on what would be the best approach for MNEs in which there is no perfect alignment or

⁶² Idem.

⁶³ Idem.

⁶⁴ As provided by Hickman A. (2021), in supra n. 61.

⁶⁵ Keen T. (2020), *The Compensation of DEMPE Control Functions in Post-BEPS Transfer Pricing*, Transfer Pricing Times – Second Quarter 2020.

misalignment of their intangible ownership and DEMPE management and control profiles.⁶⁶

Fundamentally, the guidelines indicate that the allocation of the results from controlled transactions involving an intangible should be determined based on the contributions provided by the parties and especially in the relevant functions (activities related to DEMPE of an intangible) performed in relation to an intangible and in the economically significant risks associated to these functions.⁶⁷ In other words, the relative value of each party's contribution to earning the profit is based on the relevant functions performed, risks assumed and the resources employed in the business activity that generates the profit.

It also provides that the profit split method could be applied to compensate the entity managing and controlling the significant DEMPE functions with the appropriate share of returns. In that case, the total profits earned by the economic entity from sales, for instance, to uncontrolled parties, are allocated to an entity based on their relative contributions to earning the profit. Nevertheless, this guidance does not solve the issue of calculating the split when there is a discrepancy between the location of that management and control of DEMPE functions and the location of the intangible ownership.⁶⁸

Hickman A. (2021)⁶⁹ states that when an one chooses to analyse value creation performed in a certain entity and to categorise decision-making and DEMPE functions as contributors to value creation, the lack of criteria to determine the value and to discriminate between affirmed contributions (in addition to the lack of established procedures on how to convert the heatmaps of value into profits from transactions), mean that the assessment is inevitably going to be pushed in the direction of splitting the profits. Thus, he concludes that the profit split is a “created solution” to a problem that could have been avoided.⁷⁰

Another practical example of a challenging situation would be that of intercompany transactions where, due to operational reasons, have the DEMPE activities highly fragmented between the associated entities. The compensation for each party's contribution may not be easy to specify, particularly in cases in which the industry does not offer enough availability of comparable transactions between non-related parties. Such cases may, likely, lead to the almost “automatic” adoption of the profit split method.⁷¹

⁶⁶ Idem.

⁶⁷ Supra n. 5, chap. VI.

⁶⁸ Supra n. 65.

⁶⁹ Supra n. 61.

⁷⁰ Idem.

⁷¹ H.Blankenstein & C. Russo (2016), *Intangibles in a post-BEPS world*, International Tax Review.

4.1.3 Are tax systems heading to Formulary Apportionment?

Lastly, as mentioned above, the doctrine has also been discussing whether the DEMPE acronym leads international tax systems toward a Formulary Apportionment approach and, therefore, whether the ALP is walking towards its end.

Authors have been sustaining that the changes introduced by the TPG 2017 evidence a general dissatisfaction with the ALP, as, by itself, it cannot work properly for income allocation. They also sustain that the comparative basis of the principle has been recently reduced due to difficulties in its application, especially in relation to the availability of comparables. Such side of the doctrine affirms that the AL principle has been modified several times to the point that one of the most used methods (the profit split method) is not based on the mere comparability of the facts and circumstances that would be applied between independent parties but rather on a combined profit division method.⁷²

For that reason, it is claimed that the DEMPE approach is based on a prescriptively and mechanically functional formula-based value creation standard. Although the DEMPE acronym was conceived in order to avoid any association with the notion of “formulary apportionment”, it has the same purpose as this jurisdictional allocation of benefits.⁷³ In this sense, authors consider that such mechanic application of the ALP under the value creation principle based on formula-based standard (DEMPE) reveals the vulnerability of the comparability nature of the ALP.⁷⁴

4.2 The author’s perspective

4.2.1 The value creation approach

Regarding the value creation issue, the author does not agree with the argument that the profit shifting remains through planned shift of functions and that the value creation standard serves solely to support the transfer of profits in terms of DEMPE functions with the OECD approval. When an enterprise genuinely transfers its intangible-related functions to another entity, the respective tax administrations should accept it and tax accordingly to where the value is created. This scenario cannot be considered as profit shifting, at least not artificial.

