COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT

BEPS ACTION 8:

REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAS)

1 June 2015
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25 May 2015

Mr Andrew Hickman,
Head of Transfer
Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

cc: Laura Beretta
Gianni De Robertis

Dear Mr Hickman,

Re: Discussion draft on revisions to Chapter VIII of the transfer pricing guidelines on cost contribution arrangements (CCAs)

Federazione Nazionale Imprese Elettrotecniche ed Elettroniche ("ANIE") thanks the OECD for the opportunity to provide comments in response to the OECD Centre for Tax Policy and Administration’s Discussion Draft of the revisions to Chapter VIII of the transfer pricing guidelines on Cost Contribution Arrangements (CCAs) (the “Discussion Draft”). ANIE highly appreciates the work of the OECD Working Party n. 6 on clarifying the use of CCAs and more in general on assuring that transfer pricing outcomes are in line with value creation. This letter comments on certain aspects of the Discussion Draft and suggests areas for further enhancement and clarification. We hope that our comments may be useful in enhancing the effectiveness of the new proposed guidelines, in particular with regard to the practical issues that arise when CCAs are adopted within multinational groups.

General comments on the use of CCAs
Companies use CCAs mainly to organize certain intra-group transactions related to the development, management and exploitation of intangibles, or to obtain certain services. ANIE welcomes the fact that, as indicated in paragraph 5 of the Discussion Draft, the OECD has recognized the potential benefits of CCAs: “CCAs can provide helpful simplification of multiple transactions” as they provide “a mechanism for replacing a web of separate intra-group arm’s length payments with more streamlined system of netted payments”.

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In addition to reducing the number of intra-group transactions, CCAs can also simplify the pricing of such transactions as it is generally easier for companies to identify and measure costs of activities rather than the value of a service or intangible created by such activities. In a complex business and tax environment, characterized by a growing number of intra-group transactions and compliance requirements, it is important that the use of this simplification tool is retained and enhanced in the OECD Guidelines, in order to promote an efficient use of the limited resources available to companies and tax administrations.

Specific comments

C.2 Determining participants

- While the Discussion Draft states that "a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the CCA activity itself" (paragraph 12), it would also be useful to clarify that not all parties to the CCA would necessarily need to perform the centralized activities (service or development activities). This would be important since, in many cases, in pooling resources and skills, multinational groups centralize and undertake CCA activities in a few locations/companies within the group, while a larger set of companies may benefit from such activities.

In the case of "service CCAs", for example, certain support or back-office activities (consistent with the definition of "low value services" provided by the OECD) are often performed in a number of "competence centers". Such activities are performed for the mutual benefit of the competence centers but also for the benefit of all the other group companies, which may contribute to the CCA costs. Multinationals would welcome the possibility of retaining the use of CCAs in such fact patterns, even if not all participants actively contribute to the performance of the activities.

Restricting the application of CCAs to the companies that directly perform the activities would significantly reduce the potential use of CCAs and would not help to limit BEPS.

- The Discussion Draft states the following: "Since a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. In particular, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA" (paragraph 13).

This statement is consistent with the proposed Chapter I and with one of the underlying concepts of the OECD work on BEPS, i.e. increased focus on functions and location of employees. However, we think that in the context of CCAs this concept may need to be defined and delimited more clearly, as applying such a broad restriction to CCAs may significantly decrease their use by companies and increase the compliance burden on them. In the context of CCAs, it would be extremely restrictive to require all participants to have the capability to control, assess and monitor the risk as this may invalidate several CCAs which do not involve any BEPS.
For example, with respect to “development CCAs”, it is not unusual that within a multinational group with several production sites, a limited number of sites engage in R&D, focusing on production process improvements. The findings of such activities are then shared, formally or informally, among all the production sites of the group in the form of know-how transfer. Such know-how transfers are often difficult to identify, track and value. In this context, a “development CCA” is an efficient and simple way of applying the arm’s length principle as it does not necessarily require to multinational groups to track and value every single know-how transfer but only to identify the cost and the expected benefit of the production sites.

A strict interpretation of paragraph 13 may exclude from the CCA all the production sites which do not directly perform the R&D activities, as they may not have the capability to control the risk attached to these activities. Moreover, in Example 4, even if a production site has the capability and the authority to control the risk associated with the CCA, it would only receive “a risk-adjusted rate of return on its funding commitment” (paragraph 61), and not a full right to the intangible created under the CCA, because it provides only a funding commitment to the CCA (and not an operational commitment).

We do not agree with this conclusion as the production sites mentioned in the example have an operational interest in participating in the CCA, as their main business activity would directly benefit from the intangibles created under the CCA. Using a CCA to share know-how developed by certain production sites among all group sites, as illustrated in the example, should be legitimate and does not have any BEPS implications.

In determining the participants to a CCA, therefore, we think that the OECD should also focus on the main business activity/function of the participants and, in particular, on whether the participant would be in a position to directly benefit from the outcome of the CCA by employing it in its main business activity.

In the light of the above, paragraph 13 could be improved by providing that “to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA or the capability directly to use the outcome of the CCA in its main business activity”.

This change to the wording would still prevent companies with very limited (or no) functions (hence having a pure financial role) from participating into a CCA, which in our interpretation is what the original wording is seeking to achieve. However, the rewording would allow fully operative companies to qualify as a participant when they have a direct interest in using the outcome of the CCA in their main business activity but may not have the capability to control or manage the risk of the R&D activity performed as part of the CCA.

Similarly, and still in the context of Example 4, it would be useful to distinguish between (i) entities providing funding to the CCA and having the capability to use the intangibles potentially resulting from the CCA in their main business activity/functions, and (ii) entities providing the funding and performing only a finance activity or functions totally unrelated to the content of the CCA. While the second type of entities would receive a risk-adjusted rate of return, the first type of entities would be entitled to the use and the economic ownership of any intangible resulting from the CCA activity.
More in general, we agree with the approach proposed by the OECD of limiting returns to investments made by an entity which is only providing funding to the CCA. However, when the members of a CCA are substantive entities that are carrying out and managing the risk of their local business operations, and the content of the CCA is relevant for their business operations, these companies should be allowed to participate into CCAs for both services and the joint development of intangibles, without necessarily having to prove direct control over the CCA activities.

This would be consistent with the agreements often reached between rational independent economic agents. For example, participants in a crowd-funding project very often do not have the capabilities to make decisions about the assessment, monitoring and management of the risks associated with the underlying project but have a direct interest in using the outcome of such projects.

As CCAs are a tool to simplify the management of intra-group transactions, multinational companies would welcome the possibility of maintaining the use of CCAs in a wide number of cases, including those in which some companies participate in the funding of the CCA activities (and have the capability of using the outcomes of the CCA activity) whilst other participants provide operational services or research and development activities.

C.4 The value of each participant’s contribution
The Discussion Draft states the following: “Under the arm’s length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution. That is, contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle in determining the value of contributions to a CCA the guidance elsewhere in these Guidelines should be followed” (paragraph 22).

The emphasis given to a method based on value rather than costs in evaluating the participant’s contribution introduces a subjective element in the determination of the contributions and could potentially increase complexity in the use of CCAs, increase disputes with tax authorities and reduce the use of CCAs.

With respect to low-value services, ANIE welcomes the position of the OECD on the use of costs as a measure of value. Based on the work already performed by the OECD on Chapter VII, in the case of low-value services companies should be allowed to: 1) also consider as participants in the CCAs companies which may not perform the CCA activities directly but which benefit from the services and bear the costs, 2) value the contribution of the participants at cost, and 3) apply a simplified benefit to ensure the deductibility of the costs.

With respect to other type of services and to “development CCAs”, it is important to recognize the need for practical solutions and extend the possibility of valuing contributions at cost (or cost plus in case not all participants directly carry out the CCA activities to the same extent). Participants in a CCA would benefit from economies of scale and/or economies of scope, hence even if their activity is remunerated at cost or cost plus, they would be better by performing their activities within a CCA as they can divide the cost among multiple entities.
In several cases, the additional complexity generated by the use of arm’s length values would not be justified, considering the simplicity of just sharing the costs incurred by the participants.

C.6 Disregarding part or all of the terms of a CCA

We agree with the OECD view that the reality of the arrangements among the parties should guide any transfer pricing analysis. As the topics of delineation of the actual transaction, not recognition, etc are treated extensively in the Discussion Draft of Chapter 1, we will not focus on these aspects in this memo. However, since disregarding the actual transactions (also in a CCA context) would lead to great uncertainty and would result in increasing tax disputes and potentially double taxation, we would recommend that every effort is made to limit the disregarding of the transaction only to cases where it would be strictly necessary.

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We hope that the OECD will find our comments useful and that you will not hesitate to contact us should you wish to discuss the issues we have raised in this paper in more detail.

For further information, please contact Laura Beretta [laura.beretta@prysmiangroup.com] and Gianni De Robertis [gianniderobertis@kstudioassociato.it], who have assisted ANIE in preparing this submission.

Yours sincerely,

Maria Antonietta Portaluri

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About ANIE

The Italian electrical engineering and electronics industry association (ANIE) is one of the major industry associations in Italy, representing electrical engineering and electronics companies. It was founded in 1945 and is a member of Confindustria. It has more than 1,200 members, with a combined workforce of 410,000 and a combined turnover of €56 billion at the end of 2013.

ANIE brings together very large multinationals as well as small and medium-sized Italian enterprises; 65% of its member enterprises have less than 50 employees. Its members place high importance on research and innovation and account for over 30% of private Italian investment in research and development.

Nationally and internationally, ANIE and its network of members seek to encourage and strengthen entrepreneurial values, promoting their development in pursuit of the general interests of the country and acting to ensure transparent rules. ANIE is part of the European Engineering Industries Association.
OECD Discussion Draft under BEPS Actions 8 – Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCA’s)

We welcome the opportunity to comment on the OECD’s discussion draft on revisions to Chapter VIII of the Transfer Pricing Guidelines on CCA’s issued on 29 April 2015. We are pleased to contribute our comments below.

B. Concept of a CCA

We agree with statements made under B.1 that describe CCA’s in general and confirm that this description is in line with our experience of CCA’s in third party situations. In particular, we agree with paragraph 6 that CCA’s can eliminate the need for multiple cross licences on individual compounds through the sharing of contributions and benefits across a portfolio of compounds and projects. This achieves the sharing of risks and benefits of participants whether among third parties or in intra-group arrangements.

We also agree with the two types of CCA’s mentioned in paragraph 7, but would add that often parties within a group will contribute to the development of new processes and systems, for example a new enterprise performance management (ERP) system, that may take several years to develop. While these projects may be driven centrally by personnel in one or two legal entities, other subsidiaries will benefit and therefore contribute to the costs in fair proportion to expected benefits but with minimal oversight or control of the project. Centralised delegation of responsibility for such service based CCA’s should continue to be respected as appropriate, as should pragmatic arrangements within MNC’s to allocate costs, provided the cost allocation keys are fair and reasonable relative to expected benefits.

Regarding development CCA’s, we confirm our understanding aligns with that stated in paragraph 9, and specifically agree with the statement “The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property but the other participants have an effective ownership interest in the property”. This is often the case in our industry where there is a single legally registered owner of a patent or other IP but the benefits of that IP are shared among participants in proportion to contributions made.

C. Applying the arm’s length principle

We broadly agree with the statement made in paragraph 10, but would note that the drive to pool skills and resources includes financial resources. In our industry there are significant benefits of either reducing costs or diversifying risk through sharing costs of R&D development via third party CCA’s. In our case delivering value to patients through funding all the opportunities in our pipeline ourselves is not possible, so we choose to partner with
others to alleviate the burden of investment as well as to access expertise and skills of other parties.

We agree that the value of each participant’s proportionate share of the actual overall contributions to the arrangement should be consistent with the participant’s proportionate share of the overall expected benefits, and that taxpayers should be prepared to substantiate the basis of benefits derived from a CCA, as stated in paragraph 11. These are fundamental principles in any third party CCA.

**C.2 Determining participants**

We agree that each party should be required to share contributions and risks in order to qualify as a participant in a CCA. However, we would temper the proposed threshold of “capability and authority to control risk” to simply having the capability to assess and control risk and the capacity to make decisions in relation to those risks, including oversight of outsourcing arrangements. In reality in MNC CCA’s control may be exercised by one participant only, particularly in relation to a single project within a broad, shared portfolio of projects. This reflects the objective to improve productivity and efficiency referred to in paragraph 10, as not every participant can control every decision in relation to every R&D project. Therefore, control by one participant should not preclude other participants engaged in, funding, and taking risk in the project, provided those other participants have the capability to assess and manage the risks at a strategic and operational level. This threshold requirement would continue to deny participation to low or non functioning cash funding entities.

We agree with paragraph 14. In our industry a significant proportion of late stage development is conducted through contract research organisations which are not participants to third party CCA’s. MNC CCA’s that have contract R&D arrangements with associated enterprises should be respected in the same way i.e. the associated contractor should not automatically be designated a participant in the CCA.

**C.3 Expected benefits from the CCA**

Paragraph 17 refers to uncertain benefits, and this is certainly true for development CCA’s. Regarding the statement that “the allocation of contributions will take account of projections about the participants’ shares of those benefits”, in most third party arrangements the share of benefits whatever they turn out to be are allocated in proportion to contributions made. Rarely is a renegotiation available with the benefit of hindsight applied to the benefits arising from the CCA. For example, some third party deals we have in place are based on a sharing of costs 50/50 with a view to developing a product or series of products for commercialisation in 5 to 10 years time. The benefits, if they arise, would be shared 50/50, subject only to prior allocations of returns for production. Therefore, the CCA is not dependent on a shared agreement of the precise outcomes but rather a broad expectation of returns in excess of cost of capital for both parties.

The issue in relation to accuracy of forecasts certainly comes into play for buy-in payments where a valuation is needed in respect of a contribution of a pre-existing intangible, as mentioned in paragraphs 21 and 25. A similar approach to those set out in Chapters I to VI should be taken in order to establish the value of IP contributions, and taxpayers should be prepared to provide all relevant business evidence in support of such valuations or face adjustments to pricing or the imposition of special measures.
C.4 The value of each participant’s contribution

We do not agree that “contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle”.

Paragraph 22 needs to make it clear that there is a distinction between contributions in the form of pre-existing intangibles that need to be valued and contributions to ongoing costs incurred once under the CCA. We agree that pre-existing intangibles need to be valued for the purpose of defining a return to the contributing participant, and that cost is not appropriate for this purpose. However, ongoing contributions could be measured by reference to cost, as is typically the case in third party arrangements.

By way of example, in a recent deal in relation to an IP asset in development in a non-strategic therapy area, AstraZeneca contributed the asset to a CCA with a third party and fixed the return on this IP by reference to a valuation in the form of an upfront receipt, contingent milestones and future contingent sales related receipts. Contributions to development from inception of the CCA were agreed to be met 50/50 by both participants by reference to costs (not value), with benefits, net of the pre-existing IP returns, being shared 50/50. We would expect similar arrangements to be put in place in CCA’s between associated enterprises.

The examples 1 to 3 in the Annex are theoretically sound, but we are concerned that the measurement of value of contributed services would be very subjective and lead to cross border dispute. We appreciate the pragmatic approach to dealing with low value added services, but in the case of R&D activities provided in our third party CCA’s, there is never measurement by reference to value; rather it is cost based contributions that are taken into account as in the example in the previous paragraph.

In example 4, we understand the approach and basis for the correction to contributions. However, in third party situations there is often an imbalance in activities between parties in circumstances where funding and risk is allocated 50/50. Provided both parties have capability to control and manage the allocated risks, we do not agree that any adjustment would be needed to either contributions or benefits as originally allocated. For example we have a 50/50 CCA between AZ UK and AZ Sweden across all therapy areas. On some projects AZ UK takes the lead and controls the project risk; on other projects AZ Sweden fulfils this role. Both parties share the risks and rewards across all projects, and balancing payments are made to reach an overall 50/50 sharing of costs and benefits. Both parties clearly have the ability to control and manage risks in relation to all projects and participate in the governance committees for projects and therapy areas. Therefore, we would not anticipate any adjustment owing to the imbalance of activity on any one particular project. This arrangement is pragmatic given the dynamics of project management and minor variations day to day in legal entity contributions across a portfolio of a thousand projects. We would suggest that such an arrangement between associated parties should not be subject to adjustment owing to deviations in activity levels from a strict 50/50 split.

In example 5, we do agree that a low functioning entity with no capability to control or manage risks allocated to it by contract should be disqualified from participation in a CCA.
C.5 Balancing payments

We have no concerns with the application of balancing payments, as these do take place in third party arrangements in the event one party incurs more cost than contractually obliged to, and a true up is required to meet the contracted sharing ratio. These payments are generally taxable and deductible as stated in paragraphs 33 to 35.

C.6 Disregarding part or all of the terms of a CCA

We would anticipate that non-recognition of CCA’s between associated enterprises is a very rare occurrence. As stated above, it should not be necessary that physical activities are conducted in strict proportion to contributions and benefits. Provided each participant is taking its fair and proportionate share of risk and funding, deviations in activity levels should be acceptable, as they are in third party arrangements. Therefore, a small contribution by way of activity should not preclude a party being a participant in a CCA, and similarly if a participant is performing all or substantially all of the subject activity it may not necessarily need to be a participant, but could instead be permitted to act as a service provider to the CCA, for example as a contract research organisation.

E. Recommendations for structuring and documenting CCAs

We agree with the guidance on structuring and documentation and would expect taxpayers to be prepared to provide the same to tax authorities on request.

We appreciate the opportunity to submit our views and look forward to making further contributions on the subject. Should you wish to discuss our response further in a meeting or on a call then please do not hesitate to contact me.

Yours sincerely

Ian Brimicombe
Vice President Corporate Finance
AstraZeneca
Comments on the OECD Discussion Draft on BEPS Action 8 “Revisions to Chapter VIII of the transfer pricing guidelines on cost contribution arrangements (CCAs)”

Dear Mr. Hickman,

BASF welcomes the opportunity to provide comments on the Discussion Draft regarding BEPS Action 8 that cares for transfer pricing of intangibles and requires the development of rules to prevent base erosion and profit shifting by moving intangibles among group members.

BASF is a globally operating multinational with operations in over 80 countries and more than 400 production sites. BASF centralizes functions which benefit the group as a whole in order to increase efficiency and effectiveness of its business. As the cost must be borne by the companies benefiting from those functions and taking into account that a quantification of the exact benefit is not possible, BASF, therefore, established a CCA that complies with the OECD guidance given by the current Chapter VIII.

Our CCA is applied for simplification purposes and not for the purpose of shifting profits. That fact should be especially applicable for all CCAs covering services as the shared activities do not aim at creating intangible property but simply at obtaining services and efficiency.

As the revised chapter VIII in certain aspects deviates significantly from OECDs existing guidance on CCAs BASF welcomes the opportunity to provide comments. From our perspective the most important modifications are:

1. Two types of CCAs: A differentiation between development CCAs and services CCAs;
2. The requirement that each participant’s contribution shall be derived from value rather than from cost;
3. The requirement that CCA participants need to have capability and authority to control risks related to the CCA activities in all cases, i.e. also in the case of services CCA.
1. Two types of CCAs

According to the OECD commonly two types of CCAs can be identified: Development CCAs and services CCAs.

A key difference between development CCAs and services CCAs as stated in par. 8 should be that the former are expected to create ongoing, future benefits for participants, while the latter will mainly create current benefits only. In that context the OECD states (see par. 30) that in the case of development CCAs, discrepancies between a participant’s proportionate share of the overall contributions and that participant’s proportionate share of the overall expected benefits may occur in a particular year and that tax administrations should generally refrain from making an adjustment based on the results of a single fiscal year. Rather consideration should be given to a period of years.

One example representative for the many functions that might be covered under services CCAs but do not meet the above assumption are corporate communication activities. They are performed in order to increase sales. Thus different legal entities might be interested in pooling these corporate communication efforts in a services CCA. Usually there will be a time lag between the rendering of a service (corporate communications costs that are allocated within the MNE today) and the intended effect (cost decrease or sales increase in the future). However, it will often not be possible to determine and quantify a specific (expected) benefit, no matter if in the context of development CCAs or services CCAs. Hence – from BASF’s perspective – the proposed differentiation of CCAs into development CCAs and services CCAs by means of the timing of the realization of benefits is meaningless. Benefits often will not be measurable and thus stay abstract, regardless of whether CCAs create ongoing, future benefits or only current benefits. Hence it is not possible to assign and to prove certain benefits in a quantitative way, e.g. as sales increases or cost decreases.

If the OECD nevertheless intends to keep the proposed differentiation the OECD should provide more explicit guidance, especially on the differences between development CCAs and services CCAs as well as on when to apply services CCAs compared to service charging (Chapter VII).

Moreover, in the context of buy-in payments (par. 39) the OECD introduces the new term routine administrative services. Also in this regard BASF would welcome a more detailed explanation on when administrative services can be considered as routine. The OECD should further clarify if the differentiation into routine and non-routine services is in line with the differentiation into low value and non-low value-adding services (see discussion draft on chapter VII).
2. **Value of contribution versus cost of contribution**

The OECD proposes in the discussion draft that contributions have to be based on value instead of cost (see par. 22). From BASF’s view the advantage of a simple application of a CCA when using costs – as costs can be identified easily by the MNEs - would be replaced by a subjective value-based approach.

In general if MNEs are required to charge out certain activities of units that affect also other legal entities of the group, the compliance burden should not be that high that it is almost impossible to fulfil. Already now the legal constraints for charge out of costs only lead to endless discussions with tax authorities on the cost recipient’s side. Given the fact that even based on the current framework a CCA is not easy to establish, the proposed OECD guidance would add by far more complexity to this and would open the door for even more discussions with tax authorities on the right value of a contribution. Instead OECD could make a clear statement of valuing services CCAs’ contributions at cost as we assume that also the OECD will not be able to provide sufficient guidance on how to determine the value of such contributions.

Furthermore we observe CCAs on a cost basis even among third parties (e.g. in the Oil & Gas business or also in the area of R&D). Thus CCAs based on cost should not per definition be deemed as not complying with arm’s length standards because similar arrangements between third parties can be found.

Par. 10 of the discussion draft states that “…the difference between contributions to a CCA and an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected mutual and proportionate benefit from the pooling of resources and skills.” In the light of the proposed assessment of contributions by value the outcome of a services CCA would be comparable to ordinary service charging as proposed in the OECD Public Discussion Draft, BEPS Action 10: Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-Adding Intra-Group Services (as of Nov. 03, 2014). That understanding is strengthened by the examples 1-3 that require individualized pricing of services under a services CCA to each participant. Hence it would be necessary to estimate each participant’s expected benefits from the CCA.

For BASF that has one CCA with around 100 participants sharing more than 20 types of activities such individual price setting is practically not manageable. Further the examples 1-3 suggest that direct pricing between the participants of the CCA would actually be possible as an exact benefit or portion of the contribution can be assigned to each participant. But in reality MNEs apply CCAs as vehicle to come to a reasonable allocation of costs between the participants by applying an appropriate allocation key in such cases in that a specific assignment is not possible.
Further following the proposed guidance to assess the contributions by the subjective value of the respective participants it is not clear whether the value contributed equals the benefit of the recipient. If the OECD assumes that the benefit equals the contribution the following example demonstrates that the OECD proposal might lead to non-arm’s length results:

Two related companies A and B share a certain function under a services CCA. That service function is located at A. The service performed has costs per unit of 100. The expected benefit per unit (true for A and for B) from that service is 300, thus one unit would be valued with 300. Two units are contributed to the CCA, and A as well as B receive one unit each.

Following the OECD proposal A as well as B shall contribute 300 to the CCA. As A actually contributed 2 x 300 and B contributed 0 there should be a balancing payment from B to A of 300. That balancing payment leads to a profit of 100 at A (payment from B minus the cost for providing the services to the CCA = 300 minus 2 x 100 = 100). In addition A has a benefit of 300 due to the consumption of one unit of the service. In contrary company B has after all no benefit out of the CCA because the value received is 300 and the balancing payment made to A is 300 as well simply as the value matches the whole benefit.

In a third party situation it would be meaningless to order such service as there is no benefit left.

According to our experience an unrelated party would not pay an external advisor by the benefits expected from the advisor’s services rendered. Rather the pricing (usually an hourly rate) would be somehow determined based on the service provider’s cost. However, the price for such service would be determined independently from the service recipient’s subjective valuation of the service.
3. **Requirement of having capability and authority to control risks related to the CCA activities for each CCA participant**

Whereas the proposed requirement for each participant’s capability and authority to control the risks associated with the risk bearing opportunity under the CCA (see discussion draft, par. 13) might work out for development CCAs, it does not seem to be appropriate when it comes to services CCAs.

Strategic functions for business units (other than shareholder functions) benefit multiple legal entities in a group. Hence MNEs need to allocate the corresponding costs to all beneficiaries according to legal requirements and are not allowed to keep these costs. As these functions are not classical services, MNEs charge out the corresponding cost under CCAs in order to comply with the existing arm’s length standards. The receiving entities do not have the capability and authority to control risks relating to chargeable functions generally located at headquarter level. Hence the way MNEs are usually organized contradicts to that proposed requirement.

For purpose of clarification BASF would ask the OECD to give guidance on how to deal with such situations as outlined above.

Sincerely,

BASF SE
Central Department for Taxes and Duties

Anne Wenisch         Daniel Zech
Dear Mr. Hickman,

BDI refers to the OECD Discussion Draft “Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs; BEPS Action 8)” issued on 29 April 2015. We would like to thank you for the possibility to provide our comments that allow us to engage with you on these important issues. We focus our feedback on the most fundamental issues raised in the draft.

- Par. 4, 22-26: Value of the contributions / cost-based valuation

  As generally indicated in the discussion draft, the principal purpose of a cost contribution arrangement is that the parties are agreeing in advance to share in the contributions and the risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services. (See par. 3). Based on this arrangement, each of the parties becomes an effective owner in any intangibles or tangible assets resulting from the activity, or entitled to receive services resulting from the CCA, and can exploit such interest or entitlement without paying additional consideration to any party for that interest or entitlement. (Par. 4).

  Pursuant to above and as its name implies, under a Cost Contribution Agreement, the parties are agreeing in advance to pool and share their costs and risks associated with the endeavors. To attempt to value service contributions, such as R&D services in a development CCA, based on the future results of such services,
would be contrary to the purpose and intention of a CCA or joint development arrangement.

- As far as “development CCAs” (as defined in par. 8) are concerned, the discussion draft denies that costs are a reliable proxy for the value of the participant’s service related contributions (par. 22 and 23).

- The discussion draft seems to promote a valuation of the contributions in accordance with Chapter VI of the OECD TP Guidelines (par. 26). This would imply, at least in our understanding, that in many cases the contributions of the participants (for example contribution of services in a development CCA) would have to be evaluated by means of financial valuation methods (e.g. DCF) based on expected commercial results. In addition to being contrary to the intent of the parties when entering into a CCA, frequently development CCAs are concluded in the course of the development of new and innovative business models or products. Development results and marketable results would be therefore uncertain and would leave the parties open to uncertainty in their business dealings spanning large number of years. This would also introduce high complexity in determining the potential values associated with each of their various, and perhaps differing, service contributions. Furthermore, it is well-known that financial valuation methods depend on multiple assumptions, which are, by nature, highly disputable between taxpayers and tax authorities, causing further uncertainty for the taxpayers.

- The implementation of a value based approach for CCAs would therefore significantly increase the compliance burden for MNEs (i.e. requiring more sophisticated documentation and costly expert guidance). The complex valuation principle would also increase the potential for controversy and double taxation for the MNE. Extensive documentation is (already) required to ensure tax deductibility of CCA payments, balancing payments or buy-in/buy-out payments.

- Also, such an approach would have to be aligned with VAT requirements (e.g. regarding the form of the invoice); VAT aspects should also be taken into account when discussing any modifications to the concept of CCAs.

- From that perspective, the costs of the participants should continue to be considered as an objective and pragmatic quantitative indicator for the value of their respective contributions.

- Par. 13: Control of risks

- Par. 13 would introduce an additional restriction for the participants of a CCA. Whilst the existing par. 8.10-8.12 of the
OECD TP Guidelines do not explicitly refer to risks (and their control) as a prerequisite for the participation of a CCA, par. 13 of the discussion draft now requires that all participants of a CCA “have the capability and authority to control the risks associated with risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I (of the OECD TP Guidelines)”.

- We agree that there must be a balance of risks over all participants in a CCA. It is therefore essential to also consider the pool-internal allocation of risks. However, as expressed in our comment letter on the Discussion Draft on BEPS Actions 8, 9 and 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), we have some concerns on the recently proposed approach for the treatment of risks.

- **Par. 16-19: Expected benefits / adjustment provisions**

  - Par. 17 of the discussion draft states that “[i]t may be appropriate, particularly where benefits are expected to be realised in the future, for a CCA to provide for possible adjustments of proportionate shares of contributions over the term of the CCA on a prospective basis to reflect changes in relevant circumstances resulting in changes in shares of the benefits”. It is doubtful, whether the general assumption of such an adjustment provision is a reasonable and practical approach, since a multitude of expectations about values would have to be aligned. These are the individual expectations of values of each party’s own contribution to the CCA and each party’s own benefit from the participation in the CCA. Further each participant might have a deviating own opinion about the value of the respective other parties’ contribution and benefit in the participation of the CCA.

  - Adjustment provisions that span many years will leave taxpayers open and unable to anticipate their funding/cost requirements if they are continually adjusting current payments to “top up” for prior years. An open ended adjustment clause would be an unlikely scenario between third parties.

  - To achieve some certainty any adjustment provisions should be clearly delineated and when based off of forecasted information, should be limited to material divergence that is not due to an extraordinary event that could not have been anticipated at the time the costs were shared.

**General remarks**

- As can be frequently seen in independent party scenarios (e.g. in Joint Venture contracts), expectations about benefits are not necessarily fully disclosed to the other Joint Venture partner and
the value of contributions and benefits is subject to negotiations between the parties. As such a negotiation result is a compromise in a range of potentially expected benefits. We therefore recommend allowing a range of benefits. Each value within the range of benefits should be acceptable and deemed to be a valid value. In CCA scenarios, tax authorities of different countries will further develop their own idea on how the value of each participant’s contribution and benefit should be determined. This will potentially lead to a multitude of discussions and arguments with unpredictable outcome. As a result, these situations of a multitude of deviating value assessments, will lead to double taxations and corresponding applications for dispute resolution measures (e.g. MAPs or APAs).

- For the tax authorities this valuation approach will lead to increased requirement and need for resources to enter into these MAPs and APAs. In order to overcome this issue, harmonization of taxation and transfer pricing rules should be in the focus of the OECD and G 20 rather than the development of artificial valuation rules based on hypothetically expected or deemed benefits of a party to the CCA. Valuation approaches and allocation keys would need to be generally accepted by each country. This is to be accomplished on a political level and should be aligned upfront between all tax authorities involved in auditing one party to the CCA or the CCA in general.

- **Par. 26: Interpretation of contributions as important functions**

  - The discussion draft mentions in par. 26 that contributions in the context of development CCAs “are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets”. We believe that the performance of “important functions” in the aforementioned sense is a too strict criterion for the specification of pool-relevant contributions.

- **Par. 32: Disregard of CCAs**

  - Disregarding a CCA should be a last resort. In case tax administrations may have the right to disregard the CCA in its entirety, tax administration should have the burden of proof that the CCA is not intended to reflect the economic reality, represented by the arm’s length principle.

  - Furthermore, alignment among the tax authorities in different jurisdictions should be required upfront in order to avoid double taxation issues and lengthy dispute resolution measures (MAP or APA).

- **Par. 44: Documentation requirements**
The proposed CCA documentation principles seem to go beyond the existing extensive documentation requirement as defined in BEPS Action 13. A clarification and reduction of requirements would be welcome.

Disclosure of information as requested in f) for each participant of a CCA to the other participants of a CCA is typically not an arm’s length scenario, since one participant might not disclose its individual proportionate idea of the value of benefits to the other participants in order to reduce its own contribution.

Please do not hesitate to contact us if you have any questions.

Sincerely,

Berthold Welling
Dr. Karoline Kampermann
BEPS MONITORING GROUP

BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This paper has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This paper has been prepared by Jeffery Kadet and Sol Picciotto, with comments and input from Veronica Grondona and Cristián Garate.

We welcome this opportunity to comment on the Discussion Draft (DD), and would also be willing to speak at the public consultation on the subject.

SUMMARY

This report consists of a draft revised chapter of the OECD Transfer Pricing Guidelines, with no indication of the changes made, or explanation of the reasons or intended effects, which makes the issues effectively inaccessible to all except the insider community of practitioners. This along with several other reports will result in extensive revisions and additions to the Guidelines, but it will be a piece-meal patch-up, incoherent and in some respects contradictory. The revised text could be adopted and have effect around the world, even in countries outside the OECD and G20, without the need for adoption by states. We therefore recommend that it should be regarded as only provisional, and a more fundamental reconsideration should be begun, in conjunction with the UN Tax Committee.

There can be good reasons for MNEs to share within the group the costs of activities which benefit various parts. However, such collaborative arrangements within MNEs are generally coordinated administratively, and are very different from contractual arrangements negotiated between genuinely independent enterprises each with its own separate business. Based on the mistaken starting point that CCAs between related parties should be treated as if they had been negotiated by independent ones, the proposals in this draft are contradictory and imprecise, difficult to administer, and in their present form would be ineffective in preventing MNEs from using CCAs for BEPS purposes. The suggestion that contributions should be priced according to the value of the benefits and not normally on their costs will again lead tax authorities into the quagmire of searching for non-existent comparables or estimating hypothetical values. On the other hand, it accepts that costs should usually be shared by applying an appropriate allocation key, and aims to prevent inappropriate outcomes by allowing subsequent adjustments to valuations and introducing the requirement that participants in a CCA must have the ‘capability and authority to control’ risks.

We support these proposals, as necessary measures to check CCAs from being used for profit-shifting, and indeed suggest that they should be strengthened. We nevertheless
.chk the increased complexity which is needed to make the Guidelines effective, due to the adoption of a mistaken approach. In view of the many tax planning mechanisms available to MNEs for fragmenting activities and attributing functions to different entities, separating supposedly routine activities, such as contract manufacturing or distribution, from supposedly high-value functions such as design, financial services, or IP management, to allow MNEs also to plan allocation of joint costs without considering apportionment of profits is a continued encouragement to BEPS behaviour.

GENERAL COMMENTS

A. Form of the Consultations and Proposals

1. This Discussion Draft (DD) proposes a new Chapter VIII for the OECD Transfer Pricing Guidelines. As we have noted before, notably in our comments on the Action 10 proposals on Commodities, many of the BEPS Action Points entail extensive revisions of the Guidelines, which could have a major worldwide impact. They will require no formal approval or ratification to be adopted, but could simply be accepted by the OECD Council and G20 Leaders. Yet they will have immediate effect in many states, even those which are not either OECD or G20 members, since they are relied upon by practitioners, revenue administrations and tax courts, often with legislative support.

2. Despite this importance, these proposals have again been formulated in a way which is lacking in transparency or accountability. This report consists simply of a revised version of the chapter, with no indications of the changes made to the previous version. Apart from a single short paragraph in the preamble, there is no explanation or discussion in the DD of the nature of the proposals, the reasons for them, or the intended effects. We regard it as unacceptable that this important process should be conducted in a way which makes the issues effectively inaccessible to all except for those very few insiders who are already well versed with the existing Guidelines. An effort has been made both to include representatives from some developing countries, although the OECD cannot substitute for a truly global organization, and to engage in consultations on the proposals. Yet these efforts are largely nullified if the proposals themselves assume familiarity with existing texts, which they simply aim to modify. This makes it very difficult for even interested specialists to engage constructively, and effectively excludes the wider public. There are many interested and capable people with a good knowledge of international tax who would like to engage with the BEPS project, but very few who could in the time available and in a language which is probably not their own analyze proposals presented in this way. Inevitably, the public consultations have been dominated by representatives of special interest groups, almost all employees of MNEs or of their paid legal advisers, who are generally concerned to defend the status quo. The result is that these important texts are being rewritten by a small community of essentially like-minded specialists, and involve only incremental changes.

3. We appreciate that the work on the BEPS project is being done with a very tight time-scale. This has led some involved in the consultations to argue that some proposals should be delayed or postponed. We have not generally supported such views, since there is clearly a political imperative to produce effective measures as quickly as possible. However, we are now very concerned that the rewriting of the Transfer Pricing Guidelines will produce unsatisfactory results. On the one hand, there will be extensive
revisions and additions, so that over half the text of the Guidelines will be new. Yet on the other hand there has been no attempt to rethink the approach or underlying rationale, only piece-meal additions and revisions to various parts of the text. The result, regrettably, seems likely to be an incoherent and messy patchwork of provisions.

4. This will be a particular problem for developing countries, many of which have only recently adopted regulations on transfer pricing. There may be some opportunity for them to evaluate the relevance of the revised OECD Guidelines for their circumstances in the UN Committee of Experts, where they are better represented. That Committee intends to review its own Manual on Transfer Pricing in the light of the BEPS project. However, it resolved at its last meeting in 2014 that the revision of the UN Manual should ‘seek consistency with’ the OECD Guidelines. It is clearly undesirable for there to be significant divergences in transfer pricing methodologies, yet there is a clear danger of this, especially since the Guidelines do not offer clarity and certainty, but a range of possible methods. Also, as we have several times pointed out, the priority they give to ad hoc functional analysis involves subjective judgments, and the likelihood of conflicts. Finally, a significant divergence is becoming increasingly apparent between the strict ‘arm’s length’ approach, which emphasizes respect for the separate existence of legal entities and the contracts between them, and methods based on the understanding that MNEs are unitary corporate groups and which apportion costs or profits among their members. The existing Guidelines are firmly grounded in the former perspective, but a number of proposals in the BEPS Action Plan now adopt the latter. These include those on limitation of interest deductions, low-value-adding service costs, and the profit split method. Indeed, profit-split has emerged as more likely to be effective in several contexts, including the important area of Intangibles, and for attribution of profits under a revised Permanent Establishment threshold. We support these, as beginning to lay more effective foundations for a 21st century international tax system.

5. Consequently, it seems likely that the new draft Guidelines which will be available by the deadline of October 2015 will be confusing and incoherent. In our view therefore it would be a mistake to consider this revision of the Guidelines as final. We recommend that they should be adopted only on a provisional basis. The Committee on Fiscal Affairs should then take a fresh look at the Guidelines as a whole, with a view to restoring overall clarity and coherence, beginning this effort shortly after the official conclusion of the two-year BEPS project, and in conjunction with the continuing work on the Digital Economy and the PE definition. It is clear that this has not been possible within the BEPS project, for several reasons, including (i) its tight timescale, (ii) the program of revisions on which Working Party 6 had already embarked prior to the BEPS project, and (iii) the new issues which were added as part of the BEPS project, especially Country by Country reporting (CbCR). A more general review of the Guidelines could also be carried out in closer partnership with the UN Tax Committee. This would allow the perspective of developing countries to be more directly expressed. It is clearly unsatisfactory simply to include some developing countries in the BEPS project, where they are inevitably junior partners, while the UN Committee, which also has strong OECD membership, inevitably does not depart much from the standards established in the OECD. We are also concerned that the Toolkits being developed for developing countries will focus on telling them how to implement the BEPS proposals, without considering how appropriate they are, or whether better alternatives may be available, for developing countries.
B. Nature and Treatment of Cost Contribution Arrangements (CCAs)

6. Multinational enterprises (MNEs) often have very good reasons for making arrangements to spread the costs of some types of activity across the group as a whole. These are generally the costs of the large and often continuing investments they make in activities which benefit various parts of the group, or of activities by parts of the group which benefit other parts. The DD (para. 8) now makes a clearer distinction between CCAs involving development and exploitation of intangible or tangible assets, which it suggests entail an expectation of future benefits, and those for services, which are generally for current benefits.

7. The DD continues to try to maintain the basic assumption underlying the Guidelines that such CCAs must be evaluated by treating them as if they were entered into by independent parties dealing at ‘arm’s length’. It is certainly true that independent businesses also sometimes enter into arrangements to collaborate in, and share the costs of, the development of assets or provision of services. In our view however it is a fundamental mistake to think that these are similar or can be comparable to most such arrangements within an integrated MNE. As confirmed by both theory and practice, a MNE operates as a coordinated firm under central direction. Indeed, its competitiveness and profitability largely derive from the synergies resulting from this coordinated combination of activities. These benefits are significant, since they must more than compensate for the significant difficulties and costs of managing a larger and often geographically widely spread organization. Such collaborative arrangements within a MNE group are coordinated administratively, and are very different from contractual arrangements negotiated between genuinely independent enterprises. In our view therefore a different approach is needed, based on a recognition of the reality of the integrated nature of corporate groups. However, given that these proposals aim to establish criteria for validity of CCAs, our Specific Comments section below includes several recommendations that will prohibit an entity from participating in a CCA if its operations and resources do not justify its being treated as a truly independent party.

8. Starting from this mistaken assumption, that entities which are part of a MNE group must be treated as if they were independent parties, is a basic cause of the endless difficulties, increasing complexity and enduring ineffectiveness of international tax rules. Persisting with the fictions of independent entity and arm’s length will require tax authorities to treat MNEs as disaggregated entities, and attribute costs and profits by starting from the transactions between them. This will entail detailed examination of intra-firm arrangements, requiring time and skilled resources which are scarce in the tax administrations of all countries. This resource issue is not just a developing country problem, although of course poor countries have fewer resources to deal with it. In line with several other proposals relating to transfer pricing, especially those on Intangibles and on Risk and Recharacterisation, this DD proposes further refinements to the methodology, to try to make it effective. While this may be a worthy effort, the result will be greater complexity and a system that is hard to administer and will lead to more conflicts.

9. The BEPS project has been set the aim by the G20 world leaders of reforming these rules to ensure that MNEs can be taxed ‘where economic activities take place and value is created’. In our view this entails explicit recognition of the business reality that MNEs
are unitary firms, and the adoption of appropriate methods and criteria for apportionment of the tax base. As we have spelled out in our other submissions, we support a strengthening and systematization of the profit split method, based on specified and weighted concrete allocation keys that are set for all commonly used business models.

10. The approach adopted in this DD is contradictory, and the rules it proposes are imprecise, so that it will lead to confusion and conflict. It suggests on the one hand that the contributions should be priced according to the value of the benefits to the recipient and not normally on their costs (para. 23). This will again lead tax authorities into the quagmire of attempting to estimate hypothetical values based on the unrealistic independent entity assumption and due to the non-existence of appropriate comparables. On the other hand, it accepts that the usual method for apportioning the costs is by applying an appropriate allocation key reflecting the shares of the benefits (para. 16). Furthermore, the DD aims to prevent the inappropriate outcomes which would result from a strict application of the independent entity assumption, notably by (i) accepting that subsequent adjustments to the valuations may be necessary (para. 19), and (ii) introducing the requirement that participants in a CCA must have the ‘capability and authority to control’ risks associated with a CCA (para. 13). We support such proposals, as necessary measures to check CCAs from being used for profit-shifting, and indeed suggest that they should be strengthened. We nevertheless deplore the increased complexity which is needed to make the Guidelines effective, due to the adoption of a mistaken approach to the issue. In the context of the many tax planning mechanisms available to MNEs for fragmenting activities and attributing functions to different entities, separating supposedly routine activities, such as contract manufacturing or distribution, from supposedly high-value functions such as design, financial services, or IP management, to allow them also to plan allocation of joint costs without considering apportionment of profits is a continued encouragement to BEPS behavior.

SPECIFIC COMMENTS

A. Determining Participants (C.2) Paragraphs 13 and 14 and Annex Example 4)

We support the newly added concept in Para 13 ‘that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.’

To make this new concept more effective, we suggest several amendments to new Chapter VIII.

1. Para 13 – Clarification Concerning Personnel Providing ‘Capability and Authority’

Within MNE groups, subsidiaries resident in zero- or low-tax jurisdictions will often have as directors and officers personnel who wear two hats. The principal roles of such persons will be within the MNE’s home country as officers or employees of the parent company or important operating home-country subsidiaries. In addition, these persons will wear the hat of some position within one or more of these zero- or low-taxed subsidiaries.

Under Para 13, in order to qualify as a participant in a CCA, an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity
under the CCA. Para 13 must make clear that an entity will only have the relevant capability and authority where the relevant knowledgeable and authoritative personnel are in fact regular officers and employees whose primary role is working for that entity within substantial operating offices and facilities maintained by that entity. Personnel such as those described in the preceding paragraph could not be included.

We suggest that the following sentence be added to Para 13 immediately before the last sentence in the paragraph:

For an entity to be considered to have the above-described capability and authority, its personnel who possess the relevant capabilities and authority must be employed by and working primarily for that entity, and be regularly stationed in one or more of the entity’s own operating offices and facilities in which it conducts significant operations separate from those of other participants and non-participant group members.

2. Para 14 – Clarification to Prevent the Use of Non-Participant Status for BEPS Purposes

Para 14 appropriately calls for proper arm’s length pricing that reflects other parts of the Guidelines when a non-participant group member carries out all or part of any CCA subject activity. This is of course fine where appropriate.

We are concerned, however, that this provision, without appropriate amendment, will legitimize the use of non-participant status in a development CCA as a mechanism to shift value within an MNE group. Assume the service provider has management, facilities, technical personnel, and tangible and intangible assets, all of which will be used to create value and are critical to that value creation. Such a service provider might well be an MNE group’s parent company or important domestic operating subsidiary in the parent’s country of residence. Assume further that the CCA participants all are operating companies, primarily conducting sales functions, that have some knowledgeable and authoritative personnel, thereby allowing them to arguably avoid being eliminated from participant status by application of the Para 13 requirements. However, these CCA participants neither create any significant value through non-cash contributions nor do their ‘knowledgeable and authoritative’ personnel take any important role in MNE group decisions concerning the CCA or its subject matter. In such a factual situation, allowing the service provider non-participant status would clearly shift significant value and future earnings from the service provider, typically in the MNE’s home country, to the participants, which under BEPS motivated planning will often be located in zero- or low-tax jurisdictions.

We suggest that the following sentence be added at the end of Para 14:

A non-participant would be treated as a participant where its personnel do, in fact, have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.

3. Para 13 – Clarification Concerning Personnel Having the Capability and Authority to Control CCA Risks
The participants in the MNE group described immediately above in the ‘Para 14’ section were stated to be operating companies, primarily conducting sales functions, that have some knowledgeable and authoritative personnel, thereby allowing them to arguably avoid being eliminated from participant status by application of the Para 13 requirements.

Para 13 and Examples 4 and 5 make clear that for an entity to qualify as a participant in a CCA, it must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA. Despite this relative clarity, we expect that there will be many situations like this MNE group where one or more participants attempts to claim compliance with Para 13 through knowledgeable and authoritative business personnel who use the tangible and intangible assets developed within the CCA in the conduct of business, but who neither have the capability nor the internal authority within the MNE group to participate in other than only some tangential manner.

Where group members in several countries are all conducting their own manufacturing operations that use centrally developed tangible and intangible assets and all have the capability and authority to meaningfully contribute to a development CCA and control its risk, then all would be legitimate participants. However, where a group member conducts material business operations consisting of sales, support, and other functions, that alone will not qualify that group member as having capability and authority to control CCA risk.

Considering the above, we suggest that the following sentence be added to Para 13 immediately following the sentence suggested above in ‘Para 13 – Clarification Concerning Personnel Providing ‘Capability and Authority’’:

> An entity will not be considered to have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA where its business operations consist of sales and other business functions that use CCA developed tangible and intangible property and it is only capable of making non-cash contributions to the CCA in some tangential manner.

4. Example 4

Consistent with the above-suggested additional sentence to be added to Para 13, Example 4 must make clear that the Company A personnel who will perform ‘the functions expected from an independent entity providing funding for a research and development project’ must be regular officers and employees of Company A regularly stationed in one or more of Company A’s own operating offices and facilities in which it conducts significant operations separate from those of other participants.

We suggest that the following sentence be added to Para 58 immediately before the last sentence in the paragraph:

> These personnel are officers and employees of Company A regularly stationed in one or more of Company A’s own operating offices and facilities in which it conducts significant operations separate from those of other participants and non-participant group members.

B. Expected Benefits from the CCA (C.3, Paragraph 18).
Para 18 concerns the measurement of benefits received from a CCA. Although not explicitly stated, the implication is that the CCA concerned would very likely be a service CCA rather than a development CCA.

We support the recognition within Para 18 that one or more easily measurable allocation keys may be used; however, as we have previously mentioned, the allocation of costs without a profit allocation encourages BEPS behaviour.

In regard to determining the allocation key or keys, where the various services included within the CCA are unusual or are peculiar to an industry or business sector, then it will likely be necessary to use a ‘facts and circumstances’ approach in selecting the one or more keys and, where there are more than one, assigning weights to each key.

Consistent with our Response to Action 10 Discussion Draft on Low-Value-Added Intra-Group Services, while we recognize that ‘facts and circumstances’ analyses may sometimes be necessary, we believe that such analyses should be avoided where possible to minimize the uncertainty and conflicts that are inherent with such analyses.

We therefore recommend suitable concrete allocation keys for all common categories of central group services that are commonly covered by service CCAs. Such systematization and formalization can be based both on research studies and examination of practical experience. As just one simple example of this, paragraph 7.48 of the Discussion Draft on Low Value-Adding Services lists a number of legal services. One category of such costs is ‘legal as well as administrative work for the registration and protection of intangible property’. A concrete allocation key for this category of legal services could reasonably be the number of IP assets capable of being registered owned by each group member.

We would like to add, as we also pointed out in our Response to Action 10 on LVA Intra-Group Services, that the use of the profit split method avoids any need to allocate common costs through a CCA. Under the profit split method, the costs of services provided from within a group are charged against the combined revenues which are subject to the profit split, thus avoiding the need for deciding whether and how to allocate such costs.

C. The value of each participant’s contribution (C4, and Examples 1-3)

The DD suggests that, in line with the arm’s length principle, contributions should normally be assessed based on their value rather than cost (para. 22). It allows that in some cases ‘for practical reasons’ a cost basis can be used, but only if there is no wide divergence between costs and value. It states that a cost basis would not generally be appropriate, and refers to Examples 1-3, but these only provide calculations and not a justification. For the determination of value it refers to the methods described elsewhere in the Guidelines.

As we have previously commented, attempting to determine the value especially of intangibles (both IP and services) generated within a multinational corporate group by reference to comparables available from independent third parties is wrong in principle and has been found unworkable in practice. This is particularly the case where contributions are made from different parts of the group, as for activities subject to CCAs. For example:
MNEs typically develop branding and advertising programs globally, but these will be adapted to local circumstances to take account of cultural and linguistic differences. How is the value added by such customization to be quantified? Without it, the standard global templates would have little local value, while local adaptations may be far from routine or minor, and can themselves add value to the global brand, since such local positioning enables the recognition factor that creates global value.

Similarly, product designs or processes, which may be patented, may be refined and adapted by local operatives during the production process, or in response to feedback from customers. Such contributions may be hard to identify, especially in advance, let alone to value.

Many activities carried out by MNEs are based on technical and professional skills, and involve groups of employees often working around the world. In such processes there is no clear distinction between provision of services and creation of an intangible asset, since know-how often does not take the form of a legally protected asset, while the value of intangible assets often depends on the skills or knowledge of the persons deploying them. Disentangling and separately valuing with any accuracy the various contributions will be impossible.

Commercial products often incorporate several intangibles, e.g. multi-media products, or product patents and marketing intangibles. It is often in such situations that independent enterprises may enter into collaborative arrangements, e.g. patent pools and cross-licensing. These will usually entail very different commercial and cultural dynamics from collaborations within an integrated corporate group. It is indeed often in response to the challenge of establishing and maintaining contract-based structures that large firms opt for acquisition. If such a decision has been made, for business reasons, it is perverse to treat the acquired entity for tax purposes as if it were still truly independent.

For these reasons assessing the contributions to a CCA based on value will inevitably be highly subjective, even arbitrary. Appropriate comparables will simply be non-existent. Indeed, for these reasons the DD on Intangibles accepts that in many circumstances the most appropriate method where transfers of rights to intangibles are involved is the profit split method (paras. 6.57 and 6.142). Our view, as explained in our submission on Intangibles, is that profit split should be used on a more extended basis, and should be standardized and formalized.

**D. Disregarding Part or All of the Terms of a CCA (C.6, Paragraph 31)**

We support the inclusion of Para 31 and its clarity that CCAs structured for BEPS purposes should be disregarded.

With our perception that a great number of development CCAs have been executed by MNEs primarily for BEPS purposes rather than for legitimate sharing in mutual benefits, we strongly recommend that Para 31 include a rebuttable presumption whenever substantially all non-cash CCA contributions are made by one participant.

We suggest that the following sentence be added at the end of Para 31:
Considering this, in any development CCA where substantially all non-cash CCA contributions are made by one participant or by several participants from the same country, in the absence of sufficient factors to the contrary, it will be presumed that the CCA was constructed to obtain more favourable tax results thereby allowing relevant tax administrations to disregard the CCA in its entirety.

E. CCA Entry, Withdrawal or Termination (D, Paragraph 37)

In an MNE group setting, the only likely situation where there would be a new participant that has valuable tangible and intangible property for which the existing participants would have to make balancing payments would involve newly acquired subsidiaries from a merger or acquisition transaction.

We suggest that the following sentences be added at the end of Para 37:

When a new participant brings its own intangibles and/or tangible assets to a CCA, it may be due to a consummated merger or acquisition transaction conducted at arm’s length. In such a case, the economics of the transaction should be examined for indications of value of the intangibles and/or tangible assets.
Dear Andrew,

BIAC thanks the OECD for the opportunity to provide comments on the revisions of Chapter VII of the Transfer Pricing Guidelines (the Discussion Draft) on Cost Contributions Arrangements (CCAs) relating to Actions 8, 9 and 10 of the Base Erosion and Profit Shifting (BEPS) Action Plan. As always, we want to acknowledge the significant amount of hard work and effort that has been put into this project.

CCAs are arrangements that allow participants to share in risks and benefits through jointly developing, producing or obtaining assets, services, or rights. More importantly, CCAs are cooperation models that allow MNEs to innovate and invest in high-risk projects, developing business opportunities and creating a positive impact for the global economy. Although abusive cases do exist, it is important that not all existing CCAs are automatically considered to create BEPS risks. CCAs, in the majority of cases, are used for genuine commercial purposes, and to streamline the application of the Arm’s Length Principle (ALP) where multiple parties share costs, risks and benefits.

BIAC understands and agrees that a key objective in revising the CCAs guidance is to “align the transfer pricing of intangibles under CCAs with the general guidance on the transfer pricing of intangibles found in the revised Chapter VI” [i.e., the ALP], and to make the Chapter VIII guidance consistent with the broader BEPS transfer pricing (TP) work, including proposals to address the fundamental issues of risk, capital, recharacterisation and intangibles. BIAC supports the OECD’s work to improve its Transfer Pricing Guidelines (TPG). To that end, we recommend that the CCA rules be as simple as possible, draw from current best practices and, thereby, reduce the likelihood of future litigation. To spell that out a little, we believe that the project should:

Ref: OECD DISCUSSION DRAFT: BEPS ACTIONS 8, 9 AND 10, REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS
Avoid introducing complexity into an area of the TPG that currently provides a relatively straightforward method of applying the ALP, that in turn facilitates efficient business models;

Keep the OECD’s CCA guidance as close as possible to other international CCA approaches; and

Seek to avoid more TP disputes that ultimately create adversarial relationships between taxpayers and tax administrations. (This, as we have written in other comments, is particularly important if dispute resolution mechanisms are not substantially improved.)

Unfortunately, although the Discussion Draft states that simplification and consistency are at the core of the OECD’s aims, we do still have certain concerns:

- The proposals create fundamental uncertainties about the purpose of the CCA concept. Such uncertainty is illustrated by the requirement for “contributions to be measured at value rather than at cost (...) to ensure that outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA.” The requirement for R&D and other development services/activities contributed by participants to a CCA to be accounted for at value, where costs are not considered to provide a reliable basis for value, represents a fundamental change from the existing TPG. We deal with this at length below, but this is a critical issue.

- If the proposed requirement that all participants in a CCA must have the capability and authority to control the risks associated with the “risk-bearing opportunity” under the CCA, is applied too broadly by tax administrations, much of the simplification and other advantages offered by CCAs would be diminished. The Discussion Draft should clearly state that, whilst parties to a CCA should indeed have the capacity and authority to identify and understand the risks associated with the opportunity, a related party CCA should not create an obligation for all parties to control risks associated with a CCA on an ongoing basis, which would run counter to how unrelated parties operate.

In the attached comments you will find more detail on the above, as well as on a number of related issues. We very much hope that you find these comments useful, and we look forward to continuing to work with you on this important issue.

Sincerely,

Will Morris
Chair, BIAC Tax Committee
Introductory Comments and Executive Summary

1. As a preliminary comment, it is worth considering the purpose of CCAs. A CCA creates joint economic ownership whereby the participants share the risks of activities in return for rights to the value created by those activities. This includes the risk that a service or asset does not deliver on the expected benefit for the participants/contributors in general. CCAs enable firms to effectively and efficiently develop or acquire services, goods, tangible or intangible assets. By paying for costs in proportion to the expected benefit, entities buy an entrepreneurial interest in the outcome of the activities. CCAs are commonly applied, both internally and with third parties, in high-risk industries such as biotech, pharmaceutical, movie, and oil and gas.

2. MNEs perform their activities globally and are often organized into “hubs” – creating centres of expertise. MNEs tend not to replicate their entire operations in every country where they operate, choosing more efficient global operating structures. In particular, when MNEs perform services, technical development or research activities in different entities throughout the world, such entities may contribute to the creation of intangibles or services deriving from such activities in a number of ways (for example, in cash or in kind), with various benefits and appetites to share the ownership or use of such intangibles.

3. Such global business models can lead to very complex systems of cross charges, which are very difficult to manage. Moreover, when intangible development activities are highly complementary or integrated, it can be difficult to determine the appropriate cross-charges or value contributed by each party. In this regard, we welcome the new language in paragraph 6 stating that “a CCA can provide a mechanism for replacing a web of separate intra-group arm’s length payments with a more streamlined system of netted payments, based on aggregated benefits and aggregated contributions associated with all the covered activities.” And that “a CCA for the sharing in the development of intangibles can eliminate the need for complex cross-licensing arrangements and associated allocation of risk, and replace them with a more streamlined sharing of contributions and risks, with effective ownership of the resulting intangible(s) shared in accordance with the terms of the CCA.” This language highlights some of the valuable benefits of CCAs.

4. It would be helpful to clarify the definition of “value contributed” in the Discussion Draft. Activities may create routine or non-routine (intangible) value. For example, if an entity that participates in a CCA performs R&D activities, is its contributed value equal to its R&D costs plus an arm’s-length return on those activities? Or is its contributed value equal to the amount of expected intangible value created by the entity? The examples provided in the Discussion Draft suggest that the concept of value refers to the latter, since the contributed value equals the expected benefits. While the former does not significantly alter the risk-sharing nature of CCAs, the latter would change the nature of the relationship similar to that of an IP owner that charges the other participant for the use of the intangibles that it expects to create.

5. The principle of a CCA is that all participants contribute to the arrangement, and in turn, expect to share in their proportionate benefit and risks. The two fundamental criteria that are taken into account when establishing a CCA are therefore:
i. Contributions to the CCA; and

ii. Expected benefits from the CCA.

The TPG and ALP should apply to CCAs so that contributions are commensurate with the expected benefits. This should drive all other considerations under a CCA in relation to the nature and identity of the participants, the way costs and benefits are shared, the ownership of the intangibles and the way buy-in or buy-out payments are established.

6. Testing the arm’s length nature of a CCA using an alternative method, where all embedded transactions are delineated to separately apply Chapter I and VI principles will create a new "Value Contribution" concept, making many existing CCAs untenable. That approach is not in line with the CCA concept, or how third parties might interact with each other under comparable circumstances. Requiring all component transactions are tested or valued as if the participants were not parties to a CCA, which would, by definition, eliminate much of the administrative benefit of entering into a CCA. BIAC believes that transactions within a CCA are not necessarily comparable to transactions under other business models, as there will be differences in risks shared, cooperation, or differences in the way that assets are owned throughout the arrangement. The differences in functional, risk profiles and the economic ownership of assets should be addressed. In other words, the risks that participants in a CCA assume are not necessarily the same as would have been agreed outside a CCA. Firms enter into agreements with third parties and share the costs of activities in accordance with their expected benefits. By sharing costs, entities share the risks associated with the activities. CCAs are valid commercial arrangements, reflected in third-party arm’s-length transactions, which should be recognized in the Discussion Draft.

7. Although the Discussion Draft acknowledges the need for simplification, we are concerned that it will actually create additional complexity and disputes, substantially reducing the attractiveness of CCAs in a related party context. This result seems inappropriate given that CCAs are often utilised by independent parties to share risks and returns.

**Detailed Analysis:**

**Participants:**

8. The Discussion Draft’s definition of who can participate in a CCA moves substantially away from the position in the current TPG. The new definition is greatly restricted, indicating that the ‘right’ functions must be performed to warrant participation (see Examples 4 and 5). When those functional requirements are not satisfied, the Discussion Draft suggests that the CCA should be disregarded, or that participants not connected to the intangible should be disregarded as participants in the CCA. This creates a new requirement to determine which parties can participate in a CCA, by proposing that they must have the capability and authority to control the risks associated with the “risk-bearing opportunity” under the CCA. In this regard, we believe that the Discussion Draft would benefit from clarification as to when and how a related party must have the capability and authority to control the risks associated with a CCA. As suggested above, the Discussion Draft should clearly state that, whilst parties to a CCA should indeed have the capacity and authority to identify and understand the risks
associated with the opportunity, a related party CCA should not create an obligation for all parties to control risks associated with a CCA on an ongoing basis, which would run counter to how unrelated parties operate. CCA participants may have the capacity to accept or decline the risk-bearing opportunity, but may choose not to be involved in managing the risk of the CCA project on an on-going basis. Such arrangements should be respected as being consistent with how unrelated parties conduct themselves. One reason third parties enter cost-sharing arrangements is that they would like to participate in a business opportunity in which their company lacks the capability to undertake on its own. Having multiple parties co-control activities and risk management on an ongoing basis increases bureaucratic costs and can create conflict and power struggles. For this reason, it is common practice to delegate day-to-day management of risk to the entity with the best capability to manage it, and grant all participants the control rights to intervene, only when necessary.

9. In addition to our comments above in relation to a party’s capability and authority to control the risks associated with the “risk-bearing opportunity”, we are concerned about the importance of controlling “the development, exploitation and maintenance of intangibles, for a CCA participant to be entitled to the returns from a CCA and connected to an intangible.” Again, we note that parties to a CCA, after undertaking a full and detailed assessment of the opportunity, may choose to invest but to relinquish ongoing control over the opportunity to another party (including the development, exploitation and maintenance of assets). The Discussion Draft could be interpreted as meaning that any party not controlling those ongoing activities (for example, a provider of funding), would not be entitled to participate in a CCA. Further clarity is required to determine when and how parties can be considered to have exercised sufficient control at the outset of the CCA and on an ongoing basis to better match the Discussion Draft guidance with the behaviour of third parties operating in comparable circumstances.

10. In addition, it is common practice that CCAs replace a complex web of separate intra-group transactions, the explicit requirement on the capability and authority to control the risks associated with the ‘risk-bearing opportunity’ might be difficult to evidence and could result in lengthy discussions with tax administrations.

