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In this article, the second 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 France, Italy, and Spain.

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In 2015 the OECD reached an agreement on revised guidance regarding transfer pricing[1] as part of base erosion and profit-shifting actions 8-10. It can be difficult to get a comprehensive global view of how tax authorities are applying this guidance. KPMG has surveyed its member firms from around the world to better understand how local tax authorities approach the control of risk and development, enhancement, maintenance, protection, and exploitation

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

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(DEMPE) frameworks. This article, the second in a series, is focused on France, Italy, and Spain.[2]

France

French tax law is less prescriptive than the laws of other countries.[3] The rules governing the application of the arm's-length principle are contained in a single article, just a couple of lines, supplemented by 10 pages of additional guidance issued by the French tax authority. This stands in stark contrast to hundreds of pages of U.S. regulations under IRC section 482 and the 650 pages of transfer pricing guidance published by the OECD. This lack of prescription means that French domestic law does not contain any reference to the concepts of control of risk; DEMPE; or to the OECD transfer pricing guidelines frequently used in other countries (including Italy and Spain). However, both the control of risk and DEMPE frameworks are still applied when performing transfer pricing analyses in France and are considered by the tax courts and cited in case law.

The French tax authority has not adopted a systematic approach to apply either the control of risk or DEMPE frameworks, but applies these frameworks in cases in which they consider the French entities of a multinational to have been under remunerated. In recent years, it has become relatively common for the French tax authority to review the functions performed, assets assumed, and risks borne by entities in France, and to use this analysis to disregard the way a taxpayer has characterized a controlled transaction or remunerated an entity. The French tax courts have also started to accept more frequent applications of the transactional profit-split method as a "fair" way to allocate profits between different entities within a group.

For example, in a recent case regarding a broker in the energy industry, the French tax authority challenged the broker's characterization as a routine service provider that was appropriately remunerated with a markup on cost. Instead, it argued the broker was a co-entrepreneur that was responsible for controlling economically significant risks and hence would be more appropriately remunerated with a share of profits, determined through the profit-split method. In this case, the risk controlled by French entities was a key part of the tax authority's rationale for increasing the profits allocated to the French entity.

The control of risk framework is used to argue not only that French entities should be allocated more profits but also that losses should not be allocated to France. For example, in another recent case, a French manufacturing entity was incurring losses because its manufacturing facilities were underused. The French tax authority argued that this underuse was a consequence of decisions made by the parent entity, so it was this entity that controlled this risk and should bear the losses that arose as a result. This demonstrates how the French tax authority, like other authorities in Europe, sees the control of risk framework as a way to reduce losses allocated to domestic entities (as well as increase profits). However, taxpayers should take reassurance that these arguments were ultimately dismissed by the French courts.

Though it is important for taxpayers operating in France to consider the substance of their activities, it remains important that the legal form of these activities matches the substance. There have been scenarios in which the French tax authority, in a rather opportunistic manner, has based its transfer pricing analyses on the legal agreements underpinning a controlled transaction, with little account given to the actual conduct of the parties, even though this could be viewed as inconsistent with French domestic law. For example, a foreign multinational acquired a French company that developed software and transferred the legal ownership of the acquired intellectual property to the parent jurisdiction. The IP effectively transferred at that time, but had a relatively low value, as the transfer occurred before any material development milestones had been reached. In the group's transfer pricing policy, the French entity remained an entrepreneur, reflecting its continued role in research and development (with all key employees located in the French entity) and the

[2] For the previous installment 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.

[3] This section was written in conversation with Olivier Kiet and Valentin Lescroart of KPMG Avocats France.

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fact that it remained the economic owner of the IP transferred to the parent jurisdiction. The IP was in a pre-commercial phase, so the French entity incurred losses. The French tax authority challenged the characterization of the French entity as an entrepreneur, arguing that following the transfer of the IP to the parent jurisdiction, it should be treated as a contract R&D service provider and remunerated with a markup on cost; the tax authority presented that position at the commission hearing without considerations for the control of risk or DEMPE frameworks.

Also, the tax authority continues to carefully review material R&D expenses for which French entities claim deductions to analyze the relative value of the activities performed in France and draw implications from a transfer pricing perspective.

Italy

A ministerial decree issued on May 14, 2018, substantially aligned Italian transfer pricing rules with the international best practices included in the 2017 version of the OECD transfer pricing guidelines, which incorporates the changes made by actions 8-10 of the BEPS project.[4] The decree requires the accurate delineation of the controlled transaction as part of a comparability analysis. Although there is no direct reference to the control of risk or DEMPE frameworks, the requirement to accurately delineate the controlled transaction provides the legal basis for the Italian tax authority (Agenzia delle Entrate) to apply these concepts. The decree aligns Italy's domestic transfer pricing rules with the OECD transfer pricing guidelines, as periodically updated by the OECD. This means that the interpretation of the Italian domestic rules is, in effect, automatically updated to reflect changes to the OECD guidelines.

During tax audits, the tax authority uses a range of arguments to dispute the pricing of transactions involving Italian entities and to argue that higher returns should be left in Italy. In some instances, this includes references to the local control of risk or DEMPE functions; however, there is no systematic focus on control of risk or DEMPE. At the same time, the tax authority continues to focus on the comparables used to price intragroup transactions, often challenging the comparables used by the taxpayer and selecting alternatives (with higher or lower returns, depending on the case).

For example, when reviewing the return allocated to a distributor of a technology business operating in Italy in a recent audit, the tax authority identified that the group's Italian employees included highly paid software engineers entitled to significant variable compensation. For this reason, it argued that the functions performed in Italy were valuable and warranted a higher operating profit margin than the group had initially attributed to the distribution entity.