⁷² Supra 56, Chap. 3.

⁷³ Idem.

⁷⁴ Supra 55, Chap. 3.

This is because, first, there is no place for contractual agreements without substance in terms of functions, assets, and risks in line with the ability of the parties to monitor the substance of said risks, that is, having the capacity and power to do so.⁷⁵ In other words, it is not easy to artificially transfer functions, as it is difficult to move a person from one jurisdiction to another unless there is a reason to do so, such as in the cases of international mobility of highly skilled workers.

Nevertheless, this scenario may change in an increasingly digital world, as it will be increasingly more difficult, each time, to identify where value is being created and where the functions are being performed – particularly when the performance of functions is done through technological tools. However, this is an issue not to be addressed in this context. It is an overarching issue, common to many normative provisions, and this is something that the OECD will have to make further efforts in order to solve it completely.

In general, if a business is being transferred, the enterprise will be generating employment and therefore establishing a genuine business activity in another jurisdiction. That is a decision that shall be made by the taxpayer and therefore belongs to the business strategy and management. The author understands that once the person performing such functions is genuinely transferred, the respective remuneration should also be transferred.

If high-value-added functions, such as research and development, are assigned (i.e. transferred) to low-tax countries, this transfer should not be considered as artificial profit shifting, as each function shall be remunerated wherever it is effectively performed. There is no issue insofar as there is real substance and if the function is, in fact, effectively performed.

Considering also scenarios such as this, the OECD has launched the initiative on Pillar 2⁷⁶, releasing detailed technical guidance to provide a coordinated system to ensure that MNEs bear a minimum effective corporate tax rate of 15% on the income arising in each of the jurisdictions in which they operate, and consequently where value is created.

With regard to the argument that the guidelines are unclear on how value is created and on how to discriminate between value created by different functions, assets, and risks, the author agrees with that perspective. There is lack of materials and reports that provide enough

⁷⁵ Supra n. 56.

⁷⁶ For detailed information, see OECD (2022), OECD releases detailed technical guidance on the Pillar Two model rules for 15% global minimum tax, OECD Publishing, Paris.

detailed guidance on this matter. The author also believes that this topic has not been adequately addressed, namely because what generates value in one industry may differ from what generates value in another. In other words, each intangible has a function that may add more value to one MNE than to another, even within the same industry. For instance, in the luxury clothing / fashion industry, the brand intangible may stand out, and the brand's protection should be entitled to higher remuneration than the brand's exploitation, while in another group operating in the same industry, the enhancement of the brand may generate the highest value.

Those are mere examples of how value can be created in different ways depending on the industry, and especially on the MNE group in itself, and how each of them attributes a different value to different intangibles and functions related to them.

4.2.2 Guidance on profit allocation

Regarding the argument that the guidelines provide limited guidance on how intangible-related profits should be split or how to calculate their division, the author agrees with that view. However, one should note that each tax administration is responsible for providing (binding) guidance on the profit allocation. Since guidelines are soft law, they do not have legal value and have their limitations.

As mentioned above, it is complicated to provide an universal answer to the question of how the split of profits should be done as it depends on each industry and each MNE. A multinational group may highly value the development of certain intangible, whereas another group may consider that maintenance is more important. These considerations are inherently related to the business strategy of each MNE.

On the other hand, the author considers that the TPG should be more developed and detailed, providing more examples to facilitate its application, noting that it would be extremely difficult, if not impossible, to cover all possible scenarios. A more developed guidance would prevent that tax administrations from setting up divergent regimes, which lead to double taxation and double non-taxation issues.