11. The following examples illustrate some CCAs between unrelated parties.

a. Arrangements exist in the Oil & Gas sector where unrelated parties enter into large consortiums, often in joint ventures, to share benefits and risks. An operator is appointed to run operations on behalf of the joint venture (JV). The operator functions as the substitute for operations that would otherwise have to be performed by the JV members. The operator provides technical, administrative, professional and other services. It is common in the Oil & Gas industry that contributions of JV members are valued at cost and they may not earn a profit from undertaking activities for the benefit of the JV. This is set out in contractual arrangements between the unrelated parties, which often include government-owned companies. Such practices have been common since as early as the 1950s.

b. Similarly, unrelated parties operating in the pharmaceutical and biotech industries often enter into CCAs. In this regard, we note that Biotech firms partnered with third parties to
create 63 of the 100 top-selling biotechnology drugs in 2005. In 2015, five of the ten largest U.S. Biotech firms (50%) have collaboration agreements where the participants share costs. For many Biotech firms, CCAs provide funding and risk reduction, as one CCA participant may fund the development project in return for the right to commercialize the product.

c. In the movie industry, all productions require at least one co-financing studio to provide capital. It is often the case that the co-financing studios contractually relinquish control over any and all of the creative decisions involved in making and advertising the movies.

12. Evidence of such cost sharing arrangements with third parties exists in publicly available SEC filings. We have provided extracts from a number of those public filings in the Annex to this document, including some example text from an actual CCA agreement.

13. In addition to the above comments, we would like to raise the following points and questions:

a. **Example 4:** It is not clear what the activities of Company A are. If Company A is able to i) control the risk in line with current Chapter IX of the TPG, ii) has the necessary funds, iii) has the expertise to make important decisions, and iv) control the budget for development, enhancement, maintenance, protection or exploitation, then presumably the outcome is different, and Company A would be regarded as a participant and entitled to more than just a funding return?

b. **Example 5:** We would welcome further detail in example 5 to explain what impact the conclusion (i.e. *that Company A cannot be regarded as a participant in the CCA*) would have on the arm’s length nature of the compensation, and how or if the outcome would differ to the funding type return suggested as the outcome under Example 4? We believe that the conclusions reached under Examples 4 and 5 do not reflect how unrelated parties approach similar CCAs.

c. **Paragraph 14 and Footnote 1:** What would be the outcome and appropriate TP method for services provided in a CCA (since such service provider should be assumed not to bear any risk or own any assets)?

d. **Paragraph 12:** This paragraph states that a participant must be assigned an interest in the intangibles, tangible assets or services that are the subject of the CCA. It should be clarified that this relates to an assignment of beneficial, rather than legal interest. Any requirement for formalised joint legal ownership will have many non-income tax ramifications.

e. What would the conclusion be if a participant contributed an existing intangible to a CCA, did not contribute to future development, but did provide financing (cash) on an ongoing basis? Should that participant be excluded from the CCA through an appropriate buy-out payment?

**Contributions:**

14. The Discussion Draft assumes that contributions must generally be assessed based on their value (rather than their cost). This represents a fundamental change, where it is assumed that

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cost does not provide a reliable basis for valuing the contributions of the participants to a CCA (Paragraph 23, examples 1 to 3). This approach reflects the general increased focus on the performance of functions and the assumption of risks in the BEPS discussion draft on risks and recharacterisation. In addition, this imports concepts from the latest OECD discussion draft on Intangibles, by placing functions relation to the “development, enhancement, maintenance protection and exploitation” of an intangible at the heart of any profit flow within a CCA. For example, Paragraph 13 requires all CCA participants to control risks "in accordance with the definition of control of risks set out in Chapter I." Again, we believe that this risks contradicting how third parties often conduct themselves.

15. Under the proposals, all important R&D and other development activities and services contributed by the participants to a CCA will need to be accounted for/priced individually, at value rather than at cost. In practice, this would mean that arrangements that currently allow participants to share the costs of creating or enhancing intangibles or providing services in accordance with a participant’s share of expected benefits would no longer qualify as a CCA. This would have a substantial impact for smaller MNEs or ‘start-ups’ operating on a cross-border basis, where the compliance effort associated with applying more onerous and complex TP requirements would represent a significant burden. This approach is also inconsistent with the US\(^2\) and Japanese\(^3\) rules applicable to Cost Sharing Arrangements (CSAs).

16. The Discussion Draft does not seem to consider the provision of capital as a real or legitimate contribution to a CCA. There are many places throughout the Discussion Draft where the guidelines have been redrafted to eliminate references to "costs", "amounts", or the term "whether in cash or in kind". It seems that contributions must now be something other than financial. In this regard, we note that all reference to cash contributions, other than in the context of balancing payments, have been deleted. The final example (5) also suggests that an entity providing cash without the ability to make decisions with respect to risk cannot be considered to bear or share in the risk, and, therefore, cannot be a regarded as a participant in the CCA. We note that there are real-life examples where unrelated parties contribute only financing to CCA type transactions (based on an up-front assessment of the project risk profile and expected return), where the provider of such financing will have no control over the ongoing project/risk and will be exposed to up-side and down-side potential. This is the case in the movie, pharma and biotech industries.

17. We understand that the use of “cash box” transactions (i.e. where intangibles are owned by or financing is provided by a highly-capitalised low-function entity in a low-tax jurisdiction) is at the heart of the BEPS project, and its objective to align the taxation of profits with substance. Although we support that broad project objective, we are concerned targeting cash box structures with substantial changes to the TPG will have a wide-ranging impact on CCAs, where

\(^2\) The US rules appropriately separate the contribution of pre-existing rights and ongoing contributions. The former are assessed at value, the latter are assessed at cost. The US CSA appropriately reflect the economics of CCAs. Contributions of pre-existing rights are economically very different from contribution of ongoing development. The former involves sunk costs and should be contributed at value, the latter involve fixed costs that impact the cost of capital of the participants. Ongoing contributions have to be assessed at cost so that each participant faces the same proportionate increase in cost of capital as the overall investment.

\(^3\) The concept of ‘value’ is fundamentally inconsistent with the Japanese CCA Guidelines which define a CCA as ‘a contract to share the cost required for the activities necessary for the achievement of a common purpose’. The guidelines refer only to cost, there is no reference to value. (Commissioner’s Directive on the Operation of Transfer Pricing, NTA, 1 June 2001).
related parties contribute funding from non-cash-box entities. Excluding all funding providers from CCAs will transform such arrangements into quasi-partnerships, requiring funding from related parties though some form of loan arrangement. Establishing such debt in accordance with the ALP would be complicated, and would require substantial TP analysis – in this regard, third party funding providers to pre-revenue and pre-profit start-ups often attach warrants and other security provisions to their transactions so that they can share in the up-side and down-side of the venture, even though they have no control over ongoing functions or risks (much like a funding provider to a current CCA might have).

18. We believe that revised Chapter VIII should continue to permit the contribution of funding to CCAs, and the consideration of other contributions at cost, rather than value. Concerns in relation to cash-box structures would be appropriately addressed through more targeted proposals. The purpose of a CCA is to allow the sharing of risks (and expected benefits), and, as a result, encourage the development of intangibles, where the risk may be too large to be borne by only one participant. We understand that the Chapter VIII guidance on CCAs has not traditionally intended to provide the same result as the application of the other chapters of the TPG – revising the guidance to prohibit the actual sharing of costs is inconsistent with the purpose of a CCA.

19. The key principle in applying the ALP to a CCA should not be to value contributions to the CCA, but to establish whether the benefits received from the CCA are commensurate with contributions. We believe it is also important to recognise that unpacking the components of a CCA arrangement to apply difficult TP principles goes against some of the very reasons that they are used by MNEs – to avoid the need to delineate complex transaction flows that are challenging to price.

20. CCAs are used as legitimate business models for developing (intangible) assets and performing services. With the proposed changes to the CCA concept, and the way in which contributions need to be determined, the complexity of operating a CCA increases substantially. This will lead to a disproportionate increase in administrative burden, which is inconsistent with the acknowledgment that CCAs should provide a mechanism to replace a web of separate intra-group transactions.

21. In addition to the above comments, the Discussion Draft raises the following questions and comments:

a. Paragraph 6 and 7: CCA facilitates the pooling of resources, skills, expertise and the joint sharing of risk where compensation is provided by the expected mutual and proportionate benefit derived from the CCA. They are also different to arrangements outside a CCA for various reasons, e.g. sharing risks, cooperation and that assets are owned. As a result, such transactions are not generally comparable to activities outside a CCA, as the key differentiator is sharing the risks among the participants. Such arrangements should therefore be treated differently in order to be in line with the ALP.

b. Paragraph 6: This paragraph identifies the advantages of CCAs with respect to simplification of certain transactions. We believe that simplification is largely achieved through the reliance on cost, rather than the arm's length value, to measure the contribution of low-
value service providers to CCAs. It is not clear how taxpayers should split CCAs between “low value” services and others, or how is this consistent with the discussion draft on low adding value services?

c. **Paragraph 23:** We suggest deleting the following text from the example: “mixture of low-value and high value adding services”. This suggests that companies utilising a CCA with a web of intra-group activities would not be able to value the low-value-added services portion at cost. The ‘value at cost’ option should be broadened to situations where the services received are of a similar nature to the services provided which would reflect current practices between unrelated parties, for example, as is the case in the Oil & Gas industry. Requiring all contributions to CCAs to be valued will vastly increase cost and administrative requirements, not only for taxpayers, but also for tax administrations that audit them.

d. **Paragraph 26:** We do not fully understand the rationale behind requirements for the control of the CCA (i.e. “contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation”). In line with BIAC’s previous comments on risk and recharacterisation – we would welcome greater clarity over the expected impact of the proposed changes to Chapter 1 of the TPG, and how that might apply to CCAs.

e. **Paragraphs 31 and 32** seem to provide special rules for disregarding CCAs. Disregarding a CCA should be a last resort. It should be possible in virtually all cases to adjust the contributions/benefits to reflect the ALP, and how third parties would have established prices in comparable circumstances.

**Benefits:**

22. The Discussion Draft only focuses on direct benefits deriving from a CCA (“such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants” (Paragraph 3)) and has deleted the references from the existing guidance to the possibility of “indirectly” benefiting from the interests in a CCA (Paragraph 12). As previously stated, the notion of benefits is crucial to assess whether or not a CCA respects the ALP. We would welcome further discussion on how and when to define benefits rather than applying more complex valuation and risk concepts to all components of a CCA.

23. If an entity can only participate in a CCA if there are direct (expected or actual) benefits deriving from the arrangement, this will increase the number cases where corporate tax deductions for the cost of contributions to a CCA are challenged. This also implies that only certain benefits can be received in connection with a CCA.

24. We believe that the Discussion Draft creates confusion around the new distinction between CCAs established for the joint development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets (“development CCAs”), and CCAs established for obtaining services (“services CCAs”). While we understand the intention of the Discussion Draft is not to create two separate sets of rules for these types of CCA, the revised guidance does state clearly that development CCAs typically create “ongoing, future benefits” for participants, whereas services CCAs typically result in “current benefits”. We believe that this new distinction may contribute to disputes between taxpayers and tax administrations with
25. The current Chapter VIII of the 2010 OECD TPG mentions that a CCA should normally “allow” for balancing payments or for the allocation of contributions to be changed prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants. The Discussion Draft states that a CCA requires that such balancing payments or changes in the allocation of contributions are made on a regular basis. This seems to reflect a presumption that the relative contributions and rights of the participants to a CCA will always evolve over time, and, should be looked at regularly and on a retrospective basis (not only at the beginning or at the end of the CCA project). A requirement for frequent review will not only add additional complexity, but does not reflect how unrelated parties would transact with each other in comparable circumstances – such requirements should reflect the behaviour of unrelated parties in comparable circumstances. In this regard, we note that the mechanics of cost sharing calculations between third parties may well not change for under-performance. Instead, on a look-forward basis, the budget calculations would be adjusted to account for changes in future expected costs or revenues.

26. The Discussion Draft also raises the following questions and comments:

a. Paragraph 17 and 19: The Discussion Draft suggests that if projections are different to actual results, adjustments may be required. As above, we believe that transactions between related parties should reflect how unrelated parties transact in comparable circumstances. Adjustments should therefore only be made to a transaction if unrelated parties would have done the same – although we do recognise that this can be difficult to prove either way. When considering adjustments, great care should be taken not to use hindsight, especially as regular adjustments are likely to create disagreements with tax administrations, increasing the likelihood of double taxation. Many unrelated parties accept risks based on projections, with very limited opportunities to renegotiate contracts. In this regard we note that the requirement for ‘reasonably foreseeable’ projections echoes the proposed changes to Chapter 1 of the TPG, does not clearly define the concept or take account of commercial reality - often very little reliable data is available at the date a decision is made. It is not clear how a taxpayer would evidence the appropriateness of the possible adjustment identified in Paragraph 19. Further guidance is needed to explain how to evidence when independent parties would or would not have renegotiated the terms of a CCA agreement, when the expected benefits are allocated based on an allocation key, if expected and actual benefits to participants differ.

b. Paragraph 27 and 42e: The OECD should not rule out that a cost can still be an appropriate proxy to reflect the value of services and can be used in cases where the expected benefits have not yet materialized. Value may fluctuate over time and is therefore not always a good reflection of the expected benefits. In relation to this, we ask for further clarification on the frequency and timing that balancing payments need to be made as long as the expected benefits have not yet materialized. The issue of balancing payments has always been contentious, even now when contributions are valued at cost. Under the value concept, the likelihood of disputes (when one tax authority seeks to disallow the balancing payment) will
increase. Whilst tax authorities with significant resource and experience of dealing with valuations may be able to handle such disputes (although they will be longer and thus more expensive than before), those tax authorities that do not have access to complex valuation expertise will be at a significant disadvantage. Currently, they benefit from a more level playing field because cost is relatively easy to establish compared to value. This Discussion Draft is therefore tipping the balance in favour of larger and well-established tax authorities and against those with fewer resources and less experience.

c. **Paragraph 33:** This paragraph is inconsistent with US rules on the treatment of payments under a CSA. The US rules provide that a payment under a CSA should be treated as a reduction of deductions rather than an amount of income. We believe this treatment is the appropriate treatment under the CCA guidelines.

**Documenting CCAs:**

27. The new approach to CCAs represents paradigm change in terms of Transfer Pricing Documentation (TPD). Additional requirements for documentation will lead to a higher administrative burden and increased complexity. The suggested documentation is relatively specific and detailed, and would presumably be required over and above the documentation required by the OECD’s recently issued guidance on transfer pricing documentation (BEPS Action 13). We, therefore, ask for greater alignment with BEPS Action 13.
Appendix: Examples of Third Party Arrangements
The following are just a few examples of paragraphs taken from publicly available SEC filings.

Aerospace Firm:
“We have established cost sharing arrangements with some suppliers for the [product program]. Our cost sharing arrangements state that the supplier contributions are for reimbursements of costs we incur for experimentation, basic design, and testing activities during the [product program] development. In each arrangement, we retain substantial rights to the [product program] part or component covered by the arrangement. The amounts received from these cost sharing arrangements are recorded as a reduction to research and development expenses since we have no obligation to refund any amounts received per the arrangements regardless of the outcome of the development efforts. Specifically, under the terms of each agreement, payments received from suppliers for their share of the costs are typically based on milestones and are recognized as earned when we achieve the milestone events and no ongoing obligation on our part exists. In the event we receive a milestone payment prior to the completion of the milestone, the amount is classified in Accrued liabilities until earned.”

Entertainment Firm
“We typically attempt to mitigate the financial risk associated with film production by negotiating co-production agreements (which provide for joint efforts and cost-sharing between us and one or more third-party production companies) and pre-selling international distribution rights on a selective basis, including through international output agreements (which refers to licensing the rights to distribute a film in one or more media generally for a limited term, in one or more specific territories prior to completion of the film). We also often attempt to minimize our production exposure by structuring agreements with talent that provide for them to participate in the financial success of the motion picture in exchange for reducing guaranteed amounts to be paid, regardless of the film’s success (referred to as “up-front payments”). Additionally, from time to time, we have entered into other co-financing, development and production-type arrangements with third parties. For instance, we recently entered into an agreement with [Third Party], and its wholly-owned [subsidiaries] to co-finance qualifying [company’s] feature films for three years.”

Pharmaceutical Firm
“We enter into alliances with third parties that transfer rights to develop, manufacture, market and/or sell pharmaceutical products that are owned by other parties. These alliances include licensing arrangements, co-development and co-marketing agreements, co-promotion arrangements and joint ventures. When such alliances involve sharing research and development costs, the risk of incurring all research and development expenses for compounds that do not lead to revenue-generating products is reduced. However, profitability on alliance products is generally lower because profits from alliance products are shared with our alliance partners. We actively pursue such arrangements and view alliances as an important complement to our own discovery, development and commercialization activities.”

Biotech Firm
“We are party to a collaboration with [Third Party] to jointly develop and commercialize [Product] worldwide, except in Country X. The rights to develop and market [Product] in Country X are
reserved to [Third Party]. [Third Party] has no obligation to pay royalties to [Company] for sales of [Product] in Country X. Under the agreements, we fund 50% of mutually agreed R&D costs. In the United States we co-promote [Product] with [Third Party] and share equally in the profits or losses of [Product]. Outside of the United States, excluding Country X, [Third Party] manages all commercialization activities and incurs all of the sales and marketing expenditures, and we reimburse [Third Party] for half of those expenditures. In all countries outside of the United States, except Country X, we receive 50% of net profits on sales of [Product] after deducting certain [Third Party]-related costs.”

More Detailed Example of Third Party Relationship

The following describes a collaboration agreement between a company, a third party, and the third-party’s affiliate. The following is a description from its SEC filings. The agreements were filed with the SEC.

“we entered into a worldwide collaboration and license agreement (the "Agreement") with [Third Party] and its affiliates ("Third Party Affiliate") for the development and commercialization of [Product], and certain compounds structurally related to [Product] in the U.S. and outside the U.S.

The collaboration provides [Third Party] with an exclusive license to exploit the underlying technology outside of the U.S. (the “License Territory”) and co-exclusively with [Company] in the U.S.

The collaboration has no fixed duration or expiration date and provided for payments by [Third Party] to us of a [**] non-refundable upfront payment upon execution, as well as potential future milestone payments of up to [**] based upon continued development progress, regulatory progress, and approval of the product in both the U.S. and the License Territory....

The agreement includes a cost sharing arrangement for associated collaboration activities. Except in certain cases, in general [Third Party] is responsible for approximately [**%] of collaboration costs and we are responsible for the remaining [**%] of collaboration costs. In general, costs associated with commercialization will be included in determining pre-tax profit or pre-tax loss, which are to be shared by the parties [%/%].

The agreement also provides for [%/%] sharing of pre-tax profit or pre-tax loss from commercialization of any products resulting from the collaboration. Both parties have responsibilities for the development, manufacturing and marketing of products resulting from this agreement. [Third Party] has the sole responsibility and exclusive rights to commercialize the products in the License Territory. The parties hold joint responsibility and co-exclusive rights to commercialize the products in the U.S., and [Company] will serve as the lead party in such effort. We continue to work with [Third Party] on protocols and the design, schedules and timing of trials.”

Included below is a redacted version of some of the key terms from contract relating to the third party example described above.
Development Costs.

Development Costs shall mean full-time employee Costs and Out-of-Pocket Costs incurred by the Parties and their Affiliates in Developing the Products in the Field, in each case to the extent incurred in accordance with this Agreement, the Development Plan and the Development Budget as follows:

- all Out-of-Pocket Costs and full-time employee Costs incurred for activities specified in the Development Plan;
- the full-time employee Costs of personnel directly engaged in performing Development activities under the Development Plan, which costs shall be determined based on time actually spent performing the applicable activities, unless another basis is otherwise agreed in advance by the Parties in writing. Notwithstanding the foregoing, if a finance professional employee of a Party or Affiliate is dedicated for more than 50% of his or her time, on a full-time equivalent basis, to supporting activities under the Development Plan (for example, performing financial planning with respect to the Development program), then the applicable portion of such employee’s time shall be considered a Development full time employees (or portion thereof, as applicable), and the full-time employee Costs of such employee may be included in Development Costs;
- the Out-of-Pocket Costs and full-time employee Costs of supplies for such efforts as set forth in the Development Plan, including (i) the Supply Cost of the Product; (ii) costs and expenses incurred to purchase or package Third Party [Products]; and (iii) costs and expenses of disposal of samples;
- Out-of-Pocket Costs representing fees incurred in connection with Regulatory Filings with respect to Products in the Field;
- all Out-of-Pocket Costs and full-time employee Costs associated with pre- and post-approval commitments mandated by Governmental Authorities, to the extent incurred with respect to Products;
- Out-of-Pocket Costs and full-time employee Costs incurred in connection with (i) manufacturing process, formulation and delivery system development and validation; (ii) manufacturing scale-up and improvements; (iii) stability testing; (iv) quality assurance/quality control development; and (v) qualification and validation of Third Party contract manufacturers and subject to the terms and conditions of this Agreement, the Supply Agreement and the Supply Agreement(s), and if a Party or an Affiliate of a Party is established as a supplier, the Out-of-Pocket Costs and full-time employee Costs to do so, including the transfer of process and manufacturing technology and analytical methods, scale up, process and equipment validation, and initial manufacturing licenses, approvals and inspections;
- Out-of-Pocket Costs and full-time employee Costs identifiable to establishing, updating and maintaining a global safety database for Products;
Out-of-Pocket Costs and full-time employee Costs associated with companion [Products], if applicable to the Development of a Product; and

any other Out-of-Pocket Costs and full-time employee Costs incurred that are explicitly included in the Development Budget included in the Development Plan.

Development Costs shall exclude all of the payments set forth in Sections [*], all payments pursuant to Section [*] and Allowable Expenses as defined in the Financial Exhibit and capital expenditures, and any other cost not included in Development Costs, including by way of example, costs attributable to general corporate activities, executive management, investor relations, treasury services, business development, corporate government relations, external financial reporting and other overhead. For the avoidance of doubt, Development Costs do not include Out-of-Pocket Costs, full-time employee Costs or other amounts that are attributable and allocable to Post-Approval [Activities].

Cost Sharing. Subject to Section [*], Development Costs incurred during the Term by the Parties shall be borne [%] by [Third Party] and [%] by [Company], except with respect to Development Costs for [Product], which shall be borne [**] by [Third Party] and [**] by [Company]. For the avoidance of double-counting, the Parties acknowledge and agree that Development Costs shall not be included in Allowable Expenses for purposes of calculating Pre-Tax Profit or Loss in accordance with the Financial Exhibit (and, likewise, that any amounts included in Allowable Expenses shall not be included in Development Costs). Payments under Existing Third Party Agreements incurred after the Effective Date that are attributable and allocable to the Development activities for which the Parties share (or reimburse) Development Costs under this Agreement shall be included as Development Costs shared (or reimbursed, as applicable) by the Parties.

Reimbursement of Development Costs. Subject to Section [*], the Party (with its Affiliates) that incurs more than its share of the total actual Development Costs for the Products shall be paid by the other Party an amount of cash sufficient to reconcile to its agreed percentage of actual Development Costs in each Calendar Quarter. Notwithstanding the foregoing, on a Calendar Year-to-date basis, the Parties shall not share any Development Costs in excess of the amounts allocated for such Calendar Year-to-date period in the Development Budget; provided, however, that Development Costs in excess of the Development Budget shall be included in the calculation of Development Costs to be shared by the Parties if (i) the [Committee] approves such excess Development Costs (either before or after they are incurred), which approval shall not be unreasonably withheld to the extent the Development Costs in excess of the Development Budget were not within the reasonable control of the Party (or Affiliate) incurring such expense or (ii) to the extent such excess Development Costs do not exceed by more than [**] the total Development Costs allocated to be incurred by such Party and its Affiliates in the applicable Calendar Year-to-date period in accordance with the applicable Development Budget for such Calendar Year. If any excess Development Costs are excluded from sharing by the Parties for a particular Calendar Year-to-date period pursuant to the foregoing sentence, such excess Development Costs shall be carried forward to the subsequent Calendar Quarters (provided that such Calendar Quarters fall within the same Calendar Year) and, to the extent the total Development Costs incurred by such Party and its Affiliates for the Calendar Year-to-date as of the end of such subsequent Calendar Quarter are less than [**] of the aggregate Development Costs allocated to such Party under the Development Budget for such Calendar Year-
to-date period, such carried forward amounts shall be included in Development Costs to be shared by the Parties for such Calendar Year-to-date-period (i.e., so that the total Development Costs incurred by such Party and its Affiliates that are shared pursuant to this Section [*] during any Calendar Year do not exceed [**] of the Development Costs allocated to such Party under the Development Budget for such Calendar Year, unless otherwise approved by the [Committee]).

**Pre-Tax Profit or Loss.**

**Pre-Tax Profit or Loss.** The Parties shall share in Pre-Tax Profit or Loss as follows: [Company] shall bear (and be entitled to) [%], and [Third Party] shall bear (and be entitled to) [%]. Procedures for quarterly reporting of actual results and review and discussion of potential discrepancies, quarterly reconciliation, reasonable forecasting, and other finance and accounting matters, to the extent not set forth in the Financial Exhibit, will be established by the Finance Working Group. Such procedures will provide the ability to comply with financial reporting requirements of each Party.

**License Territory Pre-Tax Profit or Loss.** The Parties shall share in Pre-Tax Profit or Loss in the License Territory as follows: [Company] shall bear (and be entitled to) [%], and [Third Party] shall bear (and be entitled to) [%]. Procedures for quarterly reporting of actual results and review and discussion of potential discrepancies, quarterly reconciliation, reasonable forecasting, and other finance and accounting matters, to the extent not set forth in the Financial Exhibit, will be established by the Finance Working Group. Such procedures will provide the ability to comply with financial reporting requirements of each Party.

**Quarterly Reconciliation and Payments.** The Reconciliation Procedures shall provide that within [**] days after the end of each Calendar Quarter, each Party shall submit to the Finance Working Group and the [Committee] a report, in such reasonable detail and format as is established by the Finance Working Group, of all Net Trade Sales and Allowable Expenses and other amounts necessary to calculate Pre-Tax Profit or Loss. Following receipt of such report, each Party shall reasonably cooperate to provide additional information as necessary to permit calculation and reconciliation of Pre-Tax Profit or Loss for the applicable Calendar Quarter, and to confirm that Allowable Expenses are in conformance with the approved Budget, as applicable. The Reconciliation Procedures shall provide for the Finance Working Group to develop a written report setting forth in reasonable detail the calculation of Pre-Tax Profit or Loss for the applicable Calendar Quarter, amounts owed by [Company] to [Third Party] or by [Third Party] to [Company], as the case may be, as necessary to accomplish the sharing of Pre-Tax Profit or Loss for the applicable Calendar Quarter, and to prepare such report promptly following delivery of the reports from the Parties as described above in this Section [*] and in a reasonable time (to be defined in the Reconciliation Procedures) in advance of applicable payments to accomplish the sharing of Pre-Tax Profit or Loss for the applicable Calendar Quarter. Payments to reconcile Pre-Tax Profit or Loss, and Development Costs, shall be paid within [**] days after the end of each Calendar Quarter.

**Development Plan.**

The global Development of the Products shall be governed by the Development Plan, and the Parties agree to conduct all their (and their Affiliates’) Development activities relating to the Products in accordance with the Development Plan, except to the extent otherwise permitted pursuant to Section [*]. The initial Development Plan is attached hereto as [Exhibit *] (which also includes overall total budget figures for the initial Development Budget as described in Section [*], and budget
forecasts for subsequent periods through [**] as described in Section [*]). The Development Plan shall allocate responsibility for each Development activity set forth in the Development Plan to a Party. The Development Plan shall include general study design parameters, specific staffing requirements and the funding budget for each stage of development for each Indication in the Development Plan, and shall be consistent with the terms of this Agreement. Guidelines for additional data and/or criteria, if any, to be generated for assessment prior to commencement of any specific [Activity] are included in the Development Plan. The terms of and activities set forth in the Development Plan shall at all times be designed to be in compliance with all applicable Laws and to be conducted in accordance with professional and ethical standards customary in the industry, taking into account where applicable each Party’s compliance policies. [Third Party] agrees to share its compliance policies and procedures, and updates thereof, with [Company] as [Company] may from time-to-time request.

**Updating and Amending the Development Plan.** The [Development Committee] shall review the Development Plan not less frequently than annually and shall develop detailed and specific Development Plan updates, which shall include the [**] Development Budget for the subsequent Calendar Year and the two succeeding Calendar Years. The [Development Committee] shall submit all such updates to the [Committee] for review and approval, such that [Committee] preliminary approval would occur no later than [Date] of each Calendar Year. Upon the [Committee]’s preliminary approval, such updates shall be submitted to each Party for its internal budgeting process with a target for final approval by the [Committee] no later than [Date] of each Calendar Year, at which time any updates shall be appended to the Development Plan. The [Development Committee] may also develop and submit to the [Committee] from time to time other proposed substantive amendments to the Development Plan. The [Development Committee] shall also review each Party’s (and its Affiliates’) performance under the then-current Development Plan (including the Development Budget) on a quarterly basis, and shall develop detailed and specific updates and substantive amendments to the Development Budget that reflect such performance. The [Committee] shall review proposed amendments presented by the [Development Committee] and may approve such proposed amendments or any other proposed amendments that the [Committee] may consider from time to time in its discretion and, upon such approval by the [Committee], the Development Plan shall be amended accordingly. Amendments and updates to the Development Plan, including the Development Budget, shall not be effective without the approval of the [Committee].

**Commercialization Plan.** In collaboration with [Third Party], [Company] shall develop, and submit to the [Commercialization Committee] for review, an updated [**] plan for Commercializing the Products for each Calendar Year (and the two succeeding Calendar Years), which shall include an updated Commercialization Budget for such three-year period. The [Commercialization Committee] shall submit each such Commercialization Plan to the [Committee] for review and approval in time to permit the [Committee]’s preliminary approval to occur no later than [Date] of the prior Calendar Year. Upon the [Committee]’s preliminary approval, such plan shall be submitted to each Party for its internal budgeting process with a target for final approval by the [Committee] no later than [Date] of the prior Calendar Year, and after final approval by the [Committee], such Commercialization Plan shall take effect on the first day of the Calendar Year to which such Commercialization Plan applies. The [Commercialization Committee] shall review each Party’s (and its Affiliates’)
performance under the Commercialization Plan (including the Commercialization Budget) on a quarterly basis, and shall develop detailed and specific updates and substantive amendments to the Commercialization Plan that reflect such performance. The [Commercialization Committee] shall also reasonably consider any proposed updates and amendments to the Commercialization Plan presented by either Party. The [Committee] shall review such proposed amendments presented by the [Commercialization Committee] and may approve such proposed amendments or any other proposed amendments that the [Committee] may consider from time to time in its discretion and, upon such approval by the [Committee], the Commercialization Plan shall be amended accordingly. Amendments and updates to the Commercialization Plan, including the Commercialization Budget, shall not be effective without the approval of the [Committee].
Dear Andrew,

1. BUSINESSEUROPE thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 8 (Revisions to chapter VIII of the transfer pricing guidelines on cost contributions arrangements (CCAs)) of the Base Erosion and Profit Shifting (BEPS) Action Plan issued 29 April 2015 (the “Discussion Draft”).

2. BUSINESSEUROPE believes that CCAs are arrangements that allow participants to share in the benefits of joint development of assets or services, as well as in risks. This includes the risk of the development failing. In practice, many large CCAs are in place, because the risk and costs of developing an (intangible) asset or service often prove too big for any single member of the CCA. Furthermore, as suggested in the Discussion Draft, one of the benefits of a CCA is that it can streamline the web of transactions within MNEs. BUSINESSEUROPE feels that CCA arrangements should not be seen as a method that by itself contributes to base erosion or profit shifting within an MNE per se.

3. BUSINESSEUROPE appreciates the need to align Chapter 8 with the revised Chapter 6 of the Transfer Pricing Guidelines, and welcomes additional clarity in the guidance to measure contributions at value. As already commented regarding Chapter 6, cost can be a relevant basis for the valuation of intangibles under circumstances. Therefore, the use of cost to measure the contribution into a CCA should not, a priori, be ruled out as an appropriate model.

4. BUSINESSEUROPE suggests that the Discussion Draft could include guidance to clarify the commercial and legal conditions that underpin a CCA. For example, benefits, potential benefits
and risks should be clear upfront to all participants, and fixed in legal agreements. Participants should share in the benefit, economic ownership and risk, including the risk of failure. Furthermore, contributions are made by CCA participants according to direct and indirect benefits that can reasonably be expected and finally, future buy-in and buy-out payments.

5. BUSINESSEUROPE strongly suggests the OECD explicitly recognize that the assumption of risk is a key differentiator for participants in CCAs. BUSINESSEUROPE believes strongly that transactions within a CCA are not necessarily comparable with transactions not covered by a CCA, as there will be differences in risks shared, mutual cooperation, assets owned throughout and as a result of activities. At the very least, in line with the guidance on Chapter I, adjustments need to be considered to reflect differences in functional-, risk profile and economic ownership of assets. In other words, the risks that participants in a CCA assume are not necessarily those that would have been agreed upon by parties outside a CCA and hence have an effect on the arm’s length price.

6. BUSINESSEUROPE is concerned that the OECD appears to be overlooking the fact that a CCA contribution may be related to costs, and that cost may be the appropriate basis for determining the value of a contribution. Widespread examples exist in certain sectors, for example in the Oil & Gas industry, where services and access to intellectual property are rendered at cost to operated ventures. This is agreed in production sharing contracts and similar arrangements between various partners and governments, being independent parties from each other. In many integrated Oil & Gas companies, access to intellectual property and provision of services are based on CCAs, which govern the sharing of benefits and risks to all participants. BUSINESSEUROPE therefore requests the OECD to consider limiting assessing contributions on their value and only assess contributions on their value in situations of base erosion or profit shifting.

7. In any case, BUSINESSEUROPE feels that additional guidance is required on how to establish the value of a contribution, in order to prevent an increase of uncertainty for tax payers due to the potential for misaligned views from tax authorities and commercial partners which could increase the number of disputes with tax authorities, the risk of double taxation, and more complex administration.

8. BUSINESSEUROPE believes that the recommendations for documenting CCAs seem to be over and above documentation requirements in OECD’s recently issued guidance on transfer pricing documentation (BEPS Action 13). BUSINESSEUROPE therefore recommends limiting the additional transfer documentation requirements introduced as a result of BEPS Action 8.

9. In addition to our general comments, more specific comments to the Discussion Drafts are included on various aspects of the CCA.
DEFINITION AND CONCEPT OF A CCA

10. BUSINESSEUROPE feels that the proposed definition of a CCA in paragraph 3 is inaccurate. A CCA is a framework among business enterprises, with a joint economic ownership, to effectively and efficiently develop or acquire services, goods, tangible or intangible assets, including research and development activities, and to share risks and costs between the participants of the CCA, including the risk that a service or asset does not deliver on the expected benefit.

11. BUSINESSEUROPE believes that 'to create direct benefits' in paragraph 3 should still include 'indirect' as well as direct benefits as mentioned in the current chapter VIII of the transfer pricing guidelines on CCAs. How does this further relate to the 'overall expected benefits' as referred to in paragraph 4 and the 'aggregated benefits' in paragraph 6?

12. BUSINESSEUROPE suggests adding to the sentence in paragraph 4: '[...] expected benefits to be received under the arrangement' the following addition: determined at the time the CCA is concluded based on facts and circumstances known at that time. Having to revalue the CCA contributions based on possible future events is unmanageable as every tax jurisdiction can have its own method or methods to determine contribution amounts or how to measure benefits received. This open ended latitude would not provide taxpayers any certainty regarding a CCA and would create a compliance burden without proportional benefits to the tax authorities.

13. BUSINESSEUROPE feels that paragraph 5 contradicts with other paragraphs in the Discussion Draft. It states that each participant's interest should be established at the outset, while future adjustments are required to establish a participant's contribution. Having interest determined at a different point in time than the contribution is not current practice between unrelated parties in similar arrangements.

14. The Discussion Draft states the following in paragraph 6: ‘[...] for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA’. BUSINESSEUROPE feels that the concept of a CCA is about pooling resources, skills, expertise and jointly sharing the risk where the compensation intended by the participants is the expected mutual and proportionate (expected) benefit of these. CCAs are also different to arrangements outside a CCA for various reasons, e.g. mainly because of sharing risks, mutual cooperation, assets owned. BUSINESSEUROPE feels this sentence is also at odds with the CCA principle. As a result thereof, the CCA transactions are not comparable to transactions outside a CCA and should therefore be treated differently in order to be in line with the arm's length principle.

It would be contrary to how third parties price their services in similar arrangements. Arrangements exist for example in the Oil & Gas sector where unrelated parties enter into large consortiums often in joint ventures to share benefits and risks. An operator is appointed to run operations on behalf of the joint venture (JV). The operator basically functions as the substitute for operations that would otherwise have to take place at the JV members. The operator provides technical, administrative, professional and other services. It is common in the Oil & Gas industry
that contributions of JV members are valued at cost and they may not earn a profit from undertaking activities for the benefit of the JV. This is laid down in contractual arrangements between the unrelated parties. This practice is in place since as early as the 1950s.

15. BUSINESSEUROPE feels that for both Development CCAs and Services CCAs as mentioned in paragraph 8, the contributions are based on the reasonable expected benefits.

DETERMINING PARTICIPANTS OF A CCA

16. BUSINESSEUROPE urges the OECD to be as clear as possible in its definitions. For example further explanation on what level of reasonable anticipated benefits from the assigned interest would meet the threshold for being regarded a participant of a CCA would be helpful as mentioned in paragraph 12.

17. The Discussion Draft mentions in paragraph 13: “a participant should have the capability to make decisions to take on the risk bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor and direct any outsourced measures affecting risk outcome”. BUSINESSEUROPE believes that MNE governance with a corporate managerial board and a control framework should meet this requirement. BUSINESSEUROPE requests the OECD to confirm that this requirement is met when the participants take the decision to enter into the CCA with all the relevant conditions, and agree to the contributions based on the agreement.

In addition, BUSINESSEUROPE urges the OECD to remain aligned with other chapters. The wording in par 13 should be more aligned with Chapter IX OECD Guidelines (the CCA Discussion Draft threshold for control over risk is higher than in Chapter IX). BUSINESSEUROPE also asks the OECD to elaborate on the treatment of a participant to a CCA that does not meet this requirement.

18. It would be highly recommendable to clarify the Paragraph 13 examples 4 and 5, align them with current Chapter IX OECD Guidelines and provide for further practical implementation examples.

19. BUSINESSEUROPE urges the OECD to clarify what an appropriate arm’s length price would be for the services provided by service-providers in and to a CCA as mentioned in paragraph 14 and footnote 1 (since these service-providers should be assumed not to bear any risk or own any assets).

20. BUSINESSEUROPE suggests the following revisions to paragraph 15. ‘The goal is to estimate the shares of benefits expected to be obtained by each participant and to ensure that their contributions are in the same proportions. This may require that participants’ contributions, at the time of the contribution, are adjusted using balancing payments.’

EXPECTED BENEFITS FROM A CCA

21. The Discussion Draft mentions in paragraph 17, that if projections are different from actual it may require possible adjustments. BUSINESSEUROPE feels that the OECD needs to exercise care with hindsight and take into consideration that in practice third parties do accept risks based on projections at the outset of arrangements without requiring adjustments. BUSINESSEUROPE would like to emphasize that within CCAs with multiple development and service transactions this will lead to a higher administrative burden and increase of costs involved.
BUSINESSEUROPE suggests limiting the period mentioned in paragraph 17 that adjustments can be made as tax-payers value certainty and if the CCA is no longer valid due to markedly different projections, a new CCA would be appropriate.

BUSINESSEUROPE requests the OECD to explain how to evidence that independent parties would not have or would have renegotiated the CCA agreement when the expected benefits are allocated based on an allocation key if expected and actual benefits by participants differ.

BUSINESSEUROPE furthermore suggests the following revisions to paragraph 19. ‘Furthermore, if unexpected or unforeseeable events materially affect the initial benefit assumptions, in exceptional cases, consideration should be given as to whether independent parties would have provided for an adjustment or renegotiation of the CCA agreement going forward.’ BUSINESSEUROPE also suggests having adjustments made only for the future when such an event is identified. Adjustments made for the past are difficult to implement as statutory accounts may already have been filed and fiscal years are no longer open to make adjustments.

VALUE OF EACH PARTICIPANT’S CONTRIBUTION

BUSINESSEUROPE asks the OECD to provide further guidance how to value contributions related to technical services that include provision of intellectual property or intangibles. How would the benefit for each participant be measured where you have a mix between a Development CCA and a Service CCA?

The Discussion Draft mentions in paragraph 22 that, ‘[...] contributions must generally be assessed based on their value (rather than their cost).’ BUSINESSEUROPE requests to provide more clarity on how to determine an arm’s length value in order to avoid the situation that contributions at value will substantially increase complexity, is open for discussions with tax authorities on the value to be determined, increases the risk of double taxation and increases the compliance burden. The paragraph is also at odds with cost contribution arrangement, and the arrangements that exist with independent parties in certain industries. As mentioned in our paragraph 10 of this document commenting on paragraph 6 of the Discussion Draft, it is current industry practice in for example the Oil & Gas industry to value at cost in CCAs between unrelated parties. BUSINESSEUROPE requests the OECD to consider allowing contributions at cost and only assess contributions on their value in situations of base erosion or profit shifting.

BUSINESSEUROPE feels that the cases where costs can be used as a proxy for the value of services can be extended to situations where the services received are of a similar nature as the services provided, and to current industry practice between unrelated parties in similar third party arrangements. In other words, BUSINESSEUROPE feels that the case that the costs of services can be considered a proxy for the value is not only applicable to low value-added services as mentioned in paragraph 23 and asks the OECD to consider extending the situations where the costs can be used a proxy of value.

Furthermore, BUSINESSEUROPE suggests deleting the comment in the example of paragraph 23 ‘mixture of low-value and high value adding services’. With the current reference, it seems that a company with a CCA with a web of intra-group activities would by definition not be able to value the low-value-added services portion at cost.
BUSINESSEUROPE asks the OECD further clarification on paragraph 26 and what is meant by: ‘[…] contributions in form of controlling and managing the CCA, its activities and risks are likely to be important functions in relation to DEMPE […]’?

BUSINESSEUROPE would also like the OECD to consider alignment of this paragraph with the proposed changes to Chapter 1 under action 9, and the comments provided to this draft changes. BUSINESSEUROPE believes that, similar as commented on Action 9, Chapter I, the control of risk needs much more work in general.

28. The OECD should not rule out that a cost can still be an appropriate proxy to reflect the value of services and can be used in cases where the expected benefits have not yet materialized. Value may fluctuate over time and is therefore not always a good reflection of the expected benefits. BUSINESSEUROPE would therefore like to ask the OECD more clarification on the frequency and timing that balancing payments as mentioned in paragraph 27 need to be made as long as the expected benefits have not materialized yet.

29. BUSINESSEUROPE suggests limiting the frequency of the adjustments in paragraph 28 since periodic re-evaluation in third party arrangements only occurs in exceptional circumstances. Additionally, BUSINESSEUROPE believes that this will increase the administrative burden/compliance burden and increases costs involved on MNEs that have a large number of CCA participants and therefore a large number of tax authorities potentially making adjustments to the contributions over many years.

30. BUSINESSEUROPE suggests considering the following to mitigate the risk of double taxation in connection with paragraph 29. If a tax authority imposes a change in the contribution or the value of the benefits received, all other tax jurisdictions should grant the taxpayer the right and opportunity for corrective action to claim a tax deduction or additional tax deduction related to the adjustment imposed by an auditing tax jurisdiction. The same right and opportunity should apply to all instances in which an adjustment is imposed by a tax jurisdiction; the other tax jurisdictions shall accept the corresponding adjustment.

31. BUSINESSEUROPE feels that if the requirements of a CCA are met, there should never be a discrepancy between proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, as noted in paragraph 32. BUSINESSEUROPE kindly requests for clarification of said paragraph and cautions to exercise care in re-characterizing transactions and only allow this in exceptional circumstances.

32. BUSINESSEUROPE requests the OECD to confirm in paragraph 39 that in the event services do not produce any valuable on-going results, no buy-in/ buy-out payment nor balancing payments are expected to be paid regarding these services.

DOCUMENTING CCAS

33. BUSINESSEUROPE feels that more requirements for documentation, as recommended in paragraphs 42-44, do lead to a higher administrative burden and complexity. The suggested documentation is relatively specific and detailed, and would presumably be required over and above the documentation required by the OECD’s recently issued guidance on transfer pricing.
documentation (BEPS Action 13). BUSINESSEUROPE therefore asks alignment with BEPS Action 13 for the OECD’s recommendations to document CCAs.

34. BUSINESSEUROPE would like the OECD to consider that the disclosure requirements in paragraph 43 may raise issues in certain circumstances where the information is regarded to be confidential.

35. BUSINESSEUROPE suggests to add the following section to chapter E ‘Recommendations for structuring and documenting CCAs’, requiring all sections in the current Discussion Draft to be renumbered starting with the additional paragraph 46:

   a. 46: Any CCA which has been in existence each year since 2000 shall be grandfathered and can, at the taxpayer’s election, continue without any modifications, and be deemed compliant. This includes any CCA which under the former guidelines was considered at arm’s length.

BUSINESSEUROPE is willing to engage in a constructive dialogue with the OECD on strengthening the Chapter VIII of the transfer pricing guidelines on CCAs.

On behalf of the BUSINESSEUROPE Tax Policy Group,

Yours sincerely,

James Watson

Director Economics Department
CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT ON BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCA’S)

1. The CBI is pleased to comment on the OECD’s Public Discussion Draft on Action 8: Revisions to Chapter VIII of the transfer pricing guidelines on cost contribution arrangements (CCAs).

2. As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

3. The CBI continues to support the BEPS programme to update international tax rules to reflect modern business practice, tackle abusive tax structures and target the incidence of double non-taxation. However, we are concerned that if complexity and uncertainty are not avoided, the outcome will be an increase of double taxation and resulting legal disputes, which could have a substantial and negative impact on cross border trade and investment, but also on tax administrations with limited resources.

Overview

4. The CBI understands that the that an underlying purpose of the proposed changes to Chapter VIII in relation to CCA’s was to align the transfer pricing treatment of CCA’s with the other work being undertaken under BEPS Actions 8-10, especially in relation to risk and intangibles. However in doing so, the proposals have lost track of the main purpose of CCA’s. We recommend that cost is used as the default measure of a company’s contribution and that other valuation models are only used in specifically defined situations design to tackle BEPS behaviour.

5. We welcome the confirmation that CCA’s can be used for low value services and that cost can be used as the basis for such arrangements. This should provide significant efficiencies for business.

6. Based on our experience, contributions to CCA’s between third parties are predominantly based on cost rather than a valuation (hence the term cost contribution arrangement). Implementing this document as drafted could therefore, in some situations, place a higher bar on internal transactions than those required for external transactions and move away from the arm’s length principle. There should be a large number of transactions, other than the provision of low value services, where cost is a reasonable proxy for value.

7. There are two areas which we believe should be reviewed in more detail. The proposals as outlined would appear to prevent such companies from being considered a participant of the CCA, even when in
comparative third party situations they would be included:

- Group’s which have a group service company employing most people which is separate from the operating company which would normally be party to a CCA.

- Companies with a small minority participation in a CCA will generally not have the capability to either manage or control the risk in question. However due to clear commercial benefits, they would still participate in third party CCA’s with a critical review clause to enable them to re-evaluate their participation as the project progresses.

8. A move to a more subjective valuation of contributions significantly increases the risk of tax authority challenge and double taxation. This is particularly so when one considers the ability of employees to work at more than one location and potentially in more than one country. In order to balance the objective of taxation where value is created with efficiency of administration the CBI requests that process of reviewing and auditing by tax authorities should also be simplified. This could be achieved by having a single process for auditing the agreement. All parties should then respect the findings of the single audit performed.

**Detailed Comments**

**Valuation of a participant’s contribution**

9. A cost contribution arrangement, by definition, is a contractual arrangement to share the financial burden (i.e. costs) to receive a proportionate return in the benefits and risks of the development of assets or services.

10. The CBI is concerned that the proposals outlined move away from cost as being the primary determinant of a company’s contribution to the use of a difficult, challenging and often subjective valuation exercise. The use of CCA’s in third party situations (common in the oil and gas sector) shows that the valuation of the contribution is predominantly measured by cost. Therefore to have the default measurement being a valuation model, would move away from the arm’s length standard.

11. Whilst it has been recognised in the proposals that costs may be used as a valuation method, this has mainly been limited in the application to low value services. Cost can also be a proxy to value especially where the main contribution is the provision of labour where, as a general proxy, wages tend to reflect the value to business. The cost of procurement of raw materials from third parties should again reflect the value to the business. In addition, the revised proposed wording in Chapter VI relating to intangibles also recognises that cost can, in some instances, represent the value of intangible assets.

12. The CBI therefore believes that cost should be the default method of valuation for a company’s contribution to a CCA. A “valuation” method should then only be used in prescribed situations which have been identified that the contribution based on cost is contributing to BEPS behaviour.

13. CCA’s are generally entered into for the efficiencies and shared benefits outlined in the discussion draft. An additional efficiency is the ability to value the contribution of a participant by reference to cost rather than undertaking a full valuation exercise for all transactions. Where such arrangements are for clear commercial purposes and not for the facilitation of tax avoidance, there would be no obvious policy reason why this efficiency should not be allowed to be maintained (so that the resources can be channelled into investment in the development and growth of the economy rather than producing documents purely for tax purposes).

**Determining participants**

14. The CBI would welcome further guidance on how to deal with situations where from a legal perspective, the company which obtains the future benefit (operating company) is a different legal
entity that bears the original cost (service company). Group service companies are a common commercial set up which would normally operate on a country-wide or regional basis. Such commercial arrangements should therefore not preclude operating companies which obtain resources in this way from being precluded in the CCA.

15. In paragraph 13 of the discussion draft, it states that each participating company must have “the capability and authority to control risks associated with the risk-bearing opportunity under the CCA”. The examples shown in the Annex only show 2 party CCA’s where the participants both have significant stakes and input. However, in both intra-group and third party CCA’s, there can be a large number of participants (in some cases 100’s) and it will be neither feasible nor desirable to have every company within the CCA having authority to control risk. To mirror arm’s length terms, the level of participation will generally determine the level of control over risk – and it would be normal commercial practice for companies with a small level of participation to have no control at all. However, on a commercial basis, they would accept the risk in return for the potential future benefits and would manage the investment through critical reviews built into the agreement (but would not be able to “control” the risk).

16. The CBI therefore requests that paragraph 13 (and an Annex example) is updated to reflect the position of a CCA with a large number of participants and that the level of control will be different depending on their participation level and that no control would be appropriate for low levels.

CCA Disputes

17. One of the issues that a move to a valuation basis (subjective) from a cost measure (objective) is that there will no doubt be a significant increase in disputes with tax authorities. If a tax authority argues for an increase in value regarding the services from that jurisdiction, then unless that is agreed by all tax authorities in the jurisdictions involved, double taxation will arise.

18. The CBI would therefore request that any move to a valuation model should be accompanied by a streamlined dispute resolution mechanism that would provide for one audit to be respected by all relevant tax authorities. Such a review could be carried out by either:

- An independent third party auditor
- One of the tax authorities involved

19. We trust that you will find the above comments helpful in understanding the potential impact of the proposals outlined in the Discussion Draft. We remain committed to ensuring that each BEPS Action achieves its stated goals, whilst ensuring that genuine business transactions are not unduly impacted.

20. We remain at your disposal should you wish to discuss the issues we have raised in this paper in more detail. Please contact neil.anthony@cbi.org.uk for more information.
Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements ("CCAs") – Concerns and Recommendations

A REPRESENTATION

May 2015
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BEPS: Action 8 - Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (“CCAs”) – Concerns and Recommendations

Background

On April 29, 2015, the OECD issued a non-consensus Discussion Draft on the revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs). The Discussion Draft primarily updates the existing guidelines to take into account the draft guidance released under other BEPS action items specifically on Risks (Chapter I of the OECD Transfer Pricing Guidelines) and Intangibles (Chapter VI of the OECD Transfer Pricing Guidelines). As the action items on Risk and Intangibles are in the draft stage, the proposed revisions to the CCAs are also likely to undergo further changes to be consistent with the Risks and Intangible discussions drafts.

In summary, the Discussion Draft, like the earlier guidelines applies to both services and the developments CCAs. The Discussion Draft provides that for a CCA to be consistent with the arm’s length principle, the outcome of operating within a CCA by various participants should be same as if the CCA had not existed amongst the participants. For this purpose, the Discussion Draft provides for measuring the contributions made to a CCA by the various participants at value rather than at cost. Also, such arm’s length contributions should be based on the reasonably expected benefits that each participant will have from the CCA.

In identifying the participants to a CCA, the Discussion Draft provides that such participants should participate in controlling and managing the risks arising under the CCA. Therefore, the activity involving only funding for the CCA or merely performing the activities under the CCA for the benefit of other participants without participating in the management and control of the risks would not be construed as a participation in the CCA though such funding/service activity shall be compensated with an arm’s length return. The Discussion Draft also provides guidance on the selection of appropriate allocation key, balancing payments and list of documents to be maintained in support of the CCA.

In general, we recognize the efforts of G20 along with the OECD towards providing guidance on the CCAs. However, we foresee certain practical challenges in the implementation of the recommendations of the Discussion Draft in its present form for companies operating in India.

We wish to highlight the possible challenges and humbly put forth our recommendations for your kind consideration.
Expected benefits derived from Development CCA

Concerns

Development CCAs are generally established for the joint development, enhancement, maintenance, protection, or exploitation of intangibles or tangible assets. Development CCAs are expected to create ongoing, future benefits for participants. In view of the benefits being realized at a later stage, the allocation of contributions is generally based on projections of the participants’ shares of the expected benefits. The use of projections may raise problems for tax administrations in verifying the assumptions based on which projections have been made and in dealing with cases where the projections differ significantly from the actual results.

In situations where actual results differ from projections, tax administrations might be prompted to enquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight.

The above guidelines for determining the arm’s length nature of the cost contribution based on the anticipated future benefits may find difficulty in acceptance by the Indian tax administration. Specifically, the Indian tax administration sees each audit year as a stand-alone year and no reference is generally made to the past or future years in determining the arm’s length nature of the transaction, even though the documentation requirements under the Indian Transfer Pricing provisions provide for maintaining detailed documentation about the economic and market analysis used, forecasts made, budgeted or any other financial estimates prepared for the business as a whole and also for each division or product separately as well which may have a bearing on the international transaction entered into by the taxpayer.

However, the Indian Tax Courts have taken cognizance of future projections of the benefits submitted by the taxpayers in certain cases though the Tax Courts have emphasized on the veracity of the projections provided.

Recommendations

In view of the above difficulties and ambiguity surrounding the use of future projections of benefits, likely to be faced by taxpayers in India, it is recommended that the OECD site clear examples or guidelines on valuation of expected benefits. Such guidance is more important where there are no comparable transactions available to determine the arm’s length value of the expected benefits under the CCA.

Such guidelines shall emphasize on the use of public data relating to the anticipated market share or sales of the assets, use of statistical and economic tools and formulas for projecting benefits. Also, the
OECD shall convince the nations participating in the BEPS project to take cognizance of such use of statistical and economic tools and market data in estimation of projected future benefits.

System of netted payments

Concerns

The Discussion Draft makes mention of netting of payments in the CCA, where the contributions made by the participants to CCA is not in conformity with the expected benefits from the CCA. In such cases, the Discussion Draft provides for payment by a participant whose expected benefit from the CCA is higher than the value of the contributions made. CCAs can be considered helpful in simplification of multiple transactions in a situation where participants to a CCA perform activities for other group members and simultaneously benefit from activities performed by other group members. Thus a CCA provides a mechanism for streamlining the system of payments through netting off instead of making separate payments to each entity for each activity performed and each service received.

Again, at the time of entering or leaving a CCA, the entrant/participant to the CCA may bring in tangible/ intangible assets to the CCA and may receive balancing payment which can be netted, although appropriate records may be kept of the full amounts of the separate payments for tax administration purposes.

Although the Discussion Draft is trying to bring in a simplified process, it may not be practically feasible from Indian foreign exchange regulation perspective. The Indian Foreign Exchange Management Act ("FEMA") has prescribed guidelines laid down for Export of Goods and Services wherein ‘set-off’ of export receivables against import payments should has certain restrictions.

Recommendations

It is recommended that the OECD may provide country specific guidelines clarifying for separate payment and receipt for the value of contributions under the CCA where the domestic regulation of specific countries do not allow for netting the payment or have specific guidelines for the same.

Economic ownership of the assets created under a CCA

Concerns

Per the Discussion Draft under a CCA, even though the legal ownership of the asset created under the arrangement rests with one of the participant who is a related party to the other participants to a CCA, such other participants will have economic ownership of the assets created by virtue of their
contribution to the CCA. As such, the economic owners of the asset need not make any payment in terms of royalty, technical fee or any other such payments for the use/ exploitation of the asset created under a CCA.

The concept of economic ownership is an evolving concept and at present, not very well accepted by the tax administration in India. As such any contribution by a participant to a CCA without having legal ownership of the assets created under the CCA shall be disregarded by the tax administration.

Further, in situations where the Indian taxpayer happens to be the legal owner of the intangible under the CCA, the tax authorities shall argue that the Indian entity should be adequately compensated by the other participants to the CCA for the exploitation of the intangible legally owned by the Indian tax payer.

Also, per the Discussion Draft the economic owners of the assets created under the CCA need not make any payment to the legal owner for the exploitation of the assets, the Indian Tax Authorities shall insist that the legal owner performs additional functions relating to protection of the assets created under the CCA and bear the related risks being the legal owner of the asset. Thus, legal owner of the asset should be compensated for the additional functions performed and risks assumed by the other participants to the CCA.

**Recommendations**

It is recommended that the OECD provide guidelines on the safeguards for taxpayers from getting caught in the difference in the views relating to legal ownership vis-à-vis economic ownership of the assets. Also, the OECD may clarify that in case of countries which do not take cognizance of the economic ownership of the assets, the participants to a CCA shall enter into a formal arrangement with respect to ownership of the assets created under the CCA. Alternatively, the OECD shall convince the nations participating in the BEPS project to take cognizance of the economic ownership of the assets created under a CCA.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

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Confederation of Indian Industry
The Mantosh Sondhi Centre
23, Institutional Area, Lodi Road, New Delhi – 110 003 (India)
T: 91 11 45771000 / 24629994-7 • F: 91 11 24626149
E: info@cii.in • W: www.cii.in

Follow us on:
facebook.com/followcii twitter.com/followcii mycii.in

Membership Helpline: 00-91-11-435 46244 / 00-91-99104 46244
CII Helpline Toll free No: 1800-103-1244
Dear Sir,

the Centre for International Fiscal Studies\(^1\) is pleased to provide its perspective and welcomes the opportunity to contribute its comments on the OECD Public Discussion Draft BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (the Discussion Draft), and we sincerely hope that our remarks will help your agenda move the draft forward to a point of consensus.

Firstly, we appreciate the significant work and accomplishments of the OECD Centre for Tax Policy and Administration for its efforts to provide further guidance relating to basic and essential issues for the activity of MNEs.

We respectfully submit hereinafter our observations on the proposed amendments to Chapter VIII of the OECD Transfer Pricing Guidelines (the Guidelines).

General remarks
In the present contribution, following a pragmatic approach, we wish to suggest the inclusion in the Guidelines of two concepts fundamental to the activity of MNEs:

- the existence of a group interest, above and beyond that of a fiscal nature;

- the awareness that uneconomic decisions can be adopted for a single associated company, when justified by the interest of the group to which it belongs.

An international economic context characterized by markets and geographic areas with strong price instability and the competition of developing countries without specific rules on transfer pricing can justify the presence of associated companies operating at both an economic and fiscal loss, or with limited profitability, but fundamental to the group’s activity and general strategy. In this scenario, the guidance contained in the Discussion Draft will therefore also take into account that the existence of positive income for an associated company, or of a measurable benefit, cannot just be assumed for the mere fact that the company belongs to a group. Entrepreneurship is not sufficient to automatically guarantee the right to positive operating results. It cannot be excluded that a company may commit errors of judgement, nor that general strategies may induce it to undertake operations which are uneconomic in themselves, in order to achieve economic benefits on other fronts, nor that an enterprise realizing losses, but functional to the other companies, may be allowed to continue operating. Similarly, within a group, a company may be kept running at a loss, because it is in any case functional to the activity of the other group companies.

\(^1\) Centre for International Fiscal Studies is a Swiss centre for studies specializing in International taxation, founded in Lugano in 2002.
In this perspective, in the absence of positive income and of benefits in measurable value terms, regardless of methods and allocation keys used, in our opinion the Guidelines should allow associated companies the possibility of justifying with documentary evidence, case by case, the following situations:

- an intra-group service received by an associated company, but considered non-relevant by the national tax authorities (non-relevant cost of a received service);
- an associated company bearing costs which should be recharged to one or more group companies (non-relevant cost of a non-recharged service) but which are not materially apportioned;

If such circumstances are in line with group strategy at the international level, given the paramount importance, for example, of boosting their trading capacity, holding their own with competitors and operating in certain markets and geographic areas, compared to hypothetical harmful tax competition practices.

Italian tax jurisprudence, for example, has elaborated over the years the so-called concept of the "relevance" of inter-company service costs, a concept certainly more familiar to Italian case law than the principles contained in the OECD Guidelines. However, even if we substituted the criterion of relevance with that of "benefit", the conclusions of Italian judges would not change, resulting in the non-deductibility of the cost of the service.

According to this logic – highly topical nowadays – contributions can sometimes not be measured at value rather than at cost, because in the current context, the economic outcomes of transfers or development of intangibles for parties outside a CCA differ significantly and inevitably from outcomes for participants under a CCA. In other words, these circumstances cannot be consistent with the arm's length principle.

Section C
The concept of interest of the group

Italian tax law does not explicitly encode interest of the group but limits itself to governing the aggregation of group income for income tax purposes (by means of the regulation of the so-called "group tax consolidation system" – national or international 2), the settlement of group VAT and the assignment of tax receivables within the group. Tax legislation constitutes "law of the second degree": this means that when it does not regulate a specific case, the same must be governed by other branches of the law.

The legal significance of group interest is laid down in Italy by Arts. 2497 et seqq. of the Italian Civil Code, as well as by the established judicial practice of the civil (not tax) court.

In accordance with Art. 2497 of the Italian Civil Code, "The companies... which exercising coordination and direction of the company operate in their own or in others' entrepreneurial interest in breach of the principles of correct corporate and entrepreneurial management are directly liable towards the members of said companies for the prejudice caused to the profitability and the value of the corporate holding for the damage caused to the integrity of the assets of the company.... There is no liability when the damage does not exist in the light of the aggregate result of the activity of direction and coordination or entirely eliminated also as a consequence of transactions directed to such purpose ..... "[free translation of the authors]

In accordance with Art 2034 of the Italian Civil Code, "... in any case the profit of the associated company or of the group is not unfair if compensated by benefits received or justifiably expected, deriving from association with or membership of the group. ...."[free translation of the authors]

Within this context the concept of so-called "compensatory benefits" (indirect benefits) has been accepted by the Civil Court and set out in the Explanatory Memorandum accompanying the 2003 reform of Italian Company Law, providing for the possibility of operating a reconciliation of the interests of the group with those of its subsidiaries, by means of the balancing of costs charged to

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2 See the rules on the "group tax consolidation system " for example in Italy and Austria.
the subsidiary with benefits deriving to the same from its membership of the group, without the necessity, moreover, that such benefits be determined by analytical calculations.

Even prior to the introduction of the new Arts. 2497 et seqq. (after 01.01.2004), Italian jurisprudence, especially that relative to non-fiscal matters, had attached importance to group interest. In the course of time the jurisprudence of the Italian Tax Courts has established that the possibly uneconomic nature of an intercompany operation may be justified by the interest of the group pursued by such operation. To this end, it is the responsibility of the taxpayer who invokes such interest to provide evidence of its existence, evidence than can go beyond a mere mathematical calculation of fairness and the allocation keys, as required, instead, by the Guidelines. The existence of such interest should emerge from management operating reports and, in any case, from documents issued by the organs of group companies (minutes of meetings) suffering damage caused by the uneconomic operation.