Another area that can lead to disputes is the transfer of IP, particularly for groups that are highly acquisitive. For some Italian groups, it has been common practice to transfer acquired IP to Italy. Increasingly, groups are choosing to leave IP they acquire with the foreign entities, recognizing that these entities continue to play an important role in the enhancement and exploitation of this IP. In part, this change in approach is a response to the focus of other countries' tax authorities on control of risk and DEMPE activities performed locally. In some circumstances, the foreign IP will be used in conjunction with existing IP owned in Italy, and Italian entities will assume an important role in the management of the foreign IP moving forward. In these cases, the profit-split method may be the most appropriate transfer pricing method. Since the tax authority has historically applied the profit-split method in a limited number of situations because of concerns about complexity and the extensive information required, this is an area where there may be benefits to taxpayers engaging proactively with the tax authority, and potentially in seeking an advance pricing agreement.

In some cases, the tax authority has also used arguments about the lack of local control over risk to increase the profits of loss-making entities. For example, in one case, the tax authority challenged a group that had used the comparable uncontrolled price method to set the remuneration for an Italian contract manufacturing entity,

[4] This section was written in conversation with Lucia Barone of KPMG Italy.

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resulting in this entity realizing a loss for three financial years. Instead, the tax authority set the price of the relevant controlled transaction using the transactional net margin method, arguing that the Italian entity did not have control over the key economically significant risks, and therefore should not bear the losses arising from the transaction.

In Italy, responsibility for enforcing transfer pricing and international tax law is attributed to both the tax authority and the tax police (the Guardia di Finanza). The tax authority is more likely to audit and challenge a group's transfer pricing based on the arguments around the performance of control of risk activities or DEMPE functions. The Guardia di Finanza more frequently investigates the existence of undeclared permanent establishments. In Italy, the failure to submit a tax return when certain thresholds are met, including in connection with an undeclared PE, is a criminal offense, and the company directors can face prosecution. In some circumstances, challenges by the tax police about the existence of a hidden PE have been settled through transfer pricing adjustments by attributing the income the tax police considered attributable to the "hidden PE" to other group entities already identified for tax purposes as having operations in Italy. The rationale for these adjustments is that the operations of the group undertaken in Italy were part of a highly integrated business and warranted a higher allocation of profit but did not constitute a hidden PE of a nonresident entity.

Spain

Spain's domestic transfer pricing rules are set out in article 18 of the Ley 27/2014, de 27 de noviembre, del Impuesto sobre Sociedades and expanded in the bylaws[5].[6] The preamble states that the guidance set out in the OECD guidelines and the EU Joint Transfer Pricing Forum can be used as interpretative tools, to the extent they are not inconsistent with Spanish domestic legislation or implementing regulations. The preamble does not reference a specific version of the OECD guidelines and, given that they are understood to be a source of explanation and interpretation, the Spanish tax authority typically refers to the most recent version of the guidelines when conducting audits or participating in advanced pricing agreement or mutual agreement procedure negotiations.

The Spanish tax authority applies the control of risk and DEMPE frameworks in situations in which it considers either the returns allocated to a group's Spanish operations to be too low, or the price for intragroup services charged to a Spanish entity too high.

In an inbound context, the Spanish tax authority has used the guidance on the control of risk to challenge the allocation of losses to entities performing distribution activities, including entities in a start-up phase, or seeking to expand their market share. It argues that these entities are not responsible for controlling the risks that give rise to these losses, and hence should not incur the losses. The Spanish tax authority has also used the guidance on control of risk to challenge the procurement fees charged by nonresident centralized procurement entities. It argues that because the foreign entities are not controlling economically significant risks, they are only entitled to a routine return for the procurement activities that they perform; therefore, any additional return should be allocated to the Spanish-related counterparty in the transaction. The returns allocated to procurement entities have been a long-standing concern to many tax authorities around the world, so it is interesting to see a novel argument being used to challenge them.

In an outbound context, the Spanish tax authority frequently highlights concerns about returns allocated to Spanish parent entities or regional headquarters that receive a cost-plus markup on the services they perform for other group entities. Increasingly, the Spanish tax authority is questioning whether a cost-plus approach is the right way to remunerate these services, or whether they include the provision of intangibles, which warrants an additional return.

The Spanish Ministry of Finance and Public Control publishes an annual tax and custom

[5]Law 27 of November 27, 2014, of Corporate Income Tax; Royal Decree 634 of July 10, 2015, approving the bylaws of the Corporate Income Tax.

[6]This section was written in conversation with Maria Teresa Quiñones Fernandez of KPMG Spain.

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control plan, which identifies areas the Spanish tax authority will focus on in the coming year. In 2022 the plan identified the significant divergence between the royalty rates paid by Spanish subsidiaries to their foreign parents against the rates charged by Spanish parents to their foreign subsidiaries as an area of concern. In the past year, we have seen an uptick in audits of Spanish multinationals, in which the tax authority is concerned about the undeclared license of manufacturing and marketing intangibles to foreign subsidiaries. For Spanish subsidiaries of foreign multinationals, the tax authority has focused on whether services have actually been rendered, are duplicative of activities performed by the subsidiary, or represent shareholder or stewardship activities that should not be recharged.

Finally, since the COVID-19 pandemic, we have seen several C-suite employees of multinationals move to Spain. There is a risk that the relocation of that staff creates a Spanish PE, and where the C-suite employees perform DEMPE functions, there is an additional risk of significant profits attributable to this PE. For this reason, though there are many good reasons to move to Spain, it is critical that groups perform a careful analysis of the tax and transfer pricing implications before C-suite employees relocate.[7] ■

[7]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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