Nevertheless, specific methods may assist in the calculation of the split and in the allocation of profits. The Value Chain Analysis (VCA) and the Process Contribution Analysis (PCA) are an example. They are quite comprehensive and inclusively cover extensive interviews with the administration within MNEs to assess the relative importance of several

value-creating processes (for instance, R&D, production, marketing, distribution, sales, after-sales and support services).⁷⁷ A VCA should be helpful in analysing DEMPE functions as it can assist in the determination of the key value drivers, i.e. the factors that contribute to creating a competitive advantage and allowing a MNE to generate profits above market standards. The VCA aims to identify the relevant valuable activities and to distinguish the primary activities (related to the creation and sale of products and services) from the support activities (activities that support the primary, such as HR, finance and IT). Furthermore, mapping the entities' different activities and attributing a certain weight to each of them may help identify intangible assets and their contributions⁷⁸. Hence, the VCA can point to the existence of unique intangibles that may or not be the result of the R&D function of the group.⁷⁹ The VCA should be seen as an important supplementary tool in preparing a complete functional analysis by allowing the understanding of the specific factors that constitute differentiators and sources of benefits for a MNE compared to other entities within the same industry.⁸⁰ The TPG require that both MNE's and tax administrations have a comprehensive and holistic understanding of the industry in which the MNE operates (and also of the relevant factors that influence its performance).⁸¹

As explained above, the two key areas that should be considered in allocating intangible-related profits among MNEs are the DEMPE functions and the assumption of the risks related to those functions. For that reason, it would be useful to perform an assessment of the contribution of each entity to the DEMPE functions and the related risks. In this sense, a well-established tool is the RACI model, which is used to identify and classify the role of each enterprise of the group, according to whether they are "responsible" for carrying out DEMPE functions, "accountable", or merely "consulted" or "informed". Hence, the result of the relative importance of the functions and the RACI weightings decides the share of residual profit to be distributed to each legal entity.⁸²

The RACI model is a business management tool that assigns roles and responsibilities to members of an MNE. It is also a useful technique in value chain analysis when one needs

⁷⁷ *Supra*, n. 65.

⁷⁸ Vallat G. (2020), *Application of the DEMPE Concepts in the Pharmaceutical Industry*, 27 *Intl. Transfer Pricing J.* 3, 12, (IBFD).

⁷⁹ *Idem*, p. 12.

⁸⁰ Dziwinski K. (2019), *Transfer Pricing and Intangibles: Report on the WU Transfer Pricing Symposium*, *Transfer Pricing J.* 3, (IBFD).

⁸¹ *Supra* n.5, paragraph 1.34.

⁸² C. Peng & M. Lagarden (2019), *DEMPE Functions and the RACI Concept – More Clarity or Confusion Ahead?*, 26 *Intl. Transfer Pricing J.* 1, (IBFD), chap. 2.2.3.

to assess the contribution of all involved entities of an MNE, and of the value that each entity adds to a controlled transaction.⁸³

The OECD has pointed to the usefulness of the RACI model in the application of the profit split method in 2014⁸⁴. Nevertheless, it does not officially recognise the model nor expressly rejects it (for use in transfer pricing analysis). In the author's view, the RACI model is indeed not only legitimate but also useful for allocating the profit derived from intangibles in transactions between related parties, despite its practical limitations.

4.2.2.1 The meaning of RACI

The RACI concept covers four roles, each having a specific meaning within the context of a business administration: responsible, accountable, consulted, and informed.

The term "Responsible" refers to the employee who performs the work to complete a certain task. It is facultative to also have a function of "support" to assist the "responsible" in completing tasks or a business process, occasions in which the RACI model is extended to RASCI.⁸⁵

The "Accountable" is the one who delegates the work to the "Responsible" ones, ultimately being the manager who approves the work provided by the Responsible. From a business perspective, there should be only one Accountable attributed to each task in order to ensure a transparent split of the work and a clear understanding of who is responsible for each task. From a transfer pricing point of view, the role of the Accountable is closely related to the decision maker in the risk control function.⁸⁶

"Consulted" is the one whose opinions are requested, usually on technical matters, and with whom there is a two-way interaction.⁸⁷

Lastly, "Informed", as the name suggests, are those who are kept up to date on the progress or status of a certain task, process or project, being usually a one-way interaction.

⁸³ Idem.