Italian civil law acknowledges that, to serve the best interests of the group, the controlling company, in the performance of its management and coordination activity, may sacrifice the abstract interests of the controlled company. This must, however, owe its justification to the interests of the group or, in any case, to a specific compensatory benefit to be conferred to the subsidiary. It is necessary for the board of the subsidiary to motivate, also within the masterfile, its reason for choosing to immediately effect a certain operation not corresponding to the corporate interests of the subsidiary but which, in the light of the management and coordination activity of the parent company, is otherwise justifiable. Indeed, the report on the Draft Delegation Bill on the reform of company law states literally that ‘membership of a group alters the business operating conditions of a company; in the sense that the economic reference framework ... varies considerably according to whether the company is, or not, an organic part of a group. It follows that a correct calculation of costs and benefits in a decision made by a subsidiary company may well, and strictly speaking should, differ from what could be conceivable if the company operated on its own, given that such calculation cannot but take into account the general costs and benefits of belonging to the group’. [free translation of the authors]

Determining whether an intercompany transaction, not in conformity with market value, may be considered tax arbitrage, contesting the deduction of partly non-relevant costs, means evaluating beforehand whether the tax system recognizes the legal relevance of interest of the group, understood as an economic or accounting notion; and if so, this means evaluating if and how such interest is of significance to the improvement of the cost effectiveness of operations within the group. In other words, if the interests of the group have legal relevance for tax purposes, it follows that in the interests of the group the abstractly uneconomic nature of the operation could be justified. The point is to verify whether this legal framework applies whenever there is an overall saving at group level or when, even though the effect of the transaction is revenue neutral within the group, there is a saving on the part of the resident company. Italian law leans towards the former, imposing on the tax officers the burden of verifying whether the transaction may lead to a tax saving for the group. For example, the provision of services at prices lower than market price by one group company to another, which enjoys local fiscal benefits, could be justified by the aim of strengthening the latter’s market position, thanks also to the opportunity of such tax advantages. And again, the failure on the part of a controlling company to charge a mark-up to a subsidiary company for services provided to the same could be explained by the fact that the parent company, thanks to the strength acknowledged to it by the market, is able to reinforce the position in the same also of

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3 See, for example, Corte di Cassazione, SS.UU., Judgement 18 March 2010, No. 6538, and No. 11226/2007.

4 The Supreme Court recognizes, for example, that also the rule on the deductibility of costs originating in blacklisted countries [TUR, Income Tax Consolidation Act, Art. 110 (7)] has an overall anti-tax elusion objective, i.e. relating to operations at the group level.
its subsidiary. When the interest of the group consists of the effective establishment of productive activity (of one or more company functions) in a specific place, via a company belonging to the same group, with the purpose also of enabling the same to benefit from local tax advantages, the uneconomic nature of intra-group transactions, where instrumental to such management options, cannot, we feel, be considered indicative of harmful tax competition.

The principle of "freedom of establishment" protected by Arts. 49 et seq. of the Treaty on the Functioning of the European Union (TFUE) guarantees economic operators the right to establish their productive activity anywhere within the EU, also with the objective of benefitting from favourable tax regimes; and this is conditional upon the actual undertaking of productive activity.\(^5\)

If the cost recharged to its subsidiary by the controlling company results as being inconsistent with the cost effectiveness parameter (having regard to market prices for the provision of services identical to those received by the group company), tax authorities could challenge the relevance of such negative component starting from the assumption that the non-cost effectiveness of the cost is indicative of its non-relevance.

The experts in Italy who defined and proposed the criterion of "compensatory benefits" however excluded that the compensatory benefit for the group should be immediate and strictly proportionate, pointing out the necessity to evaluate the operation in the framework of the group's overall policy, in order to establish whether benefits, even if not immediate, but reasonably certain, could accrue to the controlled or associated company, at levels or in areas of activity differing from those affected by the operation imposed by the parent company. The parent company performs de facto the function of direction and coordination of the controlled companies through the exercise of the powers belonging to the controlling shareholder, which escape not only specific regulations but also any possibility of an adequate understanding on the part of subjects "external" to management. On the basis of such premises, a correct cost-benefit analysis of a decision taken by a controlled company may well be considered to differ from that envisaged in the case in which the undertaking operates in isolation, given that the analysis may be influenced by the general benefits of belonging to a group.

The wording of the abovementioned regulations reflects the will of the legislator to offer a "practical" solution to the main concerns of groups of companies and to the related problem of conflict of interests (not necessarily for tax reasons), represented, as is well known, by the conflict between the unitary nature (in economic terms) of the group and the subjective separation of the centres to which risks and responsibilities are attributed (business units).

A very recent ruling of the Supreme Court \(^6\) also moves in this direction, a ruling whereby the judges of the Italian Supreme Tax Court clarified that costs sustained by a subsidiary (in accordance with an agreement with the controlling company) are relevant, and thus deductible, whenever related to the enterprise, i.e. sustained in order to achieve profits for the same, without there being the necessity to demonstrate that such costs were sustained in order to obtain a specific revenue. In other words the benefit does not necessarily translate into monetary, concrete and effective terms, in that the concept of relevance must refer to an abstract advantage for the enterprise.

To this end the "common intention of the parties" under the CCA must be considered, namely the necessity for these costs with respect to business activities. According to the judges, the tax authorities may evaluate the appropriateness of intercompany costs from a quantitative viewpoint but not their opportuneness, in that this would signify having to enter into the substance of the business decisions. The evaluation of the appropriateness of costs (quantitative analysis), the sentence specifies, cannot go as far as a verification of the opportuneness of the same with respect to the object of business activities (qualitative analysis), because an approach of this kind would entail an unjustified calling into question of the taxpayer's organizational set-up.


The concept of uneconomic operations

In practice there can be so-called "uneconomic" operations where a financial interest of the company is not immediately evident at the time they are carried out. A particular example, admittedly oversimplified, with reference to the situation in Italy might be helpful to illustrate the desirability of a more practical approach in dealing with "uneconomic operations". The notion of uneconomicalness is a concept established only by tax law, as a possibility for the tax administration to call into question the relevance (deductibility) of costs sustained for the purchase of intra-group goods and services, highlighting the "uneconomic" nature of the business decisions made in the framework of the group itself. The judges made reference also to the principle of normal value for the evaluation of the correctness of prices applied between resident companies, upholding the economic unreasonableness of business decisions, following two lines of reasoning: uneconomicalness as a quantitative limit (appropriateness) to the deductibility of costs in general, and uneconomicalness as an indicator of operations that should be carried out at market value.

Over the years we have seen an evolution of the concept of relevant cost (ordinary and necessary expenses): from relevance to revenues to relevance to company business and reality up to today's relevance to the group.

Two cases form the object of the present analysis:

1) failure to allocate or insufficient allocation (recharging) of costs: for example to maintain the survival and the geographic presence of an associated company, to diversify, to acquire know-how, etc; in unfavourable economic conditions, the redistribution of costs inferior to expected benefits permits survival in view of positive or better future profits (years);

2) the excessive allocation (recharging) of costs: these are distributed among the companies by virtue of their belonging to the group, even if the benefit is small or marginal, since they enjoy the benefits of the group's overall strategy and potential (brand, patents, advertising).

The fact that the uneconomic behaviour of the taxpayer is looked upon as a presumption of tax evasive behaviour obliges the taxpayer, according to Italian law, to go beyond the application of the so-called "internal transfer price", demonstrating the valid economic reasons underlying certain company decisions – reasons which, however, cannot always be immediately understood in full.

The principle expressed by the Supreme Court, i.e. the need to base the evaluation, for tax purposes, of internal transfer prices on normal value (see TUIR, Income Tax Consolidation Act, Art. 9), could create severe difficulties regarding decisions as to business policies to be put in place. In concrete terms, a static evaluation of prices made by the taxing authorities, based alone on the amount charged, would not permit taking into due consideration the objectives – also in a future perspective – underlying the adoption of the same. The sustaining of lower costs (as a result of their distribution), and the consequent achievement of greater profits, should not be

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7 See, for example, Corte di Cassazione, judgement 24 July 2013, N. 17955.

8 See, along the same lines, Section 162 - Title 26 - of the US "Internal Revenue Code - IRC" ["Trade or business expenses"]: "... a) in general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on trade or business, ..."

9 See idem, note n. 7.
necessarily be interpreted as tax evasion, as it may simply represent an instrument for transferring wealth, for example, in favour of more disadvantaged areas and territories to promote their economic growth or to boost, consolidate or establish a presence in a given market or territory, vying with or anticipating competitors. In Paragraphs 15, 16, 20 and 27 of the Discussion Draft, it is therefore not always possible to anticipate and estimate shares of expected benefits proportional to contributions, nor is it possible to adjust them by means of payments that can balance them, in that though participating in a CCA, and despite the existence of present and future expected benefits, the undertakings are not in a position to obtain "general additional anticipated revenues". In the case of the international apportionment of advertising expenses, for example, it can be difficult to identify and evaluate the benefits generated by such expenses for the individual associated companies operating in various geographical locations.

Recurring losses may have economic reasons, such as start-up losses or market penetration strategies. With specific reference to start-ups (not only those connected with the digital or net economy 10, or with Telecommunication, Broadcasting and Electronic services - TBES), a number of national legislations 11 envisage the possibility that such undertakings may be loss-making for the first 3, 5 or more years.

One way to approach this type of problem in the transfer pricing context is to consider when analysing losses "... that business strategies may differ from one MNE group to another, owing to a variety of historical, economic and cultural reasons. Recurring losses for a reasonable period may be justified in some cases by a business strategy to set especially low prices to achieve market penetration ... with the specific object of improving profits in the longer term."

"Business strategies could also include market penetration schemes. A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market" [...]. "Timing issues can pose particular problems for tax administrations when evaluating whether a taxpayer is following a business strategy that distinguishes it from potential comparables. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits."

The effects of an adverse economic environment, price instability and the entry of new competitors inevitably reflect also on the obligations required by the transfer pricing rules: the automatic application of the evaluation methods referred to above, when evaluating a lengthy prior period of time, would be misleading, in consideration of the fact that the results of past

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10 Issues examined in depth in BEPS Action 1: address the tax challenges of the digital economy (public Discussion Draft 24 March 2014 – 14 April 2014).

11 See, for instance the hubs rules in China, United Arab Emirates, Canada and Israel.

12 OECD BEPS Actions 8, 9 and 10: Discussion Draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, re-characterisation, and special measures), public Discussion Draft 1 December 2014 – 6 February 2015, page 11 (§ 32 and 33) and page 28 (§ 96).

13 Already in the OECD "Draft Handbook on transfer pricing risk assessment" (public consultation 30 April 2003), page 15 § 64 attention was drawn to the fact that "It should be recognised, however, that losses over a period of a few years might be justified under the arm's length principle. This might particularly be the case with regard to start-up operations. In other situations, a group policy directed at trying to break into a new market, or a new product by selling at a loss in order to gain market share could be in place. The introduction of a new product will often involve initial heavy marketing expenditure to establish the brand in the market."
financial years, used as an indicator, may not yet reflect the impact of changing economic conditions. The issue is extremely topical, considering that financial statements currently under preparation will have the difficult task of "photographing" the situation of the company as a whole and in particular the transfer prices, in this of all years following the deepening of the crisis. There are no regulations envisaging a specific alternative methodology, or which take into account the variables which have occurred in the last few years. The solution lies, therefore, in the realization, on the part of groups, of a complex model able to encompass and develop the unknowns that have presented themselves during the past months. In this sense the participants in a CCA must bear in mind the macroeconomic reference framework (significance of the crisis, currency fluctuations, embargoes and customs policies, political instability, environmental disasters, pollution, diplomatic crises, reflections on costs of raw materials, on demand and supply, etc.), relating this information to the specific case, and singling out the reflections on the company in question. However, the construction of such a complex and costly comparative model, though on the one hand ensuring greater correspondence with reality, on the other could result excessively onerous, especially for Small and Medium Enterprises (SMEs), and difficult to document objectively in any dispute with the tax authorities.

We therefore hold it to be both important and useful for companies and their consultants to provide practical and more reasonable solutions at a general, higher level already in the Guidelines, which can give MNEs and SMEs the possibility of introducing remedies within the CCAs in response to economic circumstances.

We agree with the general message of point n. 35 of the Discussion Draft, but suggest completing the clarification on the tax treatment of contributions and balancing payments as follows "... the character and tax treatment of any balancing payments will be determined in accordance with domestic law, including domestic jurisprudence and applicable tax treaties."

Section E
Further recommendations for structuring and documenting CCAs
We suggest completing letter e) of point 44 as follows:

e) The manner in which participants’ proportionate shares of expected benefits are measured, and any projections used in this determination; if in particular circumstances these expected benefits and losses cannot be measured, participants must explain the economic and strategic reasons and results under a documented interest of the group;

It has been a privilege to contribute even informally to OECD and CTPA work: we hope the OECD finds these brief comments useful. Should you need any further clarification on the above comments, please do not hesitate to contact us.

We look forward with interest to attending the public consultation to be held on 6-7 July 2015.

Yours sincerely,

Lino Lunardi
Giancarlo Cervino

Contacts:
Lino Lunardi lunardi@consulenti-aziendali.com
giancarlo@cinfs.com
Cinfis S.A.
Sede legale ed operativa:
Via Madonnina 17 – CH-6900 Lugano, Svizzera
Tel 0041 (0)91 922 24 70
Fax 0041 (0)91 922 24 76
R.C. CH - 614.4.025.464 - 9
N. IVA CHE-109.361.137
E-mail: cinfs@cinfs.com
Internet: www.cinfis.com

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REPLY TO THE OECD’S REQUEST FOR COMMENTS ON THE
“DISCUSSION DRAFT ON REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING
GUIDELINES ON COST CONTRIBUTIONS ARRANGEMENTS”
FROM CMS

CMS is a European Economic Interest Grouping that coordinates an organisation of independent law firms:

CMS Adonnino Ascoli & Cavasola Scamoni (Italy)
CMS Albiñana & Suárez de Lezo (Spain)
CMS Bureau Francis Lefebvre (France)
CMS Cameron McKenna (UK)
CMS DeBacker (Belgium)
CMS Derks Star Busmann (The Netherlands)
CMS von Erlach Poncet (Switzerland)
CMS Hasche Sigle (Germany)
CMS Reich-Rohrwig Hainz (Austria)
CMS Rui Pena & Arnaut (Portugal)

Contacts for follow-up. This contribution was prepared by the CMS Transfer Pricing Group and, in particular, by the following experts:

Name: Bruno Gibert: Partner
Stéphane Gelin: Partner
Arnaud Le Boulanger: Partner, Chief Economist
Xavier Daluzeau: Partner
Valentin Lescroart: Senior Associate

Organisation: CMS Bureau Francis Lefebvre
2, rue Ancelle
92522 Neuilly-sur-Seine Cedex

Country France

E-mail address: bruno.gibert@cms-bfl.com
stephane.gelin@cms-bfl.com
arnaud.leboulanger@cms-bfl.com
xavier.daluzeau@cms-bfl.com
valentin.lescroart@cms-bfl.com

Telephone: +33 (0)1 47 38 42 19
Fax: +33 (0)1 47 38 57 42

Do you authorize the OECD to publish your contribution on the OECD website? Yes
1. We would like first to welcome the OECD initiative to consult companies and practitioners in the framework of the update of its guidance on cost contributions arrangements (“CCAs”). We were very interested in reviewing, in the light of Action 8 of the Action Plan on Base Erosion and Profit Shifting, the “Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contributions Arrangements” dated 29 April 2015 (further referred to as the “Discussion Draft”).

2. The revisions to the current Chapter VIII of the Transfer Pricing Guidelines suggested by the Discussion Draft appear limited. The principles underlying the arm's length implementation and documentation of CCAs are unchanged. Compared to the current guidelines, the Discussion Draft gives precisions regarding the valuation of each participant's contribution, seems to provide less guidance on CCA entry, withdrawal or termination and takes into account the latest OECD works on intangibles (in particular, references to the development, enhancement, maintenance, protection and exploitation of intangibles and to the management and control of such activities). It seems therefore that, unfortunately, this revision has not allowed the OECD to tackle all the issues that, according to paragraph 8.1 of the current Transfer Pricing Guidelines, could have required additional guidance: “For example, further guidance may be needed on measuring the value of contributions to CCAs, in particular regarding when cost or market prices are appropriate, and the effect of government subsidies or tax incentives (see paragraphs 8.15 and 8.17). Further development might also be useful regarding the tax characterisation of contributions, balancing payments and buy-in/buy-out payments (see paragraphs 8.23, 8.25, 8.33 and 8.35). Additional work will be undertaken as necessary to update and elaborate this chapter as more experience is gained in the actual operation of CCAs.”

3. Our main comment relates to paragraphs 22 and 23 of the Discussion Draft. We agree with the principle according to which contributions to a CCA should generally be assessed based on their arm's length value, insofar as what is discussed here is contributions “in kind”, in most cases “at origin”, such as pre-existing intellectual property (“IP”) for a CCA requiring such pre-existing IP to develop a new IP (the object of the CCA) based on it. However, we believe that the current wording of the new sentence added to paragraph 22, stating “That is, contributions must generally be assessed based on their value (rather than their costs)” should be clarified to avoid any confusion in interpreting it when it comes to (recurring, yearly) cost contributions for the development of an IP (that is itself the subject of the CCA). Indeed:

- Either, what this new sentence actually means is that, in assessing the value of such contributions, a mark-up should be added on said development costs to assess them as if they were services for which an arm’s length value should be determined using the cost-plus method (as some of the wording of paragraph 23, and all examples provided in annex of the draft, seem to suggest), in which case we agree that such amendment to the guidelines on CCA seems reasonable. In that case, it should however i) be made

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explicit in the wording of the guidelines that this is what this sentence actually means, and ii) there should be an additional statement to indicate that such mark-ups, for measuring the value of contributions, should not be necessary when all parties to the CCA conduct similar development activities (and bear similar types of costs) in the framework of that CCA;

- Or, what this new sentence would mean would imply that, for each tax period, development costs of each party should be fully disregarded at that it is the fair market value of the IP under development (in its current state), or perhaps the change in the fair market value of this IP under development, that should be the metric for assessing contributions of each party, but in that case we would be of the opinion that such a very significant departure of the new guidelines from the current ones appears to us to be inappropriate and risk to cause very significant issues for all parties in any sort of development CCA, because:

  o Assessing the fair market value of a not yet fully developed IP may be extremely cumbersome, difficult to perform and uncertain in itself in most situations;
  o Creating a need to re-do this exercise for each tax period where costs would be contributed (i.e. new development was performed) would be extremely cumbersome for taxpayers (by replicating aforementioned difficulties every year of the life of the development CCA);
  o Besides, it would seem to us to depart from the very purpose of a CCA in itself which is to contribute, and share, costs, as the name itself suggests.

4. For the various reasons above, we would highly welcome a further clarification of this point in the new guidelines. This would also imply further clarifying paragraph 23 in a similar manner; more specifically, we believe that a distinction in paragraph 23 should be made between a) contributions “in kind” (of existing IP), for which costs would usually not provide a reliable basis on which to value contributions, b) contributions of high value-adding development services, for which a mark-up may need to be added to costs to measure the arm’s length value of said contributed development “services” as illustrated in examples 1-3 (unless all the “services” performed by all parties to the CCA are essentially of a similar nature, in which case adding a mark-up should not be necessary as it would not change the relative “weight” of such contributions made by each participant), and c) low value-adding services, for which costs alone may suffice as a reasonable measure of the arm’s length value of such contributions.
5. Finally, the Discussion Draft could have taken up or made references to the works of the EU Joint Transfer Pricing Forum on CCAs on services not creating intangible property\(^1\) to confirm to European companies and practitioners that the OECD shares the principles outlined in these works.

6. We thank you for giving us the opportunity to share with you our comments and would be pleased to provide you with any additional detail you would be interested in.

\(^*\)

\(^1\) Report adopted during the meeting of 7 June 2012. DOC: JTPF/008/FINAL/2012/EN.
Andrew Hickman  
Head Transfer Pricing Unit  
OECD Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris  
France

Submitted by email: TransferPricing@oecd.org


The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 8: Revision to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)" 29 April 2015 – 29 May 2015 (hereinafter referred to as the Draft).

General Comments

The Confederation of Swedish Enterprise acknowledges that the sharing of costs in a Cost Contribution Arrangement (CCA) should be in line with the arm's length principle (ALP). We support the OECD's work on a revised chapter VIII of the Transfer Pricing Guidelines ensuring that CCAs are consistent with the ALP. However, the revised chapter VIII of the guidelines must also enhance certainty for taxpayers and tax administrations, reducing the risk of double taxation. The Confederation of Swedish Enterprise believes that this latter goal has not been achieved in the current discussion Draft.

The risk and cost connected with certain projects might be too vast for any one company to bear. The possibility of dividing the cost and risk between several entities through a CCA is therefore of utmost importance. CAAAs should not be seen as creating BEPS per se, but rather as a way of making it possible for expensive or high risk projects to be completed. Although there might be abusive cases in which CCAs are used, this is not normally the case. In most situations CCAs are used for genuine business reasons. In order for CAAs to continue to be a useful tool, the
OECD transfer pricing guidelines on CCAs must be predictable and easy to apply for taxpayers.

Specific comments

In paragraph 3 of the Draft, a general definition of a CCA is outlined. We are concerned that the Draft only refers to direct benefits. We believe that also indirect benefits should be included. If an indirect benefit is relevant, it would be considered in a transaction between independent parties. Consequently, it is not in line with the ALP to automatically disregard indirect benefits just because the transaction is between related parties.

The Draft does also lacks guidance on how to identify direct benefits. This can create difficulties in distinguishing between indirect and direct benefits. To avoid these problems and to make sure Chapter VIII are in line with the ALP we recommend the OECD to include indirect benefits in the Draft.

Paragraph 4 and 5 discuss expected benefits and contributions to a CCA. The Confederation of Swedish Enterprise believes that a participant’s interest and contributions to a CCA should be determined from the outset of the arrangement, and not be adjusted after some time. However, the Draft seems to suggest that the interest is to be determined at the outset, whereas the contribution should be determined at a later stage. In our view, this does not seem to be in accordance with the ALP. To require re-evaluation of contributions after a period of time does also increase the compliance burden for taxpayers. If it is found that re-evaluation is necessary, there should at least be a time limit to such adjustments. If not, compliance burden for taxpayers will be massive.

The valuation of contributions is a key feature in the guidelines. The Draft states that contributions should not be valued at costs, but rather at their value. Only in the case where the difference between cost and value is relatively modest can a contribution be valued at cost. Low value-added services is mentioned as an example where the difference between cost and value is relatively modest. We believe that the possibility to use cost as a basis for valuation of contributions should be extended beyond low value-added services. For some industries it is common practice to value contributions at cost in arrangements between independent entities engaging in transactions similar to a CCA. We therefore urge the OECD to evaluate in which circumstances valuation at cost represents arm’s length valuation between unrelated entities, and add to the Draft that valuation in such cases should be at cost.

The Confederation of Swedish Enterprise is concerned about the removal of terms such as “costs” and “whether in cash or in kind”. It seems that contributions within a CCA now require something more than just a financial contribution. However, it is not uncommon between independent entities that one party of the arrangement provides financially to the project without having any control over it. In order for the
guidelines to be in line with the ALP we recommend the OECD to reconsider this aspect.

The Draft offers very little guidance on how the value of a contribution should be determined. The Confederation of Swedish Enterprise is concerned that the lack of guidance will heavily increase the complexity of the Guidelines and hence the risk of double taxation. We therefore recommend the OECD to elaborate in the guidelines how the value of a contribution should be determined.

If there are changes made by a tax administration on the value of a contribution or benefits received, all other tax administrations should, so as to avoid double taxation, grant the taxpayer right to corrective actions in their respective jurisdiction to claim a tax deduction.

In the Draft a distinction is made between two different types of CCAs; services CCAs and development CCAs. Even though the Draft states that each particular CCA should be considered on its own facts and circumstances, we are concerned that this distinction between different types of CCAs might cause confusion. Although it may not be the intention, this distinction creates the impression that two different set of rules are created for CCAs. This increases the risk for disputes between taxpayers and tax administrations. We urge the OECD to reconsider whether this distinction between different types of CCAs is necessary.

The documentation requirements regarding CCAs are very detailed and asks for extensive documentation. We believe these requirements go beyond the documentation requirements presented in BEPS Action 13 on transfer pricing documentation and recommend better alignment between these action points.

On behalf of the Confederation of Swedish Enterprise

May 27, 2015

Krister Andersson
Head of the Tax Policy Department
Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

By email: TransferPricing@oecd.org

Our ref: WJID/AL

Dear Andrew

Discussion Draft on Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Thank you for the opportunity to comment on BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) published on 29 April 2015 (the ‘Discussion Draft’). These comments are written from the perspective of the UK.

General comments

The proposed changes to the transfer pricing guidelines in respect of cost contribution arrangements will have far-reaching consequences. Any simplicity, objectivity and certainty for businesses and tax authorities arising from using costs relative to anticipated benefit (as currently permitted) will be negated.

Costs are easier to identify, manage and audit for both businesses and tax authorities. In addition, the subjectivity and complexity for development CCAs from combining ‘value’ with ‘anticipated benefit’ will be difficult to achieve on a principled and consistent basis in advance of any tangible output from the group’s activities. The proposed ‘value’ and benefit approach will also bring with it the inherent difficulties of evaluating and managing multiple subjective inputs with multiple tax authorities (similar to the practical issues that arise in relation to profit splits). Another challenge will be how an audit adjustment in one country in relation to the value of contributions will be resolved in relation to the taxation outcome in other jurisdictions.

The proposals will make CCAs unattractive in relation to their complexity and uncertainty, including for businesses that are not engaging in base erosion and profit shifting. The result will be an increase in the compliance burden for companies, and additional costs for tax authorities in understanding and auditing the arrangements, with a significant potential for...
disputes and double taxation where tax authorities do not share the same view.

The Discussion Draft does not make any reference to transitional arrangements, despite the acknowledgement that many development CCAs continue for several years, and that many existing CCAs will have, to date, been based on cost. At the very least, existing arrangements should be grandfathered. It is particularly important to note that many countries, including importantly the US, have a long history in their legislation of having cost sharing regulations. These have been the basis on which businesses, and tax authorities, have been assessing compliance for many years. Any changes of the magnitude proposed in the Discussion Draft will at the very least need time and extensive consultation with governments to ensure that changes can be made in an appropriate and co-ordinated manner. This will require a degree of flexibility that the current Discussion Draft does not convey.

Given the significant issues raised by the proposals, we consider that cost should be retained as a potential measure for contribution. We recognise that it might be necessary to consider a range of options or safeguards to achieve this.

Detailed comments on specific aspects of the Discussion Draft are set out in the attached appendix.

If you would like to discuss any of the points raised in this letter, please do not hesitate to contact John Henshall (jhenshall@deloitte.co.uk), Alison Lobb (alobb@deloitte.co.uk) or me (bdodwell@deloitte.co.uk). We would be happy to speak on this topic at the public consultation meeting in July 2015 if it would be helpful.

Yours sincerely

WJI Dodwell
Deloitte LLP
Appendix – Comments on the proposed modifications to the provisions of Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements

Sections A and B (paragraphs 1 to 9)

These paragraphs provide the necessary introduction and conceptual framework for CCAs. The distinction between ‘development CCAs’ and ‘services CCAs’ is broadly helpful. Most of the guidance provided in the Discussion Draft applies to development CCAs, but not to simpler service CCAs. For simplicity and clarification it would be helpful to provide separate guidance for development CCAs and for services CCAs in Chapter VIII of the Transfer Pricing Guidelines.

The Discussion Draft acknowledges that CCAs can be a useful mechanism in simplifying multiple transactions, including operating as a replacement for a ‘web of separate intra-group arm’s length payments with a more streamlined system of netted payments, based on aggregated benefits and aggregate contributions’ and can ‘eliminate the need for complex cross-licensing arrangements and associated allocation of risk.’ This is a very significant benefit and appropriate mechanism for businesses (and consequently for tax authorities) where there is a degree of parity in the relative levels of contribution and benefits. It would seem a disproportionate response to discourage the use of CCAs as an appropriate transfer pricing mechanism, even where there is not artificial avoidance.

There are circumstances where it would not be appropriate to apply a CCA mechanism for transfer pricing purposes. It would be reasonable to assess the appropriateness of the application of a CCA by reference to certain conditions, such as:

- a clear commercial rationale for the group as a whole for the development activity or services in question;
- the need for contributions from different group companies, based on experience, resources, sharing of risk of losses for new, untested developments, and/or pooling of services for economy of scale or avoidance of duplication;
- a degree of parity of contribution from the parties involved, (which does not mean they should be identical); and
- a reasonable expectation of benefit from the outcome (particularly relevant for development CCAs).

Paragraph 9 notes that ‘The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property but the other participants have an effective ownership interest in the property’. It is correct that there will be only one legal owner of any intellectual property, but we do not agree that there is a concept of ‘effective ownership’ that applies here. Between third parties, the outcome would be that the legal owner would grant a royalty-free licence in perpetuity to the contributors (in a specific geographic location or for a particular application) in return for their contribution to the development of the intellectual property. (See for example commercial court decisions in this area, such as Meridian International Services Ltd v Richardson & Ors [2008] EWCA Civ 609 (04 June 2008) in the UK).
Section C – Applying the arm’s length principle (paragraphs 11 to 35)

C.2 Determining participants (paragraphs 11 to 15)

One of the stated purposes of revising the guidance on CCAs is to align Chapter VIII to the changes proposed to Chapters I and VI of the Guidelines as part of the BEPS project. In order for CCAs to be consistent with such changes, the proposals include that a participant of a CCA must have the capability and authority to control the risks associated with the CCA activity, which is not unreasonable.

Where a group company is excluded from being a CCA participant it would be logical that any services or other activity will be priced on normal transfer pricing principles. It would be helpful if Example 5 of the Appendix to the Discussion Draft were to discuss the pricing that should be applied to the financing being provided by Company A if it is not a participant in the CCA (although we recognise that this work may need to be completed after further transfer pricing guidance is completed in relation to interest deductions and other financial payments later in the BEPS process).

C.3 Expected benefits from the CCA (paragraphs 16 – 19)

The Discussion Draft notes that independent parties are likely to include a clause in any CCA agreement, particularly relevant in the case of long-term development CCAs, to allow for periodic reassessment of contributions compared to actual benefits to determine whether future contributions should be adjusted. Care needs to be taken in this area to ensure that this does not become an exercise using hindsight. In practice, difficulties can arise where one contributor decides that the expected benefits to it do not warrant further participation in the costs, such that other contributors are left with the full cost of completing the development and taking on full risk, or writing off their costs incurred to date. Between third parties, where the participation of one or more contributors is a pre-requisite for other parties to participate, then this would be written into the contractual arrangements with suitable provision for termination of the arrangements, and, possibly, for compensation for parties that are disadvantaged by early termination.

C.4 Value of each participant’s contribution (paragraphs 20 to 26)

The proposals to require the measurement of a participant’s contribution at ‘value’ rather than permitting it to be at cost represents a significant divergence from the existing guidelines. Cost is the basis that many businesses have adopted to date, because it is identifiable and objective rather than subjective. (In the case of long-term development CCAs, many of these arrangements are part way through a multi-year project). Between third parties, for example in relation to joint venture arrangements, cost is frequently used for provision of services or other development activities.

There are significant advantages to using cost that would no longer be available under the proposals to measure contributions at value. Cost is simple, objective and lends itself to being readily identifiable to businesses and readily auditable by tax authorities. Furthermore, cost avoids the challenges that are associated with determining contributions based on value in the absence of readily available, reliable comparable third party transactions. This is particularly a concern when there is a mix of activities or unique activities being contributed. The work on risks, capital and intangibles as part of the BEPS process provides significant additional guidance, but there will be a number of instances where contributions will remain highly subjective. This is of particular importance for high-risk development projects where the outcome may be highly uncertain at the outset and where expected benefits may vary
considerably (or not materialise at all). In such cases, determining value as well as expected benefit will be highly subjective and could over- or under- reward different parties based on assumptions made. In such cases, contributions based on costs incurred would be a more appropriate reflection of the risks that the parties are prepared to take and would limit subjectivity to the apportionment of expected benefits between the parties.

In addition, determining the appropriate value for contributions commensurate with the expected benefits under the CCA is likely to lead to difficulty in agreeing the value, both between the CCA participants involved and multiple tax authorities.

Businesses are rightly concerned that where more than two countries are involved in a CCA a value-based approach could lead to an increase in audits, disputes and, if it is not eliminated, double taxation. At the very least it would be essential that full and binding mutual agreement procedures (‘MAP’) are available for CCA cases, and the work on Action 14 will be critical here. As with the use of multi-jurisdictional profit splits, it is difficult to manage the subsequent tax audit and dispute process in relation to several jurisdictions with different timetables, and a transfer pricing adjustment in one country will have consequences for many others (it may affect all those participating in the CCA). Advance pricing agreements may be an appropriate way for businesses to obtain certainty in relation to a CCA, but are not always practical (or offered by all countries). There are also increasing difficulties in managing the process as the number of participating countries increases from two. A practical answer, albeit requiring process change by tax authorities, would be for there to be a requirement for CCAs to be audited jointly by the countries affected, with an automatic roll into a multilateral mutual agreement procedure for any adjustments agreed. This would be consistent with the overall objectives of the BEPS project and with existing transfer pricing guidelines on simultaneous tax examinations.

The difficulties noted above will be of particular concern for those not engaging in base erosion and profit shifting, such that the compliance burden and uncertainty created are unlikely to be proportionate to the proposed outcomes. The added complexity, additional compliance burden, increased uncertainty and risk of dispute may mean that businesses choose not to use CCAs at all for future projects, despite any commercial logic that may exist for doing so. As the objective is to ensure that the outcomes for transfer pricing purposes for CCA participants are consistent with those which would have arisen had the parties made similar contributions on similar terms as third parties, it would be illogical to move away from an approach where cost is reflective of third party behaviour.

C.5 Balancing payments (paragraphs 27 – 30)

Balancing payments are required to ensure that each participant’s share of the overall contributions to the arrangement is consistent with the participant’s share of the overall expected benefits. Paragraph 28 notes that such balancing payments may be the result of periodic reassessment of the share of the expected benefits and/or contributions. Given the subjective nature of measuring contributions based on value, and particularly for long-term development CCAs in which the expected benefits will evolve over time, it will be extremely difficult (perhaps impossible) to monitor and value the relative contributions of each participant on a continually updating basis. As the expected benefit from a development CCA changes, so will the value of elements of the contributions, with no fixed reference point. It is difficult to envisage how this can be achieved on a principled and consistent basis.

C.6 Disregarding part of all of the terms of a CCA (paragraphs 31 – 32)

It is not clear that disregarding a CCA in its entirety is necessary where the proposed guidance
in the rest of the chapter are followed. At the very least ‘relevant circumstances’ in paragraph 32 should be clearly detailed in relation to CCAs. For completeness, we repeat here some of our comments in respect of recharacterisation that are relevant to the consideration of disregarding CCAs:

Recharacterisation of transactions is contentious and a source of double taxation. It should be a matter of last resort, and every effort should be made to understand and price the transactions that are actually undertaken. In particular, the arm’s length principle applies to CCAs as for other transactions. This is a principled approach, and it is the principle that allows for a basis for resolving disputes.

There are two significant issues with recharacterisation in terms of dispute and double taxation – 1) that two or more tax authorities do not agree when it should apply, and 2) that two or more tax authorities do not agree on the alternative transaction that should be priced. Given the often multi-jurisdictional nature of CCAs, there is an increased likelihood that multiple tax authorities will be affected where one seeks to disregard the CCA, in whole or in part. One safeguard that the OECD could adopt would be that for non-recognition of a CCA to apply (and to determine the alternative way in which the CCA transaction(s) should be priced) would require mandatory agreement of competent authorities under Article 25 Mutual Agreement Procedures (‘MAP’) for treaty countries. If such agreement is not reached, the default position should be to price the CCA.

Section E – Recommendations for structuring and Documenting CCAs (paragraphs 42 to 45)

It would be helpful to clarify how information regarding CCAs should be included in either master or local file documentation under BEPS Action 13 Guidance on Transfer Pricing Documentation and Country-by-Country Reporting.

Paragraph 42(e) of the Discussion Draft revises the existing Guidelines to ‘require’ (rather than ‘allow’) ‘balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants’. As noted above this will be a difficult exercise to adopt in practice and unlikely to be consistent with arrangements or terms that third parties would make in relation to, for example, joint ventures.

Transitional arrangements

The Discussion Draft does not make any reference to transitional arrangements. It is essential that thought is given to how any changes are introduced, given that many development CCAs will have been operating on a cost contribution basis for a number of years but may also have a number of years remaining. Given the difficulties that will arise from a change of basis mid-way through development, it seems that the most appropriate approach would be to apply any changes (if adopted) only to new CCAs entered into after finalisation of the guidance.

VAT/GST

It will be helpful for the OECD to consider the implications of these changes for VAT/GST regimes to ensure consistency of treatment for direct and indirect tax purposes.
May 29, 2015

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris
Cedex 16
France

Ref: OECD Discussion Draft: BEPS Action 8, Revisions to Chapter VIII of the Transfer Pricing Guidelines

Dear Mr. Hickman:

Deloitte Tax LLP1 (“Deloitte”) appreciates the opportunity to submit comments on behalf of the Deloitte U.S. tax practice, regarding the Organization for Economic Cooperation and Development’s (OECD’s) Discussion Draft on *Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)* and to contribute to the conversations that will take place at the public consultation scheduled for July 6-7, 2015, at the OECD’s headquarters in Paris.

Deloitte supports the OECD’s position in the Discussion Draft that the use of the arm’s length principle is the only viable standard to allocate profits earned by multinational enterprises (MNEs).

We, however, disagree with the interpretation of this standard in the Discussion Draft, which essentially prohibits CCA participants to share costs (at cost), even though such arrangements are widely observed in the open market, and are thus by *definition* consistent with the arm’s length principle.

Our detailed comments below address widespread arrangements between uncontrolled enterprises, and explain why they choose to enter into such arrangements.

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1 Deloitte Tax LLP is the U.S. member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”). DTTL and each of its member firms are separate and distinct legal entities. DTTL itself does not provide professional services of any kind. Please see www.deloitte.com/about for a detailed description of DTTL and its member firms.
The Discussion Draft requires participants to control risks to participate in CCAs, and also to perform actual development functions to be entitled to more than a financing return. This position is also inconsistent with unrelated arrangements in which one or more participants lack control over the performance of development activities and are, nevertheless, entitled to an equal share of the expected benefits derived from the development process. These transactions are observed in the open market and by definition are evidence of arm’s length behavior.

Our detailed comments below provide examples of situations in which third parties, in the context of a CAA, contractually agree to relinquish all control over a joint development project, and yet capture a portion of the expected intangible income upside and downside. We provide explanations for these outcomes.

As a general rule, Deloitte believes that tax authorities should not be allowed to require taxpayers to perform ex-ante valuations and then use the benefit of hindsight to adjust the results, after the uncertainty is resolved. However, should the OECD allow for such use of ex-post results, Deloitte believes that stringent safe harbors should be provided to taxpayers who have documented, at the time of the transaction, the financial projections used for the valuation.

Most of the guidance provided in the Discussion Draft applies to development CCAs, but not to the simpler service CCAs. For the sake of simplicity and clarification, Deloitte believes that Chapter VIII of the Transfer Pricing Guidelines should provide separate guidance for development CCAs and for service CCAs. Separating the two types of CCAs would improve the clarity of the new guidance. Deloitte also requests that the guidance provide grandfathering options for existing CCAs that involve sharing costs (at cost), should the final guidance require taxpayers to share costs at value.

The vast majority of active development CCAs between affiliated members of an MNE involve the sharing of costs (at cost). In fact, U.S. law and other countries’ regulations – for example, those in Germany -- require CCA participants to share the costs of ongoing intangible development activities (at cost). Deloitte believes that taxpayers that participate in CCAs qualified under the current version of Chapter VIII should be allowed to continue to share costs (at cost) without penalties or the risk of being taxed twice on the same income.

We hope Deloitte’s comments are useful and provide thoughtful observations on some of the positions taken in the Discussion Draft. We welcome any questions you may have in connection with these comments. Please contact Philippe Penelle.
(ppenelle@deloitte.com) if you have any questions about this submission or wish to discuss any of the issues discussed herein.

Sincerely,

John M. Wells
U.S. Transfer Pricing Leader
Deloitte Tax LLP
**DETAILED COMMENTS**

**Motivations for Cost Contribution Arrangements**

Both the existing Transfer Pricing Guidelines\(^2\) and the Discussion Draft\(^3\) accurately describe the reasons independent parties would enter into CCAs. Both documents provide:

“Independent parties at arm’s length might want to share risks (e.g., of high technology research) to minimize the loss potential from an activity, or they might engage in a sharing of costs or in joint development to achieve savings, perhaps from the combination of different individual strengths and spheres of expertise.”

Because uncontrolled companies are observed to engage in such arrangements in countries throughout the world, the arm’s length principle requires tax authorities to recognize similar arrangements between affiliated enterprises.

**Discussion draft is not consistent with the arm’s length principle**

The Discussion Draft takes the position that at arm’s length uncontrolled parties would share development costs at value, not at cost. We believe that such statements at paragraphs 10, 22, and 27 are inconsistent with unrelated parties’ actions that are observable in third-party arrangements in the open market. For example, in the life sciences industry it is common for third parties to agree to share the costs (at cost) of developing drugs, and for each party to receive a royalty-free license to exploit the co-developed property in its respective territory. Similarly, in the movie industry, co-financing deals are almost universally entered into between uncontrolled studios, for practically every movie under development.\(^4\) Such co-financing arrangements specifically provide that the various costs required to develop the movie (such as production costs, print and advertising costs, and distribution costs) will be shared at cost (not value) between the parties. We specifically note that in these agreements it is typically the case that:

- One party performs all the actual functions necessary to make the movie, the other party just provides part of the financing;


\(^3\) Paragraph 10 of the discussion draft.

\(^4\) The studios that have participated in the development of a movie are listed in the opening credits. It is almost always the case that more than one studio is listed. The reasons studios almost always team up financially to develop movies are (1) diversification of project-specific risks; and (2) de-levering of the fixed costs required to finance any given movie to maintain an acceptable cost of capital; this is especially the case when the owner of the copyright cannot capture certain cash-flow streams associated with certain fields of use of the subject movie (e.g., foreign routine distribution cash flows) and de-lever a portion of the fixed costs that can be diluted in those cash flows. The same reasons exist in other industries where large outlays of fixed costs are required to develop property, including the life sciences, technology, oil and gas industries, and aerospace industries.
The party that just provides financing contractually relinquishes creative control over the making of the movie to the other party (this is typically explicitly specified in the contract); and

The party that just provides financing is not limited to a financial return such as an interest rate on the financing contribution.

**Third parties share costs at arm’s length**

In most co-development arrangements, independent companies decide to share in the systemic risks of the same economic investment, where each participant’s share of the total investment is exposed to the same systemic risks as the total investment itself. Most co-development agreements entered into by third parties provide that the development costs required to develop the property will be shared between the participants in proportion to some agreed measure of relative benefit.

**Why do third parties behave this way?**

To answer this question, consider the following situation. Participant A has an investment opportunity that requires funding $1 million of R&D costs at cost with the expectation, if the development is successful, of capturing $2 million of gross intangible income. Assume that the cost of capital of this investment is 12 percent.

It is important to understand that the cost of capital of that investment (and any other investment) is determined by two factors:

- The systemic volatility of the expected $2 million of gross intangible income (that is, the co-movement of gross intangible income with macroeconomic movements); and
- The size of the funding obligation of $1 million relative to the size of the expected net intangible income of $2 million - $1 million =$1 million.

Assume that 60 percent of the expected gross intangible income is expected to come from Territory 1, and 40 percent of the expected gross intangible income is expected to come from Territory 2.

Assume that Participant A decides to undertake this investment. Participant A has two alternatives: (1) Participant A can fund the entire investment by herself; or (2) she can approach Participant B and enter into a CCA. These are Participant A’s realistic alternatives.

**Economic Point 1:** Note that both Participants A and B have access to the open market and can purchase shares in each and every alternative available investment on the efficient risk-expected return frontier. More specifically, there are a large number of realistically available investments on the frontier that have the same cost of capital of 12 percent (i.e., the same systemic risk).
Economic Point 2: Further note that every alternative investment with 12 percent cost of capital and the same systemic volatility of expected gross intangible income must have the same size of their funding obligations relative to the size of their expected net intangible income.\(^5\)

Suppose that Participants A and B decide to enter into a CCA, that is, they decide to co-fund the $1 million cost commitment. Participant A will market the results of the arrangement in Territory 1 and Participant B will market the results of the arrangement in Territory 2, such that:

- Participant A captures 60 percent of the expected gross intangible income ($1,200,000), and Participant B captures 40 percent of the expected gross intangible income ($800,000); and

- Both participants face a 12 percent cost of capital (i.e., share into the systemic risk of the total investment).

Since both participants face the same systemic volatility of expected gross intangible income, Economic Point 2 above states that the only way both participants will end up each with a 12 percent cost of capital is if they have the same funding obligation relative to the size of their expected net intangible income.

It follows that if Participant A captures 60 percent of the expected gross intangible income, it must commit to fund 60 percent of the total costs, and Participant B must commit to funding 40 percent of the total costs, for both participants to face the same 12 percent costs of capital and therefore share into the same investment opportunity under the same economic terms.

This is the reason why third parties share costs (at cost) in proportion to their respective shares of expected gross intangible income (benefit). Sharing costs (at cost) is required to ensure both parties are sharing in the same economic investment.

**What happens if they share costs in any other proportion?**

Suppose that Participant A and Participant B share the total costs of the investment, at 50 percent each. Since both participants still face the same systemic volatility of expected gross intangible income, Economic Point 2 above implies that Participant B now faces a greater cost of capital than Participant A, because its funding commitment per dollar of expected gross intangible income is greater than that of Participant A.

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\(^5\) For CCAs that involve contributions of preexisting rights, the first transaction involved (consideration for preexisting rights) may or may not affect the cost of capital of the participants required to pay; the second transaction (the CCA itself), however, always involves the same incremental cost of capital for each participant. See the section “Initial Contributions Should be Distinguished from Ongoing Contributions,” below.
Conclusion 1: The participants are no longer sharing the same investment. Participant A faces a lower cost of capital than the total investment, and a lower cost of capital than Participant B. Participant B faces a greater cost of capital than both Participant A and the total investment.

As discussed above, Participant B can purchase a 40 percent stake in any investment in the open market that carries a 12 percent cost of capital. In particular, Participant B can purchase a 40 percent stake in the total investment itself, and end up facing a 12 percent cost of capital.

Conclusion 2: A rational Participant B will never agree to fund more than 40 percent of this investment. It is not an arm's length outcome.

It should be clear that (i) the expected net intangible income of Participant B is lower when allocated 50 percent of the funding obligation; and (ii) the cost of capital of Participant B is greater when allocated 50 percent of the funding obligation.

Participant B is strictly better off buying a 40 percent share of any of the other investments available in the open market that have a cost of capital of 12 percent. The only likely way that Participant A can induce Participant B to enter into the CCA and fund 50 percent of the total costs is if Participant A commits 10 percent of total expected gross intangible income in its territory to Participant B to dilute the incremental 10 percent of funding commitment to restore the 12 percent cost of capital in the investment share of Participant B. At that point, the share of total costs borne by each participant has been realigned with the share of total benefit expected by each participant.

Sharing total costs (at cost) in proportion to expected benefit is the only arm's length outcome of a CCA. Any other allocation of funding obligations is inconsistent with the arm's length principle and results in an arbitrage opportunity whereby the investments of both parties are outside the efficient risk-expected return frontier (Participant A was above in our example and Participant B was below).

Arm’s length parties do not require control over development risk

Third parties that enter into CCAs often have only one participant perform all the actual development functions and control the development risks. For example, in a pharmaceutical co-development deal, it is often the case that all development functions are performed by one participant, who is responsible for designing the development protocols, hiring and firing the contract research organizations (CROs) that will execute the various research phases required, and assess and monitor the CROs. In the movie industry, it is often the case that co-financing studios contractually relinquish creative control over the movies they are co-financing. Typical clauses provide that the studio that owns the production rights will have ultimate say in the director and casts retained, as well as in all or most other
creative decisions along the way. These clauses directly contradict assertions made in the Discussion Draft at paragraphs 10, 22, and 27.

Other arrangements in the movie industry called “negative output deals” involve a studio signing a contract with an independent producer before a movie is produced whereby the studio commits to distribute the movie once the producer provides the “negative.” The producer then takes the contract to either a bank or another studio and obtains financing based on the distribution commitment. Such contracts also typically involve the studio committing to distribute the movie relinquishing contractually most or all creative input and control over the movie being produced, as well as the funding banks or studios relinquishing most or all creative input and control.

All these observations introduce the question as to why rational investors behaving at arm’s length would agree to neither perform any development functions nor control the risks associated with those functions, despite providing funding for the development and facing all development and market risks in their respective interest in the property.

In the context of cost contribution arrangements, it is important to define what we mean by control over risks. In all the examples provided above, one of the participants exercises control over risks by assessing the funding opportunity and by deciding whether or not to (i) seize the opportunity, (ii) participate in the development functions, and (ii) exercise control over the development risk during the development. We can thus conclude that there is always a level of risk control inherent in these arrangements, but we also conclude that at arm’s length it does not appear to matter, other than in the valuation of the arrangement, whether or not a party will perform certain functions or control development risks.

One of the reasons that control is not required is the alignment of incentives among participants in a cost contribution arrangement. All participants have proportional risk by virtue of splitting costs proportionally to anticipated benefits—it is not by accident that these arrangements are designed this way. Therefore, the optimal decision by one party is optimal to all other parties, assuming they have the same information set. It follows that if the most economically efficient way to develop the subject property is to have only one party performing all development functions and making risk-affecting decisions along the way (to maximize development speed and minimize development costs), all participants will agree to that arrangement, because it is optimal for each individual participant and to the arrangement itself.

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6 The term “negative output deal” came about when a movie was shot on analog film and a “negative master” created.

7 There is a body of economic literature regarding mechanism design, adverse selection, and moral hazard. That literature seeks to explain why we observe certain institutional or contractual arrangements emerging endogenously to achieve efficient economic outcomes.
Examples 4 and 5 of the Discussion Draft are therefore not practical, because they directly contradict arm’s length behaviors observed in the open market. Deloitte disagrees with such deviations from the arm’s length principle.

We therefore object to:

(i) The OECD prohibiting in Chapter VIII arrangements that are observed at arm’s length;
(ii) The requirement that participants must perform development functions to be entitled to more than a financing return (Example 4);
(iii) The application of the revised Chapter I control concept to Chapter VIII without a recognition of the fundamentally different nature of cost contribution arrangements; and
(iv) Ruling out a party as a participant if said party does not exercise control over the development activities (Example 5). The only notion of control that should be required is in connection with assessing the development activity and the terms of the envisioned development agreement.

**Initial contributions should be distinguished from ongoing contributions**

CCAs often involve the contribution by one or more parties of certain preexisting rights, resources, or capabilities to the CCA. Such contributions of preexisting rights may include rights to further develop an existing intangible asset whereby the purpose and scope of the CCA consists in committing the ongoing funding required to take the intangible asset from its current state to its future state.

Before explaining how such contributions are handled at arm’s length, it is useful to explain the economic differences between the contribution of a preexisting right and of an ongoing development activity (e.g., a cash funding contribution).

**Economic Point 3**: Costs associated with the development of rights contributed to a CCA as preexisting rights are “sunk,” within the meaning economists attribute to that word. Costs associated with the ongoing development of such rights and all other rights reasonably expected to be created by the CCA activity are fixed costs that are not yet sunk.

The difference between fixed costs that are sunk and fixed costs that are not yet sunk is that the latter affect the cost of capital of the party committed to fund them (see Economic Point 2), whereas the former do not. Because of this critical difference between the economic nature of these two types of contributions to a

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8 The contribution of preexisting rights to a CCA may affect the cost of capital of the participant(s) required to pay the contributing party depending on the form of payment selected (e.g., lump sum, installment sales, contingent payments). In the (common) case where the consideration is structured as a sales-contingent royalty, there is no impact on the cost of capital of the participant(s) required to pay.
CCA, we urge the OECD to amend paragraphs 19, 21, and 29 to distinguish between initial and ongoing contributions because, at arm’s length, initial contributions should be provided at value, but ongoing contributions should be provided at cost.

**Ex post adjustments**

Paragraph 19 provides that regardless of which method is used to evaluate the participants’ relative shares of expected benefits, adjustments to the measure used may be necessary to account for differences between the expected and actual benefits received by the participants. Paragraph 29 gives tax authorities broad discretion to require balancing payments if a participant’s proportionate share of value or benefits have been incorrectly assessed. 9

The interaction between Paragraphs 19 and 29 is unclear. We interpret Paragraph 19 to say that if the initial expectation of relative benefit from a CCA between two participants is 50 percent each, but the actual allocation of relative benefits turns out to be 60 percent-40 percent, it may be necessary to align contributions following the actual 60 percent-40 percent measure. Unfortunately, it is unclear (i) what “may be necessary” means—under what circumstances is it necessary and under what circumstances is it not; (ii) who is entitled to effectuate this provision, the taxpayers, the tax authorities, or both; and (iii) should the realignment occur prospectively, retroactively, or both.

Paragraph 29 does not limit adjustment to situations in which it may be necessary, therefore, arguably providing tax authorities with unlimited discretion to require or adjust balancing payments whenever the actual benefits differ from expectations. Without clear guidance, we are concerned that balancing payments will be necessary whenever there is a deviation in benefits that does not favor the tax authorities.

Deloitte believes that, as a general rule, the tax authorities should respect whatever the parties have agreed upon ex-ante based on their expectations, as long as the contract has economic substance. Thus, a contract that does not allow for ongoing recalculations of the ex-ante expectations of relative benefits should be respected. Deloitte recognizes that in certain rare cases, tax authorities could be allowed to use the benefit of hindsight. However, the rules governing the use of hindsight by tax authorities should be very clear and unambiguous. Paragraphs 19 and 29 fail on both counts.

9 If value rather than costs are shared, the potential for adjustments will increase dramatically. If the value of one participant’s contribution is based on residual intangible income then the value of that participant’s contribution will change based on the amount of total gross intangible income. If costs are used rather than value, adjustments will only be required if the expected proportionate share of intangible income changes. Thus, if contributions are based on value, adjustments may be required if either or both the gross amount of intangible income is estimated incorrectly or the proportionate amount of income is estimated incorrectly using hindsight.
In order to respect the arm's length *ex ante* analysis of taxpayers, Deloitte suggests that paragraphs 19 and 29 include limits on the ability of tax administrators to make adjustments to taxpayers’ initial and ongoing contributions. We suggest adding the following principles:

- Initial and ongoing contributions should be separately analyzed.
- The analysis should be limited in time from the date of the contribution. For example, it would not be appropriate to look back 15 years to test contributions.
- Safe harbors in which no adjustments would be made should be provided to respect the arm’s length *ex ante* nature of any analysis based on the future and to prevent adjustments for small deviations in benefits that arm’s length parties would not have expected in the absence of a specific agreement.
- No adjustments should be required if the parties can show that the deviations occurred as a result of events outside their control.

We note that paragraph 19 asserts that if unexpected or unforeseeable events materially affect the initial benefit assumptions, consideration should be given to whether independent enterprises would have provided for an adjustment or renegotiation of the CCA agreement. We urge the OECD to remove that sentence. First, there is little empirical evidence that suggests unrelated parties regularly add such clauses to their contract. To the contrary, the empirical evidence suggests that in the vast majority of cases, unrelated parties do not add such clauses to their contracts. In addition, in the context of development CCAs, all valuation calculations are based on probability-weighted averages of possible outcomes. In that sense, all outcomes are by definition expected and foreseeable—all possible cash flows on the real line (that is, all rational and irrational numbers from minus infinity to plus infinity) receive a probability measure. That probability measure may be zero—a zero probability event is still expected and foreseeable as having a zero probability of occurring. In fact, every possible outcome of a CCA does receive a zero probability measure. Yet with probability one, there will be one *ex-post* result, since there will be an actual financial result to the CCA. That particular *ex-post* outcome of the CCA had a zero *ex-ante* probability of occurring at the time of the valuation, like every other expected and foreseeable possible outcomes (i.e., all rational and irrational numbers from minus infinity to plus infinity). For these reasons, unless the parties agree to an adjustment clause, we believe adjustments by tax authorities should be only occurring in the cases outlined above.

**Chapter VIII should provide separate guidance for development CCAs and for service CCAs**

Most of the guidance provided in the Discussion Draft applies to development CCAs, but not to the simpler service CCAs. Service CCAs generally share current services without creating any discernible future benefit. The allocation keys for service CCAs are different. For example, headcount may be appropriate to share costs
attributable to the human resource function, but would not be appropriate to share costs associated with intangible developments. In addition, the documentation requirements for service CCAs, including CCAs sharing low-value services, should be different. Separating the two types of CCAs would provide additional clarity to the new guidance.\(^\text{10}\)

**Guidance requires grandfathering or transition provisions**

The OECD’s introduction of the requirement that all contributions must be shared at value breaks with decades of prior guidance, including from the OECD itself and many countries that have adopted the OECD’s Transfer Pricing Guidelines, allowing CCA participants to share ongoing development costs at cost. A significant number of currently active CCAs were executed based on that guidance. In some circumstances, participants relying on the cost at cost requirements valued their initial contributions on the basis that they would only share costs at cost in the future. For example, under the U.S. cost sharing regulations, participants using the income method would have projected future development costs at cost rather than value in determining the resources, rights, and capabilities that they are making available to the other participant. In general, projecting development costs at cost rather than at value increased the initial payment that the receiving participant was required to make. Requiring the participant making the initial payment based on development costs at cost to now value the development costs at value would essentially be requiring the participant to pay for value twice, once in the initial payment and again upon receipt of the development service.

Deloitte believes that existing CCAs that qualify under the current CCA regime and involve the sharing of costs at cost should be grandfathered under the new CCA regime and continue to enjoy any and all protections afforded by the new CCA regime. Such grandfathering should be almost automatic, and should not require an involved or expensive process. The tax authorities should defer to the contract the CCA participants entered into. We specifically note that any and all CCAs that involve a U.S. participant and that qualify under U.S. cost sharing rules will not qualify under the new CCA regime, should the OECD continue to deny participants the ability to share costs at cost.

If the OECD decides against allowing the grandfathering of existing CCAs, or provides for an election by taxpayers to grandfather into the new CCA regime or adjust their CCAs to comply with the new regime, a reasonable transition period should be provided for such adjustment. In addition, existing CCAs should be given the option to be terminated under arm’s length conditions determined based on the actual rights and obligations under the governing contract (under the current CCA

\(^{10}\) For example, the U.S. regulations have adopted a regime for development cost sharing arrangements in Treas. Reg. Section 1.482-7 and a separate regime for sharing costs in Treas. Reg. Section 1.482-9, with separate requirements and documentation rules.
regime), rather than by imputing to the arm’s length termination valuation rights and obligations required under the new CCA regime.
Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue Andre Pascal
75775 Paris Cedex 16, France

May 29, 2015

Dear Andrew:

We appreciate the opportunity to comment on the OECD Discussion Draft related to the revision of Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements as part of its work related to Base Erosion and Profit Shifting (“BEPS”) Action 8.

Please find our comments attached for your review. We very much appreciate your consideration of these comments and are hopeful to be able to provide additional guidance and consultation regarding this topic at a future date.

Sincerely,

Tim Reichert and Perry Urken
Economics Partners, LLC
Comments on Discussion Draft

The Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (“the Draft”) addresses the goal identified in Action 8 to assure that transfer pricing outcomes are aligned with value creation. As defined in the Draft, a Cost Contribution Arrangement (“CCA”) represents a contractual arrangement to share the contributions and risks involved in the development of assets, including intangible property.

The Draft incorporates the assertion, which is prominently featured in the OECD’s proposed revisions to Chapter I of the Guidelines, that the concept of “control over risks”, including the performance of functions tied to the control and management of risks, should constitute a material factor in analyses of the allocation of income attributable to intangible property among controlled affiliates. This concept is incorporated in several ways in the Draft:

1) The Draft asserts that functions in the form of controlling and managing activities and risks relevant to a CCA likely represent important “contributions” to the CCA and should be valued accordingly. Example 5 of the Draft prescribes that the computation of the value of parties’ contributions to the CCA should include the “performance of activities”.

2) The Draft also argues that, since a CCA is premised on the notion that participants jointly share in the risks of the CCA activities, an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in order to qualify as a CCA participant. Control is defined as the capability to make decisions whether to pursue risky opportunities and how to respond to risks, as well as assessing and monitoring risk. Example 5 of the Draft indicates that entities which do not control the risks associated with a CCA “cannot be regarded as a participant in the CCA”.

3) The Draft appears to minimize the importance of financial capital as a contribution to a CCA. The guidance provided in Example 5 indicates that an entity whose only contribution to a CCA is capital should receive “a risk-adjusted rate of anticipated return on its funding commitment” as opposed to a share of residual income that may be attributable to the resulting intangible asset. This statement echoes the language contained in the proposed revisions to Chapter I which asserts that little or no return may be due to “capital rich, asset owning” entities, while the lion’s share of returns should be attributed to entities which manage and control relevant risks.

As a matter of economic theory and fact, it must be remembered that at arm’s length, persons enter into contracts to accept risks over which they have very little control – and do so millions of times daily. Indeed, this is one of the purposes of financial and insurance markets. More generally, the transfer of risks that are beyond the control of the transferee is routinely achieved through contracts. These sorts of risks – which do not require “control” over the risk – are very often “routine,” meaning that the value of taking them on
is knowable and can be ascertained using either market benchmarks or risk pricing models that rely ultimately on market benchmarks.

Thus, the premise that an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity in order to qualify as a CCA participant is inconsistent with the arm’s-length standard. Numerous arm’s-length examples are observable where parties share in the economic risks associated with the development of intangible assets through the sole contribution of financial capital.

We are convinced that solutions such as those proposed in the OECD’s draft revisions to Chapter I which artificially restrict returns on financial capital to levels which are likely below the cost of capital are inconsistent with the arm’s-length principle. As the OECD points out, MNEs are free to organize their financing structures in a variety of ways, making it possible to concentrate the allocation of capital to “low substance” (so-called “cash box”) entities based in low-tax jurisdictions. The question is not whether “low substance” entities that cannot control the risks associated with an investment should be allowed to participate in CCAs. Rather, the question is whether the pricing of the risk borne by entities that are, in essence, passive investors is consistent with financial models or market benchmarks.

Moreover, as we have discussed elsewhere, it is an economic fact that profit is by definition the result of, and the return to, capital placed at risk. Capital investments, broadly defined, are the claimants of profit, and therefore of taxable income. Aspects of the Draft seem to imply that “functions” are claimants of profit.

This is incorrect as a matter of both economic theory and the operation of markets. Functions performed are the result of both capital and labor inputs. Indeed, economic theory treats the firm as a “production function,” involving labor inputs and capital inputs that are combined to produce an output of some kind. Revenue earned by the firm, less its purchases from other firms, is distributed by labor and capital markets to labor and capital inputs. Labor inputs are paid in the labor market, at an arm’s length wage rate. Similarly, capital is “paid” in the capital markets, earning profits (equity capital) or interest (debt capital). Capital is the claimant of profit.

Functions matter in transfer pricing because they aid in the determination of whether, and how, a given economic activity – or a given capital investment – should be benchmarked or remunerated. Functions tell us whether an entity (including participants in a CCA) is comparable to a “passive investor” in the open market (earning an ex ante return consistent with the cost of capital), an “active investor” such as a venture capital or private equity investor (often earning an ex ante return greater than the cost of capital, or at least associated with a very high cost of capital), or an entrepreneur whose functions are ultimately not benchmarkable but are of the nature of a residual profit claimant.

We fully recognize, and have stated elsewhere that historically, when transfer pricing practitioners have focused their attention on capital, the tendency has been to rely on an overly narrow conception of capital. That is, capital has been thought of as limited to physical and financial capital and certain kinds of “hard” intangibles (technology and trademarks). Further, this narrow conception of capital has led to a disregard of the distinctions given above (i.e., the market-observed distinctions between passive investment, active investment, and residual claimancy). This type of narrow approach ignores broad, and economically very important, categories of intangible capital such as investment opportunities, customer based assets, and capital such as the firm’s “mind and matter”.

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In part as a result of this, some CCAs may have conveyed returns to future investment opportunities, which are closely related to different types of non-financial capital, at prices inconsistent with market dealings. However, rather than addressing this problem by suggesting artificial (non-market) restrictions on controlled transactions, we have proposed alternative approaches (described in detail in our comments regarding the OECD Discussion Draft regarding Profit Splits, BEPS Action 10) that address this concern in a manner that is indeed consistent with the arm’s-length standard. As discussed in more detail in those comments, we proposed that the income retained by cash box legal entities that receive transfers of capital (broadly defined) reflect an arm’s-length payment for this capital.
Transfer pricing of intragroup intangibles to prevent BEPS

Ma. Enriqueta Mancilla Rendon, PhD
La Salle University

Marcela Astudillo Moya, PhD
National Autonomous University of Mexico

In Mexico there are two ways of classifying the methods for determining transfer pricing: the traditional or direct methods, and the transaction methods. Fiscal methodology gives priority to direct methods vis-à-vis the alternative methods (methods that examine the profits that arise from transactions). Nevertheless, the methodology is used to apply taxpayer studies that determine a price for a company that transfers physical goods and intangible properties or for the services it provides to its associated enterprises, that is, to its related party. For a license of a comparable intangible asset in independent companies, the traditional method is used by setting a price based on the Arm's Length Principle. In the sale of intangible assets, it is possible to apply the method of comparable uncontrolled price or resale price. In each situation, information supporting the context of the application should be included.

During the initial few years in which transfer pricing policies were put into place, the fiscal method was applied to companies whose tax residence was in a different country, which in this case corresponded almost exclusively to large taxpayers. Currently, the study is applied to all taxpayers engaged in intra-group activities in comparable transactions.

There are methods for measuring the intangibles, such as the Balanced Scorecard used by companies as a reference and customized to their needs. In terms of intangible assets, however, due to the virtual absence of information available within companies, the lack of objective methodology is a constant. Furthermore, the need for these assets to generate future economic benefits means there is no clarity for setting a comparable price in the market. The market value of an intangible asset generally is not comparable to the cost invested in developing and maintaining an intangible good.

A benefit generated by intangibles should be broken down by functions (development of the intangible), assets (improvement and protection of the intangible), and risks (use and exploitation of the intangible). Each related party should be compensated in the amount of their contributions. To determine a Cost Contribution Arrangement in the transfer pricing regime, it is likely that the related parties do not contribute in the same proportion, probably because the capacities of the

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1 Researcher and professor at the La Salle University Business School. maenriqueta.mancilla@ulsa.mx
2 Researcher and professor at the National Autonomous University of Mexico’s Institute for Economic Research. marcelaa@unam.mx
companies might not lend themselves to such purposes. Consequently, there will not be a payment compensation effect even when the benefit might have been mutual.

Authorities have undertaken efforts to strengthen tax collection levels by ways of the transfer pricing regime in comparable uncontrolled transactions, seeking to determine the base for efficiently taxing economic activity. One of these efforts has resulted in the establishment of a formal requirement to present an informational statement describing the fiscal situation on the relevant transactions\(^3\), including the issue of the transfer pricing regime. The authorities require considerable information in relation to a transfer pricing study that would not necessarily make it easier for them to determine when intragroup companies in comparable transactions define the market value of an intangible or the value of a service, let alone when the distribution of benefits is sought within the group.

Estimating in advance the benefits of controlled transactions is a means to manage tax risk and distribute the fiscal burden. The agreement between the related parties would provide certainty to the transaction and the profits resulting from the transactions can probably be predicted, although this might not necessarily be the case depending on specific factors and agreements within the group. The controlling company might limit the decisions to invest in subsidiaries or reverse the marketing activities, the provision of services, and the treasury operations between the related parties. It would be difficult to agree on jointly manage a fiscal cost under the Arm’s Length Principle, which would cause the erosion of the tax base.

The existence of fiscal requirements in the transfer pricing studies to be submitted to the authorities; juridical decisions and accounting standards, which are jointly presented for assessing, presenting and disclosing intangible assets in the financial situation of the companies, as well as the regulation that governs the protection of the rights of such assets, are descriptive standards that do not indicate how to assess an intangible asset or service under the Arm’s Length Principle, let alone how related parties will distribute the fiscal cost and benefits as a whole for the transfer of these intangible assets in controlled transactions. Specific, rules for the transfer of intangibles are required, particularly for those that are difficult to measure, in order to prevent the erosion of the tax base.

Treasury officials have endeavored to fiscally strengthen the current structure of royalty payments, interests and technical assistance, and have also verified that it is aligned with the BEPS actions defined, to ensure that any changes that take place are immediately incorporated into the corresponding Mexican legislation.

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\(^3\) Relevant transactions are A. Financial transactions (derivatives) B. Transfer pricing transactions C. Capital share and fiscal residence D. Reorganization and restructurings E. Other relevant transactions (sale of intangible goods or financial assets, sale of goods due to merger or split, among others).
References


OECD, BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs) 29 April 2015 - 29 May 2015


Dear Mr. Hickman

Erste Group Bank AG appreciates the opportunity to comment on the latest draft relating to BEPS Action Nr. 5 on the topic of Cost Contribution Agreements (CCAs).

We recognize OECD’s effort to clarify and unite as much as possible approaches applied in cross-border situations from tax perspective as crucial for doing business in the current environment in order to protect both the tax payers and the tax authorities.

Due to the short time allowed for public comment, we will not go into detail analyses of the draft. However, we would like to point out one major concern that we have and that is relating to the netting principle.

Paragraph B.1.6. clearly states that CCA “can provide mechanism for replacing a web of separate intra-group arm’s length payments with a more streamlined system of netted payments”. We truly appreciate that the netting principle is now clearly mentioned as there is no such guidance in the current OECD Transfer pricing guidelines, even though, netting may be indirectly understood from the principle of CCAs as such.

However, netting brings along practical difficulties, such as implication on VAT. Considering cross-border situation within European Union, services are, in principal, subject to reverse-charge mechanism – i.e. services are subject to VAT in the country of the recipient of the service with the local applicable VAT rate. If the receiving entity is a company that has full input VAT refund right then charging netted payments would have, in principle, only cash-flow impact as the service recipient would have had the option to claim the input VAT from the full amount sooner or later. However, should the entity be for example a financial institution with no or very limited input VAT refund, the netting of payments represents potential avoidance of VAT as, in majority of cases, such netting principal is not embedded in the local VAT laws. Thus, in practice, such netting would not be possible (or seen as highly risky and questionable depending on each jurisdiction).

The same concern applies also to withholding taxes, where netting of payments may be viewed as avoidance of withholding taxes in the country of source.
Therefore, in order to clarify the situation, it is highly recommended to consider implementing relevant changes to VAT and other regulations.

We would be happy to provide further comments on this issue, if required.

Yours sincerely,

Andrea Lee
Head of Desk Transfer Pricing

Günter Schmidt
Head of Group Taxes
European Business Initiative on Taxation (EBIT)

Comments on the OECD Discussion Draft on BEPS Action 8: Revisions to Chapter VIII of the TP Guidelines on Cost Contribution Arrangements

EBIT's Members at the time of writing this submission: AIRBUS, BP, CATERPILLAR, DEUTSCHE LUFTHANSA, DIAGEO, GSK, INFORMA, JTI, LDC, MTU, NUTRECO, RELX GROUP, ROBECO, ROLLS-ROYCE, SAMSUNG ELECTRONICS, SCHRODERS and TUPPERWARE.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 8: Revisions to Chapter VIII of the TP Guidelines on Cost Contribution Arrangements

Andrew Hickman
Head of the Transfer Pricing Unit
OECD/CTPA
2, rue André Pascal
75016 Paris
FRANCE

Submitted by email to: TransferPricing@oecd.org

Brussels, 29 May 2015

Dear Andrew,

EBIT is grateful for this opportunity to comment on the OECD’s BEPS Action 8 Discussion Draft: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (hereinafter: “Discussion Draft”).

EBIT generally welcomes the further guidance by the OECD on the development and use of intangibles under Cost Contribution Arrangements (CCAs) and welcomes efforts to align the revised Chapter VIII to other Chapters of the OECD Transfer Pricing (TP) Guidelines. This is a very complex issue. EBIT therefore welcomes the OECD’s acknowledgement in the Discussion Draft of the need to achieve simplification. At the same time, we believe that some of the recommendations, if adopted in their current form, are bound to significantly and unnecessarily increase complexity further as well as the number of future disputes between tax administrations and commercial parties with regard to CCAs. This surely cannot be the aim of the OECD, however. We note in this respect that there is no consensus view among the CFA or BEPS-44 on the present Discussion Draft at this late stage of the BEPS project.

EBIT has a number of concerns with the Discussion Draft which are set out below, together with a number of recommendations.

GENERAL COMMENTS

EBIT Members first of all wish to reiterate that CCAs are a valid, practical commercial arrangement. CCAs are essentially being used for the pooling of certain control and risk management functions by parties in order to achieve significant cost reductions, including the costs of joint development of intangible assets or services and risks, often for longer periods, whereby the return on investment is sometimes uncertain.

EBIT welcomes the additional clarifications in the Discussion Draft to measure CCA contributions at value. We note that the proposed changes are in line with the increased focus by the OECD on substance and less focus on contractual arrangements, as we have seen in other BEPS Discussion Drafts. For CCAs this guidance will mean that contributions should be measured based more on value rather than costs. We strongly recommend that there should still be a possibility to measure contributions at cost where cost is the appropriate basis for determining the value of a contribution.

The Discussion Draft clearly focuses strongly on discouraging the setting up of controlled entities solely to benefit from CCAs without performing any meaningful function in the CCA.
EBIT comments on the OECD’s Public Discussion Draft on BEPS Action 8: Revisions to Chapter VII of the TP Guidelines on Cost Contribution Arrangements

The Discussion Draft introduces the fundamental new requirement that any participant in a CCA shall have the “capability and authority to control the risks associated with the risk-bearing opportunity” under the CCA. EBIT believes that it is not feasible or desirable to require all participants in a CCA to perform similar functions in order to share on a perfectly equitable basis in the benefits of a CCA, as proposed by the OECD. We note that the OECD makes a distinction between development CCAs and services CCAs. Particularly in the case of development CCAs costs may not be a good measurement for value. EBIT welcomes the OECD’s rather nuanced wording in paragraph 23:

"It is sometimes the case that the value (i.e. the arm’s length price) of services contributed to a CCA corresponds to the costs associated with providing those services. It may also be the case that the difference between the value and costs is relatively modest, such as for low value-added services described in Chapter VII. In this case it is recommended for practical reasons to value contributions at cost. However, in all other circumstances (for example where contributions include a mixture of low and high value-adding services and/or intangibles or other assets) costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and the use of costs may lead to non-arm’s length results. For development CCAs costs will generally not provide a reliable basis on which to value contributions.”

At the same time, independent parties will in our view also accept risks which they do not manage and control for the full 100%, as long as they deem the return on the capital invested to be commensurate with the risk they undertake. The OECD should in our view recommend in its final Discussion Draft on Chapter VIII that any entity participating in a CCA shall conduct an analysis which takes into account the effect of performing important functions itself or as a contractor to another party, prior to joining a CCA to demonstrate that it represents its best realistic alternative.

EBIT is also concerned with regard to the Discussion Draft’s proposals for “disregarding” part or all of the terms of a CCA by tax authorities on a discretionary basis, which was also proposed in the OECD’s Discussion Drafts regarding BEPS Actions 8-10. To limit the number of future disputes between tax administrations and commercial parties, EBIT Members recommend that the OECD insert a reference into its final Discussion Draft which states that an analysis should be performed of the costs shared between the CCA participants and whether potential adjustments to the sharing of those costs might result in an appropriate arm’s length result, before disregarding the CCA.

EBIT notes that the Discussion Draft does not deal with the mechanics of the practical application of the CCA rules, for example, how to deal with income resulting from a joint ownership of IP developed under a development CCA? Where one participant in the CCA receives income from a user of the IP outside the CCA, how the income sharing transactions between the CCA participants should be handled from other tax perspectives is unclear to us. EBIT requests the OECD to provide further clarification with regard to the mechanics of the practical application of the proposed CCA rules.

Another issue including potential for increased disputes in our view is the issue of balancing payments. EBIT urges the OECD to clarify in the TP Guidelines that whilst there might be a need for balancing payments between the CCA participants due to incorrect income allocation among them, this does not include that countries outside the CCA can challenge IP payments made towards any CCA participant for the use of the IP created by the CCA.

SPECIFIC COMMENTS

In paragraph 3, the Discussion Draft considers that “intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants”, however, EBIT Members believe that when independent parties enter into transactions they may also
obtain “indirect” benefits, In our view, the Discussion Draft should include both ‘indirect’ and “direct” benefits, as per the existing Chapter VIII of the TP Guidelines on CCAs. EBIT is concerned how this ties in with the notions of “overall expected benefits” in paragraph 4 and the “aggregated benefits” in paragraph 6 of the Discussion Draft. We urge the OECD therefore to clarify a) the difference between “direct” and “indirect” benefits, and b) what benefits are acceptable direct benefits under a CCA and what benefits are not. EBIT is concerned that the strong focus on “direct” benefits from the interest in a CCA may lead tax administrations to have higher expectations regarding the income earned as a consequence of being a participant to a CCA.

The Discussion Draft states in paragraph 6 that one advantage of CCAs is that “a web of separate intra-group arm’s length payments” can be replaced with “netted payments” and that “complex cross-licensing arrangements” can be eliminated. In paragraph 33, the Discussion Draft states that contributions to CCAs need to be treated under general local tax rules (respectively for each participant). We note that the existing TP Guidelines recommend, when possible, to segment transactions to avoid the aggregation of transactions because it would make it more difficult to identify the remuneration of each transaction. For clarity’s sake, EBIT suggests to link the guidance on “netted payments” to the existing guidance on segmented and aggregated transactions.

EBIT Members welcome the statement made in paragraph 17 of the Discussion Draft that: “In situations where actual results differ markedly from projections, tax administrations might be prompted to enquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight”, as this will help reduce the risk of disputes in our view.

Paragraph 23 of the Discussion Draft proposes to accept measuring contributions to “low value-added services” by costs, a suggestion which is welcomed by EBIT, provided a link is made to the definition of low value-added services in the revised Chapter VII of the TP Guidelines. EBIT is concerned that in this same paragraph, it is concluded that costs will generally not provide a reliable basis on which to value contributions for development CCAs, as opposed to service CCAs, because in our view, this is not always the case where one or more components of the contributions to any CCA consist of low value-added services.

Paragraph 26 of the Discussion Draft states “For development CCAs, contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets and should be valued in accordance with the principles set out in Chapter VI.” However in Example 4 of the Discussion Draft Company A should receive a risk-adjusted rate of anticipated return on its funding commitment even where Company A has performed a diligent analysis and risk assessment, not only for itself but for Company B’s risk handling capacity as well.

At first sight, it seems that the functions performed by Company A under the CCA include “important functions”. However, Example 4 could also be read to mean that Company A performed the functions described in paragraph 58 of the Discussion Draft exclusively for its own development activities before it joined the CCA, but once in the CCA, it only provides the funding without performing the functions listed. EBIT Members believe that further clarification and guidance from the OECD on the interpretation of the fact pattern of Example 4 and the concept of “important functions” is needed. We recommend applying the same definition as provided in the revised Chapter VI of the TP Guidelines for consistency’s sake. The determining factors of an appropriate risk-adjusted return should also be explained to help mitigate disputes.

EBIT is concerned with paragraph 29 of the Discussion Draft which states that: “Balancing payments may also be required by tax administrations where the value of a participant’s
proportionate contributions of property or services has been incorrectly determined, or where the participants’ proportionate expected benefits have been incorrectly assessed”, as this is likely to open the door to many disputes because in our experience, tax authorities can be expected to react to such a statement by requiring balancing payments. A reference to the existing methods for evaluating contributions would be helpful.

The Discussion Draft in paragraph 42 on the general conditions that must be met for entering into a CCA between controlled parties states under paragraph (e) that: “The arrangement would require balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants”. We read this to mean that balancing payments should be made on a regular basis and for an undefined period during the life span of the CCA and in the light of the OECD’s apparent assumption that the proportionate shares of expected benefits among the participants necessarily varies with time. EBIT is concerned that, based on this assumption, tax administrations could much more easily challenge the extent or the lack of balancing payments without any time limitation, and that this would essentially become a totally subjective matter. Therefore, in order to avoid a surge in unreasonable claims from tax administrations (and a subsequent surge in disputes by businesses), we strongly recommend the OECD to rephrase paragraph 42(e) and align it wording with paragraphs 27-30 of the present Discussion Draft:

“The arrangement may require balancing payments and/or possible changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants”.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are committed to a constructive dialogue with the OECD and are always happy to discuss.

Yours sincerely,

European Business Initiative on Taxation – May 2015

For further information on EBIT, please contact its Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com).

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SUBJECT: PROPOSED REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS

29 May 2015

Dear Dr. Hickman,

By means of this letter, EY would like to share its comments on the public discussion draft on “BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)” (the Discussion Draft) as released by the OECD on 29 April 2015. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions about the transfer pricing aspects of CCAs. This letter presents the collective view of EY’s global international tax network.

Key comments

Our key comments with respect to the Discussion Draft, as further elaborated upon in the “detailed comments” section of this letter, can be summarized as follows:

- Concept of a CCA. CCAs have been adopted by multinational enterprises (MNEs) as a practical way to deal with joint development and services. In many cases, no element of base erosion and profit shifting can be found. CCA participants enter into a CCA in order to share resources and risks for mutual benefit, and to jointly share in the economic return. A CCA is therefore different in legal form from a series of transactions for the provision of services and cross-licensing of intellectual property and it has different economic consequences. The Discussion Draft fails to appreciate this, and instead asserts in paragraph 6 that the outcomes for transfer pricing purposes under a CCA should be the same as those which would have arisen outside a CCA arrangement. In our view this is not correct. The revised approach reflected in the Discussion Draft furthermore would significantly reduce the practical advantages of a CCA.

- Valuing the contribution of each participant. The Discussion Draft appears to demand an unrealistic level of sophistication from both the taxpayer and the tax authority in assessing contributions under CCAs. The thrust of the proposed guidance is that when adopting a CCA, participants would have to establish arm’s length conditions for each individual contribution and expected benefit, in particular, separately determining an arm’s length price for each separately identifiable service or activity performed within the CCA. We
appreciate that an individual valuation could be required for the contribution of pre-existing assets. The ongoing contributions of CCA participants however in practice are almost always valued at cost. This is the case both in CCAs within MNEs and in arrangements entered into by independent enterprises acting at arm’s length. In arrangements entered into at arm’s length, cost is probably the most easily audited and verifiable measure of the contribution made by each party, and in our experience parties acting at arm’s length will fiercely and vigorously contest any attempt by their partners to value ongoing contributions at anything other than cost.

- Eligibility to participate in a CCA. We are concerned that the description in paragraph 13 of the “capability and authority” of a CCA participant to “control the risks associated with the risk-bearing opportunity” that is required for an entity to be eligible to participate in a CCA is simply unrealistic. We agree that CCA participants must have the capability to make the decision to participate and must have the capability to assess the performance of activities under the CCA from time to time. Cost sharing arrangements are seen at arm’s length between third parties where the only practical choices made by some participants are, at the outset, whether or not to participate, and on an ongoing basis, whether or not to continue. We are concerned that the language in the Discussion Draft will introduce significant opportunity for tax authorities to retrospectively adjust the characterisation of a CCA and/or the CCA participants.

- Return to funding. We believe that at arm’s length parties providing funding for the development of assets and intangibles do share in the economic rent derived from the assets or intangibles under development, even where they do not control the risks or closely direct the use to which the funding is put. We disagree with the conclusion of Example 4 and believe that the proposed guidance should be amended to clarify the position of a company providing funding.

- Compliance burden. The proposed guidance would adversely affect many CCAs entered into by MNEs for good commercial reasons. It would require replacing the practicality and certainty of arrangements where ongoing contributions are valued at cost. It would thereby greatly increase the compliance burden on MNEs (and tax administrations alike) and remove much or all of the practical benefit of CCA arrangements.

In summary, our view is that the proposed revisions to chapter VIII are largely unnecessary, specifically from a BEPS perspective, and would be a significant step in the wrong direction, adding complexity and uncertainty to the implementation of CCAs by MNEs without commensurate benefit for tax authorities. It seems to us that the Discussion Draft has been drafted with the aim in mind of tackling the use of CCAs as a medium to facilitate BEPS (where low-substance entities participate in funding the development of intangibles or assets through CCAs), whilst the need for practical guidance for MNEs entering into CCAs for good commercial purposes has taken second place. We recognize the importance of the OECD’s efforts to address BEPS, but we believe that guidance on specific anti-avoidance rules is a better way to achieve this objective. If (substantial) changes to the existing guidance with respect to CCAs are considered necessary, we recommend the OECD allow more time for further discussions and significant revisions before adopting any such fundamental changes.
More detailed comments with respect to the Discussion Draft are presented below. If you have any comments or questions, please feel free to contact any of the following:

Ronald van den Brekel  
+31 88 407 9016  
ronald.van.den.brekel@nl.ey.com

Kenneth Christman  
+1 202 327 8766  
kenneth.christmanjr@ey.com

Jean-Paul Donga  
+61 3 9288 8000  
jean.paul.donga@au.ey.com

Ben Regan  
+44 20 7951 4584  
bregan@uk.ey.com

Michel Verhoosel  
+27 11 502 0392  
michel.verhoosel@za.ey.com

Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel
Detailed comments

Our detailed comments with respect to the Discussion Draft are presented in the sections below, following the structure of the Discussion Draft in terms of sections and headers.

Concept of a CCA

CCAs have been adopted by multinational enterprises as a practical way to deal with joint development and services. In general, CCAs are not tax-driven, and no element of base erosion and profit shifting (BEPS) can be found. The proposed revised guidance would affect many of these cases, substantially increasing the administrative burden for international business. We are particularly concerned about wording in the Discussion Draft that seems to suggest that CCAs require a more stringent application of the arm’s length principle than other situations.

The proposed revised description of the concept of a CCA suggests a fundamental change, from a mechanism to share the cost and risks of a certain activity (e.g. the joint development, enhancement, maintenance, protection or exploitation of intangible or tangible assets) to a system where each participant would, contrary to what the name of the arrangement and the introduction in the revised guidance suggest, be treated as if it were economically providing an ongoing service or performing an ongoing activity for the other CCA participants, and would therefore be required to determine an arm’s length compensation for each individual contribution made.

We believe that CCAs are different, economically and legally, from other intragroup arrangements that could be put in place (such as a network of service arrangements). The reason is that by entering into a CCA, the participants are entering into an arrangement to pool their resources and expertise for mutual benefit. It does not make sense to think of each CCA participant as providing services to the other CCA participants. This is the case both in controlled CCAs entered into within MNEs and in arrangements between third parties. This is why in similar third party arrangements, the contribution of individual participants is almost always valued at cost, with no mark-up.

The proposed guidance would fundamentally change the nature of a CCA and would introduce additional complexities and additional uncertainties for taxpayers participating in CCAs, undermining the utility of CCAs.

Relationship to other chapters

The Discussion Draft explicitly asks for comments on whether the goal of consistency with other parts of the OECD Guidelines is appropriate, and if so, whether the draft achieves such consistency. While we are in favour of consistency throughout the OECD Guidelines, we believe that the proposed draft misses the point that there is a fundamental difference in the legal and economic form of a CCA, which is entered into amongst participants in order to mutually benefit from the pooling of resources and the sharing of risk, and a network of service arrangements.

We therefore expect consistency with other parts of the OECD Guidelines only to the extent that it is relevant for CCAs. Specifically, we appreciate that the guidance expects the approach to valuing the contributions of pre-existing assets made by CCA participants to a CCA to be consistent with the approach to valuing transfers of pre-existing assets in other circumstances. However, we would expect differences between the guidance on valuing on-going contributions by CCA participants and
the guidance on valuing intragroup services, because participation in a CCA has different legal and economic consequences from providing intragroup services. We also believe that risk allocation and control of risks in the context of a CCA cannot and should not be addressed in the same manner as it is addressed on a transactional basis. The risks assumed by each participant of a CCA are inherently affected by the functions performed by one or more of the other participants (please also see our comments below on the extent to which control of risks should be required for an entity to be a CCA participant).

Applying the arm’s length principle
The Discussion Draft describes a number of situations in which independent parties enter into arrangements for sharing resources and skills. We would welcome an explicit statement that taxpayers are not required to substantiate that independent parties in similar circumstances would have entered into a CCA or CCA-type of arrangement as well, and that an MNE’s decision to organize certain activities under a CCA should in principle be respected. Tax administrations should not be allowed to ‘sit in management’s chair’ and should only marginally test the business decisions underpinning the CCA. In our view, the only necessary precondition is the one specified in paragraph 11, that viewed ex ante, all the parties have a reasonable expectation of benefit.

Determining participants
The Discussion Draft states that to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. According to the Discussion Draft, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA. As mentioned above, the degree of control by one participant over the risks it (indirectly) assumes under a CCA is inherently different than the degree to which it can control risks associated with a single transaction with a specific counter-party. This should be taken into account when establishing whether an entity has sufficient control over the risks it assumes to be a participant of a CCA.

In our practical experience we have seen situations where different parties enter into CCAs with a view to developing and commercializing a product. These parties bring expertise and experience in distinct areas. Over the life of the CCA these parties may each control only a particular aspect of the development process (for example, in relation to a specific product aspect or specific aspects of development for the local territories in which they will exploit the fruits of the CCA). The individual participants do not all have detailed oversight or control of the other participants’ areas of development. We also note that in practice, many development CCAs have a single entity responsible for conducting many aspects of product development. In such cases, the other participants have made the decision to take on the risk bearing opportunity by entering into the CCA, and they control the risk on an ongoing basis by reviewing progress and making decisions to continue in the CCA, but they do not control the day-to-day course of work. We believe this is consistent with many third party arrangements, and the guidance should be clearer that the extent of “control” required to qualify as a participant in a development CCA is not the same as the extent of “control” that would be required, for example, to be treated as entitled to all the residual profits arising from the development of an intangible asset.
We recommend that the OECD clarify that a participant does not necessarily have to be able to control all the risks related to the development under the CCA. In particular, we believe that additional guidance is needed to clarify the position of a company providing funding. It should be made clear that such a company’s interest in the intangibles developed under the CCA should satisfy the requirement of having to benefit from the CCA activity itself and having a reasonable expectation of being able to benefit from that interest. Furthermore, we believe that it is at arm’s length - because it occurs in dealings between unrelated parties - that a party financing the development of an intangible is entitled to a portion of the “excess profits” in connection with the intangible if that party has the management and financial expertise to bear such risks, even without any control over the use of the contributed funds or the conduct of the parties’ funded activity. Such party should also be able to participate in a CCA. We appreciate that there is a clear link with the discussion on the remuneration of funding as included in the shaded sections of the latest revised discussion draft on intangibles under BEPS action 8.

Expected benefits
Paragraph 17 mentions that in situations where actual results differ markedly from projections, tax administrations might be prompted to enquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight. In our view, it should be emphasized that the assumption is that projections have been made in good faith and that tax authorities should refrain from challenging the projections merely because the actual results are different. Taxpayers should not be required to provide an unrealistic degree of support for their projections as they are often based on management expectations and forecasts. Instead, tax administrations should only be allowed to test the validity of assumptions underlying the projections and only in exceptional should projections be rejected. A more stringent requirement would in many cases lead to the use of hindsight.

Paragraph 19 assumes that, if unexpected or unforeseeable events materially affect the initial benefit assumptions, consideration should be given as to whether independent enterprises would have provided for an adjustment or renegotiation of the CCA agreement. We believe that as a very first step, an analysis should be done on what has affected the initial benefit assumption. If, for example, one entity sells a significantly higher proportion of a product, using intangibles developed under the CCA, as the result of a change in market dynamics or as the result of its own marketing initiatives, we find it unlikely that independent parties would end or renegotiate the CCA. Moreover, we note that it should be taken into account that data with respect to independent party behaviour in this regard will be very difficult to obtain, and we recommend that the OECD clarify that tax authorities should not lightly conclude that third parties would have renegotiated the agreement. When taking such a position, tax authorities should have a strong burden of proof.

The value of each participant’s contribution
The introduction of the Discussion Draft states that the clarification in the proposed guidance to require contributions to be measured at value rather than at cost helps to ensure that outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA. While we are encouraged that application of the arm’s length principle is also the standard in case of a CCA, we believe as noted above that a CCA is by its very nature (e.g. the sharing of risk, the uncertain outcome of the activities performed, etc.) not the same as a series of separate transactions that can be evaluated on an individual basis.
This means we would not expect that the outcome for participants under a CCA would necessarily be the same as the outcomes for parties outside a CCA.

Moreover, one of the reasons for adopting a CCA is to create a system that is easier for both tax administrators to administer and taxpayers to comply with. This is also acknowledged by the Discussion Draft, e.g. in paragraph 6. Given this goal, the emphasis on figuring out the arm’s length price for each type of contribution is unnecessary. As a very practical matter, we note that the suggested approach would create significant discrepancies with US regulations regarding CCAs. As such, it would become impossible for US participants to comply with both US regulation 1.482-7 and the OECD Guidelines as proposed to be revised.

The proposed guidance prescribes that in determining the value of contributions to a CCA the guidance elsewhere in the OECD Guidelines should be followed. It mentions that for development CCAs, costs will generally not provide a reliable basis on which to value contributions. We believe it will be very impractical and cumbersome to determine the market value of a contribution on an annual basis (e.g. due to the specific nature and/or context of the activities performed and due to the lack of comparability data). Furthermore, we observe that in third party arrangements, individual ongoing contributions are normally valued at cost. Apart from anything else, cost is a readily audited measure of contribution. It is only where there is a contribution of pre-existing assets that independent parties would typically agree on an individual valuation on a different basis.

The existing OECD Guidelines in paragraph 8.3 state: “In a CCA, each participant’s proportionate share of the overall contributions to the arrangement will be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement, bearing in mind that transfer pricing is not an exact science [emphasis added by EY]”. We believe this statement should be kept in the revised guidance.

In case, however, the OECD maintains the position that each participant’s contribution should be valued at arm’s length, we believe such value should only be used to perform a high level analysis of whether each participant’s proportionate share of the overall contributions is materially consistent with the participant’s proportionate share of the overall expected benefits. Furthermore, this should be determined on a multiple-year basis, taking into account the fact that the development of certain intangibles may take a substantial number of years.

CCA entry, withdrawal or termination

Paragraph 39 refers to cases where buy-in, buy-out or balancing payments are not required under the arm’s length principle. We would like to add that buy-out payments under the arm’s length principle would also not be required if an entity decides to leave a CCA because it no longer anticipates sufficient benefits, if this does not coincide with an increase in the expected value of the interest of the other participants related to the results to that date.

Paragraph 41 states that “when a CCA terminates, the arm’s length principle requires that each participant retains an interest in the results, if any, of the CCA activity consistent with their proportionate share of contributions to the CCA throughout its term (adjusted by any balancing payments actually made, including those made as a result of the termination).” We believe that, as the CCA is terminated, it is not required per se that each participant will retain its interest in the result. There may be specific arrangements with respect to the termination of the CCA and who
becomes the owner of whatever has been developed. Further clarification with respect to this paragraph and the underlying assumption would be appreciated.

Recommendations for structuring and documenting CCAs

Paragraph 42, subpart e) notes that “the arrangement would require balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.” We recommend clarifying (by amending the first part of the sentence) that retroactive balancing payments would typically not be appropriate.

Furthermore, we believe that the phrase “(including and budgeted vs actual adjustments)” in paragraph 44, subpart g) may create an expectation that CCAs should be structured on a budgeted costs basis only. In our view, this phrase should therefore be deleted.

Examples

The Discussion Draft contains three examples in which the individual contributions are valued at arm's length. Not surprisingly, the three examples relate to services CCAs. For such CCAs, it is less cumbersome to establish the market value of the contributions. In example 4 and 5, a development CCA has been described. In example 4, the contribution of company B is determined as the residual profit, by deducting a risk-adjusted return for the funding from the total return of the CCA. First, we do not agree that a participant providing the funding (and having capacity to bear the related risks) should only be entitled to a risk-adjusted return. Second, we believe that the absence of examples of development CCAs in which the individual contributions are valued at arm's length is illustrative of the fact that it would be very hard in practice to perform such analysis.
May 27, 2015

Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
OECD  

BEPS Actions 8 Discussion Draft

Dear Mr. Hickman,

The partners of FIDAL’s Global Transfer Pricing Services would like to thank you for the opportunity to present our views with respect to the Organisation for Economic Co-operation and Development (“OECD”)’s public discussion draft entitled BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs), released on April 29, 2015 (the “Discussion Draft”).

General Comments

Overall, we welcome this new guidance as positive step in improving and clarifying the rules applicable to CCAs.

In light of the description of the mechanics of the Discussion Draft, we would perhaps suggest to change the expression “cost contribution arrangements” to “contribution sharing arrangements” as we believe that this more accurately reflects what is being targeted and the proposed workings of these arrangements.

It might also be useful to specify that CCAs must take the form of written contracts which should be included in taxpayers’ transfer pricing documentation.

Specific Comments

“Effective Ownership”

Paragraphs 4, 5 and 9 of the Discussion Draft refer to each participant becoming an effective owner of an interest in any assets resulting from the activity of the CCA. As this may create issues in the definition of what is “effective ownership”,...
particularly in light of the ever-present tension between legal ownership and alleged economic ownership, it might be better to refer to parties owning contractual (legal) rights to use or exploit the assets resulting from the CCA.

**Reasonable Expectation of Benefit**

The notion of “reasonable expectation of benefit” found at paragraph 11 of the Discussion Draft could be improved with a clarification in terms of timing of the benefit. Some tax authorities may require that the expected benefit be realized or realizable within 3 to 5 years in order to allow the deduction of the expense related to the CCA.

This position appears to us to be shortsighted and not in line with the concept of CCAs generally. Some projects may have much longer horizons than others. For instance, a CCA to fund a tree farming enterprise may not expect to reap benefits (or profits) before decades or perhaps close to 100 years, depending on the type of tree being planted and the climate or region in which the plantation occurs. Similarly, funding of blue-sky research into solar-powered aircrafts and other similar endeavours may not generate benefits for decades.

Thus, we would suggest that the Discussion Draft specify that the fact that the expected benefits may be distant in time is not a reason for disqualification of a CCA or a denial of the deduction of the participants’ share of the expenses associated with such CCA.

**Delineating Transactions and Determining Participants**

As stated in our representations in respect of the OECD’s BEPS Action 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)

1, we are quite concerned about recharacterisations/non recognitions occurring outside the exceptional circumstances currently listed at paragraph 1.65 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”). In our view, this is one of the major problems facing the most recent discussion drafts in respect of the OECD Guidelines as well as the OECD Guidelines themselves: the uncertainty brought about by various approaches which allow tax authorities to disregard the bona fide written contracts – which will result, in our view, in a fiscal free-for-all of cases with nearly irresolvable double taxation. The concept of “accurate delineation of actual transactions” is one such troubling approach.

Thus, when at paragraph 13 of the Discussion Draft, one refers to delineating the transaction and thereby deciding whether a party should be considered as a participant to a CCA, regardless of written contracts, we are concerned that this is a further example of allowing tax authorities to disregard transactions without meeting the criteria for recharacterisation. The possibility of disregarding a transaction in accordance with and following the criteria for non-recognition (currently set out at paragraph 1.65 of the OECD Guidelines) is dealt with separately at paragraph 32 of

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the Discussion Draft. This seems to be further evidence of opening the door to disregarding, via delineation, the transactions as structured by the parties without having to meet the prerequisites for non-recognition.

We believe that this is the type of approach that will give rise to more uncertainty, both for taxpayers and tax authorities alike, and that will result in more unresolvable (or extremely difficult to resolve) situations of double taxation.

**Capability and Authority to Control Risk**

This concept found at paragraph 13 of the Discussion Draft is a constructive addition to Chapter VIII of the OECD Guidelines. More specifically, we believe that the key is in having the “capability to make decisions to take on the risk-bearing opportunity” and the capability to manage or monitor the management of the risk, and to pull-out of the investment, if necessary. In other words, it is not necessary for participants to possess all the know-how related to what will be covered by the CCA and authority over all decisions related to the CCA: what is necessary is for the participant to have the capability to make the initial “investment” decision into the CCA, to be able to review what is being done by the CCA, and the authority and right to continue or discontinue investing into the CCA.

We believe that it would be useful for the OECD to affirmatively indicate that this approach would allow a pure investor to be a participant in a CCA and still be entitled to a contractual right to use or exploit the asset(s) developed under the CCA. Such situations are seen in arm’s length dealings whereby the provider of funds does retain a share of co-ownership of the ultimate product.

With the above comments in mind, we are in general disagreement with examples 4 and 5 of the Discussion Draft, as discussed more fully below.

**Link To Hard To Value Intangibles – Consistency with Other Parts of OECD Guidelines**

We agree with the proposition found at paragraph 14 that there should be consistency between the rules of Chapters I and VIII of the OECD Guidelines and that the value of the contribution of each participant should be determined on the same basis whether one is dealing with a CCA or with a simple transfer of intangibles. Of course, as the draft guidelines in respect to hard to value intangibles have not yet been published, we cannot agree with or comment on them.

**Future Adjustments to CCAs**

Paragraphs 17 and 19 of the Discussion Draft suggests that CCAs should provide for the possibility of adjustments in the future to reflect changes in the underlying circumstances resulting in in changes in shares of benefits, and to evaluate contributions vis-à-vis actual benefits received. While we do not believe that such clauses should be mandatory, we would not object to their inclusion as long as such changes are not retroactive and as long as there is evidence that such clauses would, under similar circumstances, be found between parties dealing at arm’s length.

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2 See paragraph 13 of the Discussion Draft.
Balancing Payments from One Participant to Another

Paragraph 29, dealing with balancing payments, concludes with a statement that “normally the adjustment would be made by a balancing payment from one or more participants to another being made or imputed for the period in question.” In practice, this issue of multiple payors and payees is troublesome. Should payor A make the balancing payment to payee C and payor B make the balancing payment to payee D – or should each relevant participant pay/receive an pro-rated share of the various balancing payments?

Disregarding Part or All of a CCA

As stated above in the section entitled “Delineating Transactions and Determining Participants”, every time the OECD opens the door to disregarding all or part of transaction without having to meet the criteria for recharacterisation/non-recognition, the level of uncertainty and potentially unresolvable double taxation increases. This is again the case at paragraph 32 of the Discussion Draft where it is suggested that a “tax administration may also disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions … and its proportionate share of expected benefits…” The criteria invoked in this last quoted sentence is that of “commercial reality” which is, in our view, intrinsically fuzzy. Our concern is further exacerbated by the fact that the OECD Guidelines’ provisions dealing with non-recognition are only subsequently referred to in paragraph 32 leaving one to believe that one could disregard all or part of a CCA under the first portion of paragraph 32 without necessary recourse to, or meeting the conditions for application of, the non-recognition provisions of the OECD Guidelines.

CCA Termination

At paragraph 41 of the Discussion Draft, we would suggest inserting the words “or be compensated for” after the word “retains”.

Recommendations for Structuring and Documenting CCAs

Section E of the Discussion Draft is particularly useful in setting out what is expected of taxpayers.

The one disagreement that we have with this section is with the inclusion of item e) at paragraph 42. As stated above, we do not believe that such clauses should automatically be included in all CCAs: they should only be mandatory for those CCAs where arm’s lengths parties would also include such a clause. If the OECD wants to impose the inclusion of such clauses for all CCAs, then perhaps it should refer to this inclusion in a Special Measure for the purposes of the OECD Guidelines.

In addition, if item e) is to be retained, we would suggest adding the words “important/substantial” after the word “reflect”.
Example 4
We have serious reservations with respect to the mechanism of the adjustment proposed by the country B tax administration.

First, there is a form of recharacterisation in disregarding the geographical split between Company A and Company B from the outset. In other words, example 4 essentially says that, pursuant to applying the concept of options realistically available (“realistic alternatives”), Company A should not be treated as a participant to the CCA at all but rather as a lender of funds, and Company B should be entitled to the entire world rather than strictly its own country. This is treating a CCA (i.e. a contract whereby Company A and Company B agree to share costs/contributions in proportion to the benefits they each expect to receive from exploiting the results of that CCA) as if it was a loan from Company A to Company B. This seems to be pretty clear-cut recharacterisation/non-recognition, yet no mention is made of needing to meet the criteria found in the OECD Guidelines for non-recognition.

Second, the mechanism, although presented as an adjustment to Company A’s “contribution”, is essentially making Company A pay Company B an amount equivalent to the expected future profits related to the intangibles. True, it is not an adjustment to the actual profits but neither can it be said that it is an adjustment to the contributions which are to be shared under the CCA: Company A will be asked (pursuant to the proposed adjustment) to pay to Company B an additional amount equivalent to the net present value of the expected annual benefit of $220M over the course of years 6-15. As a result, Company B could receive a payment that would far exceed the total contributions of development of the intangible under the CCA.

Adjustments to CCAs should be adjustments to the contributions to the CCAs, not adjustments to the actual or expected future profits related to the use or exploitation of the assets developed under the CCA.

Example 5
Example 5 is essentially a non-recognition of the CCA. What is disturbing to us is the fact that this non-recognition is performed via the approach of “accurately delineating the transactions” and outside of the parameters and criteria to be met for recharacterisation/non-recognition of transactions. Our prior comments in this letter and in previous representations with respect to recharacterisations find full application here again.

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3 See our prior comments on non-recognition referenced at footnote 1.
4 See footnote 1.
We would be interested in presenting on the recharacterisation/non-recognition and on the capability to control risk aspects of the Discussion Draft at the upcoming public consultation on July 6 and 7, 2015.

Best regards,

François Vincent
GTPS Partner

Pascal Luquet
GTPS Partner
Dear Mr Hickman

Response from FTI Consulting to the OECD Discussion Draft on BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements

We welcome this opportunity to comment on the OECD’s discussion draft under BEPS Action 8, Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements, published on 29 April 2015. The discussion draft sets out proposed revisions to Chapter VIII of the Transfer Pricing Guidelines and is intended to align the guidance in that chapter with the other elements of the OECD’s BEPS publications pertaining to transfer pricing.

We agree to have our comments posted on the OECD website.

We would like to thank you for the opportunity to comment on the discussion draft and hope our comments are helpful.

Yours sincerely,

Marvin Rust

Enc.

Ruth Steedman
Enclosure

1. Introduction

We welcome the Public Discussion Draft BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements of 29 April 2015 (‘the CCA Discussion Draft’ or ‘the Discussion Draft’) as a robust basis for the revision of Chapter VIII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘the OECD Guidelines’) in respect of Cost Contribution Arrangements (‘CCAs’).

Whilst the OECD is in the process of developing increasingly detailed transfer pricing guidance for CCAs, FTI Consulting’s (‘FTI’s’) view is that it is also essential for the OECD to continue to promote the cost effective use of taxpayers’ and tax administrations’ resources for improved compliance and enforcement processes.

A key concern would be achieving an appropriate balance between theory and practical application that is commensurate with the tax at stake in the countries paying and receiving intercompany charges.

It is also important to note that the usefulness of the proposed measures will depend on how many countries agree with and adopt the proposed measures. As the OECD is a standard setting organisation, it is hoped that all the countries participating in the drafting of the proposed measures recognise the mutual benefits that would inure to both taxpayers and tax administrations from the widespread adoption of a uniform approach to this issue and to avoid the potential harmful consequences of double taxation.

2. General Comments

FTI understands the need for consistency between the proposed amendments to Chapter VIII of the OECD Guidelines set out in the Discussion Draft and other guidance resulting from BEPS Actions, in particular the objective of preventing BEPS through moving intangibles among members of a multinational group. Accordingly, FTI welcomes the initiative of the OECD to update its guidance for participation in and the design of CCAs.

FTI acknowledges that a CCA as defined under the 2010 OECD Guidelines could be considered to be a concept for tax purposes. To illustrate, it would not be unreasonable to say that the ‘historic’ CCA (based on cost) was an arrangement that in the majority of cases was unlikely to be found at arm’s length, as opposed to a joint venture (based on value contribution). With this perspective, FTI appreciates the intention of the OECD to align its guidance for CCAs with the objective of ensuring that the remuneration of participants in a CCA reflects value creation.

While acknowledging the potential weakness of the historic CCA in terms of recognising value creation, the concept provided a practical way for multinational enterprises to manage complex intercompany arrangements whilst limiting the intercompany payments made. In updating the guidance for CCAs, FTI is concerned that the efficiency with which the CCA could previously be applied may be removed as a result of the proposal to base CCAs on value as opposed to cost – we expand on our comments in this respect below.
Evidently, the proposal to base CCAs on value rather than costs contributed represents a significant development and invites the determination of a new term to describe the methodology under the proposed guidance of the Discussion Draft - the term Cost Contribution Arrangement no longer being appropriate.

3. Specific Comments

The Discussion Draft provides a conceptual framework for designing and implementing CCAs, but stops short in acknowledging the commercial practicality of implementing a CCA.

Participation
FTI recognises the guidance in paragraph 13 that:

“.... a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA....”

On the basis of paragraph 13 of the Discussion Draft and the Examples therein, FTI observes that the proposed guidance for CCAs would preclude the participation in a CCA of a party that contributes only funding and does not control the risks associated with contributing that funding. It may be inferred that the requirement for participants in a CCA to control the risks associated with participation in the CCA extends the BEPS emphasis on economic substance to CCAs.

In relation to paragraph 13 of the Discussion Draft, we infer that the intention is that each participant in a CCA should be able to control the risk that it takes on through participating in a CCA and not the broader risks of the overall CCA. In this respect, we recommend that paragraph 13 is re-worded to ensure it is not misinterpreted with regard to the risk that a participant in a CCA should be able to control.

FTI notes that the OECD’s proposed guidance for CCAs does not align with the EU Joint Transfer Pricing Forum’s (‘EUJTP’s’) comments on CCAs in 2012 under which contributions can be made to a CCA in cash or in kind and, therefore, active participation is not a requirement of participating in a CCA. FTI thus observes an inconsistency between the OECD’s and EUJTP’s guidance for CCAs.

Valuing contribution
While recognising the intention to remunerate the participants in a CCA at arm’s length, the requirement to base CCAs on value rather than cost will bring new challenges in designing CCAs and potentially reduce the appetite for using CCAs.

Further, the implementation of CCAs on the basis of value contributed, as opposed to cost, marks a step away from implementing CCAs on an objective, measurable basis. Whereas the cost of contributions to a CCA could be traced to a tax payer’s financial statements and provide robust support for the quantum of contribution to a CCA, the determination of value is much more subjective and challenging – as evidenced by the OECD’s revised publication of Chapter VI of the OECD Guidelines in September 2014 for pricing aspects of intangibles.

For Development CCAs, it is very likely that non-routine contributions to CCAs will need to be valued. FTI observes that the CCA Discussion Draft provides limited practical advice in relation to
valuing contributions to a CCA and, notably, does not acknowledge the complexity of valuing the contribution of intangibles or other non-routine contributions to a CCA.

In practice, CCAs between independent parties are typically complex arrangements. For example, a joint venture agreement in the oil and gas or pharmaceutical sector may extend to hundreds of pages and cover rights to distribute, rights to exploit know-how, funding and arrangements for entering and terminating the CCA. The challenge of mirroring such agreements between related parties is not captured by the Discussion Draft. FTI believes that it is important that Chapter VIII of the OECD Guidelines illustrates the difficulty of designing and testing CCAs such that tax authorities recognise the complexities involved.

With reference to the Examples of the CCA Discussion Draft, FTI notes that the scenarios illustrated are relatively simple by comparison to the situations in which a CCA is typically implemented in practice. Thus, FTI would welcome further and more complex examples in the CCA Discussion Draft to illustrate the valuation of non-routine contributions. For example, Examples 1 to 3 of the CCA Discussion Draft may be inferred to relate to service providers for which the value of their contribution represents a mark-up on cost. FTI would welcome examples that illustrate the determination of a per unit value for a contribution of intangible assets to a CCA.

Valuing benefit
FTI observes that the CCA Discussion Draft provides less guidance in respect of valuing the benefit to participants in a CCA than valuing the contributions from participants. While FTI recognises the intention to determine benefit on an allocation basis (paragraphs 16 – 18), FTI would welcome more focus in the CCA guidance on the evaluation of benefits to the participants in a CCA and, specifically, more comprehensive examples illustrating the quantification of benefits to participants making non-routine contributions to a CCA.

In the context of Example 4 of the Discussion Draft, FTI notes that a participant in a CCA contributing only funding (with the capability and authority to control its risks) would be entitled to a risk-based return. Taking into account the commentary of paragraph 26 that recognises that for Development CCAs, contributions in the form of controlling and managing are likely to be “important functions”, FTI questions whether the benefit to the funding party in this example should recognise the capacity of Company A to make decisions and the contribution of Company A through its control of risk. Put more succinctly, in Example 4, Company A could be argued to make a contribution beyond providing funding through its interest in the joint development project with Company B. In which case, Company A may be entitled to a return beyond a risk-based return on its investment.

The estimation of the timing of the realisation of the benefits from a Development CCA is particularly challenging for tax payers and FTI is grateful that the OECD recognises this in paragraph 17 of the Discussion Draft. The proposal is made there to provide for possible adjustments of the contributions to a CCA over the term of the CCA on a prospective basis. While this is appreciated, the challenge in practice will be for related parties to demonstrate to all tax authorities that such terms would be agreed at arm’s length.

Acknowledgement of some practical issues
FTI appreciates the OECD’s acknowledgement in the Discussion Draft of some of the practical challenges of designing and testing a CCA. For example, as a key observation from the Discussion Draft, FTI appreciates the distinction drawn between Development CCAs and Service CCAs, as defined in paragraph 8. Further, FTI appreciates the fact that the actual benefits from a CCA may
diverge from the expected benefits, or uncertainty regarding when benefits will be realised from a Development CCA. However, FTI would welcome expanded guidance and, where appropriate, quantified measures that may be used.

The clarity the OECD provided in its public discussion draft ‘Proposed Modifications to Chapter VII of the Transfer Pricing Guidelines relating to Low Value-adding Services’ (of November 2014) by specifying a range of acceptable mark-ups on the cost of providing low value adding services was welcomed by businesses and advisors alike. FTI would like to see similar specificity in the guidance for CCAs.

In relation to providing more precise guidance, the following are highlighted:

**Periodic reassessment**

In paragraph 19 of the Discussion Draft, reference is made to “periodic reassessment of contributions vis-à-vis actual benefit” from a CCA. It would be helpful if the OECD could be more precise by specifying a recommended period for review of CCAs. For example, a review of a Service CCA every three years and a Development CCA every five years would appear reasonable. The Service CCA would align with the recommendation under Action 13 ‘Guidance on Transfer Pricing Documentation and Country-by-Country Reporting’ of September 2014 that comparable company data should be updated every three years with a longer period left for the more complex development arrangements. FTI believes this would give more assurance to taxpayers with respect to managing transfer pricing compliance and more structure to tax authorities.

**Balancing payments**

FTI requests clarification of the OECD’s views with respect to the requirement for balancing payments in a CCA. FTI observes that paragraph 27 makes the statement that “the arm’s length principle would require an adjustment be made” where the contribution made by a participant is not consistent with a participant’s share of expected benefits. Whereas, paragraphs 15 and 28 each use the word “may” in the context of balancing payments being made. In our view, the use of the word ‘may’ is essential as in the commercial world, bargains are sometimes struck between independent parties for which the outcomes are not as anticipated but the agreements are not always revisited nor revised. This reality appears to be reflected in paragraph 19 which states “Furthermore, if unexpected or unforeseeable events materially affect the initial benefit assumptions, consideration should be given as to whether independent enterprises would have provided for an adjustment or renegotiation of the CCA agreement.”

Paragraph 29 states that “balancing payments may also be required by tax administrations.” FTI observes that paragraph 29 does not make reference to the arm’s length principle and requests that this paragraph is amended to the effect that it is clearly stated that balancing payments should only be made by tax administrations in accordance with the arm’s length principle.

Aside from considerations regarding the circumstances in which balancing payments are appropriate, FTI requests that more precise guidance is provided for the frequency with which balancing payments and/or changes in the allocations of contributions to CCAs are reviewed. In this respect, paragraph 42(e) of the Discussion Draft indicates such a review of balancing payments be made “after a reasonable period of time.” FTI suggests that the three and five years, referred to above, would be a reasonable period of time after which to review balancing payments and the definition of a recommended review period would prevent unreasonably frequent inquiries by tax authorities.
FTI acknowledges and welcomes the proposal in paragraph 30 of the Discussion Draft that tax authorities should generally refrain from making an adjustment in respect of a CCA based on a single year.

In relation to the domestic tax treatment of balancing payments for participation in a CCA, the question arises as to how the characterisation of such payments may be affected by the proposal to base CCAs on value contribution rather than cost. Under the OECD’s historic guidance for CCAs, balancing payments reflected a difference between cost and benefit, whereas under the proposed guidance for CCAs balancing payments are anticipated to reflect a difference between value and benefit. Should, by way of example, balancing payments be characterised by a tax authority as royalties, the withholding tax implications could be far reaching and complex. Paragraph 33 is very unsatisfactory and FTI believes the paragraph should be redrafted in its entirety to ensure that all payments are treated in the same way.

In the interest of understanding the potential implications of participating in a CCA under the proposed guidance per the Discussion Draft, clarification of the views of the OECD as to how balancing payments should be characterised by tax authorities would be welcome with our belief that these should be explicitly stated to not be ‘royalties’ for tax purposes.

Implementation across multiple jurisdictions
In practice, CCAs are often implemented across multiple jurisdictions. The question thus arises as to what would happen in the scenario that not all the countries in which the participants of a CCA are located adopt the proposed guidance per the Discussion Draft. A scenario can be foreseen where a number of participants in a CCA implement a model based on value contribution, yet only a proportion of the relevant jurisdictions adopt the OECD’s recommendation to base CCAs on value contribution. Such a scenario could result in significant complications for the taxpayer trying to implement a consistent CCA across multiple jurisdictions.

FTI would welcome clear guidance from the OECD with respect to the approach tax authorities should take where not all of the tax authorities of the participating entities in the CCA have a consistent approach to testing a CCA.

Transition: implementation of new guidance
In light of the publication of the Discussion Draft and the new focus on value contribution to CCAs, the question arises as to how existing CCAs based on cost contribution should be treated by tax authorities. For example, FTI questions whether tax payers would be expected to re-evaluate and potentially align those CCAs with the new guidance. Such a requirement could result in the need for significant balancing payments. FTI suggests that it would be reasonable to apply the proposed guidance to new CCAs introduced after a given date. Further, FTI regards it as essential that the OECD should specify a grandfather clause to the effect that existing CCAs that align with the 2010 Transfer Pricing Guidelines are not required to align with any new guidance for CCAs resulting from BEPS Action 8.

Consistency
While FTI welcomes guidance from the OECD that enables tax payers to manage their transfer pricing more efficiently, such as the guidance for pricing low value adding services referred to above, the proposal in paragraph 23 of the Discussion Draft to rely on cost as opposed to value where the difference between the two is “relatively modest” would appear to be subjective and represent an
inconsistency within the Discussion Draft and potentially a divergence from the arm’s length principle.

In the interest of minimising potential disputes between tax payers and tax authorities in relation to whether the difference between cost and value is “relatively modest” or whether contributions qualify as low value adding services in the context of CCAs, FTI recommends that the draft CCA guidance is amended such that the value (not cost) of all contributions to CCAs is considered. FTI suggests that the draft CCA guidance is aligned with the guidance for low value adding services such that a CCA may be implemented on the basis of cost plus a standard mark-up where all the participants in a CCA contribute only low value adding services (as defined in the OECD’s discussion draft of November 2014). In this way, the approach to valuing contributions to CCAs would be consistent.

CCA vs. the Profit Split
The proposed step away from using cost as the basis of a CCA raises the question of when a taxpayer would choose to implement a CCA as opposed to applying the Profit Split method. In the absence of using cost as the basis of a CCA, which arguably represents an objective measure of the contribution to a CCA, the practicality of applying the CCA is diminished and with it potentially some appetite for using the CCA.

Concern has been raised in response to previous BEPS discussion drafts that the OECD is effectively encouraging the application of the Profit Split over other transfer pricing methods. With the challenges of applying the CCA on the basis of value rather than cost, the CCA Discussion Draft could similarly be interpreted to provide additional support for the application of the Profit Split.

4. Conclusion

FTI is of the view that the Discussion Draft sets out the theoretical basis for aligning the implementation of CCA arrangements with the objectives of BEPS. However, the Discussion Draft does not currently go far enough in providing guidance for the design and testing of CCA arrangements that will aid the difficulties of implementing a CCA in practice.

FTI would welcome further guidance from the OECD to illustrate the practical challenges of designing and demonstrating the arm’s length nature of a CCA. In particular, FTI believes that such guidance is particularly important for countries adopting BEPS measures where there may be less practical experience of administrating transfer pricing. While FTI acknowledges the intention of the revised guidance from the OECD with respect to CCAs, FTI believes there remain many aspects of the design and implementation of a CCA that would be open to challenge and the subject of potential dispute in the future.

As a closing comment, FTI expresses concern that with the transition of CCAs based on cost contribution to value contribution, a practical method for supporting commercial business would be eliminated. FTI requests that in determining the final guidance for CCAs, more balance is found between guidance to ensure more rigorous conduct in the design and implementation of CCAs and guidance that is not overly burdensome to implement and administer. FTI believes it is essential to ensure that CCAs remain a viable business methodology to share costs and benefits between interested parties and that existing CCAs are protected by a grandfather clause.

We look forward to the opportunity to continue to provide input on these important issues as the process moves forward. Thank you again for the opportunity to share our ideas and concerns.
Andrew Hickman  
Head of Transfer Pricing Unit  
OECD Centre for Tax Policy and Administration  
2 Rue Andre Pascal  
75755 Paris Cedex 16  
FRANCE

29 May 2015

Dear Mr Hickman,

OECD public discussion draft - BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled BEPS Action 8: Revisions to chapter VIII of the transfer pricing guidelines on cost contribution arrangements (CCAs), issued on 29 April 2015. We appreciate the work that the OECD has undertaken on the revised chapter VIII and would like to make the following comments on the public discussion draft.

We welcome the OECD’s proposal to maintain the central role of the Transfer Pricing Guidelines, within the BEPS project, in the international tax framework for the appropriate allocation of profit and avoidance of double taxation. CCAs are an important area and while we acknowledge that the OECD recognises the need for simplification, the revised chapter VIII may in fact lead to increased complexity and the risk of double taxation. Our reasoning stems from the proposed fundamental shift to measuring contributions at 'value' over 'cost'. Further guidance on how to apply this method under different scenarios would help to explain the practical implications of the proposed changes, and using real life examples would be welcomed.

Chapter VIII Revisions

Measuring the contribution – ’value’ and ’cost’

The updated guidelines as per the discussion draft emphasise that contributions should be assessed based on their "value" in most cases, as opposed to their "cost". Indeed cost is only to be permitted for services CCAs and even then only in cases where the only services contributed are low value-added services.

Comment: While we understand the BEPS focus on "substance" and "value creation", more guidance on how companies will measure their contributions at value is needed. This presumption against cost will likely increase the management and administrative cost of implementing and managing CCAs, while the added complexity will likely only serve to exacerbate the number of transfer pricing disputes.

The purpose of a CCA should be to reduce complex webs of cross charges and continually revisiting the value of "in process" developments, whilst ensuring that contributions are commensurate with expected benefits. Many third party arrangements for example between joint venture partners, or in crowd funding, follow this concept.

Currently there is no guidance on whether any retrospective alterations will be required for existing multi-year arrangements based on the new value based contributions. There is also no guidance on whether existing CCAs will either remain effective or have to re-evaluate their contribution measurements. If the
final guidance follows the draft, our recommendation is for the new rules to apply prospectively only to new CCAs entered into after the date that the new rules come into effect. This will minimise the administrative impact of the new rules on companies and tax administrators because established CCAs will not need to be revisited. Otherwise transitional provisions will be required, including a timeframe outlining when a company must become compliant with the proposed changes, to clarify the potential impact of the revised chapter. Further guidance is also important in ensuring that companies do not suffer unnecessary or excessive administrative costs in managing this transition.

If the guidance remains as drafted, a principles-based definition of the low value added services that can be valued at cost (at some, but not all, points the discussion draft cross refers to the revised Chapter VII, which reflects the BEPS Action 10 draft on low value added services) should help to provide further consistency and reduce the potential for disputes. We advocate principles because a definitive list often has the effect of introducing grey areas, particularly as a result of translation into different languages and application to different business sectors in a complex global business environment.

We suggest that the wording in paragraph 23 could be softened. For example, it is not necessarily a problem if some services valued at cost are not low value added.

Types of CCAs – the distinction

There is now a definite distinction between two types of CCAs commonly encountered – being "development CCAs" and "services CCAs". The key difference is that the former are expected to create on-going future benefits for participants, while the latter will often create current benefits only.

- **Development CCAs** - for the joint development, enhancement, maintenance, protection or exploitation of intangible or tangible assets
- **Services CCAs** - for obtaining services

**Comment:** When asked to think of an example of "cost sharing" most people would think of sharing development costs (and thereby sharing the inherent risks) in conducting research and development (R&D) over a period of time where the benefits are uncertain and indeed a loss may result. Examples exist in business sectors such as pharmaceuticals or defence where investment is often long term, costly and risky because of uncertain timing and amount of returns. The draft guidance seems to move a long way from that concept of sharing risks, and almost takes us to the point where there is no sense in having a separate chapter for these types of arrangements.

The use of "services" CCAs should in effect allow management charges to be recharged at cost, unless the entity providing the service is solely a service provider and not also a beneficiary. This will benefit all parties if it results in fewer challenges from recipient tax authorities which currently assume that management fees are "base eroding" payments.

Experience benefits vs actual benefits received – accounting for the arrangement's arm's length nature

The draft guidance addresses the importance of differentiating between an expected flow of benefits and the actual benefits received, in an attempt to better account for future developments when determining the arm's length nature of the arrangement. The aim is also to limit enquiries from tax administrators as to whether projections by independent parties would be acceptable in comparable circumstances.

**Comment:** The element of hindsight should be removed. It is inequitable on companies and inefficient for tax administrators because uncertainty remains for both parties. Unfortunately, there remains an element of hindsight and suggestion of continual revisiting and review in some of the wording (for example paragraph 42 d). Revisiting budgets and judgments with the benefit of hindsight introduces further potential for debate and inefficiency, and possible cherry-picking by tax authorities.
Determining the participants of a CCA – control of risk

In addition to the likelihood of an expected flow of benefit, a participant to a CCA must have the capability and authority to control the risks in relation to CCA activities. This is consistent with draft revisions made to Chapter I of the Transfer Pricing Guidelines.

Comment: Consistent with our earlier comment on transitional provisions, companies will need to know whether the proposed changes will be applied to existing or only to new CCAs entered into after the effective date of the revised Transfer Pricing Guidelines.

It is not immediately clear to us why there is a requirement that all participants must have the capability and authority to control risks. It is possible that one participant will contribute in part to the CCA by mitigating a particular risk, perhaps by virtue of their particular expertise. There are also numerous examples whereby third parties contribute cash but do not control any risks (for example in crowd funding), yet still accept the possibility of loss in return for the chance of superior returns from an early stage investment.

As an aside, we recommend considering replacing the word "control" with "manage" and/or "mitigate". Often, risks may have been identified but may still be outside the control of the participants. For example, foreign exchange movement is beyond the control of a company, but a company may mitigate the risk of foreign exchange movement by entering into foreign exchange hedging arrangements.