⁸⁴ OECD (2014), Public Discussion Draft – BEPS Action 10, Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains, para. 38, OECD Publishing, Paris. In the 2016 and 2017 Discussion Drafts, however, the OECD has left out the concept of RACI. See OECD (2016), *Public Discussion Draft – BEPS Actions 8–10: Revised Guidance on Profit Splits*, OECD Publishing, Paris), and OECD (2017), *Public Discussion Draft – BEPS Action 10: Revised Guidance on Profit Splits*, OECD Publishing, Paris).

⁸⁵ Supra, n. 83.

⁸⁶ Idem.

⁸⁷ Idem.

From the transfer pricing point of view, the Informed has a passive function in the process as merely an information receiver. Thus, his function does not contribute to the value creation in the process under analysis.⁸⁸

4.2.2.2 Variations of the RACI model

There are several variations of the RACI model, including other types of responsibilities: For instance, we have the PACSI model, in which replaces the “responsible” by “perform”, and the term “consulted” is replaced by “control”.

In this model, “control” corresponds to the person or to the function that reviews the result of an activity, having a right of veto, which has a binding feature.

Another variation used is the DACI model, which describes centralised decision-making assignments by implementing the term “driver” - the one who leads the project.⁸⁹

4.2.2.3 Importance of the RACI model

From the transfer pricing perspective, the RACI model is a useful tool for performing a more detailed functional analysis, as it can clarify which entity is doing what. For instance, who is the marketing performer or the R&D performer. It can also indicate which entity is the decision maker behind the activities conducted.⁹⁰ Peng & Lagarden (2019) consider that the RACI model facilitates the application of DEMPE by mapping (through a table or matrix) the roles and responsibilities of affiliated enterprises involved in the DEMPE functions of an intangible. For instance, in what concerns the “exploitation” activities, the RACI table would show which enterprise (s) is (are) responsible, which is (are) accountable, consulted, and so on.⁹¹

In the author’s view, the RACI (or RASCI) model is valid to help the practical application of the DEMPE acronym, to the extent that it is used to corroborate the DEMPE functions and used together to justify its functionality. It can effectively provide a clear overview of the contribution of each entity to each DEMPE function. It is not expected that tax administrations accept a transfer pricing analysis merely based on the RA(S)CI model.

⁸⁸ Idem.

⁸⁹ Idem.

⁹⁰ Idem.

⁹¹ Idem.

4.2.3 Formulary apportionment

Finally, the viability of formulary apportionment remains a frequent topic of debate in the tax community. Practitioners have advocated that the DEMPE functions have led to a new normative *functional-formula-based* approach, walking towards Formulary Apportionment.

The current transfer pricing framework was not designed for this purpose. Instead, it seeks to align the allocation of operating profits among the different enterprises within a MNE as independent third parties, acting under similar conditions, would have done (under the Arm's Length Principle). To be more specific, the current framework distinguishes between routine and non-routine inputs to IP value chains, where the routine inputs are only entitled to a normal market return, assuring that residual profits will only be allocated to the jurisdictions where intangible value is created.

The formulary apportionment alternative, defended by some authors, spreads residual profits across all jurisdictions in which the multinational operates (on the basis of the formula that is used). That would implicate that most jurisdictions are overcompensated, as they would be allocated more operating profits than the routine value chain inputs provided group entities resident in them are worth. On the other hand, the jurisdictions where value is created would be under-compensated by not being allocated the entirety of the residual profits⁹². Specifically, they would not be assigned operating profits proportionate to the worth of the unique value chain inputs provided by the resident entities. That approach would provide some equality, in the meaning that the taxing rights over the worldwide profits of a MNE would be equally divided between jurisdictions based on some predetermined allocation condition (such as employees and assets).⁹³

Nevertheless, such an approach⁹⁴ would not be based on an economic reasoning since it considers that all value chain inputs (routine and non-routine) are worth the same. It would not be able to reproduce the profit allocation results of transactions among independent entities with distinct interests, in which competition will naturally increase the prices of routine value chain contributions to a level where suppliers only earn a normal market return. Therefore, the

⁹² Residual Profits means the amount of leftover operating profit after paying all costs of capital used to generate revenues. Operating profits correspond to the total earnings (net income) from the core business functions during a given period, excluding the deduction of interests and taxes.