Further Comments

The draft explains that a participant that only provides funding cannot be a cost sharer and must always receive a limited return (see comment above in relation to crowd funding). We appreciate the concern relating to so-called cash box entities but we consider that disregarding a CCA, or deeming an entity cannot be a participant to the CCA, should be considered only in extreme cases.

There is an extensive list of expected documentation and support in section E which seems disproportionate, and inconsistent with the BEPS Action 13 recommendations, and we respectfully suggest that these be re-aligned.

The revised Chapter VIII is obviously intended to be consistent with the BEPS amendments to risk, capital, recharacterisation and intangible assets. The revised Chapter VIII should be revisited together with the aforementioned areas once they are nearly finalised.

If you would like to discuss any of these points in more detail then please contact either myself or Wendy Nicholls, Partner, Grant Thornton UK LLP (Wendy.Nicholls@uk.gt.com; M: +44(0)7714 069862).

Yours sincerely

Global head - tax services
francesca.lagerberg@gti.gt.com
T: +44 (0)20 7728 3454
M: +44 (0)7812 138364
Comments on the OECD Discussion Draft on BEPS Action 8 “Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)”

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, welcomes the opportunity to provide comments on the Discussion Draft on BEPS Action 8 which sets out proposals to modify the OECD Transfer Pricing Guidelines (the “Guidelines”) relating to cost contribution arrangements (“CCAs”). ICC acknowledges that transactions covered by a CCA must be consistent with the arm’s length principle and must follow the commercial reality, and that contributions of each participant should reflect their reasonably anticipated benefit. While appreciating modifications to the Guidelines where this will enhance certainty and provides simplification and objectivity in this area for both taxpayers and tax administrations, ICC does have substantial concerns on those aspects that may result in much greater uncertainty and complexity and consequently pose high risks of double taxation.

ICC in particular welcomes enhanced certainty around CCAs, contributions and expected benefits. However, the Discussion Draft places too much emphasis on the disregard of the CCA in its entirety or in relation to particular participants if they do not have a reasonable expectation of benefit from the CCA activity itself. ICC is therefore concerned that the Discussion Draft does not provide guidance concerning the identification of (direct) benefits. In addition, the Discussion Draft refers to “total anticipated benefits”, “overall expected benefits”, a “reasonable expectation of benefit”, a “share of overall benefits” and “shares of expected benefits” without providing adequate definitions of these terms. Furthermore, there are no criteria provided to distinguish between direct benefits and indirect benefits, if such distinction is intended then this should be clearly articulated. In this context, it is not necessarily correct to disregard indirect benefits if they are of value, despite being indirect, and if in an arm’s length transaction they would still give rise to consideration. At a practical level, a disregard of indirect benefits would be highly judgmental, onerous and would pose a real threat of its misuse in case of the vast majority of taxpayers, not engaged in base erosion and profit shifting (BEPS). CCAs are often the only way for services of any kind, which mainly generate indirect benefits to ensure that contributions are commensurate with the expected benefits. ICC recommends providing additional guidance in these respects. Furthermore, ICC believes that every effort should be made to recognise the CCA and its terms, where appropriate, in cases of indirect benefit.

ICC is particularly concerned that taxpayers may no longer rely on contributions valued at cost. Even in an arm’s length situation it is common for joint developments etc. where resources and skills are pooled in order to reduce overall costs, that contributions of participants are assessed based on their cost. Indeed the derivation of the term “cost contribution agreement” clearly reflects this. For instance, contributions in the oil & gas industry and the construction industry are very often valued at cost. A departure from this among independent enterprises could be and already is a very difficult task for complex contributions in particular. Therefore, ICC calls for careful reconsideration of a cost based measurement of the value of contributions in order to provide for simplification and to reflect commercial reality.
In this context, no guidance is currently available on how control functions might be valued by independent enterprises. ICC recommends providing additional guidance in this respect.

A further concern regarding the measurement and assessment of contributions is the difficulty of monitoring and re-valuing the contributions of each participant after a period(s) of time. This would create a substantial compliance burden. Moreover, with the benefit of hindsight – in the context of a tax audit conducted many years later – the original contributions might be considered to be inappropriate even before their re-valuation, even though they might have been assessed as reasonable at the time of the conclusion of the CCA. In addition, the compliance burden becomes enormous if the contributions made by each participant and all alternative options in accordance with the principles set out in Chapter I of the Guidelines by the Discussion Draft on BEPS Actions 8, 9 and 10, including the options not to make the contribution and not to participate in the CCA, have to be considered and documented for each and every (re-)measurement of the value of the contributions. ICC recommends guidance around materiality in order to increase simplification. The difficulties of dealing with long periods of time should not be underestimated. It may be a decade or more between the first incurring of expenditure and the period for which the reasonableness test is being undertaken. It may be several years after that when the audit is taking place and by then it may be wholly impossible to interview employees involved from the outset or even to find original non-critical documentation. It is very important that the CCA guidelines take the practicalities fully into consideration.
The International Chamber of Commerce (ICC) Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC’s global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.
Mexico City, May 29th, 2015

Via e-mail
TransferPricing@oecd.org
Mr. Andrew Hickman
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration
OECD

Dear Mr. Hickman,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association) kindly find below our general comments on the Public Discussion Draft on Action 8 of the BEPS Action Plan –“Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)”.

**BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)**

I. Overview

The Discussion Draft focuses on the OECD’s intention to cover transfer pricing of intangible assets and requires the development of rules to prevent BEPS by moving intangible assets among group members.

This draft presents an analysis of the requirement under Action 8 to update the guidance on cost contribution arrangements (CCA) found in Chapter VIII of the Transfer Pricing Guidelines, and the text that could be added to this Chapter.

II. Comments

**Contributions and risks assumed by the participants of a CCA – Determination of the benefit for the participants**

According to the Discussion Draft, a CCA is a contractual arrangement among business enterprises to share the contributions and risks involved expecting to create direct benefits for the business of each participant. To be considered as a participant of the CCA, it is necessary that each one of the participants make contributions and assume risks.
Based on the above, we consider necessary that the Discussion Draft strongly emphasizes that the functions, assets and risks that each participant carries in the CCA will be critical to determine the benefits that the participants expect and the value of their contributions.

**Unsuccessful CCA**

The Discussion Draft describes the assumptions where the participants obtain a benefit derived from their participation in the CCA, but it is also true that in some cases the CCA cannot be successful such as it is noted briefly in the Discussion Draft.

The Discussion Draft includes five examples which assume that the CCA will be successful and each participant will obtain a benefit derived of its contributions and risks assumed, but none of the examples shows what would be the applicable treatment in case that a CCA becomes unsuccessful.

Considering the above, we believe it is necessary to include in the Discussion Draft the detailed treatment that would be applicable in case of an unsuccessful CCA, as well as an example that shows in detail such case.

**Others Considerations**

**Deduction of Prorated Expenses**

There is a specific regulation in Mexico that disallows the deduction of expenses made on a pro rata basis with companies that are not subject to tax in Mexico. In that sense, the contribution made to a CCA could be perceived as a prorated expense and the deduction could be challenged.

Thus, it would be advisable to point out that in general the contributions to CCAs are made among various countries and it would be convenient if they included specific rules that guarantee the deductibility of such contributions, given that these are arrangements entered into with the purpose or expectation of obtaining a future benefit and which therefore, contribute to increase the tax basis in the future.

We would also like to bring to your attention that CCAs are clearly defined in the OECD Guides in Chapter VIII for which special care should be taken regarding its interaction with Chapter VII in order to avoid confusing the figures with the rendering of intra-group services.
Intangibles, benefits and financial information

In general terms, we would like to see an example of how to measure the economic benefits of a CCA in order to shed some light on this issue, which we find is not clear up to now.

*  *  *

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

Should you have any questions or comments, please do not hesitate to contact us.

Sincerely,

IFA Grupo Mexicano, A.C.
Dear Mr. Hickman,

On behalf of the Transfer Pricing Commission of the Instituto de Contadores Públicos de México, kindly find below some comments on the “Public Discussion Draft on Action 8 of the BEPS Action Plan on the revisions to the Chapter VIII of the Transfer Pricing Guidelines (“The Guidelines”) on Cost Contribution Arrangements (CCAs)” (“the Draft”).

First, we acknowledge the effort made by the OECD in analyzing the existing guidance on CCAs as part of the BEPS project. As the Draft states, CCAs can be used for the joint development, enhancement, maintenance, protection or exploitation of intangibles and it is important to clarify that measuring the contributions at value rather than at cost helps to ensure that outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA. We also consider that the revised definition of CCAs as a “contractual arrangement” rather than as a “framework agreed” is appropriate; it allows consistency with the revisions made to Chapter VI of the Guidelines. Also fitting is the classification of CCAs in two types, “development CCAs” and “services CCAs”. However, the statement regarding the key difference between the two types of CCAs should be revised by either replacing it with more specific definitions or with additional text explaining what is meant by ongoing future benefits and current benefits.

We agree with the premise presented in paragraph 15 of the Draft that there is not a general rule to evaluate the proportionality between each participant’s share of the total contributions and their share of expected benefits. Furthermore, we believe that this could result in difficulties regarding the calculation of payments or credits to re-balance the share of contributions of CCA members. Given the practical difficulties that might arise in the calculation of the re-balancing adjustments, we feel it is important to have more specific guidelines to make such adjustments to ensure that the benefits obtained by the parties involved in the arrangement are consistent with the contributions made by each party.

We also consider necessary to provide more detailed guidelines to quantify the expected benefits, since the OECD Guidelines and the Draft state that the shares expected benefits might be estimated based on the anticipated additional income generated, costs saved or
other benefits received by each participant as a result of the arrangement and that the approach that is frequently used in practice would be to reflect the participants’ proportionate shares of expected benefits using relevant allocation key (sales; units used, produced, or sold; number of employees, and so forth).

The Draft also states that the use of projections may raise problems for tax administrations in verifying the assumptions based on which projections have been made and in dealing with cases where the projections vary markedly from the actual results. These problems may be exacerbated where the CCA activity ends several years before the expected benefits actually materialize, so we consider advisable to provide more detailed scenarios for choosing an allocation method, so that the value of contributions made by each participant is properly related to the benefits expected by the participants.

We also suggest that a statement of the ultimate purpose of the CCA (i.e. development of specific intangibles – including a general description of the intangibles to be developed-, or performance of specific services – including a general description of the services) be included as a first step for structuring and documenting a CCA. Another statement describing the expected benefit for the participants in terms of efficiencies, etc. should also be required for structuring and documenting a CCA.

Finally, we understand that the examples are designed to cover the necessary adjustments during the implementation of a CCA. However considering that CCA contributions may take many forms, examples should be presented in order to clarify the analysis of the value of each participant’s contribution under different contribution forms.
29 May 2015

VIA E-MAIL

Mr. Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and Development  
2, rue André-Pascal  
75116 Paris  
France  
TransferPricing@oecd.org

Re: Comments on the 29 April 2015 Discussion Draft on BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Dear Mr. Hickman:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, transportation, computer technology, energy, pharmaceuticals, beverages, software, IT systems, publishing, and electronics. The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD with respect to the Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) released by the OECD on 29 April 2015 in the context of BEPS Action 8. Our comments are set forth in the Annex to this letter.

1 The current membership of the IAPT is made up of the following companies: Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; A.P. Møller-Mærsk A/S; AstraZeneca plc; Baker Hughes, Inc.; Chevron Corporation; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett-Packard Company; Johnson Controls, Inc.; Juniper Networks, Inc.; Microsoft Corporation; Procter & Gamble Co.; RELX Group plc; Repsol S.A.; TE Connectivity, Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; and Vodafone Group plc.
We look forward to the opportunity to participate in the consultation to be held on 6-7 July 2015 with respect to this topic and would appreciate an opportunity to speak at the consultation. We also stand ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Caroline Silberztein
Baker & McKenzie SCP
Counsel to the Alliance

Annex
ANNEX

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON THE 29 APRIL 2015 DISCUSSION DRAFT ON REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs)

29 MAY 2015
IAPT comments on the 29 April 2015 OECD Discussion Draft:
BEPS Action 8:
Revisions to Chapter VIII of the TP Guidelines on Cost Contribution Arrangements (CCAs)

1. Introduction

1. We are pleased to provide our comments on the OECD Discussion Draft: BEPS Action 8: Revisions to Chapter VIII of the TP Guidelines on Cost Contribution Arrangements (CCAs) (hereafter “the Draft”).

2. Chapter VIII completes and in our view should be consistent with the final guidance which will be provided on risk allocations and intangibles. More specifically, we believe that Chapter VIII should be viewed as an illustration of the application of the Chapter I and Chapter VI guidance in the context of a specific type of contractual arrangement. Our comments below are based on this premise.

3. We provided extensive comments on the proposed revisions of Chapters I and VI, especially on the extent to which tax administrations can disregard contractual risk allocations based on the performance of people functions. We do not reiterate our previous comments in this letter, but note that given we support consistency among Chapters I, VI and VIII, our comments on the former also apply to the latter.

2. Cost or value

4. At paragraph 22, the OECD notes that:

   Under the arm’s length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution.

5. We agree with this statement. We however disagree with the next sentence which reads:

   That is, contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle.

6. In our view, this statement raises two issues:

   − First, it creates significant uncertainty, because it does not expressly recognize that a participant in a CCA whose contribution takes the form of R&D activities will often do so on behalf of the community of the CCA participants, as discussed in Section 2.1 below.

   − Secondly, it assumes that independent enterprises would generally not agree to measure contributions based on cost. This in our view is an incorrect statement: measuring contributions based on cost or value is a risk allocation issue between the parties, as will be further explained in Section 2.2 below.

2.1 Characterizing the contributions made in the form of R&D activities

7. The proposed guidance in the Draft indicates at paragraph 22 that contributions made in the form of R&D activities should be measured based on value and that the guidance in other chapters of the TPG should be followed in measuring such value.

8. When a participant performs R&D activities, its role is two-fold:
First, it performs R&D activities on behalf of the community of the CCA participants. The CCA participants typically agree to have the R&D activities performed by various parties, some of which may be participants in the CCA and some of which may not. There is no difference in the performance of R&D activities by a participant or by a non-participant and no reason for them to be compensated differently.

Secondly, it contributes to the CCA by sharing the costs and risks of the whole R&D process (including, but not limited, to the costs and risks of the R&D performed by itself). For this role, it will be entitled to a share in the future intangible (in case of success) or loss (in case of failure).

The fact that the contribution of a participant in the CCA may be offset against the payment it should receive from the CCA participants for the performance of R&D activities does not change the nature of the two underlying transactions. The first one (performance of R&D activities on behalf of the CCA) is typically low risk and remunerated on a cost plus basis. The second one (participation in the CCA) is typically high risk and remunerated through anticipated benefits in the future intangible.

It is also possible that an entity would perform R&D activities on behalf of the CCA without sharing the costs and the risks of the development, and with no intention to use or exploit the resulting intangibles. In such a case, that party would be compensated for its activities, but would not be entitled to a share in the interest in the future intangible. The fact that it may be a party to the contract establishing the CCA (being identified as R&D provider to the CCA) does not automatically mean that it is a participant in the CCA.

It would be extremely helpful if the OECD could clarify the difference between performing R&D activities on behalf of the CCA and participating in a CCA. For instance, we would welcome confirmation at paragraph 23 that in development CCAs, contributions in the form of R&D activities can be valued at cost plus where cost plus is the most appropriate method to measure the value of the R&D contribution in the circumstances of the case.

In our view, the OECD should avoid giving the wrong impression that on-going R&D activities performed on behalf of the participants in a CCA should be compensated based on the hypothetical value of a future intangible. Otherwise, there would be dramatic consequences based on the mere possibility of outsourcing R&D activities to a participant in a CCA.

2.2 Measuring contributions and risk allocation

The existing guidance at paragraph 8.15 of the TPG reading “Countries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm’s length CCAs” can be interpreted as expressing a lack of consensus among countries as to whether costs or market prices should be used, hence creating significant uncertainty for both governments and taxpayers. We commend the OECD for its effort to clarify the guidance and reach a stronger consensus.

We believe, however, that the Draft, by stating that as a principle value should always be used (except in the case of low value-adding services, for which costs are regarded as a reasonable proxy for value), is missing a fundamental dimension of CCAs, which is to organize the sharing of risks among participants.

Cost pooling exists in third party joint ventures or joint development agreements. It is a standard practice in some industries (e.g. in the oil and gas industry).
16. We believe that countries’ concerns about potential abuse of CCAs would be better addressed through the application of the revised guidance on risk allocation and appropriate transfer pricing documentation requirements, as further explained below.

**Development of intangibles for future exploitation**

17. In a development CCA, participants share the risks associated with the R&D process. If a participant’s contributions take the form of an R&D activity, and its contributions are measured using value, that participant will be the only one bearing the risk that the value of its own R&D activities may be lower than the costs incurred (or benefitting from the upside in case it is greater). If its contributions are measured at cost, the risk (or upside) will be shared among all the participants. If several participants contribute to a CCA through R&D activities and their contributions are measured at cost, then all the participants in the CCA share the risk (or upside) arising from all the R&D activities conducted by the participants’ R&D activities.

18. Each of these scenarios can be found between independent parties and be consistent with the arm’s length principle. Sharing risks and costs can be a very useful mechanism for companies that wish to co-develop intangibles, and we see no reason for the OECD to dismiss this possibility in all circumstances: rather, we believe the OECD should provide guidance as to the situations where it is or is not consistent with the arm’s length principle.

19. Given that Chapter VIII is redrafted in the context of the BEPS Action Plan, we understand the OECD’s proposal that contributions should always be measured at value as mainly targeting situations where one participant contributes “only” funding while the other participant contributes R&D activities. If this assumption is correct, we suggest it should be made explicit in the Draft.

20. In a situation where one participant contributes “only” funding while the other participant contributes R&D activities, a valuation of the contribution at cost would mean that the risk (or upside) is shared with the entity providing funding. The question is whether the allocation of risk to a party that provides “only” funding, while the other party is performing all the relevant functions, is consistent with the arm’s length principle. This question is being addressed by the OECD in its proposed revision of Chapters I and VI, and the proposed revision of Chapter VIII on measuring contributions based on costs or value should be consistent with the Chapter I and Chapter VI guidance on risk allocation.

**Development of intangibles for internal business operations (e.g. internal software systems)**

21. Development CCAs are often entered into to develop back-office intangibles for internal use by participants, rather than for monetization through direct or indirect exploitation in the marketplace. This is typically the case of customization / adaptation / implementation of Enterprise Resource Planning software (“ERP”, such as SAP) for internal use (rather than for commercialization). Such developments can be extremely costly, but aim at maintaining the business, not at generating revenue. Costs are pooled among future users.

22. If contributions were to be measured at value rather than cost, this would create significant issues, because each of the participants would in theory have a better option available consisting in performing development activities itself, so that local tax authorities may deny deduction of charges measured based on value rather than cost. Accordingly, it would no longer be possible to enter into a cost pooling arrangement for several affiliates to share the costs of developing for instance an ERP.
This would be very unfortunate, and we strongly believe that measurement at cost should be allowed where the CCA aims at sharing the costs of developing intangibles for internal use.

This issue could be resolved by acknowledging that in the case of back-office intangibles, costs are an appropriate measure of value (as already acknowledged at paragraph 6.140 of the report “Guidance on Transfer Pricing Aspects of Intangibles”, which indicates that such intangibles may be valued based on a replacement cost method).

We would recommend that the OECD recognize the possibility of valuing contributions to the development of such back-office intangibles at cost. This could be achieved easily by making them eligible for the same practical rule as provided for low value-adding services at paragraph 23.

**Services CCAs**

While we support the acknowledgment in the Draft that costs can be a good proxy for value in case of low VA services, we find it over-restrictive. Participants in a services CCA agree to pool the costs of services they anticipate they may need. By doing so, they share the risk that they may not use all the services for which they incur costs, and that the costs of providing the services may be greater (or lower) than budgeted.

We therefore urge the OECD to recognize that pooling the costs (rather than value) of services can be a rational and arm’s length decision depending on the circumstances of the case, and should not be viewed as a mere simplification or safe harbour restricted to low value-adding services.

We further believe that it would be extremely helpful for the OECD to specifically acknowledge the possibility of entering into cost pooling arrangements for central services / shared service centres. We would support the development of a safe harbour rule for central services based on cost pooling, whereby all costs incurred in the interest of the business (except shareholder activities) would be chargeable, possibly with no mark-up, and subject to an aggregated benefit test at the level of the arrangement itself (instead of each category of services) and a harmonized documentation standard.

We submitted comments on the November 2014 OECD discussion draft on low value-adding services, which we generally welcomed. We suggest that the guidance in Chapter VIII on services CCAs should be better coordinated with the revised guidance in Chapter VII, and that the possibility of entering into cost pooling arrangements should not be restricted to low value-adding services but should encompass all central services.

**Conclusion on cost or value**

For all the above reasons, we believe that the OECD, instead of prescriptively dictating that contributions should always be measured at value, should rather:

- acknowledge that it is possible to outsource R&D activities to a CCA participant under the same conditions as if they were outsourced to a non-participant, and differentiate between the (typically low risk) performance of R&D activities on behalf of the CCA participants and the high risk participation in the CCA,

- acknowledge that measuring contributions at cost or at value has dramatically differing consequences on the risk allocation among the parties, and articulate the consequences thereof, and
provide that the consistency of the sharing of risk resulting from the CCA, and especially from the measurement of participants’ contributions at cost or value, will be assessed by following the guidance in Chapters I and VI.

31. Doing otherwise would introduce distortions among the guidance in the various chapters in the TPG, and would dismiss an important contractual mechanism even where it meets the arm’s length principle and follows from a strong business purpose.

32. The above concerns are captured in the existing guidance at paragraphs 8.15-8.16, and we support the language in those paragraphs which currently states:

[...] in determining the value of contributions to a CCA the guidance in Chapters I through VII of these Guidelines should be followed. For example, as indicated in Chapter I of these Guidelines, the application of the arm’s length principle would take into account, inter alia, the contractual terms and economic circumstances particular to the CCA, e.g. the sharing of risks and costs.

No specific result can be provided for all situations, but rather the questions must be resolved on a case-by-case basis, consistent with the general operation of the arm’s length principle. [...] It is unlikely to be a straightforward matter to determine the relative value of each participant’s contribution except where all contributions are made wholly in cash, for example, where the activity is being carried on by an external service provider and the costs are jointly funded by all participants.

3. Simplifying a web of transactions

33. We agree with the statement at paragraph 6 of the Draft that CCAs can simplify a web of transactions. However, this is not the only, and in fact not the most important advantage of CCAs, and we think that paragraph 6 needs to be revised.

34. As explained above, a CCA is an agreement to share costs (or contributions) and risks. A development CCA is not equivalent to a web of licensing agreements in terms of allocation of rights and risks. A development CCA implies sharing the risk of failure and also funding the development possibly several years before exploitation (in case of success) can start. For instance, in the pharmaceutical industry, R&D costs can be incurred up to 10 years before a product first reaches the market. By contrast, in a licensing arrangement, the licensee often does not bear the risk of failure of the R&D or fund the development before exploitation. This has dramatically differing financing consequences.

35. We therefore urge the OECD not to suggest a CCA could be valued as a web of licences, and to recognize the specificities of development CCAs in terms of risk allocation among the participants and timing of the funding (development phase for CCAs, post-exploitation for licences).

4. Types of CCAs (Section B.3)

36. We believe that the Draft could be significantly improved if it differentiated more clearly between:

− development CCAs aimed at developing intangibles for future exploitation,
− development CCAs aimed at developing back-office intangibles for internal use in business operations (e.g. customization / adaptation / implementation of an ERP),
− development CCAs aimed at tangible assets, and
− services CCAs.

37. Each of these categories has its own features, and not all the guidance should be common to all. Each would therefore deserve a specific section in Chapter VIII.

38. For instance, the guidance should note that there is generally no requirement for buy-in or buy-out payments 3 in the case of services CCAs (whether restricted to low value-adding services or not), contrary to development CCAs. Accordingly, paragraph 21, 3rd sentence should be amended.

39. Additionally, the guidance on allocation keys should not be the same for all CCAs. This is because, as stated at paragraph 8 of the Draft, services CCAs are generally expected to create current benefits only, while development CCAs are expected to create ongoing, future benefits. Thus,

− In CCAs, aimed at developing intangibles for future exploitation, allocation keys are typically based on prospects for future intangible exploitation, which may occur several years after the development costs are incurred. Such allocation keys may be complex to determine because the prospects of exploitation of a future intangible may be highly uncertain and may not be reflected in the current size or structure of the participants.

− In services CCAs or CCAs aimed at developing back-office intangibles, allocation keys are typically based on prospects for utilisation of services or intangibles during the period (e.g. the fiscal year in case of a service CCA, possibly a longer period in case of development CCAs). Such allocation keys are generally easier to determine (e.g. based on indicators of the size of the company (such as sales figures), number of users, etc.).

40. As indicated above, we recommend that the OECD specifically acknowledge the possibility of entering into cost pooling arrangements for central services / shared service centres, and we would support the development of a safe harbour rule for central services based on cost pooling.

41. Finally, we agree with the statements in the Draft (at paragraphs 3 and 8) that it is possible to enter into a CCA to develop tangible assets. We would welcome some guidance on the specificities of tangible asset development CCAs.

5. Controlling and managing the CCA

42. We find the proposed language at paragraph 26 unclear and wonder what the intention is. In a development CCA, each participant will generally have (and have the capacity to exercise) a role in the key decisions such as the type of R&D to be undertaken, the maximum costs to be incurred, as well as key decisions regarding the transfer or exploitation of the resulting intangible. The day-to-day management and control of the CCA will generally be viewed as an administrative function, performed centrally by one participant or by a non-participating entity, on behalf of all the CCA participants.

3 There may be termination payments in the case where a participant leaving before the end of the period is contractually obligated to share the costs of the whole period, in order not to leave the service provider at a loss or increase the costs to other participants, but these are different from a buy-out payment because they do not entail a transfer of property rights at the time of the participant’s withdrawal.
43. We wonder whether paragraph 26 is suggesting that the entity centralizing the costs and administering the CCA should be entitled to rights in the future intangible or bear losses in case of failure, rather than being compensated on a cost plus basis for its support function. If this is the intention, we disagree with the proposal. In any event, we think that the language in this paragraph should be clarified.

44. More generally, we suggest the OECD recognize that an entity can perform activities on behalf of the CCA participants, whether it is itself also a participant in the CCA or not. For example, arrangements in which participants outsource R&D to a non-participant on a cost-plus basis are clearly arm’s length and occur frequently in some sectors. We discussed this possibility in relation to the provision of R&D activities in Section 2.1 above. A similar reasoning should be followed for administrative and management services.

6. Disregarding part or all of the terms of a CCA (Section C.6)

Small transactions

45. We find the following sentence at paragraph 31 both unclear and theoretically unfounded:

[…] Although in principle the smallness of a participant’s share of expected benefits is no bar to eligibility, if a participant that is performing all of the subject activity is expected to have only a small fraction of the overall expected benefits, it may be questioned whether the reality of the arrangements for that party is to share in mutual benefits or whether the appearance of sharing in mutual benefits has been constructed to obtain more favourable tax results.

46. We see no relationship between alignment of substance with form (which we support) and size of the transaction. The OECD should refrain from introducing such statements which create unfounded presumptions of abuse with no principled explanation. We suggest this sentence should be deleted.

Determining a participant’s arm’s length share in interest in the subject of the CCA

47. The situation described at paragraph 32

[…] where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA.

is a case for a transfer pricing adjustment. It is not a case for disregarding part or all of the terms of the CCA (beyond pricing).

48. We therefore suggest the OECD should revise this paragraph and have a more appropriate heading for it, such as “Determining a participant’s arm’s length interest in the subject of the CCA”.

Hard to value intangibles

49. Paragraph 32 indicates that:

The guidance in Chapter VI on Hard to Value Intangibles may equally apply in situations involving CCAs.
50. Our ability to comment is constrained as we do not know what the final guidance on Hard to Value Intangibles will be. Is this sentence intended to refer to the existing guidance at paragraphs 6.28-6.35 and the Annex to Chapter VI? Or is it a reference to the proposed Special Measure, Option 1 proposed in the December 2014 discussion draft on Revisions to Chapter I of the TPG (including Risk, Recharacterisation, and Special Measures)? And if so, what will be the parameters of this new Special Measure?

51. We analyse the December 2014 proposed Special Measure on Hard to Value Intangibles as prescribing, in the situations which are in its scope of application, a solution in terms of risk allocation between the parties in relation to the uncertain valuation of the transferred intangible. In a nutshell, it would provide that the transferor should be protected from such risk in relevant situations, rather than bearing the risk or sharing it with the transferee.

52. Such a Special Measure, if adopted, is potentially applicable to the valuation of pre-existing intangibles (buy-in payments) in cases where the taxpayer does not produce adequate evidence on the valuation. It should not be applicable to the valuation of the on-going contributions of the parties in cases where the risk is allocated between the contributor and the other members of the CCA and such risk allocation is respected (see our comments in Section 2 above). Furthermore, it should not be a case for disregarding part or all of the terms of a CCA (beyond pricing), but rather a case for transfer pricing adjustment.

53. Accordingly, we recommend that this sentence be moved to paragraph 37 of the Draft.

6. Documentation (Section E)

54. We generally find this section of the Draft helpful. We are however concerned with the proposal at paragraph 43 that

Each participant should have full access to the details of the activities to be conducted under a CCA.

55. While we agree that the participants should have access to sufficient information to exercise their decision-making power and control their risk in relation to their participation in the CCA, we do not believe that they would need full access to the details of the activities. In our view, what is needed is information of the type of R&D activity undertaken, the budget, and the performance of the activity -- the same level of information as that needed for outsourcing R&D or other service activities (see paragraph 9.26 of the TPG). The CCA participants typically receive management type reports. Requiring them to have full access in all cases to all the details of the activities conducted would go beyond what is needed to allow them to exercise the control required to bear the risk.

7. Drafting suggestion

56. At paragraph 8, first sentence, we suggest replacing the words “or exploitation” with “and/or exploitation”.

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RE: Public Discussion Draft on BEPS Action 8: Cost Contribution Arrangements

Dear Mr. Hickman,

Pursuant to Action 8 of the Plan, on 29 April 2015 the OECD released the public discussion draft entitled BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements ("CCAs"), with the invitation to interested parties to respond with written comments by 29 May 2015. On behalf of the International Association of Oil & Gas Producers ("IOGP"), we are pleased to respond to the OECD’s request for comments.

Introduction to IOGP

IOGP is the voice of the global upstream industry. Oil and gas continue to provide a significant proportion of the world’s energy to meet growing demands for heat, light and transport. Our members produce more than half of the world’s oil and over a third of its gas. They operate in all producing regions: the Americas, Africa, Europe, the Middle East, the Caspian, the Arctic, Asia and Australia.

We serve industry regulators as a global partner for improving safety, environmental and social performance. We also act as a uniquely upstream forum in which our members identify and share knowledge and good practices to achieve improvements in health, safety, the environment, security and social responsibility.

IOGP comments

1. In the O&G sector, CCAs are legitimate business models and not designed to contribute to BEPS

CCAs are arrangements that allow participants to share in the benefits and risks of joint development of assets or services. In the Oil & Gas sector (O&G sector), widespread use is made of CCAs for the development of technology, and the rendering of technical and non-technical services.
Unrelated parties enter into large consortiums, often in joint ventures that include government owned companies (“National Enterprises”), to share benefits, costs and risks. An operator is appointed to run operations and provide technical and non-technical services, including R&D, on behalf of the joint venture (JV). The development of the required technology, know-how, delivery capability and services organisations that need to be in place to allow the operator to carry out its responsibilities require large, and often uncertain, investments by the operator. The risk and cost involved have proven to be too big for any single entity to assume and manage. CCAs facilitate the sharing of responsibilities, risks, benefits and costs.

All activities undertaken and technology developed within these CCAs are, ultimately, for the benefit of the cost sharers’ own oil and gas exploration and production operations. CCAs are driven by and fundamental to the business.

Therefore, contrary to what is suggested in the discussion draft, CCAs are requested by and firmly embedded in the business of many O&G sector MNEs and the JVs in which they participate, often with National Enterprises. IOGP suggests that, certainly in the O&G sector, CCAs are not contributing to base erosion or profit shifting within an MNE.

2. In the O&G sector, CCAs are fundamentally linked to ‘at-cost’ contributions

The discussion (page 9) draft states that contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle. This is a departure from the existing OECD transfer pricing guidelines, which holds that actual costs incurred under a CCA or cost sharing arrangement can be shared or allocated among the participants based on their proportionate expected future benefit. The current OECD transfer pricing guidelines are more consistent with actual cost sharing arrangements where the participants would share in actual costs and risks, in return for relative expected future benefits.

In the O&G sector, it is common that the operator’s contributions are valued on an ‘at cost’ basis, without a profit from undertaking the activities. This is contractually laid down between the unrelated JV parties. The practice of at-cost services in the O&G sector has been in place since as early as the 1950s. Production sharing agreements and similar contracts, which stipulate responsibilities of partners in a project, are testament to this claim.

One of the key reasons why ‘at cost’ has remained a feature of O&G sector CCAs for so long, is that it is recognized that projects typically take a very long time to mature; 20 years between exploration and production is not uncommon, and in this time, only a few initiatives actually will reach operating status. By the time a project starts generating income, the link between services income and cost has gone, which makes cost the only practical way of pricing contributions into a CCA.

A change to value based contributions would therefore be complicated and not rooted in business reality, and in conflict with existing contractual arrangements with partners and partners’ commercial expectations. From a tax perspective, value based charging is likely to result in double taxation for the operator.

3. Transactions within a CCA are not necessarily comparable to similar transactions outside a CCA

The discussion draft steps away from the notion that CCAs are about sharing cost in line with participants’ expected returns. Instead, on page 7, it states that “for the conditions of a CCA to satisfy the arm's length principle, the value of participants’ contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances […]. Third parties do enter into such joint arrangements when there is a common need […].”

In stating this, the discussion draft seems to downplay the difference between how risks are controlled and shared within a CCA vs outside a CCA. Benefits of scale, simplicity and pooling are part of a CCA’s reason of existence, but as mentioned above, the main reason for the existence of CCAs in the O&G sector is the sharing of not just the benefit and cost, but also the risk of development and services, where the development would be too large or risky for any single participant to assume and manage. In other words, transactions in a CCA are not necessarily those that would have been agreed upon by parties outside the context of a CCA, and cannot be compared.

The discussion draft’s proposed requirement that all participants in a CCA must have the capability and authority to control the risks associated with the “risk-bearing opportunity” is similarly not in line with actual practice in the O&G sector. Operator services, rendered under the CCA, are controlled via the operator’s governance framework, such that not all participants have equal capability to manage all aspects of the CCA’s contributions. The JV partners, all of whom share in the JV costs and benefits, exercise the operator’s contributions within this governance framework through, amongst others, budget approval, monitoring and auditing rights.

4. The discussion draft will likely result in increased complexity and higher administrative burden

In its current form the discussion draft has a large scope for misaligned views on the value of activities performed in a CCA, from the many interested partners and tax authorities – which could number into the hundred. This misalignment has the potential to significantly increase the number of disputes with tax authorities, which are costly to manage, carry a large degree of uncertainty, and hence are likely to result in double taxation.

The increased uncertainty – or room for interpretation – will also likely drive a need for much more documentation to explain an MNE’s global practice, than is currently the case, and also likely extends beyond the measures proposed as part of BEPS Action 13. This will result in the need for significant additional administrative resources and costs. Many of the larger O&G sector MNEs already publish hundreds or even thousands of transfer pricing documents to explain the arm’s length nature of their business models and transactions.

Conclusion

IIOGP appreciates the need to align the Transfer Pricing Guidelines’ chapters 6 and 8 as part of BEPS action 8, and the OECD targeting the misuse of CCAs as a tool to achieve base erosion and profit shifting.

However, as we’ve tried to make clear in this note, certain changes proposed in the discussion draft are not in line with the at-cost practice and the organisation of CCAs in the O&G sector. Apart from introducing technical and administrative complexities for both MNEs and National
Enterprises, the changes would likely undermine current business practices in the Oil and Gas sector, and lead to double taxation.

We therefore ask the OECD to clearly define the potential abuse situations in relation to CCAs and based on this, adopt specific measures to target this abuse. These measures should not affect the appropriate use of CCAs in the Oil & Gas sector, in which both MNEs and their JVs, often with National Enterprises as co-venturers, make widespread use of and depend on CCAs for technology and services for the benefit of their own oil and gas exploration and production operations. These CCAs are driven by and fundamental to the business - and not contributing to BEPS.

We trust that you find our comments useful. We would be happy to elaborate with you on this via a face-to-face meeting in case you agree that there is an opportunity to do so.

Sincerely,

Michael Engell-Jensen
Executive Director
Andrew Hickman  
Head of Transfer Pricing Unit, Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and Development 

Comments on the Public Discussion Draft on BEPS Action 8  
(Cost Contribution Arrangements) 


Cost contribution arrangements (CCAs) have been used by some multinational enterprises to effectively transfer intangibles from the country in which they are headquartered to a lower-tax jurisdiction and thereby unjustly reduce the total tax burden of the corporate group. This is pointed out as one of the causes of base erosion and profit shifting (BEPS). Keidanren supports the OECD’s work on the revisions to Chapter VIII of the Transfer Pricing Guidelines, from the perspective of preventing base erosion and creating a level playing field for companies. 

Of particular importance is the descriptions of risks in this Public Discussion Draft. As seen in the “cash box” scheme, when an entity merely plays the role of providing funding for a research and development (R&D) project and has no capability or authority to control the risks associated with the CCA, it is not appropriate for the entity to receive benefits from the CCA, including the acquisition of an interest in the resulting intangibles. We therefore concur with the essence of the proposed revisions. Japan’s administrative guidelines on transfer pricing also provide that "degree of contribution shall be assessed as low when the corporation or the foreign-related party merely bears the cost of the formation and so on of the intangible properties that are highly expected to be the source of income". 

However, as for the proposed rule of measuring contributions made by CCA
participants at value rather than at cost, we are uncertain whether it will work in practice, even though it seems to be theoretically correct in light of consistency with the guidance on intangible transactions not covered by a CCA, would be effective in preventing BEPS, and is conceptually comprehensible.

In Japan, although many companies frequently conclude R&D outsourcing contracts with associated enterprises, entering into CCAs for transfer pricing purposes is not that common. There are a number of conceivable reasons for this. One is that, in many corporate groups, their intellectual property rights tend to be managed almost exclusively by the parent company domiciled in Japan. Another reason is the absence of incentives to transfer intangibles to a lower-tax jurisdiction without a legitimate business reason. But, the dominant reason seems to be the uncertainty perceived in the method of CCAs whereby costs are allocated in accordance with the participants’ proportionate shares of expected benefits.

If, despite such circumstances, contributions were to be measured not at cost but at value (i.e., the arm’s length price) with the exception of some low value-added services, companies might accordingly suffer a heavier administrative burden and undergo more disputes with tax administrations over the validity of the value measured. Tax consequences would become particularly unpredictable in cases where the proportionate shares of the benefits produced by the intangibles resulting from a CCA turn out to be different from the initial expectations or where participants in a CCA spread over multiple (three or more) countries. These might make the already high hurdle of using CCAs even higher going forward.

To enhance competitiveness, companies are considering the implementation of various types of R&D projects. Their future projects may include joint R&D projects that are run by the parent company and its overseas subsidiary or that use the intangibles of a multinational enterprise the company acquired. It is therefore fairly possible that companies will enter into CCAs in the future. Paragraph 6 of the Public Discussion Draft states that an advantage of CCAs lies in the simplification of multiple transactions for transfer pricing purposes, such as by offsetting payments against receipts and vice versa with regard to royalties associated with the cross-licensing of intangibles. Care needs to be taken to ensure that the revisions to Chapter VIII do not inadvertently deter companies from using CCAs and jointly engaging in open R&D activities on a global scale.
We therefore suggest that, in the process of finalizing the revisions to Chapter VIII, additional consideration be given, in particular, to the following matters:

The first is the creation of safe harbor provisions, which is significant in two aspects. The one aspect relates to the fact that the revisions to Chapter VIII are being made as part of the BEPS Project. Given this background, we consider it rational to limit the subjects of heavily detailed transfer pricing analysis, especially the measurement of contributions at value, to those CCAs that pose the high risk of BEPS. They may include CCAs with an entity domiciled in a lower-tax jurisdiction, and "important" CCAs involving the intangibles required to be reported on in the master file. Requiring each and every CCA to be subjected to measurement at value is excessive. At least, measurement at cost should be permitted in certain cases. As described in paragraph 23, in a case where the contribution consists of low value adding services, such a contribution should be measured at cost.

The other aspect relates to the possibility that questions may subsequently arise as to the appropriateness of the value of contributions measured, depending on the level of benefits resulting from the CCA. Even in that situation, the value measured and the benefits expected initially should be respected as much as possible. Subsequent corrections, if at all necessary, should be limited to highly exceptional cases, and the conditions those cases must satisfy need to be clearly defined. (It is also conceivable to take such measures as deeming deviations up to a certain percentage to be acceptable in principle.)

CCAs have the very nature of an advance agreement between the parties for transfer pricing purposes, stipulating the value to be contributed and the benefits to be received. Given that nature, CCAs are considered to have an affinity to advance pricing arrangements (APAs). We thus suggest that the Transfer Pricing Guidelines include a statement that recommends obtaining bilateral and multilateral APAs.

The second matter to which consideration should be given is the methods of measuring value. This Public Discussion Draft only states in paragraph 7 that Chapter VI, which deals with intangibles, and other chapters of the Transfer Pricing Guidelines should be referred to, and the existing Guidelines provide no clear guidance either. This is not necessarily adequate from the perspective of encouraging the use of CCAs. In the case of joint R&D projects involving intangibles, identifying comparable transactions as a benchmark is especially difficult due to the unique nature of each
Although it may be one of the options to use, for example, the discounted cash flow method for measuring value, problems remain as to arbitrariness and subjectivity. In such cases, we assume that other approaches, including a combination of multiple methods, need to be considered, but hope that these Guidelines will recommend the best practices.

From that standpoint, we highly appreciate the addition of Examples 1 to 5 by this Public Discussion Draft, but it should be even more useful to include a greater number of examples in these Guidelines. As partly detailed later, additional examples are needed to illustrate the treatment of cases in which the proportionate shares of expected benefits have subsequently changed, of cases of non-recognition, of cases in which a CCA has been terminated without producing a successful outcome, and of cases of buy-ins and buyouts, among other things.

The third matter is the interactions with other chapters of the Transfer Pricing Guidelines. This Public Discussion Draft pays attention to consistency with the revisions to Chapters I (The Arm’s Length Principle) and VI (Special Considerations for Intangibles) made as part of the BEPS Project. A question however arises as to how the interaction with Chapter II (Transfer Pricing Methods) would change if contributions to CCAs were to be measured at value rather than at cost. Take paragraph 2.138 of these Guidelines that explains how to split combined profits under a residual profit split method. While the paragraph states that “an allocation key based on expenses may be appropriate” that include R&D expenses, we are concerned about how much impact the revisions to the guidance on CCAs would have on the current transfer pricing practices as a whole, including those being implemented in compliance with Chapter II.

The fourth is balancing payments. In paragraph 27 of this Public Discussion Draft, those payments are defined as an adjustment to the value of participants’ contributions under a CCA. Example 4, however, seems a little bit confusing, because the balancing payment from Company A to Company B (equal in present value to $220 million per annum in years 6 to 15) appears to be an adjustment not to the value of Company A’s contributions but to its “profits,” the term used synonymously with benefits. We hope that this example will explicitly explain the mechanism of triggering balancing payments, that is, the system under which a change in the shares of benefits triggers a revision to the shares of contributions.

The fifth is the treatment of non-recognition as a CCA participant. As was discussed
concerning the Public Discussion Draft on "Risk, Recharacterisation and Special Measures", the consequences of non-recognition are not always clear. Take Example 5 of this Public Discussion Draft, in which Company A is, under the CCA, anticipated to provide funding of $100 million per annum for the first five years of the project and to receive profits of $330 million per annum in years 6 to 15. While the example simply concludes that Company A cannot be regarded as a participant in the CCA, further explanation is needed to illustrate what adjustments for tax purposes are required of Companies A and B, respectively, in that case.

Last but not least, the OECD has repeatedly argued in relation to BEPS Actions 8 to 10, including in this Public Discussion Draft, that transfer pricing outcomes should be in line with value creation. We have no objection to this argument per se. However, we are gravely concerned that no progress has been seen on dispute resolution mechanisms despite the fact that, without consensus among the member countries as to what constitutes value, discussions are moving forward on taxation methods, such as the introduction of non-recognition and special measures, and the expanded application of profit split methods.

Keidanren believes that in general, the source of value creation of many corporate groups lies in the parent company’s R&D function, rather than the overseas subsidiaries’ activities for marketing products and enhancing intangibles, at least in the manufacturing industry. We emphasized this point in our comments concerning the Public Discussion Draft on "Profit Splits", and hereby confirm that this position of ours remains unchanged (i.e., CCA should not be used in a way that inappropriately allocates income to an entity which does not contribute to value creation). We strongly hope that, as the deliverables of BEPS Action 14, the OECD will present truly effective dispute resolution mechanisms that include the introduction of a mandatory and binding arbitration provision.

Sincerely,

Subcommittee on Taxation
KEIDANREN
To Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for Tax Policy and Administration  
OECD  

From KPMG  

Date May 29, 2015  
Ref Comments to the OECD:  
BEPS Action 8 – Revisions to  
Chapter VIII of the Transfer Pricing  
Guidelines on Cost Contribution  
Arrangements  

cc Clark Chandler, KPMG in the U.S.  

Comments on the Discussion Draft on Cost Contribution Arrangements  

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD’s Discussion Draft titled “Public Discussion Draft: BEPS Action 8:  
Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements” (“Discussion Draft”). KPMG commends the OECD for acknowledging the role of Cost Contribution Agreements (“CCAs”) and providing guidance around their formation and use.  

Why Cost Contribution Arrangements Are Important  

There are a number of cases in which one or more members of an multinational enterprise (“MNE”) group perform services that provide benefits to some or all other members of the group, either immediately (e.g., centralized administrative services) or in the future (e.g., by contributing to the development of intangibles). CCAs are contractual agreements in which different legal entities agree to share the costs that provide a common benefit in proportion to the benefits that each legal entity expects to receive from those costs. The two common forms of CCAs are (i) CCAs that are used to share the cost of developing intangibles (which are called Cost Sharing Agreements in the United States) and (ii) CCAs in which the cost of providing common services (e.g., administrative, IT, etc.) are shared.  

Companies enter into CCAs to realize business efficiencies – it is often less expensive to carry out one research and development (“R&D”) project whose benefits can be shared throughout the group than to have each group member fund that project on its own; it is often cheaper to provide certain administrative services centrally than to have each member of the group incur duplicative costs. In cases where such common benefits exist, CCAs can substantially simplify transfer pricing issues, as it is often much easier to measure the cost of providing services than to either determine the value of the intangibles that are produced based on that R&D or price specific individual elements of that service.  

As a simple example to illustrate this point, consider an MNE that has five different subsidiaries,
each of which operates a steel rolling mill. One of the legal entities may be enhancing software that optimizes the operations of the steel mills, another may be pursuing an engineering project designed to lower energy costs, while yet another may be working with a particular customer to address certain quality issues that are lowering yields. Each of these three projects, if successful, may be useful to all five of the legal entities. Pricing the results of these projects on an individual basis is likely to be a very difficult task – should a new software product be priced at (i) the cost of developing it; (ii) the cost of developing it divided by 5 if all five legal entities use it but by 3 if only three use it; (iii) at a fixed price regardless of the different size of the mills owned by the five legal entities, (iv) at a variable cost based on sales? Not only are these questions complex with possibly multiple inconsistent answers, but they also require the taxpayer to put in place systems for determining when specific pieces of intangible property (“IP”) or services are transferred, and to whom. A CCA simplifies this process by allowing the taxpayer to simply add up the cost of the three projects, allocate these costs among the five legal entities based on expected benefits, and thereby avoid the entire issue of tracing what is transferred when and what price should be charged. This is also a relatively easy arrangement for tax authorities to audit.

KPMG welcomes the fact that the OECD has recognized the potential benefits of the CCAs (see Paragraph 6) and agrees with the statement in Paragraph 7 that “…the provisions of Chapters VI and VII, and indeed all the other chapters of these Guidelines, will continue to apply to the extent relevant, for instance in measuring the value of a contribution to a CCA…” As a general matter, the OECD’s Guidance around CCAs should focus on issues that are specific to sharing costs that benefit multiple legal entities in proportion to their relative benefits, and cross reference rather than replicate Guidance contained in other Chapters.

KPMG’s two primary concerns with the Discussion Draft are that (1) in some cases the specific guidance undermines the overall benefits of CCAs - e.g., simplification - when this is not needed to ensure the effective operation of the arm’s length principle and/or to avoid double non-taxation and (2) in some cases the guidance covers issues that are covered in other Chapters, raising the possibility of confusion and inconsistency. The latter is of particular concern with respect to the various references in the Discussion Draft to the valuation of intangibles and the treatment of uncertain forecasts – the valuation of intangibles and the treatment of uncertain forecasts should be the same for intangibles contributed to CCAs as for intangibles transferred from one legal entity to another legal entity.

KPMG’s specific comments with respect to these two general issues are set forth below.

**Requirement that Contributions to CCAs Should be Based on Arm’s Length Value Rather than Cost**

Paragraph 22 of the Discussion Draft makes it clear that contributions to CCAs are to be based on their arms’ length value rather than on their cost per se,\(^1\) although Paragraph 23 softens this

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1 Under the arm’s length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution. That is, contributions must generally be assessed based
Guidance somewhat by noting that in some cases the arm’s length value may be very close to costs. (See examples 1 through 3 at the end of the Discussion Draft). KPMG believes that the Discussion Draft should provide additional guidance on circumstances where sharing at costs may be appropriate. Unrelated parties enter into CCA arrangements based on costs in a variety of circumstances where the administrative simplicity of using costs outweighs any benefits to more detailed analysis and tracking of contribution value. In the case of CCAs between related parties, the benefits of such administrative simplicity accrue to tax authorities as well as taxpayers, and therefore use of such arrangements when they do not materially distort the allocation of taxable income across jurisdictions benefits all parties, and further mirrors the actual behavior of unrelated parties in such circumstances.

In the case of the MNE with 5 legal entities that own rolling mills set forth above, the Discussion Draft would clearly require an arm’s length charge for the contributions that are made by the three legal entities that are carrying out projects that are cost shared. However, if each legal entity has 500 employees, but only 6 are engaged in software development, 8 are engaged in projects to look for ways of saving energy, and another 3 employees working to address an issue that will increase yields, the costs of deriving an arm’s length charge (other than by marking up cost using a common 5% to 10% markup) is likely to be higher than any benefits from increased accuracy. The need to balance the additional complexity imposed by the use of arm’s length pricing against the simplicity of simply sharing costs extends beyond taxpayers but also to tax authorities. The guidance in the Discussion Draft could certainly make auditing CCAs much more complicated and time consuming. Thus, it is important to weigh the benefit of this potential change because of the added complexity.

Therefore, we recommend that the OECD expand the Guidance for when sharing at cost is appropriate in a CCA. At minimum, sharing at cost should be allowed when the parties can document the existence of similar arrangements in similar circumstances between unrelated parties. (For example, it is relatively common in the oil and gas industry, in particular, for one member of a joint venture to provide even high value services at cost rather than market value, even though these contributions benefit all members of the joint venture equally.) In addition, the Guidance should include an explicit cross reference to the OECD’s proposed guidance on low value-adding services, and make it clear that cost can be treated as an arm’s length value in the case of such low value-adding services. The existing Example 2 would then be modified so that it provided an example of that guidance. The Discussion Draft should also note the need to balance the additional complexity imposed by the use of arm’s length pricing against the simplicity of simply sharing costs.

**Capability to Control Risks**

While the Discussion Draft states that costs should be allocated based on expected benefits (Paragraph 12), it also make it clear that all participants to the CCA must have substance and the

on their value (rather than their cost) in order to be consistent with the arm’s length principle. In determining the value of contributions to a CCA, the guidance elsewhere in these Guidelines should be followed.
ability to exercise some form of control over their investments. Paragraph 13 of the Discussion Draft states that:  

Since a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. In particular, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA…. Absent such substance, the CCA can be disregarded. (See Example 5.)

KPMG would like to make two key points with respect to the language contained in Paragraph 13. First, CCAs are to quote the language used in Paragraph 3, “…a contractual arrangement among business enterprises.…” Therefore, the key question is whether or not the CCA is a contract that would be entered into at arm’s length, and the requirements for this are set forth in other Chapters of the OECD Guidance on Transfer Pricing. The Discussion Draft should simply state that CCAs are contractual arrangements, and that the same considerations apply for respecting the terms of the CCA as any other intercompany contract.

Second, the evaluation of whether or not the contractual terms of the CCA are arm’s length should take the specific economic function of the CCA – to share costs that provide a common benefit, and thereby avoid incurring duplicative expenses while simplifying the transfer pricing structure – into account. Therefore, control over risk should reflect control over the use of the intangibles created by the CCA or the services provided through the CCA. In many cases it is much more efficient and practical to have one or a small number of legal entities specialize in the provision of a particular type of service, even though there are a number of different legal entities that may realize the benefits of that service. In the example of the MNE with five affiliates operating rolling mills given above, it may be much more efficient to have the R&D team focused on software improvements located in one specific legal entity, the team of engineers focused on generating energy cost reductions located in a different legal entity, and the engineering team working with a customer to overcome certain technical issues located in yet a third legal entity, even though the work carried out by these different groups is beneficial to all of the different legal entities. Indeed, the key benefit of a CCA in this case is to allow MNEs to organize in a way that best meets the needs of business (e.g., by using functional specialization) while allowing each of the legal entities to benefit from the output of these specialized groups without trying to track and price every enhancement that may or may not have been shared.

Similar examples exist for CCAs that are designed to share in the cost of low value-adding services. For example, a back office services CCA may have only one or two legal entities that actually

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2 See also Paragraph 32.
perform the service, but all members of the MNE group may use and benefit from the service. While it is appropriate to evaluate whether the different legal entities would enter into a CCA at arm’s length (e.g., would they commit to bearing the expected costs based on expected benefits), it is unrealistic to expect them to exert day-to-day control over the performance of the administrative activities.

KPMG welcomes the statement in Paragraph 14 that “In some cases, the participants in a CCA may decide that all or part of the subject activity will be carried out by a separate entity that is not a participant under the standards of paragraph 12 above. In such a case, an arm’s length charge would be appropriate to compensate the entity for services or other contributions being rendered to the CCA participants.”

**Expected Benefits**

Paragraphs 16 through 19 discuss general principles with respect to expected benefits. KPMG has three general concerns with the discussion set forth in these paragraphs.

First, Paragraph 17 and Paragraph 19, in particular, note various concerns about variations between expected and actual results. The discussion should be framed in terms of relative rather than actual benefits. The fact that a particular intangible development project is much more successful or much less successful than expected will clearly have an impact upon profits and lead to a difference between actual and projected results, but often may have very little impact upon relative benefits, and therefore will not change the way in which costs are allocated. To the extent that there are concerns with the impact of such disparities on the initial contribution of an intangible to a CCA, the OECD’s Guidance on CCAs should simply cross reference its guidance on the valuation of intangibles when actual results differ from projections.

Second, while KPMG agrees with the specific point made in Paragraph 18 (e.g., that if a CCA is undertaking Projects #1 and #2, a participant that can only benefit from Project #1 should not share in the costs of Project #2), KPMG would like to note that in many cases CCAs are sharing costs as incurred rather than the value of services or intangibles as they are received. It may very well be the CCA that funds R&D on Projects #1 and #2, and that some members of the CCA choose to use the intangibles developed under Project #1 but not Project 2, or vice versa. For example, Project #1 may lead to a development that can lower labor costs while Project #2 leads to a development that may lower energy costs. It may cost 1.0 million Euros each to change the manufacturing line based on these new options. CCA Participant A may decide that it is worth the investment to adopt the results of Project #1 but not the results of Project #2, while CCA Participant B may make the opposite decision. As long as both had reasonable expectations of benefitting from the two projects, there should not be any need to retroactively recompute benefit shares.

In addition, KPMG believes that it is important to clarify that benefits of a CCA should be evaluated as a whole. For example, if there is a CCA whereby the participants are undertaking 50 projects, it is entirely possible that certain participants will know in advance that there will be specific projects they will not benefit from. Yet they would agree to the arrangement because the costs of segregating and tracking the separate costs outweighs any benefits of doing so. As long as
the costs as a whole are shared in proportion to expected benefits and, considering all the facts, the participants at arm’s length could reasonably be expected to agree to the arrangement, it should be respected without detailed tracking of who expects to benefit from each project.

**Balancing Payments**

The Discussion Draft indicates that balancing payments should be made when one CCA participant receives a greater (smaller) proportion of benefits than it incurs in costs (arm’s length value of its contributions). This is of course entirely appropriate – the entire purpose of a CCA is to allocate costs/the arm’s length value of contributions on the basis of expected benefits.

Participants to CCAs should be able to make such balancing payments in whatever way is most administrable, provided of course that the balancing payments reach the correct arm’s length amount. In this regard, the last sentence in Paragraph 29, which states that balancing payments would be “…from one or more participants to another…” should be amended to clarify that any reasonable arrangement that accumulates costs and re-distributes such costs in proportion to expected benefits is appropriate. The end result is the critical objective, not the specific approach used to reach that result.

Adjustments to balancing payments should re-allocate the value of contributions based upon expected benefits, and not reallocate benefits based on contributions. CCAs are not partnerships or joint ventures, where the benefits of an investments are allocated based on the relative share of investments. Instead, CCAs are essentially joint buying arrangements, in which several participants that need a common service share in the costs of acquiring that service.

KPMG also recommends that the OECD keep the following existing guidance around balancing payments that is in Chapter VIII that clarifies that a balancing payment would not constitute a royalty for the use of intangible property (paragraph 8.25). Therefore, the following language from the existing paragraph 8.25 should be inserted:

> A balancing payment should be treated as an addition to the costs of the payer and as a reimbursement (and therefore a reduction) of costs to the recipient. A balancing payment would not constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property belonging to a participant (or a third party) and the payer does not also obtain a beneficial interest in the intangible property itself. In some cases a balancing payment might exceed the recipient’s allowable expenditures or costs for tax purposes determined under the domestic tax system, in which case the excess could be treated as taxable profit.

**Disregarding the Terms of a CCA**

Paragraphs 31 and 32 discuss situations in which tax authorities can disregard all or some of the terms of a CCA. KPMG has concerns that the following language may be used by tax authorities to re-characterize CCA arrangements inappropriately:
• Paragraph 31: “… Although in principle the smallness of a participant’s share of expected benefits is no bar to eligibility, if a participant that is performing all of the subject activity is expected to have only a small fraction of the overall expected benefits, it may be questioned whether the reality of the arrangements for that party is to share in mutual benefits or whether the appearance of sharing in mutual benefits has been constructed to obtain more favorable tax results.”

• Paragraph 32: “A tax administration may also disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA”

As stated in KPMG’s initial comments, CCAs are contractual arrangements among related parties, and the same standard for respecting such contractual arrangements should apply to CCAs as to any other contractual arrangement. More specifically, services CCAs in particular often have a limited number of legal entities that perform services that are beneficial for a large number of legal entities. The language in Paragraphs 31 and 32 could be interpreted to say that such CCAs should not be respected and that charges made under such arrangements are therefore not deductible even in cases where the CCA is being used solely to realize corporate efficiency and to allocate costs that generate common benefits based on those benefits. KPMG believes that other sections of the OECD’s guidance – e.g., those that require a certain level of substance in the form of decision making to be in place in order to respect a CCA and the requirement that contributions be valued at their arm’s length value rather than cost – should be sufficient to address the concerns set forth in Paragraphs 31 and 32.

Required Documentation

While listing the types of documentation that tax authorities may need is helpful, KPMG would note that:

1) Given that a CCA is a contractual arrangement that is, in principle, no different than other contractual arrangements, the required documentation should be no different from that expected in other arrangements; namely a requirement to document that its terms are consistent with an arm’s length arrangement and that the participants adhere to the terms of the arrangement; and

2) There are a number of CCAs, and in particular CCAs involving low value-adding services that may have a large number of participants that benefit from the service and where the administrative burdens of maintaining documentation at the detailed level implied in the Discussion Draft may be high.

Mutual Agreement Procedures (“MAP”) and CCAs

The Discussion Draft’s explicit recommendation that in most cases contributions to a CCA have to be valued at their arm’s length value rather than at cost has the potential to increase the number of
disputes related to CCAs. Moreover, these disputes may be procedurally complex in cases where there are more than two participants to the CCA. While a detailed discussion of MAP issues is clearly beyond the scope of this Discussion Draft, the OECD should make it clear that participants to a CCA should have access to MAP, and that MAP procedures should be flexible enough to incorporate the procedural complications that may arise as a result of CCAs.

Indirect Tax Implications of CCAs

It would be extremely useful for the OECD to include guidance on how CCA payments should be treated for VAT purposes. Specifically, we think that in Paragraph 6 the OECD should state that where a streamlining of flows has been achieved through a system of netted payments that are arm’s length and within a compliant CCA then this should eliminate the VAT / GST charge that would otherwise arise if the parties were charging each other based on a web of separate intra-group arm’s length payments. There may still be a potential VAT/GST charge on any balancing payments that are required to be made under the terms of the CCA.

Examples

The Discussion Draft provides five examples of how companies can determine the value of the contributions in both Development CCAs and Services CCAs. KPMG has the following comments with respect to these examples.

We suggest that the OECD should include an example that shows that contributions to a CCA are deductible expenses even in cases where one or more participants incurs a loss. Companies operating at arm’s length continue to invest in the development of intangibles and continue to need low value-adding services even when they are incurring losses, and costs that are incurred through a CCA should be treated no differently than if they were incurred directly by the CCA participant.

Example 1

Example 1 provides a clear description of the principle that contributions should be based on arm’s length value rather than cost. However, KPMG believes that footnote 2 should be deleted, as it can be interpreted as requiring that the markup (or the difference between arm’s length value and cost) be included as part of an initial up-front payment. This is generally not something that is observed at arm’s length, and would require taxpayers to use projections of expected future benefits and contributions even though the OECD has repeatedly expressed concerns over the reliability of such projections.

For example, legal entities A and B may enter into a CCA with the initial expectation that A will do 60% of all R&D and B will do 40%. If both parties expect equal benefits, B will have to make a balancing payment to A so that they share in the costs (based on the arm’s length value) of their activities equally. Several years later, due to a change in circumstances or other good business reasons, this may be reversed with A doing 40% of R&D and B doing 60%. If benefits are still 50:50, the direction of the balancing payments will be reversed. If the difference between arm’s length value and cost is incorporated in the annual charges, this shift in relatively responsibilities is automatically addressed by changes annual balancing payments. However, if a tax authority has required that the difference between arms’ length value and cost has to be included in an upfront
payment, logic suggests that there needs to be a second payment in the opposite direction once the relative shares of R&D have changed. This adds administrative complexity while also lowering reliability due to the inherent uncertainty about future projections.

**Examples 4 and 5**

KPMG recommends that Examples 4 and 5 be deleted as they concern issues that are addressed elsewhere in existing or forthcoming OECD guidance, and further are problematic as written.

Example 4 is extremely problematic for two reasons: (1) it presumes that, if one of two CCA participants contributes cash while the other contributes an intangible, the best measure of the value of the intangible is necessarily equal to the total value of profits created under the CCA less the other party’s contribution, rather than valued using the most appropriate (reliable) method; and (2) opens up without addressing very significant issues regarding use of *ex ante* (expected) vs. *ex post* (actual) profits in computation of subsequent balancing payments.

Example 4 as written is inconsistent with the principles advanced elsewhere in this Discussion Draft. Paragraphs 20 through 22 of this Discussion Draft emphasize the importance of valuing each participant’s contributions to the CCA as the arm’s length value based on guidance elsewhere in the Guidelines. But Example 4 does not present any discussion of the arm’s length value of intangibles contributed by Company B. Instead, in paragraph 61 the balancing payments are calculated as if the total value of the contributions is equal to the total expected benefit of the parties. What happens, for example, if the participant to the CCA that is contributing the intangibles acquired them a few days earlier for a specific price – is that information to be ignored? Or perhaps the participant contributing the intangibles are a similar arrangement with a third party that provide a specific royalty rate or price – is that information to be ignored? If Example 4 is retained, it should state that the value of the IP that Sub A is contributing to the CCA should be determined using the most appropriate method as determined based on the transfer pricing guidance given with respect to intangibles in other parts of the OECD Guidance. The fact that the IP is being contributed to a CCA should not change the valuation method and there is no need for the OECD to suggest that contributions to CCAs should be valued in a special way.

Paragraph 61 also raises significant issues regarding the treatment of *ex ante* expected benefits vs. *ex post* actual results. For example, is the $110 million per year “risk adjusted” return for Company A for years 6 to 15 an *ex ante* expected amount? How would that return be adjusted as actual results differ? Should deviations of actuals from forecasts create any need to “top up” balancing payments?

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3 Contrast paragraph 10 of the Discussion Draft “What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected mutual and proportionate benefit from the pooling of resources and skills” – so valuing contributions as equal to expected benefits contradicts the Discussion Draft statement of the distinguishing characteristic of a CCA that expected benefit exceeds the value of the contributions.
KPMG does not see any advantage to addressing any of these issues in the CCA chapter as they are appropriately addressed elsewhere in the Guidance on intangibles. As we do not believe Example 4, properly modified to emphasize consistency with other guidance on intangibles valuation, addresses any issues specific to CCAs, we recommend that it be deleted.

Similarly, Example 5 does not seem to serve any useful purpose. The standards to disregarding/re-characterizing a CCA should be the same as those that apply for any other contract, and the results of disregarding the contract involving intangibles and intangible development should be addressed under whatever special measures that the OECD adopts. Having said that, the OECD should make it clear in its guidance that disregarding a transaction should not allow a tax authority the right to tax income related to functions, risks, or assets outside of its jurisdiction. For example, considering the facts of Example 5, the tax authorities of Country X, upon auditing related Company X that is paying a royalty to a Company A, may determine that the CCA lacks substance and should be disregarded. However, the royalty deduction allowed to Company X should be an arm’s length payment for the intellectual property used by Company X. Under the Example 5 facts as stated, absent the CCA the rights to the royalty payment should revert to Company B. Allowing the tax authority of Country X to unilaterally disallow the deduction of the royalty payment, quite possibly without providing for access to MAP, places taxpayers at a high risk of double taxation and is inconsistent with the arm’s length principle and the principle of taxing income where value is created.

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About KPMG

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.
Date: May 14, 2015

To: Mr. Andrew Hickman, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration

From: David R. Jarczyk, ktMINE, CEO

Subject: Comment on Public Discussion Draft BEPS ACTION

Dear Mr. Hickman:

In its capacity as a data company focused on intangibles, and as a small business with significant interests in transfer pricing matters, ktMINE submits the following comments related to the revised Discussion Draft. Any questions or comments should be forward to David R. Jarczyk at david.jarczyk@ktMINE.com or (773) 401-8962.

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Transfer pricing analyses of intercompany transactions should be 1) the determination of the conditions that would be agreed upon between independent parties, as well as 2) dependent on evidence of market behaviors.

The Discussion Draft has a recurring theme, best communicated in the statement from paragraph C.1.10., “For the conditions of a CCA to satisfy the arm’s length principle, the value of participants’ contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.” The objective is to assure that transfer pricing outcomes are in line with value creation. One prudent way to accomplish this is by understanding the form, substance, and valuation of transactions (a.k.a. functions, risks, and pricing) that occur between unrelated parties. In fact, the real theme of the discussion draft can be summarized by one question: how would independent parties behave given the tested transactions’ facts and circumstances?

Market evidence (or “comparables”) can and should be used 1) to determine the behaviors - specifically the deal structure including functions performed, risks assumed, and assets utilized - of independent parties to transactions, and 2) to determine the arm’s length pricing in such transactions. By failing to examine the behaviors of the market, tax payers and practitioners are not exercising proper due diligence to complete a prudent arm’s length analysis.
The revised discussion draft spends significant time asking “how would independent parties act given the tested transactions’ facts and circumstances”, yet lacks guidance on what market evidence exists to determine an answer. It is my hope this document begins the discussion on this matter.

I suggest including language in the guidance that provides an introduction to the data that is available. It is my opinion that it is ineffective to ask practitioners to answer a question (e.g., how would independent parties behave?) and not provide them with the tools to answer the question (e.g., sources of market evidence). I submit the language provided in the next section for addition to the draft.

Sincerely,

David R. Jarczyk

ktMINE, CEO
PROPOSED LANGUAGE FOR INCLUSION

Determination of Arm’s Length Conditions
Agreements are available in the public domain that encompass the deal terms and conditions between independent parties, including those entering into arrangements consistent with cost contribution arrangements. This data should be utilized to identify evidence of deal structures typical among independent parties. The use of this information provides transparency to the behavior of independent parties; specifically, the functions performed, risks assumed, intangibles utilized, and payment terms agreed upon.

Agreements exists for a multitude of transaction types, including:

- Joint Development;
- Toll/Contract Manufacturing;
- Financial Services;
- Sales and Buying Agents;
- R&D and Engineering Services;
- Management Services; and
- License of Intangibles.

Determination of Arm’s Length Pricing
Agreements within the public domain include information on payment structures as well as the payments themselves for a multitude of transaction types, including those mentioned in the previous section. The use of this information provides market evidence of pricing structures and prices typical among independent parties. Used in conjunction with a prudent analysis that considers factors of comparability, these data points provide benchmarks for related party transactions.

Payment terms exist for a variety of structures, including:

- Gross Sales;
- Net Sales;
- Cost Plus;
- Gross Profit;
- Operating Profit;
- Assets; and
- Per unit.
Various valuable insights into how independent parties construct payment terms extend beyond the royalty rates being paid. These include answers to the following questions:

- What are the events that trigger payments?
- When are licensees incurring interest charges?
- What is the royalty base definition?
- Are there milestone payments?
- What are the audit terms around the royalty payment?
- Would third parties agree to royalty reductions due to profitability?
- Would third parties agree to royalty offsets?
- What is the invoicing process?
Andrew Hickman  
Head of Transfer Pricing Unit  
Centre for tax Policy and Administration  
Organization for Economic Co-operation and Development

May 29, 2015

VIA E-MAIL (TransferPricing@oecd.org)

**BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)**

Comments by NERA Economic Consulting, Vladimir Starkov, Emmanuel Llinares and Pim Fris

Dear Mr. Hickman,

NERA is pleased to provide comments on the Discussion Draft that deals with revisions of the OECD *Transfer Pricing Guidelines* in the part that is related to Cost Contribution Arrangements (“CCAs”) and would like to acknowledge a significant effort put by the relevant OECD committees and working parties into preparing this document. We applaud the idea promulgated in the Draft that contributions to CCAs should be assessed in terms of their value, and that costs may not always be the best measure the CCA contributions. We would also like to offer a few additional observations that we believe would enhance the new edition of Chapter VIII.

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1 These comments represent independent views of the authors and do not necessarily reflect the views of NERA Economic Consulting
Objective of Chapter VIII

Paragraph 1 states the purpose of Chapter VIII as “to provide some general guidance” for determining consistency of CCA transactions with the arm’s length principle. Consequently, analysis of CCAs should be “informed by” the provisions of Chapter VIII, as well as based on “adequate documentation”. Where documentation is a given in the field of transfer pricing, the first element is a relevant indication of the importance and authority of the guidelines in general: they inform the analysis. That means that, in designing a TP policy, an MNE should be aware of the approach of tax authorities (as expressed in the Guidelines) and, should its solution be different, explain this difference, in addition to the normal, “adequate” documentation.

Paragraph 7 indeed not only stipulates that provisions of other Chapters of the Guidelines continue to apply in respect of CCAs (is this stipulation really necessary?), but also that “MNEs are encouraged to observe the guidance” of Chapter VIII. We welcome this clarification, and would extend this to the authority of the Transfer Pricing Guidelines as a whole.

Recognition of CCAs

When it comes to the principles of CCA recognition, the Draft often makes references to proposed revisions of Chapter I of the Transfer Pricing Guidelines. Chapter I outlines several recognition principles, one of which says that if the same transaction can be seen between independent participants in comparable circumstances, the transaction between related parties must be recognized.

An example of a CCA non-recognition given in the Draft is that of a party that provides funding for the CCA activity but does not manage or control the risks of intangibles development. The Draft

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states that such a party cannot be regarded as a CCA participant. We note that, by excluding
availability of CCAs to entities that are solely involved in funding activities, one may actually
eliminate a whole spectrum of transactions that parallel arm’s length behavior. This observation
coupled with the principles of recognition expressed in Chapter I points to a conclusion that
absence of certain functions and capabilities on the part of some CCA participants should not
prevent them from being recognized as CCA members as long as the value of contributions and
benefits of these parties are determined according to the arm’s length principle. The same is true in
the case when a related party receives only small benefits from a CCA as discussed in paragraph 31
of the Draft.

Chapter I also discusses alternatives available to parties as being useful in pricing certain
transactions. A realistic alternative to a CCA may be licensing, therefore the benefits of the
“passive” CCA participants could be considered with respect to this alternative. We also feel that
the draft needs to be more explicit on how the principle of recognition will work for related
companies that are contractually assigned to perform activity for a CCA but are not treated as CCA
participants (as discussed in paragraph 14).

As an aside, we note that the Draft continues the tradition of having both Services CCA (which can
be seen as a cost allocation arrangement) and Development CCA (often referred to as a cost
sharing arrangement, CSA). However, in practice, we believe that there are a number of important
differences between these two types of CCA. In particular, there are important aspects relating to
the timing of the investments and the risks involved in a Development CCA which are not
necessarily relevant in a Service CCA.

**Adjustments to CCAs by tax authorities**

From our point of view, it would be important for the Draft to clarify the principles under which
the tax authorities will be able to make adjustments to payments made under CCAs because
uniform application of these principles is essential for avoiding double taxation. In its current version, we believe that the Draft is not detailed enough in this respect, leaving tax authorities with wide latitude of re-characterization.

Verifying the arm’s length nature of payments made under CCAs is associated with the typical challenges of judging payments that are predicated on medium- or long-term forecasts. As is often the case with arm’s length arrangements, realization of benefits in a long-range development-type CCA may differ markedly from the projections. We believe that the Draft needs to provide principles which would allow for recognition (and non-recognition) of ex post outcomes that are different from ex ante projections of the CCA activities. Arm’s length arrangements typically permit certain deviation of outcomes from the projections without triggering adjustments or renegotiations, thus introduction of safe harbors for the deviations of ex-post CSA outcomes from their ex-ante expectations may be worth considering.²

The Draft may also benefit from developing further the guidelines for the necessary (but not sufficient) evidence to be presented by the taxpayers to demonstrate the business rationale of a given CCA. Such evidence may include, for example, taking into account the risks of a CCA activity by means of developing risk-adjusted discount rates, preparing scenario analyses or both. Well-supported discount rates are a particularly important factor in modeling of a development CCA because in CCAs of this type costs and benefits need to be compared among different periods.³

² For an example of how the safe harbors are used in the U.S. transfer pricing regulations applicable to CCAs, see U.S. Treas. Reg. §1.482-7(i).

³ A method of computing discount rates using the scenario analysis in the cost sharing framework is discussed in the paper by NERA authors soon to be published in Transfer Pricing Management Report.
Impact of CCAs on Pricing of Other Related Parties transactions

Establishment of a CCA may have a significant impact on pricing of other intra-group transactions. For example, if before the CCA took effect intercompany prices of tangible goods included royalties to the intangibles owner(s), and the newly established CCA covers development of the intangibles associated with these tangible goods, then prices of the tangible goods transactions in the CCA may need to be reset to cover only routine returns for manufacturing of those goods. We believe that a possible impact of CCAs on pricing of other controlled transactions should be addressed in the Draft.

Complex CCAs

We believe that the Draft should acknowledge certain situations that may complicate calculations contributions and benefits under a CCA and provide guidance for dealing with such “complex” CCAs. Some of the situations of “complex” CSAs may be as follows.

CCAs with Pre-Existing Intangibles

Even though the feasibility of pre-existing intangibles being contributed to a CCA is acknowledged in the Draft (e.g., in paragraphs 21 and 25), we feel that the document should devote more attention to this type of contributions as in some cases values of these contributions may be rather significant. A special case of pre-existing contribution is when pre-existing intangibles (“IP”) support already-marketable products. A consideration for such pre-existing IP should include the remuneration to the original developer from all of the other CCA participants for the right to develop this IP further. This right to develop the pre-existing IP further is distinct from the right to merely exploit the pre-existing IP. Should a CCA participant wish to sell the products based on the pre-existing IP, it must pay a separate compensation for licensing of this IP. Further, if there are ongoing sales of pre-existing products, care needs to be taken to separate the profit related to those sales from the profit attributable to the newly developed products. Given this, the list of payments in paragraph 42, condition c) that does not allow for a separate license payment for the right to merely exploit the
pre-existing intangibles may be overly restrictive.” In general, a more detailed discussion on pre-existing intangibles may enable to close the gap between the OECD guidance and country specific regulations on CCAs such as the one in the U.S.  

**CCAs with Complementary intangibles**

Business models adopted by multinational enterprises today often incorporate several complementary value drivers. Taxpayers may and often do choose to organize their business in the way that not all of the intangibles that drive the value creation are to be subject to cost sharing. As an example, R&D activities for the benefit of all worldwide affiliates of a multinational enterprise may be cost shared, while the cost of marketing activities will remain the responsibility of local affiliates. Therefore, we believe that the Draft should acknowledge a possibility that other valuable intangibles may exist outside of a CCA and provide guidance for dealing with these situations.

**CCAs with More than Sole Contributor of Valuable Intangibles**

Even though the Draft provides an illustration of more than one party providing valuable contributions in a CCA (e.g., Example 4), we think that it would be helpful to add another example that illustrates application of the principles of the Draft to the case when valuable contributions of pre-existing intangibles of similar type (e.g., technology intangibles) are provided by more than one party.

**Definition of “contribution” and “effective ownership”**

Paragraph 4 explains that, under the arm’s length principle, a participant’s proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall

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4 The discussion of pre-existing intangibles, called “platform contributions” in the U.S. regulations, can be found in *U.S. Treas. Reg.* §1.482-7(c).
expected benefits resulting from the CCA. The Chapter’s title speaks of cost contribution, paragraph 4 about a share of the contributions and it becomes clear in what follows that “contribution” has a much wider reach (and rightly so) than a cost contribution as such. Paragraph 42, finally (condition e)), speaks of the “allocation of contributions”. The term “contribution” is used in a different sense at different places in the Draft. This brings up the question whether the expression in the title, CCAs, is correct: the word “contribution” in the title reflects a key element, while the addition of “cost” risks restricting the focus unnecessarily, and so why not speak about Development Contribution Arrangements, resp. Service Contribution Arrangements?

Trying to avoid the term “economic ownership”, the Draft introduces the “effective ownership”. The term is significant, as it distinguishes the CCA participant from a purely passive investor. It refers to the (paragraph 13) capability and authority to control the risks associated with the risk-bearing opportunity (i.e., the use of the fruit of the CCA by the participant for its business purposes) under the CCA. In order to avoid a dummy status of this term, the Draft would benefit from a precision of the meaning of this term.

In conclusion, we would like to say that even though the Draft can be already regarded as a laudable effort in outlining the core principles of CCAs, certain improvements, such as those discussed in this letter, would go a long way toward clarification of CCAs workings in a wide variety of settings and improving resolution of disputes related to CCAs.

Sincerely yours,

Vladimir Starkov, Emmanuel Llinares and Pim Fris

Chicago / Paris
May 28, 2015

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Andrew Hickman, Head of Transfer Pricing Unit
2, Rue André Pascal
75775 Paris, France

Re: Comments on Discussion Draft on BEPS Action 8: Cost Contribution Arrangements (“CCAs”)

Dear Mr. Hickman:

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Discussion Draft on BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs), published April 29, 2015 (the “CCA Discussion Draft”).

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC’s Board of Directors is attached as an Appendix.

The NFTC appreciates the opportunity to provide comments to the OECD on these important issues. In general, we believe that the rules, as proposed, would create substantial uncertainty and lead to a proliferation of disputes.

Our comments focus on four main areas of concern. First, we believe that the additional guidance provided has highlighted the fact that different sets of rules should apply to the two different types of CCAs, services CCAs and intangible development CCAs. Second, the requirement that participants in an intangible development CCA must have the capacity to identify and assess the risks of the CCA’s activities is unduly restrictive and inappropriate. Third, consideration should be given to allowing taxpayers to account for each participant’s
ongoing contributions to the CCA at cost, consistent with the current guidelines. Fourth, we believe that, as proposed, the rules for disregarding all or part of a CCA are overly broad and that the fact patterns animating those concerns are better addressed by adjustments within the CCA framework. We also provide comments to Example 4 of the Annex.

B.3 – Types of CCAs: Development CCAs and Services CCAs

Chapter VIII of the current guidelines addresses two types of CCAs:

- Development CCAs, in which affiliates pool resources for the joint development of property (typically intangible property) that, if successfully developed, would be separately exploited by the affiliates free of any obligation to pay a royalty (see Transfer Pricing Guidelines at ¶ 8.6); and

- Services CCAs, in which affiliates pool resources for the provision of corporate support or other services on a centralized basis (see Transfer Pricing Guidelines at ¶ 8.7).

Because of the fundamental differences in the economics for each type of CCA, the NFTC recommends that the final guidance be divided into two parts, one dealing with development CCAs and the other dealing with services CCAs. A development CCA involves the joint sharing of expenses (and therefore risk) in regards to the development of property that, if successfully developed and commercialized, can be separately exploited by each of the participants to generate revenue in future periods. In contrast, a services CCA involves the joint sharing of period costs that typically are not intended to provide a future benefit. The fundamental economic differences between the two types of CCAs give rise to different transfer pricing considerations and therefore militate against a single set of rules.

The issues raised by attempting to address both arrangements in a single set of rules are highlighted by the more detailed guidance provided by the CCA Discussion Draft. At times, it is unclear whether this guidance is related to only one type of CCA or both. For example, paragraph 13 of the CCA Discussion Draft states that each participant must have the capacity to evaluate the risks of the CCA activity. Although this standard is problematic generally for reasons discussed below, it appears directed only at development CCAs. It seems strange to require participants in a services CCA to have the capacity to evaluate the risks of providing centralized legal or human resources services. In contrast, paragraph 16 discusses how to estimate the expected benefits of a CCA and suggests that headcount would be a suitable allocation key. This seems directed only at services CCAs (for example, in the context of allocating human resources or information technology expenses). These and other issues could be remedied or clarified by providing distinct and appropriate guidance for each of development CCAs and services CCAs.
Finally, we note that to the extent the CCA Discussion Draft addresses services CCAs, it covers many of the same issues as the discussion draft dealing with low value-adding services (the “Services Discussion Draft”). As discussed in more detail below, some of the issues do not appear to have been coordinated. The Transfer Pricing Guidelines should have a single set of coherent rules addressing services CCAs and similar centralized services arrangements.

C.2 – Determining Participants: Capability and Authority to Control Risks

The CCA Discussion Draft proposes that each participant in a CCA must have the capability and authority to control the risks associated with the risk-bearing opportunity underlying the CCA. See ¶ 13 of the CCA Discussion Draft. This participant standard is similar to the standard proposed in the discussion drafts related to intangibles for determining the extent to which a person will be respected as the economic owner of intangible property. Presumably, under the CCA Discussion Draft, a person would be ignored as a participant if it did not have such capability or authority. The NFTC disagrees with this approach. We recommend that this standard be eliminated for services CCAs and, at the very least, be reconsidered for development CCAs.

We note at the outset that the CCA Discussion Draft could be read to limit the requirement that a participant have the capability and authority to control risks to the contributions made by that participant. The NFTC would support such a principle. Participants should not necessarily be expected to have the capability and authority to control the risks of other participants. The remainder of this discussion assumes that the drafters of the CCA Discussion Draft intended to require participants to have the capability and authority to control all of the risks of the CCA activity.

The participant standard set forth in the CCA Discussion Draft is not appropriate for services CCAs. As noted above, participants in a services CCA pool resources to pay for the provision of services on a centralized basis. Unlike in a development CCA, there typically is no material risk underlying the CCA activity. The services provided through the CCA, such as corporate head office or other centralized services, typically provide benefits (such as reduced cost or increased standardization) in the period in which they are provided, not in a future period. Hence, the issue of whether a putative participation has the capability and authority to control risks is irrelevant. As a result, this standard is inappropriate and should be eliminated in this context. Note that this would be easier to do if the guidance for services CCAs were separated from the guidance on development CCAs, as recommended above.

This participant standard should be reconsidered for development CCAs as well. As noted in paragraph 6 of the CCA Discussion Draft, development CCAs can aid in tax administration and compliance by “eliminat[ing] the need for complex cross-licensing arrangements and associated allocation of risk, and replac[ing] them with a more streamlined sharing of
contributions and risks, with effective ownership of the resulting intangible(s) shared in accordance with the terms of the CCA. “This beneficial feature of CCAs distinguishes them from structures involving single principals in contract R&D arrangements, which has been the focus of other elements of the BEPS work. As noted in other elements of the BEPS work, determining the transfer pricing consequences of licenses or other transfers of hard-to-value intangibles outside of the CCA context is extraordinarily challenging and presents significant risk of disputes. Imposing the participant standard unduly limits the availability and flexibility of CCAs, thereby harming tax administration and making compliance more difficult.

The inappropriateness of the participant standard can be illustrated with a simple example. Consider a development CCA in which R&D is performed mainly by one member of an MNE in one location for the benefit of itself and four other affiliates that will use the developed R&D in their manufacturing process. Assume further that each of the five manufacturing affiliates provide inputs to each other and to the R&D center related to process improvements or other know-how developed in the course of performing their manufacturing activities. There is no rationale under the arm’s length principle, or from a broader policy perspective, for requiring the MNE to establish redundant R&D offices in each of its manufacturing companies with the capability and authority to control the risks underlying the CCA activity. It seems appropriate to permit each of the five manufacturing companies to pool resources to jointly support and fund centralized R&D efforts in exchange for the rights to use any developed intangible property in each of its activities. In such a case, the revenues from the exploitation of the intangible property in the manufacturing activity are matched to the operating company’s share of development costs. A failure to permit such an arrangement would force MNEs into licensing models in which each of the operating companies must pay an arm’s length royalty to the developer of the intangible property for its use, with the attendant uncertainties of determining an appropriate royalty.

As another example, it is possible in a development CCA for one participant to contribute existing intellectual property and a second participant to contribute future development work. It is not clear whether the CCA Discussion Draft would permit this common arrangement unless each of the two participants has the capability and authority to control future development risks. There does not appear to be any policy basis for precluding such an arrangement. To the extent such an arrangement is not permitted, the final guidelines should explain the rationale for this result.

We are sensitive to the desire by some participant countries in the BEPS process to ensure that CCAs do not lead to BEPS through the allocation of returns from intangible property to persons with little or no substance. We believe that this concern is addressed in the development CCA context by ensuring that each participant has the capacity to benefit from the use of the property being developed. See paragraph 12 of the CCA Discussion Draft. To the extent the participant
has the capacity to benefit from the use of the property developed, it should be permitted to acquire such property, whether by pooling its resources with other participants to fund the development activity, or by acquiring or licensing the property once it is developed.

To the extent that the OECD does decide to impose such a participant standard that focuses on the capacity of each participant to control risk, it should be consistent with the standard for risks applied in other contexts, including business restructurings in Part I of Chapter IX of the current guidelines.

C.4 – Measuring Each Participant’s Contribution: Value versus Cost

The current Transfer Pricing Guidelines endorse the use of cost or value to determine the ongoing contributions of services by participants in the context of the CCA activity. See ¶ 8.15. This Discussion Draft, however, proposes to use only value, except perhaps in the case of certain low value-added services. ¶¶ 20-23. The NFTC disagrees with this approach. We believe that cost continues to be appropriate in the context of services CCAs, in particular as applied to low value-added services. In addition, we believe that cost can be used for development CCAs, as well, except in narrow circumstances where that could result in standard material distortion (for example, where the service provider has only a small percentage interest in the development CCA).

For both types of CCAs, the use of cost is simpler, easier to administer, and less subjective. The use of cost also minimizes the possibility of disputes among governments and taxpayers in a context where relatively little revenue is likely to be at stake.

Moreover, the use of cost in development CCAs recognizes that the participants to a CCA are looking to the results of the CCA activity itself to provide a return for all of their contributions. Each participant is willing to jointly fund development activities in exchange for the right to separately exploit developed property free of any royalty obligation. In this context the decision to locate development activities within one participant or another is irrelevant to the economics of the arrangement because each participant has committed to jointly fund the activities. Conceptually, it is as if the employees performing the development activities are jointly employed by all participants in that effort.

For all of these reasons, the NFTC recommends keeping the use of cost both for services CCAs and for development CCAs.

The NFTC does recognize that there is a potential for distortions in some situations, such as where the participant providing services has only a small percentage interest in the development CCA (for example, less than 10%) or is otherwise not a bona fide participant. These situations seem narrow, however, and can be better addressed through a targeted rule.
As noted above, many of the issues covered in the CCA Discussion Draft overlap with the issues discussed in the Services Discussion Draft. We recommend that the final versions be better coordinated. For example, under the Services Discussion Draft, the safe harbor for certain low value-added services is available only if a small plus (2%-5%) is added to the costs. In contrast, the CCA Discussion Draft contemplates the pricing of low value-added services at cost. As a second example, the CCA Discussion Draft provides that participants to a CCA must have the capacity to control the risks of the underlying CCA activity, while no comparable standard is provided in the Services Discussion Draft. Because of the similarity between the centralized services arrangements contemplated by Services Discussion Draft and services CCAs, we recommend that the rules be reconciled so as to avoid disputes among governments and taxpayers, especially in a context where relatively little revenue is likely to be at stake.

C.6 – Disregarding Part or All of the Terms of a CCA

Under the CCA Discussion Draft, a CCA may be disregarded in whole or in part if the reality of the arrangement differs from its terms. See ¶¶ 31-32. The NFTC is very concerned about the proposed guidance in these paragraphs and believes that the circumstances identified could be better addressed through adjustments within the CCA construct.

As noted above, the proposed guidance in ¶¶ 31-32 is problematic. The example in ¶ 31, for instance, posits a situation where a service provider has only a small interest in a CCA. The example then questions whether the goal of the arrangement is to share mutual benefits or to obtain a more favorable tax result. The NFTC believes that the issues raised in this example could be better addressed by ensuring that the compensation of the service provider is appropriate under the arm’s length principle rather than by disregarding the terms of the CCA.

The example in ¶ 32 is problematic, as well. It discusses a situation where the participant bears disproportionately high costs as compared to its expected benefits from the CCA activity. The Discussion Draft then states that it may be appropriate to disregard the CCA in its entirety. The NFTC disagrees. Instead, in a case where a participant bears costs that are materially higher on a percentage basis than its expected benefits as a result of systematic or deliberate actions, a better solution would be to impose an implicit transfer of interests to that participant.

Both examples, then, should be revised. Neither one justifies the disregarding of all or a part of the CCA. If there are in fact situations where such a draconian set of rules is necessary, we believe that those rules should apply in only the narrowest of circumstances.
Example 4 of the Annex

Finally, Example 4 in the Annex to Chapter VIII should be clarified. Under the facts as given, this example effectively provides a 12% rate of return. The final guidelines should clarify that the risk adjusted rate of return could be substantial if the development activity is sufficiently risky. We are concerned that tax authorities may view the 12% rate of return as a standard rather than an example.

Sincerely,

Catherine G. Schultz
Vice President for Tax Policy
National Foreign Trade Council
cschultz@nftc.org
202-887-0278 ext. 2023
Appendix to NFTC Comments on BEPS Action Items 8: Discussion Draft on Cost Contribution Arrangements

NFTC Board Member Companies:
McKenna Long & Aldridge LLP
ABB Incorporated
AbbVie Pharmaceuticals
Applied Materials
Baxter International Inc.
British American Tobacco
Caterpillar Incorporated
Chevron Corporation
Chrysler Corporation
CIGNA International
Cisco Systems
Coca-Cola Company
ConocoPhillips, Inc.
Deloitte & Touche
DHL North America
eBay, Inc.
E.I., du Pont de Nemours & Co.
Ernst & Young
ExxonMobil Corporation
Fluor Corporation
Ford Motor Company
General Electric Company
Google, Inc.
Halliburton Company
Hanesbrands Inc.
Hercules Group
Hewlett-Packard Company
Johnson & Johnson
JP Morgan Chase & Co.
KPMG LLP
Mars Incorporated
Mayer Brown LLP
McCormick & Company, Inc.
Microsoft Corporation
Occidental Petroleum
Oracle Corporation
Pernod Ricard USA
Pfizer International Inc.
PricewaterhouseCoopers LLP
Procter & Gamble
Prudential Insurance
Ridgewood Group International, Ltd.
Siemens Corporation
Sullivan & Worcester LLP
TE Connectivity
Toyota
Tyco International
United Parcel Service, Inc.
United Technologies
Visa, Inc.
Walmart Stores, Inc.
May 29, 2015

BEPS Action 8: Discussion draft on revisions to Chapter VIII of the Transfer Pricing Guidelines concerning cost contribution agreements

Comments by Pat Breslin of NERA Economic Consulting

Dear Mr. Hickman,

I would like to thank you and the members of the relevant OECD committees and working parties once again for the opportunity to comment on the above-mentioned document.

The introductory comments on page 3 of the discussion draft (dated April 29, 2015, the “draft”) highlight the extent to which the revised Chapter VIII on Cost Contribution Arrangements (CCAs) requires coordination with other key chapters of the revised OECD Transfer Pricing Guidelines (the “guidelines”). In fact, while this level of coordination is noted among other chapters of the guidelines, it is particularly necessary here with respect to Chapter I (regarding risk), Chapter VI (on intangibles valuation) and Chapter VIII (on development CCAs).

In this present round of comments on Chapter VIII, I make a similar attempt to refer to some of my previous comments on these other chapters, to further facilitate a coordinated view of the interactions between these closely related chapters and the respective comments. To that end, I attach a published article which was also referenced in my submission to the December 19, 2014 request for comments on the discussion draft revisions to Chapter I on risk. This article and others will be referred to in the comments below.

In this author’s view, the necessary coordination present between the above-mentioned chapters is particularly salient with respect to

1) the valuation of a transfer of rights in intangibles under any circumstances, including as a contribution to a development CCA (as addressed in Chapter VI and, with respect to risk, in Chapter I) and
2) an arm’s length analysis of that CCA itself under Chapter VIII.

These comments represent the independent views of the author and do not necessarily reflect the views of NERA Economic Consulting, or any of the author’s colleagues. The author would like to thank Simon Wu of NERA in Washington, DC for his helpful review and comments.

To be clear, Chapter VI applies to any intercompany transfer of rights in intangibles, whether or not it is in the context of a CCA.
Not only is there an inherent linkage between the proper valuation of an intangible contribution to a CCA and the proper implementation of the corresponding CCA, it would be more accurate to consider these as parts of the *same* transaction.

For example, to evaluate whether participation in a CCA is beneficial, any participant would need to forecast its expected income streams under the CCA—including its related revenues and other benefits net of its related costs. Clearly, such revenues, benefits and costs would result from items 1 and 2 above in combination. A participant may also need to consider its opportunity costs, such as those associated with alternative uses of an intangibles contribution. Taking all of this information into account, the prospective participant might then compare the present value of its income streams under the CCA to the present value of its income streams under its other options, and thereby choose its best option.3

As discussed throughout the draft Chapter VIII, a CCA will be considered arm’s length to the extent that, over a reasonable period time, each participant realizes a share of benefits from the CCA activity that is proportional to its share of contributions (including cost contribution payments and non-monetary contributions).

Failure to comply with this standard may be corrected by rebalancing the participants’ respective levels of costs and benefits pertaining to the CCA after the fact, in order to make them proportional. To the extent necessary, such rebalancing must be done on a periodic basis in a manner consistent with what independent parties would willingly agree. Presumably, this would consider some period of sufficient length to allow for a leveling of any shorter-term variability in the proportions of costs relative to benefits arising through the CCA activity.

In light of the above, it would appear that improper valuation of contributed intangibles and potentially other non-monetary contributions would be more likely to account for any need for large-scale rebalancing. Unlike with services, the benefits related to intangibles development are often realized over a longer horizon relative to the costs associated with intangibles development. In contrast, services often provide benefits to the CCA participants in periods that are largely current with the related costs.

Of course, it is feasible that inconsistent allocations of ongoing cost contributions and corresponding benefits could also arise due to the inability of chosen allocation keys to reflect cost contributions that align with the participants’ respective benefits (taking into account all parties’

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3 See also, for example, Breslin, “The Veritas Decision: An Incomplete Picture of the Arm’s Length Standard Under Section 482.” Tax Management Transfer Pricing Report 19, no. 14 (2010): 815–23. This article contains additional discussion on arm’s length analysis in this CCA context and the need to analyze the entirety of a transaction (and all related cash flows) in cases involving intangible contributions to an R&D-based development CCA. Note that this article uses terminology under the U.S. regulations, such as “cost-sharing arrangement” or “CSA” in place of OECD “CCA” terminology.
initial and ongoing non-monetary contributions). This may be the case in the context of a services CCA, for example.

However, such inconsistencies would be incrementally realized and would not produce discrepancies on the orders of magnitude seen in some controversies in this area, which largely appear to stem from questionable valuations of intangibles that are contributed at the outset of the CCA.\(^4\) In other cases, the undervaluation of acquired intangibles contributed by one participant to a CCA during the course of the arrangement might also lead to large-scale mismatches between the benefits realized by other participants relative to their own costs, contributions and risks.

Regarding the frequency of rebalancing, this would need to take into account the short- or long-term nature of the benefits expected to result from the CCA activity—such as with respect to services and intangibles development activities, respectively—in relation to all of the costs and other contributions under the CCA.

*Measuring value contribution*

Page 3 of the draft also notes that the draft Chapter VIII guidance provides clarification to “require contributions to be measured at value rather than at cost” to help to “ensure that outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA.”

The distinction between the cost of any asset (such as one’s home) and the market value of that asset should be easily recognized by anyone who has undertaken the corresponding risks and responsibilities associated with acquiring, financing, owning and maintaining such a property. But accounting costs and conventions related to intangibles also depart dramatically from market value, and therefore an economic analysis of intangible value contribution is a necessity in this context.\(^5\)

The point is also well-taken throughout the draft (e.g. section C.4), which properly elevates the importance of measuring the *economic value* of an individual participant’s contributions to a CCA, such as the contribution of its rights in intangibles (taking into account its opportunity costs), even


\(^5\) See, for example, Breslin, “Comments on the Discussion Draft on Chapter VI of the OECD Transfer Pricing Guidelines,” (2012): 99–122, available at http://www.oecd.org/ctp/transfer-pricing/Intangibles_Comments.pdf. At pages 104-106 in a section entitled “Goodwill Paradox,” the commentary addresses the fact that, through a purchase price allocation (PPA), accounting measures of “separately identifiable” intangible assets and “goodwill” often produce arbitrary and unreliable results that depart dramatically from the actual arm’s length transaction which the PPA (i.e. an accounting based measurement) purports to analyse.
though subsequent development and maintenance of these intangibles may result from the cost contributions of multiple participants.

The draft appropriately points to the revised drafts Chapter VI (on intangibles transactions) and further to Chapter I for needed guidance on these complex valuation questions. Chapter I is invoked for its guidance on “bearing risks by all participants” to a CCA, and the “concept of control over risks” as a barometer for determining whether participation in a CCA is truly a realistic alternative for a given participant.

*Analysing Risk in the context of a CCA*

Action 8 of the BEPS Action Plan states as its objective to “Assure that transfer pricing outcomes are in line with value creation.” The draft revisions to Chapter I highlight the critical role of taking risks in creating value and the fact that, at arm’s length, economic actors that assume and control risks related to value-creating activities require a corresponding return.

In the attached article, I include a game model to illustrate that parties taking risks in the earlier stages of a process realize payoffs that increase with the certainty of favorable outcomes—because their decisions and actions in the face of greater uncertainty (*i.e.* *ex ante* risks) are rewarded when positive outcomes are realized, *ex post*. Correspondingly, the value of an asset increases after positive outcomes associated with that asset are realized and associated risks (*i.e.* uncertainty) are reduced.

Substantial arm’s length evidence regarding venture capital (VC) investments in R&D-based companies and other types of intangible development supports the game model, as discussed further below.

The game model and corresponding arm’s length evidence have direct implications for determining the arm’s length nature of a CCA in its inception and implementation. A common mistake in implementing development CCAs occurs when one conflates the value contribution of participants contributing developed intangibles with the subsequent cost contributions of participants under the CCA. This contextual mismatch rewards later-stage investors as if they assumed the early-stage risks—and correspondingly denies early-stage investors of their corresponding returns. At arm’s length, one would be hard-pressed to find a venture capitalist willing to go along with such a deal.

Under a CCA, the participants often share costs and risks associated with the later stages of development (at least in relative terms), and the maintenance and exploitation of any contributed intangibles. In such cases, the participants share risks *after* the outcomes of earlier-stage development (and related risks) are known with respect to the subject intangibles.

Meanwhile, in such cases, the party contributing the intangibles has already assumed substantial risks associated with developing contributed intangibles—often meeting with substantial
commercial success. Many of these issues apply equally to the contribution of related resources that have proven success, such as providing a research team with a proven track record in the intangible development area.

When these mismatches occur, the effect is to reward later-stage investors with earlier-stage returns and vice versa. Such scenarios effectively mismatch returns on investment and associated risks—giving higher returns to parties taking relatively less risk (such as at later stages when key outcomes are known) and depriving parties that are able to take on and control key early-stage risks of the necessary incentives to do so.

To illustrate, Figure 1 below depicts the game model described in detail in the attached article, “Coin Flips, Rational Decisions and Risk.” In the game, the holder of an “in the money” game ticket at stage 2 earns the upside associated with having invested in the ticket before knowing whether or not the ticket dealer would flip “heads” or “tails” in the first two stages. That is, his upside corresponds to his risk. Once these outcomes are known, the expected value of his ticket increases to $50, as the risk of flipping “tails” (i.e. losing the game) is substantially reduced—and the chances of winning the game overall are substantially increased. Thus, the game model illustrates how value creation inherently aligns with risk.

Figure 1

<table>
<thead>
<tr>
<th>Stage of game</th>
<th>ex ante</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
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<tbody>
<tr>
<td>$5 = Game ticket:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-“Heads” 4 times straight wins $100</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>-“Tails” once loses</td>
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<tr>
<td>Probability (P) of winning: 6.25% = 50% x 50% x 50% x 50%</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>A. Expected value @ stage (no prior “tails”): (eV) = $100 * P (current stage)</td>
<td>$6.25</td>
<td>$12.50</td>
<td>$25</td>
<td>$50</td>
<td>$100 or (5)</td>
</tr>
<tr>
<td>B. Ex post Multiple (eV / $5)</td>
<td>2.5x</td>
<td>5x</td>
<td>10x</td>
<td>20x or (1)x</td>
<td></td>
</tr>
</tbody>
</table>

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6 Figure 1 originally included in P. Breslin presentation Comments on the OECD Public Discussion Draft “BEPS Actions 8, 9, 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures),” presented before OECD Committee on Fiscal Affairs working parties and country delegates, at public consultation hearings on draft revisions to Chapter 1 of the guidelines. Paris, March 19-20, 2015. See also, attached article, “Coin Flips, Rational Decisions and Risk” for detailed discussion on the game model.
In a development CCA, it is also critical to consider the known outcomes associated with contributed intangibles. These might include any important milestones that have already been realized before the intangibles are contributed to the CCA—such as the issuance of approved patents, other regulatory approvals and registrations, installed bases of earlier versions or generations of the product, existing customers for such predecessor products and planned new products, brand recognition, reputation, etc. Thus, the party contributing these intangibles would have taken the risks associated with these positive outcomes and, at arm’s length, would demand the corresponding returns.

Of course, ex ante, the outcomes of such risks were not known. Thus, for example, when investments are made in developing technology intangibles yet patents are rejected or found to be invalid, by analogy these downside risks reflect the risk of flipping “tails” in stages 1 or 2 of the game. Lack of initial commercial acceptance or failing product tests could also reflect “tails,” for example.

At arm’s length, it would be unrealistic for a party that assumed these earlier-stage risks to forego the related returns by transferring its assets as if the outcomes of past actions and events were unknown. Doing so would reflect a player selling an “in the money” game ticket at stage 2—worth $50—for the original ticket price of $5, as if the prior outcomes were unknown and the risks associated with flipping “tails” in stages 1 and 2 were not resolved. This also further illustrates the distinctions between cost- and value-based measurements, and highlights the potential pitfalls of relying heavily on cost-based analysis in evaluating the arm’s length value of a transaction.

As noted above, substantial arm’s length evidence regarding venture capital (VC) investments in R&D-based companies and other types of intangible development supports the game model. That is, returns on earlier-stage (i.e. riskier) VC investments far exceed the returns on later-stage VC investments, by orders of magnitude. This is illustrated below in Table 1.
In fact, once favorable outcomes are realized on investments in risky early-stage companies, later-stage investor returns on the same or similar companies may eventually converge with risk-adjusted returns associated with mature companies—such as companies within major stock market indices like the S&P 500 index. (e.g. compare Table 1, row B to Table 2, row D below.) As discussed in the next section, this empirical evidence may lend support for conclusions drawn in some of the examples of the discussion draft, depending on interpretation of the arm’s length evidence, facts and circumstances.

<table>
<thead>
<tr>
<th>Early vs. Late stage % return (VC indices)</th>
<th>15 years ended 2012</th>
<th>15 years ended 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Early Stage Index</td>
<td>68.8</td>
<td>82.07</td>
</tr>
<tr>
<td>B. Late Stage &amp; Exp.</td>
<td>8.6</td>
<td>9.37</td>
</tr>
</tbody>
</table>

Table 2

<table>
<thead>
<tr>
<th>VC vs. S&amp;P 500 % return (on index)</th>
<th>20 years ended 2013</th>
<th>15 years ended 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>C. VC Fund Index</td>
<td>30.8</td>
<td>22.6</td>
</tr>
<tr>
<td>D. S&amp;P 500</td>
<td>9.2</td>
<td>4.7</td>
</tr>
</tbody>
</table>

Options realistically available at arm’s length

In fact, the requirement that outcomes for participants under a CCA “should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA”

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7 Source data for venture capital (VC) index returns found at National Venture Capital Association, [http://nvca.org/](http://nvca.org/). For detailed references on specific data points, also see attached article, “Coin Flips, Rational Decisions and Risk.” Tables were originally included in P. Breslin presentation Comments on the OECD Public Discussion Draft “BEPS Actions 8, 9, 10: Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures),” presented before OECD Committee on Fiscal Affairs working parties and country delegates, at public consultation hearings on draft revisions to Chapter 1 of the guidelines; Paris, March 19-20, 2015.

8 Ibid
corresponds to the fundamental principle that independent parties would fully consider the options realistically available to them. At arm’s length, they would choose the most preferable among these options and, at a minimum, would not choose any option that would make them worse off given the alternatives. Status quo—such as not contributing intangibles to and/or remaining outside of a CCA—is clearly among the options realistically available to any party at arm’s length.

Examples 4 and 5 create a helpful context in which to illustrate and further discuss a number of the principles discussed above. The following comments offer just a few initial reactions. Of course, any variations in the stylized fact patterns and related interpretations and assumptions in these examples might have considerable impact on suggested arm’s length results. The discussion below will try to clarify some such assumptions for the purposes of these comments but, of course, any actual analysis would require access to much more detailed facts and information and any general conclusions below are purely for illustrative purposes.

A fairly straightforward starting point for the analysis in Example 4 might consider the funding options realistically available to Company B, given its intangibles-based contributions to the CCA and its functional, asset and risk profile.

B’s potential interest in participating in the CCA appears to be to obtain funding (while potentially still contributing its own funding). Otherwise, B (and not A) contributes the key assets and resources needed to develop the intangible and produce the benefits under the CCA. Thus, one can analyse the degree to which B’s opportunity cost of capital from sources other than Company A would compare to the returns B foregoes when it accepts funding from Company A.

A useful measure in this regard might be to compute A’s internal rate of return (IRR) on the project, given its projections in paragraph 60 (before any adjustment by tax authorities in country B). Of course, Company A’s return on the capital that it invests under the CCA corresponds to B’s financing costs for these same funds. The IRR measures the rate of return that would produce a net present value (NPV) of zero on a project, given the streams of income that project produces for the investor. An investor often compares the IRR on a potential investment to its own “hurdle rate,” i.e. the minimum return it requires to go ahead with a project. If the IRR exceeds the hurdle rate, the investment may typically be approved.9

9 Alternatively, if we knew A’s hurdle rate, one might discount the corresponding project income streams by that discount rate to see whether the NPV on the project is positive for A. Either approach may be used in deciding to make (or reject) the investment—and may be useful to both the investor and the investee depending on the case and information available to each. It is important to note that neither the IRR nor the zero NPV approach suggests that the investor would not seek to exceed such threshold measures (e.g. a zero NPV). They are, however, determinative in rejecting projects that do not meet with the investor’s required rate of return on investments—a key measure of arm’s length behavior given that capital markets are competitive.
In the original projections in paragraph 60, Company A’s IRR is about 33%, which generally reflects the level of returns realized in the long-term (20 years) by venture capital funds as shown on Table 2, row C, above. Thus, A’s deal reflects a considerable financing cost for B.

Given the comments above, the question then may arise as to whether the risks assumed, and other key functional contributions provided, by Company A correspond to those of the partners in a VC fund, for example. Venture capitalists demonstrate a very high capacity for, and core competencies needed to, manage portfolios of many risky early-stage and later-stage technology development companies. Is this the profile of the funding affiliate in country A—and does it have a track record to attract high-risk capital from its own investors, similar to that attracted from uniquely qualified financial investors in a VC fund? Or is A’s financing capacity more of a function of its membership in the multinational group as a whole?

Further, it must again be acknowledged in looking at Table 1 above that, but for the very high returns earned on VC funds’ early-stage investments (which range from 69% to 83% in Table 1, row A above), VC investments otherwise approach risk-adjusted returns earned by mature, late-stage companies (see Table 1, row B and Table 2, row D). If one views Company B’s contributions as a later-stage technology investment, would returns that VCs realize on their later-stage investments apply?

Of course, it is Company B that is weighing its funding alternatives. At arm’s length, Company B (and any of its existing investors) would inspect the stage of its relevant investments to date in the intangibles and other options to utilize the key resources it would contribute to the CCA. It would value them accordingly and retain any early-stage returns it may rightfully claim in its pursuit of new funding. Recall that B has already assumed some of the relevant early-stage risks. Like a player entering the coin game after stage 2, it is too late for A to assume risks that are already resolved and earn the corresponding return.

Thus, B would closely review its funding alternatives. Further, if Company B has access to its own cash flows to make these financial investments in the project, it could potentially realize a much higher return on its own without entering into the CCA.

These possible scenarios take into account the assumptions that B’s contributions include unique intangibles that appear to be developed to a considerable extent, as well as other unique resources and capabilities to continue the development of such intangibles. As paragraph 58 notes, the intangibles to be developed under the CCA are “anticipated to be highly profitable based on
Company B’s existing intangibles, its track record and its experienced research and development staff.” Does Company A offer “more than money” to Company B’s prospects for success?

Without going into much further detail here, in Example 4 the country B taxing authority considers a risk-adjusted rate of return of 12% to be a reasonable arm’s length return for A in co-funding the project with B—and this return happens to exceed the longer-run returns often earned on late-stage VC investments and the S&P 500 shown in tables 1 and 2 (e.g. 9%).

At arm’s length, B is likely to consider multiple potential sources of capital and will not leave money on the table. This arm’s length behavior is no different than when one refinances his own home with a new mortgage at a better interest rate. Under such arm’s length conditions, the home owner reviews his financing options (and other transactions costs) and rebalances his cost contributions on this investment to align them with available benefits—given market rates.

Sincerely,

Patrick Breslin  
Washington, DC  
May 29, 2015

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11 Based on an IRR calculation of A’s income streams after the taxing authority adjustment described in paragraph 61.
PwC's Comments on BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Introduction

PricewaterhouseCoopers LLP ("PwC" or "we"), on behalf of its international network of member firms, welcomes the opportunity to comment on the OECD BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) released on April 29, 2015 ("Discussion Draft"). As a global professional services organization with a worldwide network of firms, we have worked with tax authorities around the world over many years regarding the development of transfer pricing regulations that apply to the cross-border intercompany transactions of multinational entities ("MNEs"). As a result, we have accumulated extensive experience with the wide range of transfer pricing issues relevant to both taxpayers and tax authorities, including CCAs.

We have organized our comments on the Discussion Draft into two parts. We begin by providing general comments to be followed by more detailed comments on specific paragraphs of the Discussion Draft.

General Comments on the Discussion Draft

We appreciate the OECD’s efforts to revise Chapter VIII of the Transfer Pricing Guidelines to make it consistent with the revisions to other chapters of the Guidelines under the BEPS initiative. However, we would like to stress that a revision of the framework relating to CCAs is a complex matter. Given that the first Discussion Draft was issued on April 29, 2015 and that the proposed revisions will need to be finalized for the G20 finance ministers meeting on September 4-5, 2015, we would urge caution in making fundamental revisions and that such revisions are consistent with the other changes to the Guidelines to be finalized later in 2015. Given that the final revisions to the Guidelines will significantly change from the existing Chapter VIII of the Guidelines, we recommend that the OECD allow for the grandfathering of existing CCAs.

The Discussion Draft proposes a fundamental change by requiring any participant in a CCA to have the "capability and authority to control the risks associated with the risk-bearing opportunity" under the CCA. This change is in line with the increased focus on substance introduced by the OECD when revising the relevant sections of the Transfer Pricing Guidelines. In this respect, the Discussion Draft achieves consistency with the concepts developed as part of the other Discussion Drafts on Intangibles, Risks, Recharacterisation, and Special Measures.¹

We understand the OECD’s intent to ensure that controlled entities are not established simply to participate in CCAs without performing any other meaningful function. However, we believe that the

¹ We refer to our comments on the Discussion Drafts on Intangibles and Risk, Recharacterisation and Special Measures for our views on the changes suggested to chapters I, III, and VI of the OECD Transfer Pricing Guidelines.
requirement for each CCA participant to have the “capability and authority to control the risks associated with the risk-bearing opportunity” broadly applied across every CCA participant would unnecessarily impair the usefulness of CCAs. More specifically, MNEs commonly centralize certain control and risk management functions to create valuable cost efficiencies. Therefore, in our view, outsourcing certain activities through engaging other MNE entities or even third parties to perform such functions would be commercially rational and in line with the other Chapters of the Transfer Pricing Guidelines. In addition, independent parties could very well accept risks they do not entirely manage and control, as long as they deem the return on the capital invested to be commensurate with the risk they undertake. Therefore, we suggest that the revised drafting of Chapter VIII does not require all CCA participants to perform similar functions in order to share equitably in the benefits of a CCA. Instead, a clarification is needed that any entity participating in a CCA must engage in an analysis prior to joining a CCA to demonstrate that it represents its best realistic alternative taking into account the effect, if any, of performing key functions itself or as a contractor to another party.

We also note that such a change will have collateral consequences. In particular, the current wording in the Discussion Draft is not consistent with existing U.S. rules on Cost Sharing Agreements (CSAs) (see Treasury Regulation Section 1.482-7). For example, the U.S. Regulations do not have a similar “capability and authority to control risk” requirement for CSA participants. If similar changes are not made to the U.S. regulations (or any other country’s domestic legislation) in a consistent and coordinated manner, companies will face two sets of rules (i.e., domestic or OECD) in each respective country, something that may certainly trigger disputes.

Another important change is the necessary measurement of all contributions based on value rather than costs — as is accepted under the existing Transfer Pricing Guidelines. That change is proposed “to ensure that outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA.” We assume that this comment is predominantly meant for development CCAs, as the Discussion Draft notes that in certain situations (service CCAs), contributions should be valued at cost. However, if this assumption is correct, there would seem to be no need for a separate chapter in the Guidelines on CCAs if the same result could be achieved through application of provisions in other Chapters of the Guidelines. Moreover, by analogy, unrelated parties often engage in transactions through partnerships to share costs in return for a share of the benefits from their development activities, demonstrating that such sharing of costs of development is arm’s length. Removing agreements to share costs in intangible development activities from qualification as a CCA under the Guidelines may simply drive taxpayers out from arrangements covered by the Guidelines into partnerships. (We note that a CCA is not meant to create a partnership in any event.)

We believe the Discussion Draft inappropriately applies this “value” requirement rather than cost requirement to all “contributions.” It should be clarified whether it is development CCAs that are in focus, and possibly also service CCAs when the services cannot be qualified as low value-added. “Contributions” appears to be defined to cover both contributions of pre-existing intangibles (for which a “buy-in” payment would be required), as well as contributions of ongoing services required to develop intangible property. While it may be appropriate to require contributions of pre-existing intangibles to be “assessed based on their value (rather than their cost),” it should remain possible (as it is under the current

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2 See para. 22 in the Discussion Draft.
3 See e.g. para. 8.3 of the 2010 OECD Transfer Pricing Guidelines, where in the sentence “A CCA is a framework agreed among business enterprises to share the costs and risks”, the word “costs” has been replaced by the word “contributions” in the Discussion Draft. See also para. 8.15 of the 2010 OECD Transfer Pricing Guidelines, where it is mentioned that “Countries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm’s length CCAs”.
4 See para. 23 in the Discussion Draft: “It is sometimes the case that the value (i.e. the arm’s length price) of services contributed to a CCA corresponds to the costs associated with providing those services. It may also be the case that the difference between the value and costs is relatively modest, such as for low value-added services described in Chapter VII. In this case it is recommended for practical reasons to value contributions at cost”.
5 See paragraphs 21 and 25 of the Discussion Draft.
Guidelines) for CCA participants to share the “costs” (not value) of the ongoing services required to
develop intangible property. That is entirely consistent with similar arrangements for sharing of costs
related to intangible development between unrelated parties.

We see a problem with the current Discussion Draft requiring tax administrations to determine market
value for the services provided as part of a development CCA. This bears the risk of confusing arm’s length
value with the value of the outcome from these services. This would almost certainly lead to double
taxation and protracted disputes.

Additionally, the current draft includes some vague statements that may be subject to different
interpretations. For example, it is mentioned that “direct benefits” are expected for a participant of a CCA
(para. 3 in the Discussion Draft) without further clarification on what qualifies as “direct benefits”. It is
also mentioned that a participant’s proportionate share of the overall contributions shall be consistent
with the participant’s proportionate share of the overall expected benefits “over a period of years” (para.
30 in the Discussion Draft); while a reference to the para. 3.75-3.79 of the Transfer Pricing Guidelines is
included, it is not clear how to determine a reasonable “period of years” and whether such a period may
vary depending on the activity at hand.

We are also concerned with the proposals for “disregarding” part or all of the terms of a CCA. In our view,
this continues a troubling trend in other recent discussion drafts under Actions 8-10 of recharacterizing
legitimate transactions. That will lead to a great deal of uncertainty and chaos, especially in the likely
event that tax authorities take different views on when it is appropriate to exercise this expanded ability to
disregard transactions. Subject to the presence of economic substance, we believe it makes far more sense
to accept the transaction as set forth in contractual arrangements and simply make any appropriate
adjustments to ensure arm’s length pricing between related parties. Thus, we believe a comment would be
helpful that before disregarding the entire CCA, an analysis should be performed of the costs shared
between the participants and whether potential adjustments to the sharing of those costs might result in
an appropriate arm’s length outcome. This would also limit potential disputes.

The mechanics of how to practically apply the CCA rules are not covered by the Discussion Draft. For
example, it is unclear how income that results from a joint ownership of IP developed under a
development CCA should be handled: if one participant receives income from a user of the IP outside the
CCA, it is unclear how transactions between the CCA participants with the purpose to share income shall
be handled from other tax perspectives. It would be worth thinking about including a statement regarding
joint ownership for such IP and about whether payments to share income between the owners shall be
considered as transactions at all for other tax purposes. Another issue including potential for increased
disputes is balancing payments. These payments might also trigger certain secondary tax consequences. It
remains unclear if a balancing payment from an over/undercompensated CCA participant to another CCA
participant can have any effect on payments made outside of the CCA to the participants. One
interpretation could be that the payment coming from outside of the CCA is the reason for the recipient to
be over/undercompensated, concluding that the payment was not at arm’s length. It could therefore be
clarified in the guidelines that there might be a need for balancing payments between the CCA
participants due to incorrect income allocation among them but that the existence of balancing payments
should not allow countries outside the CCA to challenge IP payments made towards any CCA participant
for the use of the IP created by the CCA.

These comments highlight what we believe to be the most significant conceptual flaws in the Discussion
Draft. Below are further details on the practical handling of CCAs which are needed for companies and tax
authorities to have a more common view and predictable interpretation of how to handle CCAs for
transfer pricing.
Comments and Recommendations to specific paragraphs in the proposed revisions to Chapter VIII of the Transfer Pricing Guidelines

Para. 3: “direct benefits”

The Discussion Draft states that “intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants”. It is unclear why contributions in a CCA necessarily should have a “direct” benefit and could not have indirect benefits. In our opinion, when independent parties enter into transactions they may very well receive “indirect” benefits, or other types of benefits. It would be helpful including clarification upon the differences between “direct” and “indirect” benefits. An additional example could be included to make more clear what benefits are deemed as approvable direct benefits under a CCA, and what benefits are not. Last, the emphasis on “direct” benefits as opposed to the previous possibility to “indirectly” benefit from the interest in a CCA is likely to increase the expectations of tax administrations when it comes to the income earned as a consequence of being a participant to a CCA.

Para. 6 and 33: “Netted payments” and “Eliminate complex cross-licensing”

It is mentioned (para. 6) that as one advantage of CCAs, “a web of separate intra-group arm’s length payments” can be replaced with “netted payments”, and “complex cross-licensing arrangements” can be eliminated. It is further mentioned (para. 33) that contributions to a CCA need to be treated under general local tax rules (respectively for each participant). At the same time, the existing Guidelines recommend, when possible, to segment transactions in order to avoid the aggregation of transactions as such an aggregation would make it more difficult to identify the remuneration of each transaction. Therefore, to avoid confusion, we recommend the final chapter VIII to link the guidance on “netted payments” to the existing guidance on segmented and aggregated transactions.

Moreover, we recommend considering whether it may be worth including clarification with respect to the need for considerations of netted or eliminated payments from other tax perspectives (e.g., VAT or withholding tax). A possible interpretation of a development CCA could be, for example, that the participants form a joint owner with regards to the developed IP and that any payments between the partners of such partnership are not treated as transactions or exchange of services and consequently do not trigger any VAT or withholding tax consequences.

Para. 17: “Hindsight”

It is further stated under para. 17 that “tax authorities might be prompted to enquire whether projections [of benefits] made would have been considered acceptable by independent enterprises in comparable circumstances [...] without using hindsight.”

We agree on this statement and stress the need to consider all of the developments that were reasonably foreseeable by the parties and not to use hindsight in the final revision of chapter VIII, so as to help mitigate the risk of disputes.

Para. 23: “Low value services”

We appreciate the suggestion to accept measuring contributions to “low value-added services” by costs. In order to mitigate the risk of disputes, we recommend including a link to the definition of low value services as is provided in the revised chapter VII. However, the Discussion Draft summarily concludes that costs will generally not provide a reliable basis on which to value contributions for development

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6 See para. 8.10 of the 2010 OECD Transfer Pricing Guidelines.
7 E.g. as an “undisclosed partnership” (“Innengesellschaft”) in German tax law.
CCA’s, drawing a contrast in effect with service CCAs. This is not always the case in which one or more components of the contributions to any CCA are comprised of low value-added services.

**Para. 26 and example 4: “Important functions”**

Para. 26 mentions that, “For development CCAs, contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets and should be valued in accordance with the principles set out in Chapter VI.” Such functions need to be remunerated above a limited return. We suggest clarifying the fact pattern of Example 4. On the one hand, Example 4 states that Company A should receive a risk-adjusted rate of anticipated return on its funding commitment including extensive analysis and risk interpretation as well as a judgement of the other participant’s risk handling capacity. In our view it is unclear whether these functions include certain “important functions”. If this is the case, Para. 26 may be fully in line with Example 4 of the Discussion Draft. Another interpretation of Example 4 could be that Company A performed the functions described under Para. 58 for its own development activities only before entering the CCA, but under the CCA only provides the funding (financial capacity) without performing the functions listed. Such differing interpretations suggest clarification of Example 4 would be beneficial.

Further clarification should be provided as to the term “important functions”. A reference to the definition provided in the revised chapter VI might be helpful, especially given the goal of achieving consistency with the other amendments to the OECD Transfer Pricing Guidelines. Moreover, the determining factors of an appropriate risk-adjusted return are not explained; guidance in that respect would help prevent disputes.

**Para. 29: “Incorrect determination of values”**

Under para. 29, “Balancing payments may also be required by tax administrations where the value of a participant’s proportionate contributions of property or services has been incorrectly determined, or where the participants’ proportionate expected benefits have been incorrectly assessed.”

As it will often be difficult to perform precise valuations of contributions (e.g., how to value “control of functions”) and that the Discussion Draft does not provide concrete guidance on how to perform such valuations, we see an increased risk for disputes resulting from the tax authorities requiring balancing payments. A reference to the existing methods for evaluating contributions would be helpful. It should also be kept in mind that potential disputes might affect more than one/two countries, since potentially all the participants to a CCA may be affected by claims from their residence countries.

**Para. 42: “the arrangement would require balancing payments”**

The Discussion Draft seems to require that balancing payments are made on a regular basis and potentially for an undefined period of time during the length of the CCA given the apparent assumption that the proportionate shares of expected benefits among the participants necessarily varies with time (Para. 42(e) of the Discussion Draft). Although possibly correct from a theoretical perspective, this assumption would certainly trigger disputes as tax administrations may easily challenge the extent or the lack of balancing payments. The need for and the extent of balancing payments would become a highly subjective matter. Therefore, we would suggest replacing the word “would” with “may”, and to add the word “possible” before the word “changes” at Para. 42(e) of the Discussion Draft. Such amendments would not impinge the theoretical need to make balancing payments, while at the same time preventing unreasonable claims from tax administrations. Such amendments would also, in our opinion, be consistent with the guidance provided at Para. 27-30 of the Discussion Draft.
Considering the aspects previously mentioned, we further advise that the Discussion Draft, as to be revised prior to the G20 finance ministers meeting on September 4-5, 2015, is finalized in a manner fully consistent with the other relevant BEPS Action Items and changes to the OECD Guidelines. Furthermore, given that the final revisions to the Guidelines will significantly change existing Chapter VIII of the Guidelines, we recommend that existing CCAs be grandfathered from these changes as to the ongoing operation of such existing CCAs.