⁹³ Torvik O. (2019), *Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains*, Amsterdam: IBFD Doctoral Series, *Chapter 1: Research Questions, Methodology and Sources of Law in Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains*.

⁹⁴ We refer here to Formulary Apportionment.

formulary apportionment alternative would not provide consistency in the tax treatment of associated and independent parties, which is why the OECD has decided not to follow this approach. Consequently, Formulary Apportionment could lead to base erosion and profit shifting.

The author understands considering DEMPE as a formula for the application of the profit split method (formal repartition / formulary apportionment) is a misinterpretation of the guidelines. It is also an area of concern, as it would lead to BEPS and increase the risk of double taxation⁹⁵ as well as divert from the value creation approach.

Even though the guidelines do not provide enough clear guidance regarding profit allocation, and even if there may be some practical challenges in the application of the arm's length principle, one should consider the historical context in which the DEMPE acronym has been introduced, as well as recognise the common view among jurisdictions that the ALP should govern the evaluation of TP within associate enterprises, and therefore should not see DEMPE as a formulary approach method.

5. Conclusion

Although some criticism has arisen, the relevance of the OECD/G20 BEPS work in this field should not be underestimated. The modifications that have been implemented into the Transfer Pricing Guidelines are aimed at avoiding artificial massive schemes where profits could be legally shifted to low or no-tax jurisdictions, through well-designed tax planning techniques and at putting an end to box-offices commonly used to legitimate profit allocation to jurisdictions where no value is being generated.

The DEMPE acronym emerges in a context where intangible assets have gained importance as the most valuable assets in a group. However, their value is often extremely difficult to assess. Therefore, DEMPE was introduced to assist in identifying the functions of high added value and thus in determining the value created by an intangible and in assigning the residual benefits proportionally.

The doctrine has raised the question of whether the value creation approach actually achieves its objective of preventing base erosion and profit shifting. According to some scholars, multinational enterprises are able to legitimately allocate profits to low or no-tax

⁹⁵ In this sense, the TPG provides that a move away from the ALP would threaten the international consensus, thereby leading to a substantial increase of the risk of double taxation, *supra* n. 5 , paragraph 1.15.

jurisdictions through the simple shift of functions. In this regard, we understand that the genuine split of functions is a business decision, and should not be considered artificial profit shifting, as it will usually have substance.

Regarding profit allocation, practitioners consider that the TPG provide limited guidance on how profits should be allocated and how to calculate this allocation. In this sense, the author agrees and considers that the guidelines should be developed, in order to provide a more detailed guidance on profit allocation, so tax authorities can design their domestic frameworks in harmony and reduce double taxation issues. In this sense, more examples should be provided that better illustrate the application of DEMPE, being certain that it would be impossible to cover all the possible scenarios.

The author considers that business management tools can be useful in a TP analysis involving intangibles, being the RA(S)CI model a notable example. It may assist in identifying, in a clearer way, the contributions that each enterprise would have made to a given business process, complementing, thus, the DEMPE functional analysis.

In relation to the Formulary Apportionment approach, which some scholars defend, the author understands that when one interprets the DEMPE acronym as a formula for applying the profit-shifting method, BEPS issues and double taxation may arise.

The inadequate interpretation of the guidelines, as a Formulary Apportionment of the residual profits among MNES, generates profit shifting to jurisdictions in a way not proportional to the creation of value. The author recognises that the guidelines could provide more clarity on how such profits should be allocated. However, one should consider the historical context in which DEMPE was introduced and therefore assume that the acronym has its roots aligned with the arm's length principle and, thus, a comparability nature.

In sum, we conclude that, in fact, some of the changes introduced to the transfer pricing guidelines regarding intangibles still causes some issues in terms of its interpretation and interpretation by MNEs, advisors, and mainly by tax administrations. Thus, it remains evident that some work still needs to be done in order to clarify the guidance provided and to provide a better understanding of the OECD's underlying rationale. Only in that way will it be possible to achieve more harmonic domestic frameworks on how intangible-related profits should be priced and allocated, and, thus, increase the resilience of tax systems against BEPS.

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