On behalf of the global network of PwC Member Firms, with the contribution of our colleagues Henry An, Ian Dykes, David Ernick, Marios Karayannas, and Jérôme Monsenego, we respectfully submit our response to the OECD BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs). We welcome the opportunity to participate in the public consultation on these and other transfer pricing issues on July 6-7, 2015. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

Isabel Verlinden
Partner
PricewaterhouseCoopers, Brussels

Adam M. Katz
Partner
PricewaterhouseCoopers LLP, New York

cc Stef van Weeghel, Global Tax Policy Leader

<table>
<thead>
<tr>
<th>PwC Contact</th>
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</tr>
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<tbody>
<tr>
<td>Adam Katz</td>
<td><a href="mailto:adam.katz@us.pwc.com">adam.katz@us.pwc.com</a></td>
</tr>
<tr>
<td>Isabel Verlinden</td>
<td><a href="mailto:isabel.verlinden@be.pwc.com">isabel.verlinden@be.pwc.com</a></td>
</tr>
<tr>
<td>Henry An</td>
<td><a href="mailto:henry.an@kr.pwc.com">henry.an@kr.pwc.com</a></td>
</tr>
<tr>
<td>Ian Dykes</td>
<td><a href="mailto:ian.dykes@uk.pwc.com">ian.dykes@uk.pwc.com</a></td>
</tr>
<tr>
<td>David Ernick</td>
<td><a href="mailto:davidernick@us.pwc.com">davidernick@us.pwc.com</a></td>
</tr>
<tr>
<td>Marios Karayannas</td>
<td><a href="mailto:marios.karayannis@us.pwc.com">marios.karayannis@us.pwc.com</a></td>
</tr>
<tr>
<td>Jérôme Monsenego</td>
<td><a href="mailto:jerome.monsenego@se.pwc.com">jerome.monsenego@se.pwc.com</a></td>
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</table>
To Mr. Andrew Hickman - Head of Transfer Pricing Unit, Centre for Tax Policy and Administration.

Email: TransferPricing@oecd.org

Dear Mr. Hickman, dear Andrew

Please find attached the comments of Quantera Global in respect of the Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements.

Kind regards,

Richard Slimmen
Managing Director
M: +31 6 50 88 94 37
E: r.slimmen@quanteraglobal.com

Quantera Global

The Transfer Pricing Specialists
ASIA Brisbane | Ho Chi Minh City | Hong Kong | Jakarta
Kuala Lumpur | Manila | Shanghai | Singapore | Sydney | Tokyo
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www.quanteraglobal.com
Comments on
the Discussion Draft on Revisions to Chapter VIII of the Transfer
Pricing Guidelines on Cost Contribution Arrangements

By

Quantera Global
Quantera Global welcomes the opportunity to provide its comments to BEPS Action 8: Proposed Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (“Discussion Draft”).

We highly appreciate the work that the OECD has done so far and appreciate the difficulty of the matter. We have opted to provide more general comments on the Discussion Draft.

We look forward to discussing these matters in more detail during the public consultation in July 2015.

General observations

We believe the discussion draft provides for a good update of the CCA guidance. It is aligned with the general tendency of other BEPS Actions to put emphasis on realistic substance. We do feel however that there still is a difficult challenge to get to a reasonable implementation of this concept.

We have some difficulty in understanding the statement that ‘outcomes for participants under a CCA should not differ significantly from the outcomes of transfers or development of intangibles for parties outside a CCA’. We believe that there may be good reasons for participants to consider a CCA as it might provide for specific benefits compared to not applying a CCA. Where it is meant to indicate that the contributions made by parties should be valued equally whether within or outside the context of a CCA this might be made more clear. We assume it is not intended to suggest that a CCA could no longer be a useful tool to structure international transactions in a way that would best fit a MNE. The wording in paragraph 6 seems to better reflect the focus on value of the contributions made.

Value versus costs

We welcome the clear choice for applying the arm’s length value of the respective contributions to determine the relative contributions of participants. The clear choice may help to avoid unnecessary disputes and therefore support practical application. We agree that applying value instead of costs seems to best reflect arm’s length behaviour. At the same time we appreciate the suggestion to apply costs when it involves low value services as this may avoid unnecessary compliance burden for participants. This is however only to be seen as a pragmatic approach.

Expected benefits should drive the allocation of contributions

When applying the concept of a CCA it is clear that the expected benefits are leading in the sense that the allocation of the benefits over the participants is determining the allocation of proportionate contributions over the participants. When there is a mismatch the adjustment would be made in the allocation of contributions to the participants. We believe this to be logical and appropriate. However the Discussion Draft seems to bypass
this concept when it suggests to adjust the allocation of benefits instead of the allocation of contributions.

Qualification of participants

The Discussion Draft introduces new criteria for parties to be able to qualify as participant to a CCA. This includes the introduction of reference to ‘direct benefits’ as well as introduction of the ‘control over risk’ concept.

Benefits of a participant

There is a clear indication that a participant should have some direct benefits from participating in the CCA (par. 3). This deviates from the current guidance where both direct and indirect benefits are considered to determine whether one could qualify to be a participant in a CCA. In the further paragraphs the distinction between direct and indirect benefits is not further clarified. Under the current guidance indirect benefits would include licensing of the intangibles developed under the CCA arrangement. We assume it is not intended to exclude a party from being a participant under a CCA if it would only seek or expect to derive any benefits by means of licensing the intangible. Often reference is only made to ‘overall benefits’ or ‘benefits’. Reference is made to paragraph 11 and 12 where one would expect reference to ‘direct benefit’ instead of just ‘benefit. This raises the question whether and when the distinction between direct and indirect benefits would be relevant. Would ‘direct benefit’ only be relevant in determining whether a party would qualify to be a participant? We believe in order for participants to behave in an arm’s length manner it would be necessary to take into account both direct and indirect benefits when determining each participant’s relative contribution. We suggest to further clarify the scope of the ‘direct benefit’ test as referenced in paragraph 3.

Control over risk

The new guidance introduces the concept of control over risk as an essential element in the determination whether a party might qualify as a participant under a CCA. However little specific guidance is given as to what might constitute sufficient control. Especially when a lack of control would exclude a party to qualify as a participant it would be welcomed when some further guidance would be provided in this respect.

Example 4 addresses a control that would allow a party to be recognised as a participant. Still it is suggested that the allocation of benefits is adjusted instead of the allocation of contributions. We feel this to be a deviation of the essence of a CCA. The example introduces a total deviation from the expected CCA benefits and introduces another totally separate expected benefit. It suggests ‘balancing payments’ in the years of development based on expected benefits of the CCA compared to the imputed benefit. We fail to see the logic why the guidance would need to cut loose from the basic concepts of the CCA. It might make more sense to seek a solution along the lines of example 5 when the funder would not be allowed to act as a true participant.

Balancing payments

We welcome the clear instruction to tax administrations to refrain from making adjustments in a single fiscal year without proper consideration of the multiple year results of the CCA.
Disregarding all or part of the CCA

Paragraph 32 indicates that tax administrations may disregard part or all of the CCA when it determines that the balance between contributions and expected benefits would be substantially wrong and the ‘commercial reality is that the participant bearing the disproportionate high share of the contributions should be entitled to a greater interest in the subject of the CCA’. It then is suggested that tax administrations might impute additional compensation for the use of that interest. This seems to provide for potential substantial impact on profits and we would appreciate further clarification when such a case would occur. How to determine ‘commercial reality’? We feel the current wording might stimulate tax authorities to use it without proper evaluation of the facts and circumstances.
Regards: BEPS action 8 - Comments on the discussion draft on revisions to chapter VIII of the Transfer Pricing Guidelines on cost contribution arrangements (CCAs)

Concerns: Introducing a distinction between routine and non-routine contributions and amending the discussion draft’s wording on the tax treatment of balancing payments

Nijmegen, 28 May 2015

Dear Mr. Hickman,

Through this letter I would like to submit the following comments in respect of the OECD’s discussion draft on revisions to chapter VIII of the Transfer Pricing Guidelines on cost contribution arrangements (‘CCAs’).

In particular this letter advocates introducing a distinction between routine and non-routine contributions and amending the discussion draft’s wording on the tax treatment of balancing payments. After some preceding general observations, this is further explained below.
1. **Routine and non-routine contributions**

1.1. **Introduction**

CCAs are generally bona fide arrangements intended to provide MNE group members easy access to group services and facilitate the joint development of tangible and intangible assets, whilst allocating the related costs and risks in line with the arm’s length principle. However, in certain instances CCAs have been known to enable profit shifting by facilitating the transfer of high value intangibles to low substance companies located in tax havens. It is understood that this is the reason for including a revision of the guidance on CCAs as part of BEPS action 8.

Most notably the discussion draft suggests two measures:

(i) To make explicit that participants should have the capacity and authority to control the risks associated with the risk-bearing opportunity under the CCA;

(ii) To require most contributions to be assessed at value rather than costs when testing whether the outcome of the CCA is in line with the arm’s length principle.

The control-over-risk requirement is expected to exclude cash box entities from participation, whilst assessing contributions at value should more generally ensure that profits are taxed where value is created. As such, these are understandable measures that fit in well with the overall BEPS objectives.

At the same time, it should be observed that they are likely to lead to more technical valuation discussions. That will also affect MNEs that use CCAs for legitimate reasons. It implies more uncertainty and could potentially result in double taxation. In my opinion this negative side-effect could be mitigated by introducing a distinction between two types of contributions: routine and non-routine contributions.

1.2. **Definition of routine and non-routine contributions**

Routine contributions are contributions involving limited risk for the contributing participant. That does not only concern performing low value added services and development activities. It also includes performing high value added services and development activities, if the risks associated with those activities are proportionately controlled by and therefore shared with the rest of the participants’ community.
In contrast non-routine contributions are contributions involving significant risk for the contributing participant. This concerns performing high value added services and development activities, if the risks associated with those activities are not proportionately controlled by and therefore shared with the rest of the participant’s community. It also includes making available pre-existing assets (tangible or intangible), which the contributing participant obtained or developed at its own account and risk externally from the CCA.

The difference between routine and non-routine contributions in respect of high value added services and development activities may be further illustrated by the following example:

*Consider a development CCA with two participants: Participant A and Participant B. Only Participant A performs high value added R&D activities.*

*If both participants make decisions about entering into (or terminating) the CCA, the type of R&D activities performed and the available R&D budget, then they both control the risk associated with the R&D activities. They will also proportionately bear the risk of the activities not being successful. As such, the additional contribution made by Participant A consisting only of the performance of R&D activities is similar to contract research and qualifies as a routine contribution.*

*If on the other hand participant B does not have the capacity or authority to control the risk associated with the R&D activities, then the additional contribution made by Participant A consists of more than only the performance of contract research. It also includes taking control over the full risk associated with the R&D activities and by consequence qualifies as a non-routine contribution.*

1.3. **Valuation of routine and non-routine contributions**

Taking into account the limited risk involved in making routine contributions it should be regarded appropriate to value them using the cost-plus method. Moreover, for long term or open-ended CCAs in decentralized organizations it may be assumed that the routine contributions per participant will average out over the years. In that case a valuation at cost could be recommended for practical reasons(1).

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(1) Please note that valuing routine contributions under development CCAs at cost or cost-plus would require amending or deleting the language in paragraph 23 of the discussion draft, which states that for development CCAs costs will generally not provide a reliable basis on which to value contributions.
Unfortunately it is unavoidable that valuation issues will remain in respect of non-routine contributions. This is specifically true for contributions consisting of pre-existing intangibles. In that case the difficulties are not fundamentally different from those in respect of other transactions involving intangibles (not part of a CCA). In this regard tax practitioners will have to revert to the guidance provided in chapter VI as amended under BEPS action 8.

Nevertheless, introducing a distinction between routine and non-routine contributions would help to identify a sizeable number of contributions for which a relatively straightforward valuation method could apply (i.e. routine contributions) and leave a much smaller number of contributions in respect of which valuation issues are likely to arise (i.e. non-routine contributions).

2. **The tax treatment of balancing payments**

A separate issue that I would like to take the opportunity to address concerns the tax treatment of balancing payments. The discussion draft’s wording in this respect is much more general than that of paragraph 8.2 of the current Chapter VIII. This opens up the door to qualifying balancing payments as royalties, which under many bi-lateral tax treaties could result in a withholding tax levied by the source state(2).

However, also under the proposed revised definition of a CCA balancing payments should not constitute a royalty, unless they are related to pre-existing or newly developed intangibles made available for use without the payer becoming an effective owner of those intangibles. Explicitly confirming this interpretation does not appear to contradict with the BEPS objectives, whilst it would help to avoid disputes and potential double taxation. Therefore, it is suggested to include such confirmation either in the revised Chapter VIII of the Transfer Pricing Guidelines or in the Commentary to article 12 of the Model Tax Convention.

3. **Concluding remarks**

Taking into account that CCAs are used to transfer high value intangibles to low tax jurisdictions, it is understandable that a revision of Chapter VIII of the Transfer Pricing Guidelines is included under BEPS action 8. However, it should be observed that the proposed measures do not disproportionately affect bona fide situations.

(2) Even though the OECD Model Tax Convention does not allow for source state taxation on royalties, many bi-lateral tax treaties do.
For reasons explained in this letter I believe that it would limit valuation issues under CCAs, if the revised Chapter VIII would include a distinction between routine and non-routine contributions. It would also be helpful to explicitly confirm that balancing payments should only be treated as a royalty in exceptional cases.

Alternative wording for sections C.4 and C.7 of the discussion draft facilitating these suggestions are attached as an annex.

I hope the foregoing is a useful contribution to the ongoing discussion. I would be more than happy to further elaborate on the contents of this letter, so please feel free to contact me in case of any questions.

Yours sincerely,

[Signature]

Dennis J.R. Nijsen LLM

External researcher at the Radboud University of Nijmegen, the Netherlands, writing a PhD-thesis on CCAs, and in-house tax lawyer with a Dutch based MNE
ANNEX: Alternative wording for sections C.4 and C.7 of the discussion draft on revisions to chapter VIII of the transfer pricing guidelines on cost contribution arrangements (CCAs)

C.4 The value of each participant’s contribution

20. For the purpose of determining whether a CCA satisfies the arm’s length principle – i.e. whether each participant’s proportionate share of the overall contributions to the CCA is consistent with the participant’s proportionate share of the overall expected benefits – it is necessary to measure the value of each participant’s contributions to the arrangement.

21. Contributions to a CCA may take many forms. For services CCAs, contributions primarily consist of the performance of the services. For development CCAs, contributions typically include the performance of development activities (e.g. R&D, marketing), and often include additional contributions relevant to the development CCA such as tangible assets or intangibles. Irrespective of the type of CCA, all contributions of current or pre-existing value must be identified and accounted for appropriately in accordance with the arm’s length principle. Since the value of each participant’s relative share of contributions accords with its share of expected benefits, balancing payments may be required to ensure this consistency. The term ‘contributions’ as used in this Chapter includes both initial or ongoing contributions made by participants to a CCA as well as any balancing payments that may be required. See section C.5.

22. Under the arm’s length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution. That is, contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle. In determining the value of contributions to a CCA the guidance elsewhere in these Guidelines should be followed.

23. It is sometimes the case that the value (i.e. the arm’s length price) of services contributed to a CCA corresponds to the costs associated with providing those services. It may also be the case that the difference between the value and costs is relatively modest, such as for low value-added services described in Chapter VII. In this case it is recommended for practical reasons to value contributions at cost. However, in all other circumstances (for example where contributions include a mixture of low and high value adding services and/or intangibles or other assets) costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and the use of costs may lead to non-arm’s length results. For development CCAs costs will generally not provide a reliable basis on which to value contributions. See examples 1-3. For the purpose of valuing contributions it is useful to distinguish routine and non-routine contributions. Routine contributions are contributions involving limited risk for the contributing participant. This concerns performing low value added services and development activities as well as high value added services or development activities, if the risks associated with those high value added services or development activities are proportionately shared with the other participants in the CCA. Non-routine contributions are contributions involving significant risk for the contribution participant. This concerns performing high value added services and development activities, if risks associated with those high value added services are not proportionately shared with the other participants in the CCA, as well as making available pre-existing tangible or intangible assets that the contributing participant obtained or developed externally from the CCA.

24. Routine contributions are appropriately valued using the cost-plus method. It may be the case that the difference between value and costs is relatively modest, such as for low value added services described in Chapter VII. It may also be the case that each participant is reasonably expected to make the same amount of routine contributions over the entire term of the CCA, such as with long term or open ended CCAs in decentralized organizations. In these cases it is recommended for practical reasons to value routine contributions at cost.
25. In respect of non-routine contributions costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and the use of costs may lead to non-arm's length results. To the extent that non-routine contributions consist of controlling and managing development CCAs, its activities and risks, they are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of intangibles and should be valued in accordance with the principles set out in Chapter VI. The same applies for non-routine contributions that consist of making available pre-existing intangibles.

24-26. Since contributions are based on expected benefits, this generally implies that where a cost reimbursement basis for valuing contributions is permitted, the analysis should initially be based on budgeted costs. This does not necessarily mean fixing the costs, since the budget framework may accommodate variability arising from factors such as varying demand levels (for instance budgeted costs may be expressed as a fixed percentage of actual sales). Additionally, there are likely to be differences between budgeted costs and actual costs during the term of the CCA. In an arm’s length situation, the terms agreed between the parties are likely to set out how such differences should be treated since, as stated in paragraph 2.96, independent parties are not likely to use budgeted costs without agreeing what factors are taken into account in setting the budget and how unforeseen circumstances are to be treated. Attention should be paid to the reason for any significant differences between budgeted costs and actual costs, since the difference may point to changes in the scope of activities which may not benefit all the participants in the same way as the activities originally scoped. In general terms, however, where cost is found to be an appropriate basis for measuring contributions, it is likely to be sufficient to use actual costs as the basis for so doing.

25-27. It is important that the evaluation process recognises all contributions made by participants to the arrangement. This includes contributions made by one or more parties at the inception of the CCA (such as contributions of pre-existing intangibles) as well as contributions made on an ongoing basis during the term of the CCA. Contributions to be considered include property or services that are used solely in the CCA activity, but also property or services (i.e. shared property or services) that are used partly in the CCA activity and also partly in the participant’s separate business activities. It can be difficult to measure contributions that involve shared property or services, for example where a participant contributes the partial use of assets such as office buildings and IT systems or performs supervisory, clerical, and administrative functions for the CCA and for its own business. It will be necessary to determine the proportion of the assets used or services that relate to the CCA activity in a commercially justifiable way with regard to recognised accounting principles and the actual facts, and adjustments, if material, may be necessary to achieve consistency when different jurisdictions are involved. Once the proportion is determined, the contribution can be measured in accordance with the principles in the rest of this chapter.

26. For development CCAs, contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets and should be valued in accordance with the principles set out in Chapter VI.

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C.7 The tax treatment of contributions and balancing payments

33-34. Contributions, including any balancing payments, by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA, to carry on the activity that is the subject of the CCA. The character of the contribution will depend on the nature of the activity being undertaken by the CCA, and will determine how it is recognised for tax purposes.

34-35. In services CCAs, a participant’s contribution to the CCA will often give rise to benefits in the form of cost savings (in which case there may not be any income generated directly by the CCA
activity). In development CCAs, the expected benefits to participants may not accrue until some time after contributions are made, and therefore there will be no immediate recognition of income to the participants on their contributions at the time they are made.

35-36. Any balancing payment should be treated as an addition to the contribution of the payer and as a reduction in the contribution of the recipient. As with contributions generally, the character and tax treatment of any balancing payments will be determined in accordance with domestic laws, including applicable tax treaties. For these purposes a balancing payment should not constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property itself.
Dear Mr. Hickman,

RBS RoeverBroennerSusat welcomes the opportunity to submit comments on the Discussion Draft, “BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)”. We appreciate this opportunity to share our views and hope you find our comments useful in your work on BEPS.

In addition to providing comments regarding the CCAs, it is our intention to direct your attention towards specific issues of relevance for small and medium-sized companies (SMEs).

As the Discussion Draft does not contain specific questions for consultation, we would like to focus on the following core aspects:

- Measuring contributions at value rather than at costs (Section 1)
- Balancing Payments (Section 2)
- Structuring and documenting CCAs (Section 3)

Our general evaluation of the Discussion Draft is that it constitutes a sensible follow-up of the preceding consultation process and is largely consistent with the revised Chapter VI of the Transfer Pricing Guidelines ("TPGs"). The focus of the Discussion Draft is clearly on providing additional guidance on how to ac-
count for intangibles in the context of Cost Contribution Agreements ("CCAs"). Again, while the focus appears sensible, the potential benefits of a closer alignment of the guidance on CCAs with Chapter VII (specifically with the proposed simplified benefit test) have not been (fully) realized. As pointed out in our response to BEPS Action 10, a simplified benefit test may reduce legal uncertainty in respect to transfer pricing of low value added services.

Limiting documentation and reporting requirements for services CCAs relating to low value added services would be a welcome contribution to prevent further administrative burden, particularly for SMEs. Thus, we encourage the OECD to widen the scope of application for the simplified benefit test in the context services CCAs.

1. Measuring contributions at value rather than at costs

The revised provisions of Section B.3 (para. 8 and para. 9) TPGs provide a more distinct delineation between the two types of CCAs, development CCAs and services CCAs, by emphasizing that the key difference between the two types will often be that the former are expected to create ongoing, future benefits for the participants, while the latter will often create current benefits only.

We concur with the assessment of the OECD (revised Section C.4. (para. 23)) that for development CCAs costs will generally not provide a reliable basis on which to base value contributions.

In respect to services CCAs, the OECD correctly points out that the difference between value and the costs is relatively modest for low value-added services (revised Section C.4 (para. 23)) and that for practical reasons it is therefore sensible to value contributions at cost. We hold the subsequent stipulation, namely “However, in all other circumstances (for example where contributions include a mixture of low and high value-added services and/or intangibles and other assets) costs are unlikely to provide a reliable basis for determining the value of the relative contribution of the participants, and the use of costs may lead to non-arm’s length results”, to be overly restrictive and highly impractical.

For defining low value-added services, Section C.4 (para. 23) includes a general reference to Chapter VII. While no specific reference to para. 7.46 of Chapter VII is made, it must be assumed that the respective guidance for identifying low value-added services should also apply in the context of service CCAs. It remains, however, unclear whether activities listed in para 7.47 of Chapter VII, including manufacturing as well as marketing and distribution, which do not qualify for the simplified benefit test, would automatically be regarded as high value-added services in the context of service CCAs. While we have already pointed out that disqualifying manufacturing services as well as marketing and distribution activities from the simplified benefit test appears unnecessarily restrictive, we have grave concerns that adopting a similar approach in the context of service CCAs would minimize the scope for valuing contributions at costs.
Specifically, the following three aspects appear questionable:

- Disqualifying a broad range of activities without considering the specific nature of the value-added
- Assuming that any mixture of low and high value added services renders costs unreliable as a basis for determining the value of relative contributions
- Assuming that any intangible (i.e. not only unique and valuable intangibles) renders costs unreliable as a basis for determining the value of relative contributions

In deciding whether costs constitute a reliable basis for determining the value of contributions, it must be decisive whether the results are commensurate with the arm’s length principle. Depending on the facts and circumstances of a specific service CCA, it is not evident that i.e. a mixture of low and high services renders costs unreliable for determining the value of contributions. In case that the high value-added services are of routine nature (i.e. not based on unique and valuable intangibles) determining the value of contributions based on costs should generally not lead to non-arm’s length results. Considering that remuneration or profit mark-up for low-value added services should generally be in a range between 2% and 5% (para. 7.57 of Chapter VII) combining these services with services that are not depending on unique and valuable intangible (routine services with a mark-up between 5% and 10%) would imply a comparatively minor difference between value and costs of contributions. In these circumstances determining the value of contributions should generally be commensurate with the arm’s length principle. The provisions contained in Section C.4 (para. 23) should allow taxpayers sufficient flexibility in evaluating whether costs are reliable basis for determining the value of contributions for their specific service CCA. In this context it should also be considered that the potential implication of service CCAs on BEPS can be assumed to be comparatively minor.

We would welcome a further revision of the provisions contained in Section C.4 (para. 23). Additional guidance on how to account for low value-added services and services that do not depend on unique and valuable intangibles would be welcome and could be integrated in Example 2 of the Discussion Draft.

2. Balancing Payments

The Discussion Draft puts an increased emphasis on the requirement of balancing payments for ensuring consistency between the values of each participant’s relative share of contributions with its share of expected benefits. While requirement of balancing payments in the context of CCAs is evident, we are concerned that some provisions contained in the Discussion Draft imply rather strict requirements regarding the accuracy of balancing payments. Section C.5 para. 29 appears rather vague in stipulating that tax administrations can require the taxpayer to conduct balance payments when the value of a participants contribution has been “incorrectly determined” or where the expected benefits have been “incorrectly assessed”.
In order to provide unambiguous guidance, the OECD should clarify the terms indicated above.

We hold the opinion that any balance payments requested by tax authorities should be strictly limited to cases in which substantial indications for an infringement of the arm’s length principle have been identified. In this context it should be stressed that the value of contributions will generally fall within an arm’s length range of “correct” transfer prices. Similarly to not making adjustments based on the results for a single fiscal year, tax authorities should thus refrain from making adjustments in cases where the participants contribution or expected benefits falls within an arm’s length range. Respective guidance should be illustrated in an additional example.

3. Structuring and documenting CCAs

In regards to Section C.1 para. 11 (para. 8.9 current TPGs), we hold the opinion that ultimately the burden of proof in transfer pricing issues should be on the tax administration. While it is reasonable to expect taxpayers to be prepared for substantiating the basis of their claim with respect to the CCA (Note: Section E, not Section D), the principle of proportionality should be observed.

We concur with Section E para 43 insofar as the application of prudent business management principles would indeed lead participants in a CCA to prepare or obtain materials about the nature of the subject activity, the terms of the arrangement and its consistency with the arm’s length principle. It would, however, also appear to follow from the application of prudent business management principles that the required level of detail of respective materials depends on the economic importance of the agreement for the taxpayer relative to other transaction as well as on the ease with which a prudent business manager can substantiate the benefits of participating in the CCA. For service CCAs the arm’s validating the arm’s length nature of the agreement should require comparatively little information. For service CCAs determining the value of contributions based on costs a one-side approach (comparing the costs and benefits of the individual taxpayer without considering the total costs and benefits of other participants) would theoretically be sufficient in order document consistency with the arm’s length principle. In order to account for the principle of proportionality and to prevent further administrative burden, particularly for SMEs, we would welcome the introduction of respective de minimis rules and/or a simplified benefit test. Again, the tradeoff implied in implementing de minimis rules is to be regarded as positive as potential implications of service CCAs on BEPS can be assumed to be comparatively minor.

Further it should be observed that the stipulations in Section E para 42 as well as para 44 are stricter (more comprehensive) than the current TPGs (Section F para 8.40 and para 8.42). The documentation of management and control activities (para 44 c) as well as of respective mechanisms (para 44 h) while sensible in the context of development CCAs could translate into an additional administrative burden, as respective mechanism are seldom available in writing. This also applies to the documentation of expected benefits of
each participant para 42 b as well as the documentation of the manner in which any future benefits are expected to be exploited para 44 f. Lastly, para 42 e requires a CCA to include balancing payments while para 8.40 e merely stipulated that a CCA would allow for balancing payments.

We remain at your disposal for any further discussion of these issues.

Yours sincerely,

RBS RoeverBroennerSusat GmbH & Co. KG
Wirtschaftsprüfungsgesellschaft
Steuerberatungsgesellschaft

Gertrud R. Bergmann
Diplom-Kauffrau
Wirtschaftsprüfer
Steuerberater
Partner

Marcus von Goldacker
Diplom-Kaufmann
MBA (International Taxation)
Steuerberater
Partner
Dear Sir/Madam

BEPS Action 8: Discussion Draft on the Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

We are writing in response to the OECD’s request for comments in relation to the Discussion Draft on the Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) released on 29 April 2015.

RELX Group (formerly Reed Elsevier) is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. RELX Group operates in more than 30 countries and employs approximately 28,500 people worldwide.

We set out below our representations on the discussion draft. Our representations are focused on the key issues for our business in relation to the discussion draft as follows:

1. Our primary concern is that the revisions outlined in the discussion draft would appear to represent a fundamental change in the application of CCAs under the OECD transfer pricing guidelines.

   Cost contribution arrangements have existed for a very long time among third parties and for half a century in the more modern forms. They serve important commercial purposes well and provide an efficient and effective mechanism for joint development and common business functions. It would be extremely unfortunate if this valuable, well-understood and commonly used facility was abolished simply because in some cases it has given rise to BEPS. Any measures designed to address BEPS should be measured, commensurate with the problem and appropriately targeted. The present draft goes too far.

   Under the existing guidelines a CCA enables business enterprises “to share the costs and risks” whereas the revisions outlined in the discussion draft enable business enterprises “to share the contributions and risks”. Paragraph 23 of the discussion draft makes it clear that, other than in the case of a CCA relating to low value-added services, cost is not regarded as a reliable basis for valuing contributions. It therefore would appear slightly confusing to continue to refer to this as a “cost” contribution arrangement as in most cases the contributions would not be valued at cost under the revised guidelines. It would therefore seem more
appropriate to refer to the type of arrangements outlined within the discussion draft as “value”
contribution arrangements”.

Under the existing guidelines each participant to the arrangement agrees to share the costs of a specific
activity. CCAs are used within our business for the development of global technology platforms which host
content used by our operating companies around the world. Developing a global platform creates
commercial benefits for the RELX group as it allows our products around the world to have the same overall
look, feel and functionality while supporting the use of relevant local content sets. Developing a global
platform is also less expensive to develop and maintain than a large number of individual platforms specific
to each country.

At the start of such a project, each party will agree to share the costs of developing the platform, whether
the subsequent development activity is successful or not. We consider that the success of the platform is
the largest risk involved and therefore by agreeing to share the costs of the development, whether
successful or not, in proportion to the expected benefits, the participants to the arrangement are sharing
the major risk associated with the development activity.

It is our view that the principle of cost sharing is an important one for businesses when undertaking
development activities, with clear commercial benefits for all parties to the arrangement. We consider
such sharing of costs to be consistent with the arm’s length principle where the costs are shared in
proportion with the expected benefits of the project. It is our view that our local businesses would be less
supportive of the use of CCAs for such development activities if the implementation became more
complicated by the need to value contributions using methods other than cost. For these reasons we
suggest that the revised guidance should continue to permit the use of cost sharing CCAs for development
projects.

2. Paragraph 23 of the revised guidance suggests that low value-added services may be valued at cost for the
purposes of a CCA. It would be helpful to have clarification as to how this statement should be
distinguished from the discussion draft on low value-added services which permits a mark-up in the range
of 2-5%.

For example, the discussion draft on low value-added services indicates that once a business has elected to
apply this methodology, it should be applied consistently to all the low value-added services. Does this
therefore mean that where a MNE has a fixed cost plus mark-up under the low value added-services
methodology, it is not also able to have a CCA at cost relating to low-value services?

3. Paragraph 13 of the revised guidance states that participants must have the “capability and authority to
control the risks”. As outlined in in our comments at point 1, we consider that the major risk relating to
CCAs is the risk that the activity will be unsuccessful. We would consider that in these cases as long as the
participant can choose whether or not to sign up to the CCA and is able to withdraw from the CCA then
they have the capability and authority to control this risk. This ability to choose to take on the risk-bearing
opportunity, as well as the option to withdraw from the CCA as a response to the risks identified, should be
considered sufficient to enable qualification as a participant to the CCA. It is therefore our view that the
guidance should be amended to reflect this.

4. Paragraph 19 of the revised guidance discusses the need to account for differences between the expected
and actual benefits received by the participants of the CCA. Whilst we agree that a periodic review of
allocation keys going forward would be a sensible approach, we are concerned that this paragraph could be interpreted to suggest a true-up is required to charges that have already been made to account for such differences in the expected vs actual benefits. In our view such a true up would affect the level of risk borne by the participants because, as outlined previously, one of the major risks is that the participants would bear the costs of the project being unsuccessful. We therefore feel that this section should be further clarified.

5. Paragraph 26 indicates that activities undertaken in controlling and managing the CCA and its activities are likely to be important development, enhancement, maintenance and protection (DEMP) functions and should be valued in accordance with chapter VI of the OECD guidelines. As outlined at point 1, we consider that sharing the cost of development should be permitted under a CCA and therefore do not agree with the wording of this paragraph. We typically consider a CCA in its current form to be an alternative method to the five principal transfer pricing methods outlined in the OECD guidelines. Changing the overall approach relating to CCAs from a cost contribution approach to a value contribution approach increases the complexity of a CCA and compromises the businesses operational efficiency.

6. Section C5 of the guidance discusses the need for balancing payments where the value of a participant’s contributions under a CCA is not consistent with a participant’s share of expected benefits. As with our comments at point 4, our view is that it is important that this should not be taken to mean a “true-up” for the actual share of benefits received which could impact the risks assumed by the participants. Furthermore it should be noted that some projects undertaken as CCAs can take place over a number of years and the “expected benefits” of participants can vary over the course of the project and could therefore be different at any given point in time. As tax audits happen retrospectively we have some concerns that tax authorities may use current data regarding expected benefits to adjust prior year allocations under CCAs. We therefore think the guidance should be clarified to indicate that this should not be the case.

7. Paragraphs 31 and 32 are concerned with disregarding all or part of the terms of a CCA. We believe that this should be reserved for exceptional cases where the facts and circumstances are not consistent with the arrangements between the parties.

8. Examples 1, 2 and 3 – These 3 examples are essentially based on the same underlying fact pattern and although these examples are expressed clearly it is not immediately obvious to us how the CCA for services detailed in the example differs from a TNMM (e.g. cost plus) method using an indirect charging methodology with units consumed as the allocation key. We would therefore be grateful for further clarification of how the application of CCAs under the revised guidance would differ from applying the standard TP methods. Additionally, example 2 would appear to be effectively allowing low value services to be recharged at cost. If this is the intention it would seem more straightforward to allow for low value-services to be recharged at cost in the low value-services guidance.

9. Examples 4 and 5 – We do not agree that these examples are consistent with the arm’s length principle. It is likely that there would be examples of third parties operating at arm’s length who would agree to a situation where one party contributes the development skills and expertise and the other party contributes principally funding, in exchange for an ownership share of the asset developed under the arrangement. Therefore, limiting one party’s return to a risk adjusted return on its funding in such circumstances would go against the arm’s length principle. In relation to example 5, we would consider that by providing the funding, company A has made the decision to take on the risk that the development project will be
unsuccessful. As outlined in our previous comments we consider that this is often one of the largest risks involved with such projects and therefore do not see how Company A could be considered to have “no capacity to make decisions to take on or decline the risk bearing opportunity” in this scenario.

We would like to thank you for providing us with the opportunity to comment on the discussion draft and look forward to being included in the discussion process. We would be happy to present our views at the public consultation scheduled for July 2015.

Yours faithfully

[Signatures]

Paul Morton
Catherine Harlow
Paul Hewitt
Andrew Hickman  
Head of Transfer Pricing  
Unit Centre for Tax Policy and Administration  

Paris, 29/05/2015  

CONFIDENTIAL  

OECD Discussion Draft under BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)  

Dear Mr. Hickman,  

We welcome the opportunity to comment on the Discussion Draft. We renew our support to the OECD BEPS Action Plan to address weaknesses and distortions in the international tax environment and our comments reflect the necessity to ensure that the proposed measures are manageable, well targeted, and proportionate in the context of the efficiency of pharmaceutical operations / pharmaceutical business model. We are pleased to contribute our comments below.

1. Costs typically do not provide a reliable basis for valuing the contributions of the participants to a CCA  

One of the significant changes introduced by this draft compared to prior guidance is the proposal that costs typically do not provide a reliable basis for valuing the contributions of the participants to a CCA (paragraph 23 of the report, and examples 1 through 3 of the annex). Under this proposal, all of the major R&D and other development activities contributed by the participants to a CCA would need to be accounted for at arm’s length prices. We believe that such a view is consistent with the features of other actions (on intangibles valuation for instance) and with usual practice in the pharmaceutical industry. Nevertheless, there are always exceptions to common rules and in some instances and under certain circumstances, third parties can also deviate from such approach.

The pharmaceutical industry is one of the most research intensive industries. Developing an innovative new drug takes more than 10 years over which the flows and proportionate shares of CCA participant may vary (in nominal amounts as well as in relative value). In addition, the financial cost of tying up significant capital investments in multiyear drug development projects, earning no return until and unless a project succeeds, represent a significant part of costs borne by pharmaceutical companies. That “opportunity cost” of capital reflects forgone interest or earnings from alternative uses of the capital. Opportunity costs are common to all innovative industries, but they are particularly large for pharmaceutical firms because of the long time that is often required to develop a new drug combined with the high risk of failure in the process development. As such in order to properly weigh the contributions of CCA participants it is necessary to weigh the costs to reflect the opportunity costs of those contributions (with for example a properly risk adjusted WACC factor for the cost of capital aspect and adequate consideration of the clinical possibilities of success).

The pharmaceutical industry is characterized by high attrition rates that are variable depending on the phase of development. As such, the relative value of a particular stage cannot be derived simply by considering the original out of pocket costs. The relative poor success rate of early stage development drives up the unitary full economic
costs of achieving that success as research and early stage development does not ultimately produce a commercially viable product. Thus the relative value of a successful development is not equally correlated to the unitary out of pocket costs of development depending on the clinical development phases that are considered.

We believe that a failure to incorporate a significant weighting factor for the time value of money and the corresponding intrinsic risk of the development activity is likely to generate an incorrect and seriously flawed result.

If such a lack of correlation between the value of a contribution and the associated nominal costs is acknowledged for purposes of intangibles or contribution valuations in the context of Cost Contribution Agreements, we are of the opinion that a similar approach should be retained in Action 5 and more specifically on the modified Nexus approach. Indeed, while the Nexus approach is not directly correlated to the value of the intangible, and its remuneration, it does aim to be an “economic proxy” for concepts like activity and substance. By retaining sole nominal costs in its formula, the modified Nexus approach should fail to accurately capture the contribution of the taxpayer, as its contribution would not take into account the complexity and the reality of developing a product in our industry, especially if such Nexus approach is applied on a product by product basis.

It is therefore our opinion that there should be a conceptual alignment in the proper valuation of contributions to the generation of intangibles in the different BEPS related drafts (for instance between Action 5 considerations and Actions 8/9/10).

2. Risks of losses to be taken into consideration

In addition, we suggest that the Discussion Draft should include further guidance on the different options for Participants to share the benefits, the economic ownership and risks, including the risk of failure which is inherent to the development of pharmaceutical products. Failure is one of the main features of the generation of intangibles in our industry, and the sharing of losses has proven to be a contentious point of discussion with tax administrations.

Given the nature of the shared risks and rewards in a CCA in the pharmaceutical industry (joint economic ownership, development or acquisition of services, goods, tangible or intangible assets including research and development activities, and the high probability that a service or asset does not deliver its expected benefits), a particular focus should be made on the potential losses resulting from the R&D activity which could lead to disputes with tax authorities if not properly addressed.

3. Hindsight / regular adjustments to be avoided

The Discussion Draft mentions, that if projections are different from actual it may require possible adjustments. In addition it suggests that the CCA requires that balancing payments or changes in the allocation of contributions are made after a reasonable period of time (para. 42(e) of the discussion draft). Such a broad definition (“reasonable”) will require for taxpayers and tax administrations to exercise their judgment based on the features of the industry and the normal life cycle of the activity that is the object of the CCA.

This seems to be a consequence of a presumption that the relative contributions and rights of the participants to a CCA will necessarily evolve with time. If it is true that each participant’s contributions may, over time, vary to
some extent, it appears difficult if not impossible to constantly accurately monitor and value the relative contributions of each participant. This is specifically the case for development CCA and in the pharmaceutical industry where development is conducted over a long period and where the outcome is highly unpredictable. Moreover, there is no clear evidence that independent parties would necessarily do so.

Careful attention has to be paid in our opinion to the use and potential abuse of hindsight and it has to be acknowledged that in practice third parties do tend to accept risks based on projections (the best available anticipations of the parties) at the outset of arrangements without necessarily requiring periodic adjustments other than adjustments linked to an extremely material event usually foreseen in certain agreements (product recall for clinical reasons, etc).

Such rules have the potential to give rise to numerous tax audits and disputes which could span over a number of years. This will increase the administrative burden, compliance costs and uncertainty for taxpayers. In practice, because R&D activities are long-term in nature or due to significant levels of abortive expenditures, CCA structures are mainly reviewed by tax administrations on an ex-post basis, increasing the risk of hindsight. Such features make it more difficult to demonstrate that the expectation of benefits was reasonable at the time the contributions to the cost sharing arrangement were made.

A such, we would suggest to add to paragraph 42d ‘[…] expected benefits to be received under the arrangement’ the following section: determined at the time the CCA is concluded based on facts, data and circumstances known or reasonably identified at that time. Reevaluate the CCA contributions based on a large spectrum of possible future events can be very burdensome as every tax jurisdiction can have its own method or methods to determine contribution amounts or how to measure the benefits received.

4. Inappropriate treatment / return allocated to companies providing funding

The Discussion Draft suggests (paragraph13) that a participant must have the capability to make decisions to take on the risk bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor and direct any outsourced measures affecting risk outcome. The report also stresses the importance of controlling risks as well as the development, exploitation and maintenance of intangibles, for a CCA participant to be entitled to the returns. As such CCA Participants only providing funding to the CCA are deemed to be entitled to limited returns. Examples 4 and 5 in the report illustrate the need to perform the right functions; when this is not the case the report proposes that a CCA should be disregarded, or that a company should not be regarded as a participant in the CCA. Under such guidance, a party providing funding only, with no control over risk or significant functions should not be regarded as bearing them, and as such would not be entitled to participate in the CCA (example 5). Such an imperative requirement does not reflect third party behavior.

In example 4, one territory provides the funding and benefits from “rest of world” exploitation of the developed asset, while another has most of the control functions, brings historic intangibles to the arrangement and benefits from exploitation of the asset in its territory only. One must presume that the funding territory has sufficient risk management functions to avoid the recharacterization outcome in example 5. In such a case, the funding territory is deemed to be entitled only to a risk-adjusted rate of return on funding, and any future benefit that it is entitled to under the CCA (in this example the profit from the “rest of world” exploitation of the developed intangible) must be compared with the funding-only benefit, and finally the net present value of any difference must be allocated to the other party as representing the effective value of their contribution. This approach contains some challenging issues which go to the heart of the arm’s length principle and is not necessarily in line with specific provisions on Cost Sharing in some jurisdictions. An emphasis on substance and control over risk, to be effective
in levelling the playing field, would require significant modifications of existing Cost Sharing Regulations of certain jurisdictions so as to avoid creating a distortion between jurisdictions and also between taxpayers.

We believe that it is critical that the envisaged approach recognizes the value of financial investment, and the intrinsic risks of such investment. A multinational pharmaceutical company’s prospects may rise and fall on the back of a single drug or a limited number of products. As a result, companies must and do dedicate vast financial resources to the success of the next potential blockbusters. Pharmaceutical companies invest billions of euros into R&D whilst the probability of success is low and potential sales are extremely volatile and highly unpredictable. As such the risk associated with R&D capital is significant and the potential rewards are high, although the timing between the investing and earning a return is usually in excess of 10 years. The success in the pharmaceutical industry is not only dependent on the technical capacity to successfully develop and commercialize drugs, but also on their capability to mitigate the financial risk associated with failures.

Capital is a requirement for all businesses but it plays a vital role in the pharmaceutical industry. Further evidence is provided by the returns observed on venture capital in the pharmaceutical industry and more specifically in the biotech segment. Such returns are far from being correlated with typical pure financial returns but also capture part of the value of the outcome of the investment, which is the only way to compensate for the numerous failures. Because the draft is oriented towards the appraisal of the value to be allocated in successes, it fails to capture the fact that the actual value (and cost) of capital is also related to the possibility of funding a loss. It is important to recognize that financial returns have to be commensurate with the effective risk the investment and the role of capital in intangibles generation.

The discussion draft also seems to have taken the view that third parties would never enter into an arrangement where a pure owner or financier would be entitled to residual profits. The examination of arrangements between third parties, that can have with different objectives, different risk preference profiles and different bargaining power, indicate that this approach is not strongly corroborated by facts. In the pharmaceutical industry, typical unrelated agreement include the financing of R&D by a company which do not perform by itself the R&D activity and which captures a part of the profit if the product is successful and is marketed (venture capital, R&D funding structures).

The option to target inappropriate returns for providing capital from the perspective of an independent investor does not take into account the economic reality that capital is scarce. For example, in capital intensive industries, such as pharmaceutical industry, value can only be created if the required funding is available; funding may be scarce due to the high risks to which the investments are exposed to. For illustration purpose, in the private equity industry, it is not rare that the providers of capital funding can be allocated often up to 80% of the profits and gains realized with the investment, while management receives a carried interest of 20% or less of the profit, although it provides the significant people functions to manage the value creation process. As scarcity is one of the main drivers of value creation in economic activity and capital being a rare resource, the independent “investor approach” suggested by the Draft could constitute a fundamental divergence from the arm’s length principle.

In the marketplace, an investor does attract part of the residual gain or loss of an enterprise. The investor’s claim to the return does not only depend on whether the investor is knowledgeable or is meaningfully engaged in the process.

The discussion draft generally limits contributors of capital, either in the form of ownership of assets or cash, to a routine financial return unless they are also managing the risk related to those assets. Such an approach lacks of economic substance. Investors are quite willing to invest in valuable assets without the ability to manage them and rely on others to do so. This is ultimately what corporate shareholders do; an investment in a company that
they do not directly control in order to earn the premium returns that a risky business investment may make, rather than the more secure financial return of a risk free investment. Shareholders do not directly exercise a management function or have a direct control on the risk of the entities in which they invest but ultimately they bear the losses and earn the premium returns. Shareholders, by the role of governance bodies that are appointed by them, have an indirect oversight and visibility on risks, but do not control them on an operational basis.

Based on the above, it is our opinion that the Discussion Draft results in an understatement of the returns that should be due to financial investment which is critical in the pharmaceutical industry.

5. Inappropriate links between control /management of risks and returns linked to the financial burden of risks

We believe the discussion draft has resulted in an understatement of the returns that should be allocated to financial investment, focusing too heavily on the expectation that control or management of risk should be paired with the financial burden of a risk to justify the participation to a CCA and a return, namely assuming that unrelated parties do not accept risk that they do not manage.

In practice, risk allocation among third parties is far more complex, and can be driven by a large number of factors which do not align with this general principle. The perceived profit potential in a transaction, the perceived benefit for one of the parties, or the valuation of a certain risk, bargaining power, risk preference frequently does result in risk assumption which deviates from this general principle. There are many situations between independent parties in which the party assuming the risk is not in a position to control or manage the risks and agrees to assume risks over which they have limited control. Unrelated parties routinely do this, in some cases because they are willing to accept the risk in exchange for the possibility of high returns in other cases because they perceive that their interests are generally aligned with the other party. These types of arrangement are common. Returns in these types of arrangements reflect an assumption of risk by both parties and the return to both parties ought to reflect that shared-risk. That is, both parties should be entitled to an entrepreneurial return.

The Discussion Draft often takes the position that the assumption of risk is not separable from control over risk at arm’s length. This is simply inconsistent with observed arm’s length business arrangements. While a certain level of expertise is needed to evaluate whether or not a risky investment should be made, this is very different than exercising detailed control over how this investment is made and managed on a day to day basis. The reason for this is that the expertise needed to manage the investment may lie with another company. In addition, it may be the case that a company lacks functional capacity to create value through exploiting its assets and managing its risk and is mainly reliant on a framework of arrangements with other companies to exploit its assets and manage its risks.

The Discussion Draft, as well as other drafts addressing the issues related to control over risk, are likely to increase the insecurity of taxpayers, in the context of CCAs as well as in more simple operations. The main reason behind this is that several BEPS related documents seem to suggest – and encourage – that the appraisal of control over risks and the reality of decision making should be analyzed with a very low level or granularity. Because of the nature of vertically integrated MNEs, there will always be a possibility during the review of functional analysis and contributions to observe a certain continuum on day to day decision making within the MNE. In our view, this feature does not invalidate the fact that the focus should remain on strategic control over risk and risk allocation, which might reflect on a more accurate way the effective allocation of risk within the MNE.
To cope with such issues, we suggest the OECD Guidance set forth a description of decision making resources and capability (including outsourced functions) that is needed to qualify a participant as being able to assess risks.

Failing to do so will generate a risk that fully commercial and legitimate Transfer Pricing models with centralization of risk and IP commonly used in the pharmaceutical industry, which have been built up and accepted by a large majority of tax authorities around the world, will be very difficult to sustain given a potential onerous but unspecified risk oversight requirement of the revised Guidelines.

On this basis, we suggest that the Guidelines should further clarify what types of decision making functions are required to be able to manage, control and thereby assume risks, with the proper degree of granularity at the level of the MNE, so as to avoid an increase of uncertainty and disputes.

We appreciate the opportunity to submit our comments. Please do not hesitate to contact us if you would like to discuss any of the above matters.

Catherine Henton
VP TAX

Philippe Paumier
Global Head of Transfer Pricing
May 29, 2015

VIA E-MAIL

Andrew Hickman

2, rue André Pascal
75775 Paris Cedex 16
France

OECD/CTPA

Re: Comments on Public Discussion Draft—BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs)

Dear Mr. Hickman,

The Silicon Valley Tax Directors Group ("SVTDG") hereby submits these comments on the above-referenced Public Discussion Draft, issued on April 29, 2015. SVTDG members are listed in Appendix A.

Sincerely,

[Signature]

Jeffrey K. Bergmann

Co-Chair, Silicon Valley Tax Director’s Group
I. Introduction and summary

We thank Working Party No. 6 for preparing the Public Discussion Draft—BEPS ACTION 8: REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES ON COST CONTRIBUTION ARRANGEMENTS (CCAs) ("Action 8 CCAs PDD") and for asking interested parties to give written comments. In this letter we comment on four aspects of the Action 8 CCAs PDD: (1) the requirement that CCA contributions must be assessed at their value rather than their cost; (2) risk bearing by CCA participants; (3) allocation keys for measuring CCA expected benefits; and (4) authority for disregarding part or all of the terms of a CCA.

The Action 8 CCAs PDD is wrong to assert that consistency with the arm’s length principle ("ALP") requires contributions to a CCA be assessed based on their value rather than their cost. The assertion is contrary to the latitude permitted in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TPG"), and to evidence of arm’s length behavior cited in the TPG, by the U.S. government, and in tax court case law. A typical R&D (development) CCA between associated enterprises will assess contributions of pre-existing intangibles based on value, but contributions of ongoing development based on cost. This is consistent with behavior of independent enterprise CCAs, and there are practical reasons for agreeing to this sort of sharing. The requirement that all CCA contributions must be assessed based on value is contrary to the ALP and should be removed.

The requirement in the Action 8 CCAs PDD that to qualify as a participant in a CCA an entity must have “the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA” is inconsistent with the ALP and should be removed. Risks the CCA as a whole bears must be distinguished from unique risks each participant may bear. At arm’s length it’s sufficient that at least one participant in a CCA be capable of controlling and/or
managing any risks borne by the arrangement (and the costs of this activity may be added to the pool of costs to be shared), but clearly not necessary that each participant have such capability. Lack of common capability to deal with risks the CCA as a whole faces can be expected to motivate independent enterprises to form CCAs. By contrast, each participant to an R&D CCA, for example, will face risks associated with successful commercial exploitation of intangibles assigned the participant under the arrangement; it’s reasonable to require each participant to have the capability and authority to manage such specific risks. Thus requiring complete consistency with the general risk allocation principles in Chapter I of the TPG isn’t appropriate for CCAs, which can be distinguished from typical associated enterprise transactions.

The list in the Action 8 CCAs PDD of explicit allocation keys for measuring expected benefit shares under a CCA should be expanded to include gross or operating profits. These keys are explicitly mentioned in the TPG, and are in many cases linked to additional income generated as a result of the CCA.

Article 9 and the TPG provide no grounds for disregarding part or all of the terms of a purported CCA. Local country law must be applied to determine the transaction—the “commercial or financial relation[]”—between associated enterprises necessary for application of Article 9. Such law may provide a basis—e.g., using equivalents of substance-over-form or economic substance doctrines—for recharacterizing or disregarding the terms of a purported CCA, but no such authority arises from Article 9 or the TPG. The Action 8 CCAs PDD should properly acknowledge this. Anti-abuse provisions under local law may in egregious circumstances justify total disregard of a CCA, and the TPG acknowledge this. But the Action 8 CCAs PDD removes the requirement that disregard potential be triggered only in abusive situations. This should be corrected.
II. Discussion of specific concerns

A. The Action 8 CCAs PDD improperly requires all contributions be assessed at value

1. Relevance of the ALP to CCAs

Paragraph 1.6 of the TPG provides that the authoritative statement of the ALP is found in Article 9 of the OECD MTC:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. [Emphasis added]

The ALP grounds application of the TPG, including treatment of CCAs. If any difference referenced in the opening clause exists, an allocation of profits among the associated enterprises is allowed by the second part of the sentence. In the phrase “those which would be made between independent enterprises,” “those” refers to conditions that would be made between independent enterprises. So the opening clause asks whether there’s a difference between (1) certain conditions that exist (“are made or imposed”) between associated enterprises; and (2) hypothetical conditions (“those which would be made”) between independent enterprises.

The existing conditions among associated enterprises must relate specifically to (actual) “commercial or financial relations” between such enterprises. The hypothetical nature of the conditions must relate to supposed (i.e., assumed) behavior of independent enterprises. Making the comparison between (1) and (2) is only meaningful if the hypothetical independent enterprises are assumed to be engaging in the same commercial or financial relation as that between the associated enterprises. The comparison in the first clause of the ALP is only meaningful if the clause is interpreted as “[where] conditions are made or imposed between the
two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises engaging in the same commercial or financial relations . . . .” . The ALP should operate to price associated enterprise transactions, not restrict—upon penalty of recharacterization—the set of transactions among such enterprises to those that independent enterprises would, under various assumptions, normally only engage in.¹

The mandate that an adjustment, if any, under the ALP be based on hypothetical conditions among independent enterprises has two corollaries, and they apply to CCAs just as to transactions among associated enterprises. The first is that application of the ALP in general doesn’t require evidence of actual independent enterprise behavior. Accordingly, if a CCA involving particular terms and conditions can’t be observed among independent enterprises, the ALP can nonetheless be used to determine transfer pricing. The second corollary is that if there exists evidence of actual behavior of independent enterprises engaging the same commercial or financial relations as those associated enterprises, such evidence controls application of the ALP in comparable circumstances. In this case, speculation is removed. This is important because there’s plenty of evidence of independent enterprises having engaged in CCAs that assess contributions at cost.

¹ We supported this conclusion in detail in our letter (submitted in conjunction with another trade association), dated February 6, 2015, on the OECD Public Discussion Draft BEPS Actions 8, 9 and 10—Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures (“Comment Letter on BEPS Actions 8–10 PDD”)), a copy of which is attached as Appendix B to this comment letter. We reference our Comment Letter on BEPS Actions 8–10 PDD where relevant—e.g., in the discussion on recharacterization, below.
2. Evidence of independent enterprises engaging in CCAs

In 1986 the United States modified § 482 of the Internal Revenue Code (26 U.S.C.)—the basis for U.S. transfer pricing adjustments—to add “commensurate with income” language permitting in some situations ex post adjustments.\(^2\) In adding this language, the U.S. Congress also directed the Internal Revenue Service (“IRS”) to conduct “a comprehensive study of intercompany [transfer] pricing rules.”\(^3\) Two years later the IRS and the U.S. Treasury Department produced the § 482 “White Paper,”\(^4\) which defined an R&D “cost sharing arrangement” (“CSA”) to be “an agreement between two or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any property that is developed,”\(^5\) and stated that “[c]ost sharing arrangements have long existed at arm’s length between unrelated parties.”\(^6\) In *Xilinx, Inc. v. Commissioner*, 125 T.C. 37 (2005)\(^7\) the U.S. Tax Court held that petitioner domestic corporation and its foreign subsidiary—which were engaged in a CSA under § 482 regulations—didn’t in their CSA have to share “costs” associated with stock employee stock options because two unrelated parties (i.e., independent enterprises) in a cost sharing agreement wouldn’t share any such costs. The § 482 regulations defined a CSA as “an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from

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\(^2\) § 1231(e)(1) of the Tax Reform Act of 1986, 100 Stat. 20185 (1986) added the sentence: “In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”


\(^5\) *White Paper*, 493 (emphasis added).

\(^6\) *Id.* (emphasis added).

\(^7\) *Aff’d*, 598 F.3d 1191 (9th Cir. 2010).
their individual exploitation of the interests in the intangibles assigned to them under the arrangement.”

Xilinx at trial produced evidence of R&D cost sharing arrangements among independent enterprises.

The 2010 TPG defines a CCA as “a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interest each participant in those assets, services, or rights.” It’s clear that an R&D CSA as defined under U.S. § 482 is a particular example of a CCA, so there’s evidence that R&D CCAs have long existed among independent enterprises. This is entirely consistent with the statement in the 2010 TPG that “[p]erhaps the most frequently encountered type of CCA is an arrangement for the joint development of intangible property, . . . ,” but is more precise in that it points to evidence of parties at arm’s length sharing development contributions at cost. The 2010 TPG are thus relevant to associated enterprises choosing to adopt such arrangements.

3. **Why the Action 8 CCAs PDD is wrong to require assessment of CCA contributions at value**

The Action 8 CCAs PDD proposes a different definition of a CCA, as—

a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such

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8 Former Treas. Reg. § 1.482-7(a)(1) (emphasis added).
9 “Petitioners also established that . . . companies (i.e., those who enter into cost-sharing arrangements relating to intangibles) do not take into account [employee stock option costs].” 125 T.C. at 59.
10 TPG, ¶ 8.3 (emphasis added).
11 TPG, ¶ 8.6.
intangibles, tangibles assets or services are expected to create direct benefits for the businesses of each of the participants.\(^{12}\)

The proposed definition of a CCA is markedly different than that in 2010 TPG, and some important consequences follow. We’ll call the proposed arrangement a “Proposed CCA” to distinguish it from the conventional CCA in the 2010 TPG.

The Action 8 CCAs PDD asserts that “[t]wo types of [Proposed] CCAs are commonly encountered: those established for the joint development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets (‘development CCAs’); and those for obtaining services (‘services CCAs’).”\(^{13}\) The Action 8 CCAs PDD makes this assertion without citing evidence. We think it doubtful that Proposed CCAs are “commonly encountered,” so it’s unsurprising no evidence was proffered. As discussed below, the requirement in the Action 8 CCAs PDD to value all contributions—i.e., whether contributions of resources, capabilities, or rights acquired by a participant outside the arrangement (e.g., pre-existing intangibles), or whether contributed within the arrangement (e.g., development activities)—makes a Proposed CCA much more complex to administer than a (conventional) CCA, which (in the case of intangible development) simply shares ongoing costs of co-developing intangibles. Moreover, while intangible joint development CCAs are common, much less common we think would be CCAs formed to carry out the other D-E-M-P-E activities.\(^{14}\) We think Proposed CCAs would be relatively rare.

\(^{12}\) Action 8 CCAs PDD, ¶ 3 (emphasis added).

\(^{13}\) Id., ¶ 8.

\(^{14}\) Development, enhancement, maintenance, and protection (“D-E-M-P”) activities were the focus of the July 2013 Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, while the Action 8: 2014 Deliverable—Guidance on Transfer Pricing Aspects of Intangibles added “exploitation,” rounding out “D-E-M-P-E.”
A fundamental error of the *Action 8 CCAs PDD* is the assertion that “to be consistent with the arm’s length principle,” “contributions must be assessed based on their value (rather than their cost) . . . .” This presumptive assertion of what independent enterprises would do is entirely contrary to the evidence, discussed above, of arm’s length CCAs in which participants assess contributions such as R&D and marketing activities at cost, not at value. The administrative superiority of forming such an arrangement over a Proposed CCA (requiring assessment at value) is obvious; it’s unsurprising evidence of such arm’s length cost-sharing CCAs is plentiful. In any case, even if some CCAs assess development contributions based on value, some (we believe most) assess them at cost, and there’s no principled basis for asserting compliance with the ALP requires assessment at value.

The *Action 8 CCAs PDD* asserts that satisfaction of the ALP requires each participant’s proportionate share of the overall contributions to a CCA be consistent with the participant’s proportionate share of the overall expected benefits. Satisfaction of the ALP doesn’t, however, require blanket use of value to assess contributions. The ALP is satisfied, for example, if

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15 *Action 8 CCAs PDD*, ¶ 22 (emphasis added). The *Action 8 CCAs PDD* repeatedly makes this incorrect assertion in slightly different ways—e.g., at ¶ 10 (“For . . . a [Proposed CCA] to satisfy the [ALP], the value of participants’ contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.” (emphasis added)); ¶ 11 (“Independent enterprises would require that the value of each participant’s proportionate share of the actual overall contributions to the arrangement is consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement.” (emphasis added)); ¶ 20 (“For the purpose of determining whether a [Proposed CCA] satisfies the arm’s length principle . . . it is necessary to measure the value of each participant’s contributions to the arrangement.” (emphasis added)); and ¶ 27 (“A [Proposed CCA] will be considered consistent with the arm’s length principle where the value of each participant’s proportionate share of the overall contributions to the arrangement (taking into account any balancing payments already made) is consistent with the participant’s share of the overall expected benefits to be received under the arrangement.” (emphasis added)). We presume equivalence of a participant’s contribution (¶¶ 10 & 20) and the value of a participant’s proportionate share of the overall contributions (¶¶ 11 & 20).

16 *Id.*, ¶ 20.
participants assess contributions of pre-existing intangibles at value but contributions of the performance of R&D activities at cost, so long as each participant’s proportionate share of each sort of contribution equals its proportionate share of overall expected benefits.  A typical R&D (development) CCA involves participants sharing costs of ongoing R&D performed on pre-existing intangibles, often with subsequent injections of acquired intangibles upon which further R&D is performed. Assessing CCA contributions of intangibles at value makes sense because (1) information about the cost to develop the initial intangibles mightn’t be available; and (2) acquired intangibles typically involve an outlay of value by a participant. Assessing CCA contributions of ongoing R&D activities at cost makes sense because (1) such costs are generally easier to determine than the value of the performance of the activities; and (2) a participant’s overall costs (costs directly incurred and balancing payments) of participating in a CCA are typically lower than had assessment been at value.

The TPG recognizes that contributions to a CCA needn’t be assessed at value. This isn’t surprising, as the TPG define a CCA to be an arrangement for sharing certain costs and risks. The TPG asserts, for example, that in determining whether a CCA satisfies the ALP it’s “necessary to measure the value or amount of each participant’s contributions to the arrangement.” The amount of a contribution could be gauged at cost. The TPG further

17  For example, a participant could bear 40 percent of the appropriate value of pre-existing intangibles contributed to a CCA, and 40 percent of the cost of ongoing R&D activities.

18  TPG, ¶ 8.3.

19  TPG, ¶ 8.13 (emphasis added).
explains that “[c]ountries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm’s length CCAs.”

The Action 8 CCAs PDD should accordingly be changed to remove the requirement that all contributions to a CCA be assessed at value. Such requirement is contrary to the ALP. Assessment at cost should be permitted.

B. Other concerns with the Action 8 CCAs PDD

1. Risk bearing by CCA participants

The Action 8 CCAs PDD discusses the risk bearing opportunity a CCA participant gets:

The general principles set out in Chapter I of these guidelines on the allocation of risks when delineating transactions apply to situations involving CCAs. Since a CCA is premised on all participants sharing not only contributions but also risks of the CCA activities, to qualify as a participant in a CCA an entity must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA in accordance with the definition of control of risks set out in Chapter I. In particular, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.

Requiring complete consistency with the general risk allocation principles in Chapter I of the TPG isn’t appropriate for CCAs, which are in respects fundamentally different from controlled transactions. Considering for example an R&D (development) CCA, ignoring contributions of pre-existing intangibles, there’s no transfer of developed intangibles in a CCA among participants—rights in developed intangibles arise ab initio in the participants, who fund

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20 Id., ¶ 8.15 (emphasis added).

21 Action 8 CCAs PDD, ¶ 13.

22 The TPG Glossary defines “controlled transactions” as transactions between two enterprises that are associated enterprises with respect to each other.
development. There’s likewise no transfer among participants of risks associated with newly
developed intangibles.

It’s important to distinguish risks a CCA as a whole bears from unique risks each
participant may bear. For example, an R&D CCA as a whole—thus the participants
collectively—bears risk intangibles mightn’t be successfully developed under the arrangement.
This risk is mitigated through effective management and control of R&D activities. The costs of
such management and control activities generally would be added to the pool of costs to be
shared under the arrangement, but the ALP doesn’t give a basis for asserting each participant
must have “the capability and authority” to control such risk. Independent enterprises strike
arrangements (e.g., joint ventures) in which one enterprise provides funding and another
provides R&D capability: each enterprise needn’t have the capability and authority to control
risks associated with successful R&D—in fact this lack of common capability in each participant
may be an important factor causing such enterprises to enter into such an arrangement, allowing
them to pool and share aggregate functions and assets. At arm’s length it’s sufficient that a (i.e.,
at least one) participant in a CCA be capable of controlling and/or managing any risks borne by
the arrangement, but clearly not necessary that each participant have such capability. It’s thus
contrary to the ALP to condition an entity’s qualification as a CCA participant on the entity
having the capability and authority to manage risks under CCA. The Action 8 CCAs PDD
should be changed to comport with this.

For an R&D CCA, even if intangibles are successfully developed, each participant bears
its own risks relating to commercialization and exploitation of developed intangibles. For
example, a participant assigned rights in such intangibles in a particular geographic region risks
not being able to successfully exploit its assigned rights in that region. Such participant should have the capability and authority to manage such participant-specific risks.

2. **The listed allocation keys for measuring expected benefits should be expanded**

   The TPG explain that shares of expected benefits under a CCA might be estimated based on anticipated additional income generated or costs saved by each participant as a result of the arrangement, and that in practice this is frequently done using “allocation keys,” including “sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth.”

   The *Action 8 CCAs PDD* echoes this for Proposed CCAs, but inexplicably drops explicit mention of gross or operating profit as possible allocation keys (although one might argue they’re covered by the catch-all “and so forth”). This is puzzling. Because “additional income generated” is an obvious measure of benefit generated from a CCA, one would expect (in addition to sales) either gross or operating profit to be obvious candidates for allocation keys, as they’re linked to additional income generated. In a development CCA, one would expect gross or operating profit to reliably measure benefits to the extent such profits are largely attributable to exploitation of intangibles developed under the CCA, or if the portion of such profits attributable to such intangibles is anticipated to be similar for each participant.

   We accordingly recommend that “gross or operating profit” be explicitly included as examples of allocation keys.

3. **Article 9 provides no grounds for disregarding part or all of the terms of a CCA**

   The *Action 8 CCAs PDD* in essence repeats language from the TPG:

   \[23\] TPG, ¶ 8.19.

   \[24\] But a negative inference of their exclusion might be intention to exclude such allocation keys.
A tax administration may . . . disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA.\textsuperscript{25}

Paragraph 1.65 of the TPG describes two circumstances permitting a tax administration to disregard a controlled transaction, one of which arises if “the economic substance of a transaction differs from its form.” Application of Article 9 of the OECD Model Tax Convention (which embodies the ALP) requires local law determination of transactions (“commercial or financial relations”) among associated enterprises, and for this purpose a tax administration can use local tax law principles such as equivalents of the “economic substance” doctrine or “substance over form” doctrine common in many jurisdictions.\textsuperscript{26} These doctrines, or related local law legal principles, may—depending on the facts and circumstances—justify the partial or total disregard of a CCA outlined in the cited passage. Neither Article 9 nor the TPG, however, provide independent authority (i.e., provide no separate grounds) for a tax administration to disregard the terms of a transaction among associated enterprises.\textsuperscript{27} By its terms the ALP applies—after the associated enterprise transaction has been delineated under

\textsuperscript{25} Action 8 CCAs PDD, ¶ 32; TPG, ¶ 8.30 (the TPG uses the phrase “greater beneficial interest” rather than “greater interest”).

\textsuperscript{26} This is discussed in greater detail in § II.A.3 of our Comment Letter on BEPS Actions 8–10 (see Appendix B to this letter). In particular, the second circumstance described in ¶ 1.65 of the TPG permitting a tax administration to disregard a controlled transaction—if “arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price”—is entirely without support from the ALP.

\textsuperscript{27} Id.
local law tax principles—solely to determine (transfer) pricing of associated enterprise transactions.28

Similarly, the TPG asserts that “[i]n circumstances [indicating] an attempt to abuse the rules governing CCAs, it may be appropriate for a tax administration to disregard the CCA in its entirety.”29 Local country anti-abuse laws may—in egregious circumstances—justify total disregard of a CCA. The Action 8 CCAs PDD purports to give tax administrations even greater authority, removing any requirement that there be a taint of abuse: “In relevant circumstances it may be appropriate for a tax administration to disregard the CCA in its entirety in accordance with the principles for non-recognition of the delineated transaction set out in Chapter I.” To repeat, while local country legal principles may in some circumstances be applied to disregard all or parts of a CCA, neither Article 9 nor the TPG provide any independent ground for such action.

28 Id.
29 TPG, ¶ 8.30.
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38. Ingram Micro, Inc.
39. Intel Corporation
40. Intuit, Inc.
41. Intuitive Surgical, Inc.
42. KLA-Tencor Corporation
43. Lam Research Corporation
44. Marvell Semiconductor, Inc.
45. Maxim Integrated Products, Inc.
46. Mentor Graphics, Inc.
47. Microsoft Corporation
48. Netflix, Inc.
49. NVIDIA Corporation
50. Oracle Corporation
51. Palo Alto Networks, Inc.
52. Pandora Media, Inc.
53. Pivotal Software, Inc.
54. Plantronics, Inc.
55. Power Integrations, Inc.
56. Qualcomm, Inc.
57. Riverbed Technology, Inc.
58. Rovi Corporation
59. salesforce.com
60. SanDisk Corporation
61. SAP
62. Seagate Technology, PLC
63. ServiceNow, Inc.
64. Silicon Image, Inc.
65. Silver Spring Networks
66. SMART Modular Technologies Corp.
67. SunPower Corporation
68. Symantec Corporation
69. Synopsys, Inc.
70. Tesla Motors, Inc.
71. The Walt Disney Company
72. Trimble Navigation Ltd.
73. Twitter, Inc.
74. Uber, Inc.
75. Visa, Inc.
76. VMware Corporation
77. Xilinx, Inc.
78. Yahoo! Inc.
79. Yelp Inc.
February 6, 2015

VI A E-MAIL

Mr. Andrew Hickman
Head of Transfer Pricing Unit
Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

Re: Comment letter on the OECD Public Discussion Draft BEPS Actions 8, 9 and 10—
Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines
(Including Risk, Recharacterisation, and Special Measures)

Dear Mr. Hickman,

These comments are submitted by the undersigned independent trade associations, described in Appendix A and B, which together include over 100 companies as members, in response to the invitation to submit comments on BEPS Actions 8, 9 and 10—Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), issued December 1, 2014.

Respectfully submitted,

Silicon Valley Tax Directors Group (SVTDG)
www.svtdg.org

TechNet
www.technet.org
I. Introduction and summary

We thank Working Party No. 6 (“WP-6”) for preparing the Public Discussion Draft—BEPS ACTIONS 8, 9 AND 10: DISCUSSION DRAFT ON REVISIONS TO CHAPTER I OF THE TRANSFER PRICING GUIDELINES (INCLUDING RISK, RECHARACTERISATION, AND SPECIAL MEASURES (“Actions 8–10 PDD”)) and for asking interested parties to give written comments. In this letter we comment on three aspects of the Actions 8–10 PDD: (1) the proposed changes to § I.D.2 of the TPG—in particular, the additional points and questions relating to moral hazard risks and risk-return trade-offs; (2) the proposed changes to § I.D.4 of the TPG relating to non-recognition of associated enterprise transactions; and (3) the proposed special measures in Part II of Actions 8–10 PDD.

A. Summary of comments on Part I of the Actions 8–10 PDD, proposing changes to § I.D of the TPG

1. Summary of comments on § I.D.2 of the TPG—identifying risks

The questions in the Actions 8–10 PDD relating to moral hazard risk and risk-return trade-off can best be answered by reviewing how the arm’s length principle (“ALP”) in Article 9, ¶ 1 of the MTC works in the context of risk. The ALP is concerned with pricing associated enterprise transactions consistently with prescribed behavior of independent enterprises. When evaluating a particular associated enterprise commercial relation, the ALP first requires one to hypothesize that independent enterprises enter into the same commercial relationship, performing the same activities and having comparable assets. The associated enterprises in the commercial relation will generally be exposed to extrinsic risks, but they may not be exposed to moral hazard risks to the same extent as are independent enterprises. Applying the ALP further requires hypothesizing the independent enterprises being exposed to the same extrinsic risks as are the associated enterprises, and that the independent enterprises also choose the same contract
terms (assuming the contract terms are consistent with the economic substance of the associated enterprise transaction) and allocation of extrinsic risks as chosen by the associated enterprises. The specific payment terms such independent enterprises would agree upon would reflect both any extrinsic risks imputed from the associated enterprise commercial relation and also any moral hazard risks arising from the imputed contract provisions and allocations of extrinsic risk. Under the ALP, the associated enterprises must price their commercial relation the same way—i.e., the payment terms incorporate compensation for both extrinsic risks they bear and also any moral hazard risks the associated enterprises mightn’t actually bear (or bear only to a much smaller degree). This pricing of associated enterprise transactions can, under the ALP, come either through observations of independent enterprise behavior (comparables) or by determining pricing through methods not relying on comparables (including, e.g., TNMM, profit splits, etc.).

In response to the questions relating to moral hazard and risk-return trade-off: (1) arm’s length payments between associated enterprises will generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk, but this doesn’t mean such moral hazard risks and the corresponding contractual incentives/penalties are being imputed to the associated enterprises; (2) the observation in ¶ 67 of the Actions 8–10 PDD that unrelated parties may be unwilling to share insights about core competencies for fear of losing IP or market opportunities is generally not accurate—agreements and behaviors between independent enterprises allow flows of proprietary information among such enterprises while preventing misuse of such information; (3) the assertion in the example in ¶¶ 90–91 that the conditions of sale of the trademark would create moral hazards so acute that such a sale wouldn’t be economically rational if the transferor (S1) and transferee (S2) were independent enterprises isn’t
justified; (4) pure risk shifting transactions among associated enterprises can arise among associated enterprises and—assuming the economic substance of such transactions mirrors the form—such transactions should be respected; and (5) the trademark transfer in the example in ¶¶ 90–91 likely reduces S1’s exposure, but increases S2’s exposure, to risks of the business in which the trademark is used, but S2 may for various reasons be better-positioned to bear such risk, in which case S2 would value the trademark more highly than would S1; and (6) the risk-return trade-off principle is consistent with the choices of both S2 (which assumes the risk of the trademark’s income (royalties) in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark’s expected income stream) and S1 (which accepts a lump sum by and gives up the risk-adjusted expected return on the trademark’s future income in exchange for not bearing the risks of the trademark).

2. Summary of comments on § I.D.4 of the TPG—recharacterization

If circumstances are such that the economic substance of a transaction among associated enterprises doesn’t mirror its form then for purposes of applying the ALP to find a transfer price the transaction must be recharacterized. Authority to recharacterize transactions for tax purposes exists in the tax laws of many jurisdictions, and its reach is broader than transfer pricing, but recharacterization in such circumstances is needed for proper application of the ALP, which can only work sensibly if hypothetical independent enterprises undertake what is in economic substance the nominal transaction at issue among associated enterprises.

No other grounds for recharacterization of associated enterprise transactions are needed for proper application of the ALP, and the ALP by its terms doesn’t permit recharacterization in any other circumstances. Proper application of the ALP requires determining a transfer price assuming independent enterprises undertake the same commercial arrangement (in economic
substance) as that among associated enterprises, imputing the same extrinsic risks and taking into account moral hazard risks that arise. The pricing determination required under the ALP can sometimes be done by resort to observable behavior among independent enterprises (comparables), or failing that, other methods (such as TNMM, profit split methods, etc.) may be used. But there’s no indication in the ALP itself that the process should collapse if either observable comparable independent enterprise behavior can’t be found, or if in that event the determination is challenging. The TPG nonetheless introduced a second ground for recharacterization, based on whether “the arrangements made in relation to the transaction, viewed in their totality, [(1)] differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and [(2)] the actual structure practically impedes the tax administration from determining an appropriate transfer price.” The Actions 8–10 PDD tries to give “greater definition” to this opaque test. This “greater definition” comes in essence from asserting requirement (2) to be redundant if requirement (1) is met, then recasting requirement (1) by asking whether the associated enterprise transaction exhibits “the fundamental economic attributes” of arrangements between unrelated parties, and then finally asserting that such an arrangement “would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted . . . basis, compared to other opportunities realistically available to them at the time the arrangement was entered into.” The Actions 8–10 PDD thereby in effect would allow recharacterization of any associated enterprise transaction that would be unlikely to be observed among independent enterprises. This is contrary to the ALP, which requires finding a transfer price for an associated

30 TPG, ¶ 1.65.
31 Actions 8–10 PDD, ¶ 89.
enterprise transaction using either observable independent enterprise behavior in a comparable
transaction or, if not observable, calculating a price based on hypothesized behavior. The ALP
wasn’t intended to restrict the transactional behavior of associated enterprises to that observed
among independent enterprises. The Actions 8–10 PDD incorrectly equates lack of observable
independent enterprise transactions with inability to solve a hypothetical economics problem.
The tack taken by the Actions 8–10 PDD with respect to recharacterization arguably
misinterprets the ALP in Article 9, ¶ 1 to give tax administrations authority to rewrite associated
enterprise transactions unlikely to be observed among independent enterprises. Because it is not
grounded in the ALP, the PDD’s approach to recharacterization must be rejected.

The associated enterprise trademark transfer example in the Actions 8–10 PDD contrived
to try to show application of the “fundamental economic attributes” test has questionable
economic analysis in places and has confusing facts that under trademark law best practices and
the law of several jurisdictions may invalidate trademark ownership. Correcting the analysis,
aligning the facts consistent with trademark law best practices (i.e., the transferee must conduct
core trademark functions), and assuming the economic substance of the arrangement between
transferor and transferee mirrors its form, yields different results than those in the Actions 8–10
PDD (although the “fundamental economic attributes” test should in any event be rejected).

B. Summary of comments on Part II of the Actions 8–10 PDD, proposing special
measures

The special measures in Options 1 (HTVI) and the primary rule in Option 5 (taxation of
excess returns) warrant further consideration and could, if suitably modified, form practicable
BEPS tools for WP-6 to endorse.
Option 1 should be modified so as to be subject to the ALP: taxpayers could thus avoid *ex post* adjustments based on actual outcomes by proffering evidence of comparable independent enterprise transactions. Making the special measure subject to the ALP mitigates risks of double taxation. Conditioning application of the special measure on lack of contemporaneous documentation encourages taxpayers to create robust contemporaneous economic analysis in support of their transfer pricing.

The primary rule in Option 5 operates like a CFC rule, in which the ultimate parent can tax “excess returns” of a CFC if it’s subject to a three-year average effective tax rate lower than some threshold. The primary rule should apply after application of the normal transfer pricing rules (and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime with respect to that CFC, to determine effective tax rate), and will ensure a baseline level of taxation of most income currently subject to BEPS concerns. This work should be coordinated with that on Action 3 (strengthen CFC rules). The secondary rule in Option 5 should be rejected. It clearly is not consistent with the ALP. Only the ultimate parent jurisdiction, as location of the ultimate owner of a multinational group, has primacy of right in taxing “excess returns” of a CFC. The parent jurisdiction’s deferral of its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions”, whatever those jurisdictions might be. In the secondary rule, it’s unlikely that the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns would ever be the subject of agreement among jurisdictions. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.
The special measures in Options 2–4 should be rejected. Each such Option is arbitrary, impracticable, and/or subjective, and would lead to protracted disputes unlikely to be resolved. There is no generally agreed upon optimal level of capitalization, making Options 2 & 3 arbitrary. Option 4—dealing with minimal functional entities—is in effect an end-run around application of normal transfer pricing rules under the ALP (including revised TPG Chapter VI).

II. Specific concerns

A. Part I of Actions 8–10 PDD, proposing changes to § I.D of the TPG

1. Relevance of the ALP to risk and possible recharacterization

   a. The ALP can be interpreted to require transfer pricing of all associated enterprise commercial relations

Paragraph 1.6 of the TPG provides that the authoritative statement of the ALP is found in Article 9 of the OECD MTC:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. [Emphasis added]

The ALP grounds application of the TPG—including analysis of risk and the possibility of recharacterization—so it’s important to review what this sentence says about those two topics. If the difference referenced in the opening clause of the sentence exists, an allocation of profits among the associated enterprises is allowed by the second part of the sentence. In the phrase “those which would be made between independent enterprises,” “those” refers to conditions that would be made between independent enterprises. So the opening clause asks whether there’s a difference between certain conditions that exist (“are made or imposed”) between associated enterprises and hypothetical conditions (“those which would be made”) between independent
enterprises. But the ALP is more precise. The existing conditions among associated enterprises must relate specifically to “commercial or financial relations” between such enterprises. But to what must the hypothetical conditions among independent enterprises relate? Because the conditions are hypothetical, the ALP doesn’t require evidence of actual independent enterprise behavior. The hypothetical nature of the conditions must relate to supposed (i.e., assumed) behavior of independent enterprises—i.e., for purposes of seeking any difference in conditions in the first clause of the ALP—the independent enterprises must be supposed or assumed to be doing something to which the (hypothetical) conditions relate. A difference in conditions would generally be meaningless if the commercial relation between associated enterprises involved, say, an intangible transfer but that between independent enterprises involved the provision of services. Comparing conditions is only meaningful if the hypothetical independent enterprises are assumed to be engaging in the same commercial relation as that between the associated enterprises. That is, the comparison in the first clause of the ALP is only meaningful if the clause is interpreted as “[where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises engaging in the same commercial or financial relations.”

Various arguments might be raised against this interpretation, but they don’t withstand scrutiny under the ALP. One argument is that the emphasized phrase isn’t there and it shouldn’t be inferred. As pointed out above, however, inferring such a requirement allows an apples-to-apples comparison: assume hypothetical independent enterprises engage in the same commercial relation as that existing between associated enterprises, and only then compare the conditions made or imposed between the two sets of parties.
Another argument might be that one isn’t—under the ALP—free to assume the hypothetical independent enterprises engage in the same commercial relations as that among associated enterprises. Rather, it might be argued, under the ALP one is restricted to commercial relations independent enterprises would engage in, in the sense that if as a matter of economics independent enterprises wouldn’t normally engage in a commercial relation then one can’t assume for purposes of the ALP comparison that they do engage in it. But the ALP by its plain terms seeks to compare actual conditions (between associated enterprises) with hypothetical conditions (between independent enterprises), and the hypothetical conditions (“those which would be made”) must relate to a hypothetical commercial relation—that which would be made between independent enterprises. Interpreting the ALP to prevent the hypothetical commercial relation among independent enterprises from being one not normally engaged in among independent enterprises would violate a canon of statutory construction: it would make the ALP inoperative in situations in which associated enterprises undertake transactions not normally engaged in, or not observable, among independent enterprises. 32 This interpretation should accordingly be rejected. The more natural reading of the ALP—that the comparison of conditions in the ALP should be done assuming independent enterprises engage in the same commercial relation as that of associated enterprises—allows the ALP to function in all circumstances: (1) assume independent enterprises engage in the same commercial relation as that existing between associated enterprises; (2) find the conditions that would be made or imposed between such independent enterprises; (3) compare those conditions with those actually made or imposed between the associated enterprises; and (4) determine the “delta” in profits that

32 Critics of our interpretation might argue that this breakdown of application of ALP is precisely what permits recharacterization, but there’s nothing in Article 9 (or the Commentary for that matter) suggesting such inapplicability of the ALP with consequent allowance of recharacterization.
can be included in the income of the relevant associated enterprise and taxed accordingly. The purpose of the ALP must surely be not to force commercial relations among associated enterprises to mirror those among independent enterprises, but rather to suitably price associated enterprise relations.

A variant of the last argument is that by assuming in the ALP that hypothetical independent enterprises engage in the actual commercial relation undertaken by associated enterprises, it may not be possible as a matter of economics to determine (to solve for) the appropriate transfer price. This argument also can be refuted. It may be possible to find associated-enterprise transactions not normally observable among independent enterprises. But this doesn’t mean that hypothetical independent enterprises assumed to have entered into such a transaction wouldn’t arrive at a constellation of contract provisions, risk sharing, and pricing terms that optimizes their respective economic positions. This is discussed further below.

To summarize, finding the difference sought in the first clause of the ALP doesn’t require one find evidence of independent enterprises in the same commercial or financial relation as that existing between associated enterprises. The use of “which would be made” means the conditions must be hypothetical, and the difference is only meaningful if one assumes the hypothetical independent enterprises engage in the same “commercial or financial relation[]” as that actually consummated by the associated enterprises. The ALP should operate to price associated enterprise transactions, not restrict—upon penalty of recharacterization—the set of transactions among such enterprises to those that independent enterprises would, under various assumptions, normally only engage in.
b. Associated enterprise commercial relations and risk

An important element of the conditions associated with a commercial or financial relation between associated enterprises is the set of risks borne by each enterprise under this relationship. As the *Actions 8–10 PDD* notes, these risks can arise from a variety of factors external or internal to these enterprises, such as the economic environment in relevant markets, the degree of competition they face in relevant markets, the reliability of the supply chain for raw materials, or uncertainties in employee capabilities.\(^33\) These risks may be described as “extrinsic” to the associated enterprises in that they are substantially outside the control of these enterprises while being material to the outcome of their commercial relations. To find a transfer price under the ALP, a commercial or financial relation between independent enterprises must be imbued with the same extrinsic risks as the relations between associated enterprises to serve as a benchmark for arm’s length terms in the latter.

When independent enterprises are placed in a relationship with the same extrinsic risks as an associated enterprise relationship, however, additional risks could arise that may not occur between associated enterprises. These risks arise when an independent enterprise is unable fully to observe or regulate the conduct of the other independent enterprise within the relationship, and terms of the relationship incentivize one such enterprise to take actions that may not be in the best interests of the other. For example, if a firm engages an independent contract manufacturer to make its products and stipulates payment terms independent of the quality of the products, the manufacturer might have an incentive to reduce its quality control efforts to save costs. These risks arising from imperfect observability and control can be termed “moral hazard” risks.

\(^{33}\) *Action 8–10 PDD*, § D.2.1. ¶ 42.
Although it’s possible for moral hazard to arise among associated enterprises, the likelihood and the scale of moral hazard is typically greater between independent enterprises.

Independent enterprises can adopt a variety of measures to curb moral hazard risks in their commercial or financial relations. First, moral hazard risk can be mitigated through provisions of a contract governing the relation. For example, the terms of their contract can allow one enterprise to monitor the actions of the other to the extent feasible (for example, through rights of periodic inspection) or to penalize misbehavior by the other if such misbehavior can be observed after the event. To the extent moral hazard cannot be eliminated through enforceable contract terms, it can be mitigated through the provision of incentives within the contract. For example, under certain conditions, the contract may, to align incentives of both enterprises to deal with extrinsic risks, stipulate a compensation structure that exposes both enterprises to extrinsic risks. Such risk-sharing contracts, however, may be inefficient in other settings where one enterprise is highly risk-averse or has limited capacity to manage risks to which it’s being exposed. Finally, given the contractual provisions and the structure of extrinsic risk-sharing agreed upon by the parties, the specific payment terms chosen by independent enterprises will reflect any moral hazard that remain within their commercial or financial relations. Thus, if the nature of the moral hazard is that one enterprise may provide a sub-optimal level of effort in its stipulated tasks, the value of the payments the other enterprise will agree to make will likely be lower to reflect the anticipated value-loss arising from this moral hazard.

Given the different ways independent enterprises can deal with moral hazard, the conditions chosen by such enterprises for a particular commercial or financial relation may lie anywhere on a spectrum of possible outcomes, characterized by different combinations of
contractual restrictions, incentive structures, and payment levels. Depending on the nature of the activity involved in this relationship, the degree of observability in the actions of the enterprise, or their degrees of risk aversion, we may find some enterprises choosing to impose significant contractual restrictions on behavior and limited risk-sharing, with a corresponding level of stipulated payments. Others might choose limited contractual restrictions on behavior but significant risk-sharing, with a different level of stipulated payments. Yet others might agree to few contractual restrictions or risk-sharing but with significant adjustments to the resulting stipulated payments.

Under these circumstances, with arm’s length conditions for a particular commercial or financial relationship potentially falling anywhere within a set of possible combinations of conditions, how should the ALP be applied? In pursuing the ultimate objective of the ALP—the determination of the arm’s length transfer price—one must ensure the conditions of commercial or financial relations between associated enterprises match those that would be observed among independent enterprises engaging in the same relations. The ALP thus requires the following analysis. When evaluating a certain relationship between associated enterprises, hypothesize that independent enterprises enter into the same relationship, entailing the same activities, undertaken with comparable assets, and exposed to the same extrinsic risks. Further, hypothesize that these independent enterprises also choose the same contractual terms and the same allocation of extrinsic risks that the associated enterprises have chosen. Now ask: what specific payment terms would the independent enterprises agree upon under these circumstances? Applying these payment terms to the transaction between associated enterprises will ensure their relationship is consistent with the ALP.
As an illustration of how the ALP applies to determine a transfer price, consider an enterprise that licenses certain intangible property to an associated enterprise for commercial exploitation in certain markets. The two associated enterprises agree upon certain contractual restrictions on the licensee’s use of this intangible property and agree further to share extrinsic risks by stipulating that royalty payments will be contingent on the actual revenues generated by products incorporating the licensed intangibles. To determine the arm’s length royalty rate, we would examine any evidence of independent enterprises licensing comparable intangibles, with comparable commercial potential, facing comparable extrinsic risks, operating under comparable contractual restrictions, and structuring license payments as royalties contingent on sales. The royalty rates in such independent enterprise licensing agreements would serve as the arm’s length royalty rates for the associated enterprise transaction. If, by contrast, the intangible property owner licensed the intangible with a stipulated lump-sum payment from the licensee to the licensor, so that the risks of extrinsic outcomes are borne entirely by the licensee, we would have to look for evidence on how independent enterprises would set a lump-sum payment when entering into a comparable commercial relationship now marked by focusing extrinsic risks on the licensee. If no such evidence was observable, other transfer pricing methods can yield an arm’s length lump-sum price.

As discussed above, the payment terms observed among independent enterprises will reflect any moral hazards that arise in their commercial or financial relations, given the contractual provisions in these relations and the allocations of extrinsic risk undertaken. Therefore, the ALP requires that the payment terms between associated enterprises should reflect not only extrinsic risks but also the moral hazard that would arise between independent enterprises if they were to engage in the same relations on similar terms. The ALP thus requires
associated enterprises to select payment terms that embed a compensation for moral hazard risks they may not actually bear, or bear only to a much smaller degree. The ALP thus properly interpreted has the advantage of allowing associated enterprises to draw on the significant body of market evidence on payment terms between independent enterprises to establish intercompany payments, without requiring adjustments for the absence of moral hazard risks.

The ALP, as articulated above, is consistent with transfer pricing methods that have had a well-established history both in the TPG and in U.S. transfer pricing regulations. The Comparable Uncontrolled Transaction ("CUT") method identifies arm’s length payment terms with respect to payments between independent enterprises engaged in comparable commercial relations under comparable contractual terms and allocations of risk. To the extent moral hazard exists in comparable relations between independent enterprises, this moral hazard is already embedded in the payment terms of CUTs. Similarly, the profit margins of enterprises performing economic activities through market-mediated transactions with unrelated firms reflects the effect of moral hazard in these transactions, at least to the extent they’re sufficiently material to affect the pricing of these transactions. Transactional net margin methods—which determine intercompany prices in relation to the profit margins of independent enterprises performing comparable activities—thus also reflect moral hazard risks prevalent in the market-mediated transactions of such enterprises.

In certain situations, the commercial or financial relations between associated enterprises are not directly comparable to relations observed between independent enterprises. As the OECD Guidelines repeatedly recognize, however, the absence of a directly comparable transaction between independent enterprises doesn’t mean a transaction between associated
enterprises isn’t arm’s length.\textsuperscript{34} One can use methods described in the TPG and U.S. Treasury Regulations for determining payment terms independent enterprises would negotiate under the conditions applying to the transaction between associated enterprises. The requisite economic analysis might consist of determining an appropriate adjustment to the terms of market transactions that are substantially similar to the associated enterprise transaction except for particular contractual terms or extrinsic risk allocations. Alternatively, where appropriate, this analysis might entail a fundamental analysis of how independent enterprises might split the aggregate profits from the subject transactions within a profit split method. Considerations of moral hazard risks may require economists to analyze the effects of information and incentives in finer detail within their models but this doesn’t impugn applicability of such non-transactional methods in determining arm’s length payment terms.

2. \textbf{Proposed changes to § D.2 of the TPG—moral hazard and risk-return trade-off}

The \textit{Actions 8–10 PDD} invites comments on several issues relating to moral hazard, the risk-return trade-off and their implications for the ALP.

\textbf{Question 1. Under the arm’s length principle, what role, if any, should imputed moral hazard and contractual incentives play with respect to determining the allocation of risks and other conditions between associated enterprises?}

The ALP requires payment terms between associated enterprises to be determined with reference to payment terms that would be observed among independent enterprises engaged in the same commercial or financial relation under comparable contractual provisions and comparable allocations of extrinsic risk. As discussed in § II.A.1.b above, payment terms

\textsuperscript{34} TPG, ¶ 1.11.
negotiated between independent enterprises under such conditions will reflect any moral hazard risk remaining between these enterprises under these conditions. Arm’s length payments between associated enterprises will thus generally reflect moral hazard risks arising among independent enterprises operating under the same commercial relationships under similar contractual provisions and comparable allocations of extrinsic risk.

The fact that arm’s length payment terms reflect the moral hazard operating between independent enterprises doesn’t mean that moral hazard risks and the corresponding contractual incentives between such enterprises are being imputed to associated enterprises. As discussed above, the existence of common control between associated enterprises may reduce moral hazard between such enterprises. To impute all independent enterprise moral hazard risks to such associated enterprises would be to imbue the associated enterprises with risks they may not actually face. Arm’s length payments reflect moral hazards faced by independent enterprises because: (a) market prices, the best source of information on the pricing of economic transactions between independent enterprises, reflect moral hazards faced by such enterprises in their dealings with each other; (b) there’s little market-based evidence to adjust these prices for the absence of moral hazard, precisely because moral hazard typically arises in market-mediated transactions; and (c) the use of such market prices has the virtue of being consistent with long-established and widely adopted methods of transfer pricing analyses, which are based on direct evidence or economic modeling of the terms on which independent enterprises would transact.
Question 2. How should the observation in paragraph 67 that unrelated parties may be unwilling to share insights about the core competencies for fear of losing intellectual property or market opportunities affect the analysis of transactions between associated enterprises?

The observation is correct only in the limited sense that such lack-of-sharing behavior “may” be observed, but it’s incorrect as a general matter. In many technology-intensive industries, such as semiconductors, networking or computer hardware, technologies that have to be integrated within a final product used by consumers are developed by independent enterprises. These enterprises have developed effective contractual mechanisms to share vital information about their proprietary technologies with other firms in the value chain to facilitate a mutually advantageous cohesion in their technology development efforts.35

The prevalence of such agreements within the information economy indicates that it’s possible to design a set of contractual provisions that enable proprietary information to be transmitted through market-mediated relationships to facilitate certain transactions while preventing its leakage into unintended uses. If a transaction among associated enterprises would involve the transmission of valuable intellectual property or core competencies from one enterprise to another, the arm’s length conditions for this transaction can thus be determined as follows: (i) first, hypothesize a transaction between independent enterprises involving the same functions and requiring the same flow of proprietary information from one such enterprise to the other; (ii) identify contractual provisions that would effectively constrain each such enterprise from using the other’s proprietary information in unintended ways; (iii) conduct an economic

35 Many examples can be offered for such mutually advantageous flows of information. One such example arises in the world of enterprise software, where the developers of operating systems for enterprise computing systems share proprietary information about their software code with independent developers of tools that enhance the productivity of these operating systems for consumers. A variety of contractual, relational, and compensation mechanisms have emerged to curb moral hazard and information risks among independent enterprises, thereby helping companies develop and exploit knowledge-based assets within such relationships.
analysis to identify the additional costs and risks (if any) borne by each such independent enterprise as a result of the constraints to which it’s subjected under these contractual provisions, offset by the anticipated economic benefits they stand to realize by complying with these provisions; and (iv) in light of these economic benefits, costs, and risks, determine the payments to be made by the independent enterprises to each other under the transaction. Such an analysis may be economically complex, but it’s not qualitatively different from the analyses required to quantify other complex sources of economic benefits, costs, and risks.

**Question 3. In the example at paragraphs 90 and 91 how should moral hazard implications be taken into account under the arm’s length principle?**

In this example, the *Actions 8–10 PDD* asserts that a potential moral hazard could arise because Company S2, which will own the trademark after the sale transaction, doesn’t perform the extensive marketing functions needed to maintain and enhance the trademark. These functions will continue to be performed by the seller of the trademark, Company S1, under the monitoring and supervision of S2. However, S1 will now be performing these marketing functions for the benefit of a trademark it doesn’t own or fully control. Under these conditions, ¶¶ 90–91 asserts that the proposed sale of the trademark would create moral hazards so acute as to render the sale economically infeasible if S1 and S2 were independent enterprises.

This conclusion is unjustified by the facts in ¶¶ 90–91. We’re told that as part of the agreement under which S1’s trademark is sold to S2, S1 gets a license from S2 to use the trademark in exchange for an annual royalty payment. The example is silent on whether this

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36 We raise other concerns with this example below, in § II.A.3, below, where we discuss how the *Actions 8–10 PDD* addresses recharacterization under the ALP.

37 This assertion relates to the “fundamental economic attributes” test the *Actions 8–10 PDD* fashions to permit recharacterization of associated enterprise transactions. We address this test in § II.A.3, below.
license is exclusive in S1’s territory. If the license is exclusive, it’s readily seen that S1 will have a strong incentive to maintain and enhance the trademark as effectively as possible, because S1 will get any incremental revenues that arise from the enhanced value of the trademark. Provided the royalty rate for the license is set efficiently to leave some benefit of these incremental revenues with S1, S1’s incentives to maximize the value of the trademark will be strong. Knowing this, S2 will be prepared to purchase the trademark from S1 for a lump-sum that reflects the present value of the anticipated future royalty stream from licensing the trademark back to S1. This lump-sum amount also should fully compensate S1 for the anticipated income foregone by selling the trademark.

Paragraph 91 expresses the concern that “Company S2 has no practical safeguards and is dependent on S1 to act appropriately . . . and S2 itself does not direct the way in which it can optimize returns on its asset.” But this concern is moot in light of the strong alignment of incentives between S1 and S2 regarding the value of the trademark. Equally moot is the concern that “Company S1 is theoretically subject to the constraints of the terms agreed with S2 on ongoing activity related to the maintenance and enhancement of the trademark.” Given their shared interest in maximizing the value of the trademark, S1 isn’t constrained by contract terms that require it to conduct marketing activities for the trademark because S1 has a direct economic incentive to do so even in the absence of such terms.

There remains the question of how S1 “enhances or protects its commercial or financial position” through such a transaction. Even if the lump-sum compensates S1 for the income foregone by selling the trademark, why should S1 not just hold on to the trademark and realize this stream of anticipated trademark income in the future rather than converting this income into a lump-sum amount up-front through the sale of the trademark? Again, ¶¶ 90–91 are silent on
the facts necessary to evaluate this question, but one can envisage circumstances under which the sale of the trademark would be beneficial to S1 and S2. If S1 is specialized in the business associated with the trademark, its risks are concentrated in this business. Considered as an independent enterprise, S1 may have an interest in diversifying its business risks. Selling the trademark for a lump-sum and then investing this lump-sum in an uncorrelated activity or financial instrument allows S1 to achieve this diversification. Depending on its circumstances, S2 may be in a better position to bear the risks associated with the trademark than S1. This could happen if S2 holds other intangible property rights that aren’t highly correlated with the trademark (e.g., if S2 owns a broad portfolio of intangible property rights). If S2 can bear the risks of the trademark better than S1 can, the trademark would be more valuable in S2’s hands than S1’s. If so, this would be an added rationale for the transaction.

As an alternative to incentives, S2 may consider contractual provisions as the solution to S1’s potential moral hazard. Paragraph 90 notes that S2 has several employees with capability to “assess, monitor and direct the use of the trademark by S1.” These capabilities may ensure that S2 can assess the marketing activities needed to enhance the value of the trademark, direct the efforts of S1 in performing these activities and monitor whether S1 is performing the specified tasks. These capabilities are sufficient to support contract provisions stipulating actions S1 should take, identify any failures by S1 to perform these tasks, and impose penalties in this eventuality. Thus, as an alternative to incentives, contract provisions can also serve to effectively bind S1 into acting in the interests of the trademark.

We’ve so far assumed that after the sale of the trademark, S2 will license the trademark back to S1 on an exclusive basis. This assumption isn’t necessary for the overall transaction between S1 and S2 to be viable. If S2 licenses the trademark back to S1 only on a non-exclusive
basis, S1 will have to consider the possibility that its marketing efforts aimed at maintaining and enhancing the trademark will benefit not only its own future sales but also sales of potential rival manufacturers who may license the same trademark. S2 can still maintain S1’s incentive to provide such marketing efforts for the trademark by making S1’s compensation for these efforts contingent in some form on aggregate sales of all products sold under the trademark (not just S1’s sales). Now, after S1 initially sells the trademark to S2 for a lump-sum amount, S1 will still have an incentive to enhance the overall value of the trademark through its marketing efforts because it retains a financial interest in this overall value through its compensation for these marketing efforts.

As a non-exclusive licensee and producer of goods sold under the trademark, S1 may lose some market share after the transaction if S2 licenses the trademark to other enterprises. However, S1 can recover the value of these lost profits up-front through the lump-sum price it charges S2 for the trademark. If this price is properly calibrated, S2 should be in a position to pay this price because it gets the incremental profits earned by the trademark from licenses to enterprises other than S1. Of course, careful economic analysis will be necessary to establish the economically efficient set of lump-sum values and royalty rates.

Question 4. Under the arm’s length principle, should transactions between associated enterprises be recognized where the sole effect is to shift risk? What are the examples of such transactions? If they should be recognized, how should they be treated?

Independent enterprises transacting at arm’s length often enter into transactions whose sole economic effect is to shift risk. A classic example is the purchase of insurance. When a firm enters into a contract with an insurance provider to insure against the risk of an adverse business outcome (for example, the firm buys business casualty insurance), the firm is shifting
the risk of this outcome to the insurance provider. In exchange, the firm pays the insurance provider a series of stipulated payments (or insurance premiums) to bear this risk.

Between associated enterprises, an example of pure risk-shifting arises when a parent company implicitly or explicitly guarantees the debt of its subsidiary. Without such a guarantee, the subsidiary would have to pay its creditors an interest rate that included not only a benchmark borrowing rate such as the prime rate but also a spread above this rate for the default risk associated with its borrowing. If the parent company is regarded as more credit-worthy than the subsidiary, the parent’s guarantee will ensure the subsidiary will have to pay its creditors only the lower interest rate associated with the parent company. At arm’s length, the subsidiary will have to compensate the parent for providing this guarantee. Drawing on well-established models for pricing credit risk, it’s possible to determine the lump-sum payments or the stream of annual premiums that would give the parent company an actuarially fair return on its anticipated payment obligations under the guarantee.

So pure risk-shifting transactions occur regularly between independent enterprises, and they can also arise between associated enterprises. They should therefore be recognized as valid transactions\(^{38}\) and priced according to well-established analytical models for the pricing of risk.

**Question 5. In the example at paragraphs 90 and 91, how does the asset transfer alter the risks assumed by the two associated enterprises under the arm’s length principle?**

As discussed above in response to Question 3, the sale of the trademark by S1 to S2 will likely reduce S1’s exposure to the aggregate risks of the business in which this trademark is

\(^{38}\) This assumes that the economic substance of such transactions is consistent with their form (see discussion below in § II.A.3.a.i).
used. In exchange for the risky stream of incremental income associated with this trademark, S1 gets a fixed lump-sum amount, which can be invested in other income-generating assets whose risks are different from those of the trademark’s line of business.

By contrast, the same transaction increases S2’s exposure to the risks of the trademark’s line of business. However, the lump-sum paid by S2 to S1 would fairly compensate S2 for holding this risk. Specifically, under economic principles for the pricing of risky cash flows, the trademark should be valued by first identifying the risk-adjusted return S2 should expect to get for being exposed to the trademark’s overall risks. The lump-sum value of the trademark should be the present value of the incremental expected future income from the trademark, discounted at this risk-adjusted rate of return. At this value, S2 will earn the risk-adjusted expected return on the amount spent to buy the trademark.

If S2 is better positioned to bear the risks of the trademark than S1 (for example, because S2 has alternative assets or investments, that provide better diversification for the trademark’s income stream, than has S1, which is specialized in the business associated with the trademark), the risk-adjusted expected return S2 requires to hold the trademark is lower than the corresponding expected return S1 requires. Therefore, S2 would value the trademark more highly than S1. 39 If so, both enterprises can stand to gain from the transfer of the trademark from S1 to S2.

39 The discount rate used by S2 to determine the present value of the trademark’s expected income would be lower than that used by S1. Therefore, the present value of the trademark’s expected income will be higher for S2 than for S1.
Question 6. In the example at paragraphs 90 and 91, how should the risk-return tradeoff implications be taken into account under the arm’s length principle?

The answers to the previous questions also indicate the answer to this question. As the *Actions 8–10 PDD* notes, the risk-return tradeoff principle supports the notion that it’s economically rational to take on (or lay off) risk in return for higher (or lower) anticipated nominal income.\(^\text{40}\) The example in ¶¶ 90–91 illustrates the application of this principle both for S1 and S2. First, S2 takes on risks associated with the income from using the trademark. S2 gets royalty payments by licensing the trademark to S1, but S2 also has to pay S1 a lump-sum amount to buy the trademark from S1. These two streams of payments are connected; the lump-sum value paid by S2 to S1 should equal the present value of S2’s anticipated income from licensing the trademark, computed at a discount rate that reflects the risks associated with the trademark’s royalty stream. The higher this risk-adjusted discount rate, the lower is the value S2 should pay as a lump-sum in exchange for the royalties anticipated from S1. The net effect of the sale and subsequent license is that by paying up-front the discounted value of the anticipated future income stream from the trademark license, S2 is in the position to realize an expected return equal to the risk-adjusted discount rate from purchasing the trademark. Thus, in summary, S2 takes on the higher risk of the trademark’s income in exchange for an expected return that includes a risk-premium commensurate with the risks incorporated in the trademark’s expected income stream.\(^\text{41}\)

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\(^{40}\) *Actions 8–10 PDD*, p. 14.

\(^{41}\) If S2 gives S1 not an exclusive but rather a non-exclusive license to the trademark, and licenses the trademark to other firms, as discussed above S2’s risk profile changes but the overall conclusion remains the same.
As the counter-party to both legs of this transaction, S1 is in the reverse of S2’s position. Specifically, S1—by getting the lump-sum but giving up the future income stream—is giving up the risk-adjusted expected return on the trademark’s future income in exchange for not bearing the risks of the trademark. Therefore, the choices of both S1 and S2 are consistent with Actions 8–10 PDD’s risk-return trade-off principle.

Question 7. Under the arm’s length principle, does the risk-return trade-off apply in general to transactions involving as part of their aspect the shifting of risk? If so:

a) Are there limits to the extent that the risk-return trade-off should be applied? For example, can the risk-return trade-off be applied opportunistically in practice to support transactions that result in BEPS (for example by manipulating the discount rates to “prove” that the transaction is economically rational)?

b) Are there measures that can be taken in relation to the risk-return trade-off issue to ensure appropriate policy outcomes (including the avoidance of BEPS) within the arm’s length principle, or falling outside the arm’s length principle?

Yes, the risk-return trade-off does, under the ALP, apply in general to transactions involving as part of their aspect the shifting of risk (see the answer to question 6). Question 7a) is unclear, but seems directed at putative “opportunistic” behavior of taxpayers. The discussion in this letter regarding risk-return trade-off presumes proper application of the ALP, accurate assessment of risks, and justifiable use of corresponding discount rates. Question 7b) is excessively open-ended. We believe BEPS concerns are adequately addressed within the ALP (including perhaps a special measure allowing, in narrow circumstances and subject to the ALP, ex post adjustments to be made to associated enterprise transfer prices) and perhaps by the implementation of adequately-tailored CFC regimes. The response to question 5 shows, consistent with the risk-return trade-off principle, that associated enterprise transactions can—depending in part on the risk profiles—enhance the economic positions of both enterprises and may be observable among independent enterprises. The function of the ALP, however, is to
price associated enterprise transactions based on hypothetical behavior of independent enterprises.

3. Proposed changes to § D.4 of the TPG—non-recognition

a. General comments

i. The ALP doesn’t justify recharacterization of an associated enterprise transaction unless the economic substance of such transaction doesn’t mirror its form

Section D.4 of the TPG involves fundamental attributes of associated enterprise transactions, and it’s critical to keep in mind some basic tax principles.

The first concerns “economic substance.” The tax laws of many countries have—either in common law or in statute—a version of the economic substance doctrine allowing a tax authority to disregard the form of a transaction as structured by a taxpayer and recharacterize it (i.e., treat it for tax purposes) according to its perceived “economic substance.” This is most often, but not exclusively, applied to transactions involving associated enterprises. A tax authority may, for example, assert that a transaction structured by associated enterprises as a sale is in economic substance a structured financing arrangement, and tax it accordingly.

The ability to disregard the form of an associated-party transaction and recharacterize it according to its economic substance must be a fundamental part of the ALP. Obviously one must, when applying the ALP, know the substance of the “commercial relations” between associated enterprises because under the ALP this commercial relation is imputed to the independent enterprises so an arm’s length transfer price can be found. If a transaction among associated enterprises lacking economic substance is imputed to independent enterprises, the wrong transfer price will result. This application of economic substance principles looks to what
in substance the associated enterprises are doing, and ignores considerations of whether independent enterprises would do this. If the form of an associated enterprise transaction has economic substance—if, for example, a transaction whose form is a license is in economic substance also a license—the transaction should be respected for transfer pricing purposes.  

A similar use of economic substance characterization of a transaction comes when one performs a comparability analysis. Obviously one must, for comparability of contracts with independent enterprise transactions, use what is in economic substance the associated enterprise transaction.

Consistent with this discussion of recharacterization that must be allowed under the ALP, ¶ 1.65 of the TPG allows a tax administration—if the economic substance of a transaction differs from its form—to “disregard the parties’ characterisation of the transaction and re-characterise it in accordance with its substance.”

The TPG assert in ¶ 1.65 that for transfer pricing purposes, being able to recharacterize a transaction consistent with its economic substance isn’t enough—tax administrations need a further recharacterization tool. To justify this additional recharacterization authority, the TPG discusses an example of—

a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research

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42 See, e.g., U.S. Treasury Regulation § 1.482-1(f)(2)(ii)(A) “The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance.”

43 See, e.g., U.S. Treasury Regulation § 1.482-1(d)(3)(ii)(B)(i) “The contractual terms, including the consequential allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions.”
for the term of the contract (as indicated in paragraph 1.11). While in this case it may be proper to respect the transaction as a transfer of commercial property, it would nevertheless be appropriate for a tax administration to conform the terms of that transfer in their entirety (and not simply by reference to pricing) to those that might reasonably have been expected had the transfer of property been the subject of a transaction involving independent enterprises. Thus, in the case described above it might be appropriate for the tax administration, for example, to adjust the conditions of the agreement in a commercially rational manner as a continuing research agreement.\textsuperscript{44}

The example posits enterprise X selling to associated enterprise Y for a lump sum payment “unlimited entitlement to the intellectual property rights arising as a result of future research.” The example doesn’t say so, but presumably the research is done on some underlying set of intangible property;\textsuperscript{45} the example also doesn’t say which enterprise owns the underlying intangibles, but from the conclusion we can suppose it’s Y. That is, what’s happening in the example is X nominally selling Y, for a lump sum “unlimited entitlement to the intellectual property rights arising as a result of future research” done on intangible property owned by Y. But if X doesn’t own the underlying intangible property it has nothing to sell Y—X is merely providing services to Y: this is the economic substance of the arrangement. Tax case law is used to addressing these situations by gleaning the substance of a transaction.\textsuperscript{46} No new recharacterization tool is needed, merely proper application of the existing economic-substance-over-form recharacterization tool.\textsuperscript{47} Thus the proffered example justifying the need for another recharacterization tool doesn’t support the need for it.

\begin{itemize}
\item \textsuperscript{44} TPG, ¶ 1.65.
\item \textsuperscript{45} Reference to “continuing research” supports this presumption, but the presumption isn’t necessary—the same conclusion obtains if X purports to “sell” Y any fruits of future “blue sky” research not based on existing intangibles.
\item \textsuperscript{46} See, e.g., Boulez v. Commissioner, 83 T.C. 584 (1984).
\item \textsuperscript{47} If in fact the example intended X to own the underlying intangibles then X could sell “unlimited entitlement to the intellectual property rights arising as a result of future research” done on the underlying intangibles X owned, and if so X wouldn’t be performing R&D services for Y.
\end{itemize}
As explained above, the ALP by its terms doesn’t require or condone recharacterization of a transaction assuming the economic substance of the transaction mirrors the form. With this assumption, the ALP posits that independent enterprises engage in the same commercial relation (transaction and extrinsic risks) as that between associated enterprises, and then determines the appropriate transfer price based both on the imputed extrinsic risks and any moral hazard risks arising. There’s a distinction between recharacterizing or disregarding a transaction between associated enterprises and recharacterizing or disregarding a particular term or terms of such a transaction—in particular, pricing terms. In the case of transactions involving hard-to-value intangibles one might argue that in some circumstances a form of ex post pricing is warranted. To emphasize, this would respect the overall transaction but simply recast the amount and form of the pricing to be based on actual outcomes. This is precisely the approach of special measure Option 1 in the Actions 8–10 PDD, dealing with hard-to-value intangibles (discussed below). Taxpayers should not be subject to this modification to the pricing terms of their associated enterprise arrangements if they can demonstrate conformity with the ALP—i.e., the authority to make ex post adjustments to the amount and form of pricing terms in the case of hard-to-value intangibles should always be subject to the ALP.

ii. The “fundamental economic attributes” test for recharacterization in the Actions 8–10 PDD rests on flawed reasoning

As just explained, the ALP strictly doesn’t condone disregard or recharacterization of a structure adopted by associated enterprises in entering into a controlled transaction unless the economic substance of the transaction differs from its form. The example in ¶ 1.65 of the TPG allegedly justifying an alternative tool for recharacterizing associated enterprise transactions can be readily dealt with using economic-substance principles, and doesn’t justify a second ground
for recharacterizing associated enterprise transactions. The second recharacterization tool is set out as follows:

The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price. 48

This ground for recharacterization is difficult to understand, but in any event it’s not justified under the ALP, nor is it needed to apply the ALP to get an arm’s length price. The Actions 8–10 PDD, however, to give “greater definition” 49 to this alternate test for recharacterization, recasts the alternate test and ends up with a “fundamental economic attributes” test for disregarding associated enterprise transactions.

The plain meaning of this alternate test is that two requirements must each be met for recharacterization to be permitted: (i) commercial arrangements made in relation to an associated enterprise transaction “differ from those which would have been adopted by independent enterprises behaving in a commercially rationale manner;” and (ii) “the actual structure practically impedes the tax administration from determining an appropriate transfer price.” The Actions 8–10 PDD calls this the “two legs” test. The plain meaning of this test is that if either requirement (i) or (ii) isn’t met, recharacterization isn’t permitted. But the Actions 8–10 PDD states that the “two legs can lead to the assertion that if you can find a price, the arrangement is not commercially irrational.” This assertion would be unfounded—the legs are independent, so

48 TPG, ¶ 1.65.
49 Actions 8–10 PDD, ¶ 88.
failing requirement (ii) generally says nothing about whether requirement (i) is met or fails. The assertion doesn’t comport with a plain reading of the two legs test.

But the *Actions 8–10 PDD* makes this assertion apparently to cast doubt on the two legs interpretation, which it contrasts with “interpreting the pricing impediment reference as an inherent quality of an arrangement lacking commercial rationality.” With this, the *Actions 8–10 PDD* recasts the two legs test—which nominally says a tax administration can recharacterize if both requirements (i) and (ii) are met—into something different: it asserts that if requirement (i) is met (i.e., commercial irrationality) then requirement (ii) will be met (i.e., impedance of appropriate transfer price). Thus according to the *Actions 8–10 PDD*, requirement (ii) is redundant: “commercially irrational” arrangements—whatever that might mean—would automatically impede appropriate transfer pricing. The focus then, according to the *Actions 8–10 PDD*—shifts from determining an appropriate transfer price (which is the base function of the ALP) to commercial rationality (which is arguably indeterminate).

The *Actions 8–10 PDD* asks “whether it is appropriate in the first place to try to find a price for something which lacks the fundamental economic attributes of arrangements between unrelated parties.” With this, the *Actions 8–10 PDD* has replaced requirements (i) & (ii) of the two leg test for recharacterization (which isn’t in the first place justified under the ALP) with just requirement (i) (because, the *Actions 8–10 PDD* asserts, requirement (ii) is automatically met if requirement (i) is), and then replaced requirement (i) by a “fundamental economic attributes” requirement.

As a final step, the *Actions 8–10 PDD* explains the “fundamental economic attributes” requirement—
An arrangement exhibiting the fundamental economic attributes of arrangements between unrelated parties would offer each of the parties a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted (the return adjusted for the level of risk associated with it) basis, compared to other opportunities realistically available to them at the time the arrangement was entered into. If the actual arrangement, viewed in its entirety, would not afford such an opportunity to each of the parties, or would afford it to only one of them, then the transaction would not be recognised for transfer pricing purposes.  

The *Actions 8–10 PDD* in essence asserts that if a transaction didn’t offer two independent enterprises “a reasonable expectation to enhance or protect their commercial or financial positions on a risk-adjusted . . . basis, compared to other opportunities realistically available to them at the time the arrangement was entered into,” the transaction likely wouldn’t be observed among independent enterprises. What the “fundamental economic attributes” test thus does is allow a tax authority to recharacterize any associated enterprise transaction that likely wouldn’t be observed at arm’s length.

What the *Actions 8–10 PDD* has done in ¶¶ 88–89 is take a test for recharacterization of associated enterprise transactions that isn’t justified under the ALP, and in any case is hard to understand,51 and—purporting to give “greater definition” to the test—replaced it with the “fundamental economic attributes” test, which in essence would allow recharacterization of any associated enterprise transaction that isn’t observed among independent enterprises. This isn’t justified. The original two step test for recharacterization arguably had no basis in the ALP. Particular associated enterprise transactions may not always be observable among independent enterprises because of moral hazard risks that might arise among independent enterprises, but

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50 *Actions 8–10 PDD*, ¶ 89 (emphasis added).

51 “That [commercial rationality] test can be difficult to apply since it is hard to delineate what independent enterprises behaving in a commercially rational manner would have done.” *Actions 8–10 PDD*. 
this doesn’t mean that (a) such associated enterprise transaction doesn’t make sense economically intra-group; (b) a transfer price can’t be found (see the discussion above); or (c) the associated enterprise transaction must be recharacterized. The ALP by its terms, and normatively, applies to find a transfer price using the hypothetical behavior of independent enterprises assumed to be engaged in the same commercial relation as associated enterprises, taking into account the same extrinsic risks and any moral hazard risks that arise.

Recharacterization of the related party transaction—other than to ensure economic substance mirrors form—is neither permitted nor needed under the ALP.

b. Comments on the example in ¶¶ 90–91 of Actions 8–10 PDD

The example in ¶¶ 90–91 of the Actions 8–10 PDD tries to show application of the “fundamental economics attributes” test, which as explained above is based on flawed reasoning and is in any case not required for proper application of the ALP. The Actions 8–10 PDD ignores the relevant question: what’s the transfer price in this case under the ALP? We make four interrelated points. First, the analysis in the example is in several places flawed. These failures were described in § II.A.2 above, where we addressed the example under questions 3, 5, and 6 posed in the Actions 8–10 PDD relating to moral hazard and risk-return trade-off.

Second, the example posits that “extensive marketing functions with regard to the maintenance and enhancement of the trademark will be undertaken and managed by Company S1,” but also that “Company S2 has several employees with capability to assess, monitor, and direct the use of the trademark.”

It’s unclear why Company S2’s direction of the use of the trademark wouldn’t overlap or even trump Company S1’s management of the maintenance and enhancement of the trademark. Third, trademark law best practices would have Company S2 conducting core

\[52\] Actions 8–10 PDD, ¶ 90.
trademark control functions — e.g., making decisions on what products to brand, their quality, etc. If Company S2 failed to conduct those functions, it may be subject to challenge that its trademark is invalid, and its trademark rights could be cancelled. Fourth, assuming Company S2 performs such core trademark control functions, the substance of the arrangements mirrors its form, and properly analysing the underlying economics, yields different results, as shown in the table below.

<table>
<thead>
<tr>
<th>Actions 8–10 PDD assertion</th>
<th>comments (assume S2 performs core TM mgmt &amp; control)</th>
</tr>
</thead>
<tbody>
<tr>
<td>likely to have lost commercial value because it no longer owns the trademark key in generating its income</td>
<td>◊ S1 received $400m—if price is arm’s length, commercial value of S1 shouldn’t drop</td>
</tr>
<tr>
<td></td>
<td>◊ it’s wrong to assert that a sale for arm’s length price subject to license-back results in loss of commercial value for S1</td>
</tr>
<tr>
<td>subject to additional risk it’s reliant on S2 (treated as independent under ALP) being willing to license TM and not to take actions that might enhance TM value for S2 but detract from S1</td>
<td>◊ sale of TM can be made subject to license back (a common commercial arrangement)—i.e., little risk (a common extrinsic risk)</td>
</tr>
<tr>
<td></td>
<td>◊ situation of S2 taking actions that enhance TM value for S2 but detract value for S1 is extreme in a way not normal—generally one could expect enhancement in value of TM to benefit S1, too</td>
</tr>
<tr>
<td>“theoretically” subject to constraints of contract with S2 on ongoing activity relating to maintenance and enhancement of TM</td>
<td>◊ if substance mirrors form, S1 is subject to constraints of services contract with S2</td>
</tr>
<tr>
<td></td>
<td>◊ if S2 employees make core branding &amp; other decisions relating to TM (i.e., properly manage TM) ⇒ benefit to S1 from performing functions directed by S2 employees</td>
</tr>
<tr>
<td>has no practical safeguards and is dependent on S1 to act appropriately to enhance &amp; protect its asset (TM) through marketing functions S1 undertakes</td>
<td>◊ S2 control substance mirrors contractual form</td>
</tr>
<tr>
<td></td>
<td>◊ S2 makes core decisions re maintenance, enhancement, &amp; protection of TM</td>
</tr>
<tr>
<td></td>
<td>◊ S2 would contractually bind S1 to take no action adverse to TM (trademark law practice)</td>
</tr>
<tr>
<td>doesn’t direct way in which it can optimize returns on its asset (TM)</td>
<td>◊ S2 makes core decisions relevant to optimizing returns on its asset</td>
</tr>
<tr>
<td>has less capability than S1 to manage &amp; control marketing that will affect generation of income streams;</td>
<td>◊ S2 has full capability to manage &amp; control marketing</td>
</tr>
<tr>
<td>hasn’t enhanced or protected its commercial position but may have damaged it by not managing risks to achieve a return on its investment in the asset</td>
<td>◊ S2 has enhanced or protected its commercial position by managing risks</td>
</tr>
</tbody>
</table>
The point of the exercise is to show that varying the facts to parallel those in arrangements considered sound from a trademark law perspective, and assuming the substance of the arrangement mirrors its form, can yield a different result under the “fundamental economic attributes” test $^{53}$—but as explained above this test in any event should be rejected under the ALP.

B. Part II of Actions 8–10 PDD, proposing five special measures

The special measures in Option 1 and the primary rule in Option 5 warrant further consideration and could, if modified, form practicable BEPS tools for WP-6 to endorse. The special measures in Options 2–4 and the secondary rule in Option 5 should be rejected, however. Below we expand on these recommendations.

1. The special measures in Option 1 & the primary rule in Option 5 could, if modified, form practicable BEPS tools

   a. Option 1—HTVI

      i. General comments

      The special measure in Option 1 shares features with “commensurate with income” adjustments permitted under § 482 of the U.S. Internal Revenue Code of 1986, as modified, and implemented under the “periodic adjustments” rule in § 1.482-4(f)(2) of the associated U.S. Treasury Regulations. Option 1 could, if suitably modified, be appropriate for dealing with hard-to-value intangibles.

      By its terms, the special measure could be invoked if two requirements are met:

$^{53}$ As pointed out in § II.A.2 above, in the responses to questions 3, 5, and 6, the economic analysis in ¶ 91 supporting the conclusion in the Actions 8–10 PDD is flawed.
[1] a taxpayer fixes a transfer price for an intangibles transaction either as a lump sum or as a fixed royalty rate on the basis of projections without any further contingent payment mechanism; and

[2] the taxpayer doesn’t contemporaneously document those projections and make them available to the tax administration.

Thus the special measure wouldn’t operate in a situation in which a taxpayer adopts a lump sum or fixed royalty, but contemporaneously documents projections and makes them available to the tax administration. If the special measure is invoked, a tax administration could presume a price adjustment mechanism would have been adopted and would be permitted to “rebase the calculations based on the actual outcome, imputing a contingent payment mechanism.” Option I presents conditions under which the presumption would be rebuttable.

We recommend Option 1 be modified to make clear that any adjustments made under an HTVI special measure should be subject to the ALP and the TPG. Accordingly, the special measure wouldn’t operate in circumstances in which a taxpayer produced evidence of the same intangibles being the subject of transactions with independent enterprises under substantially the same circumstances as those of the associated-enterprise transaction. Any HTVI special measure should acknowledge the difficulty of making projections over multi-year periods and accordingly be inoperable if a taxpayer has, say, five post-transaction years in which no adjustments were warranted under the special measure.

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54 Actions 8–10 PDD, p. 41. We assume the contingent payment mechanism would be such that any adjustments would be based on actual income.
ii. **Answers to framework questions for Option 1**

[1] **Efficacy**—The modifications to Option 1 outlined above would improve it. The goal of getting closer alignment between transfer pricing outcomes and value creation may—in the absence of comparable transactions and absent a robust contemporaneous transfer pricing analysis—be furthered by a special measure, subject to the ALP, allowing a tax administration to make the rebuttable presumption outlined in the special measure, as modified.

[2] **Advantages/disadvantages**—Option 1 as modified would ensure the special measure operates within the framework of the ALP, which has long served as the yardstick for pricing associated-enterprise transactions. This would minimize risk of double taxation inasmuch as adjustments made under the special measure (as modified) would be covered by Article 9, ¶¶ 1 & 2 of the OECD MTC.

[3] **Likely effect**—Option 1 as modified likely wouldn’t encourage behavioral changes, other than to encourage robust and contemporaneous transfer pricing documentation.

[4] **Adaptation of TP rules**—Option 1 as modified would be subject to the ALP and TPG.

[5] **Targeting**—Option 1 as modified targets situations involving hard-to-value intangibles using bright lines rules that increase the likelihood of tax administrations agreeing a case meets the criteria for application of the measure and on the resulting measurement.

[6] **Tax advantage**—the special measure makes no reference to tax attributes; the measure as modified shouldn’t include criteria limiting it to circumstances where the arrangement results in a tax advantage to the group.
Ordering—Option 1 as modified would be subject to the ALP and TPG, and thus become part of the “normal” transfer pricing rules.

Eliminating double taxation—the special measure as modified would be subject to the ALP, so that adjustments made under the measure would be consistent with Article 9, ¶ 1, thereby under Article 9, ¶ 2 minimizing the risk of double taxation.

Excluding sectors—no sectors should be excluded from application of the measure.
b. **Option 5—excess returns**

i. **General comments**

The primary rule special measure in Option 5, if applied to tax CFC income at the CFC’s ultimate parent jurisdiction and if suitably crafted, could address any residual BEPS concerns, after application of the ALP and TPG, about non-taxation of CFC income. A CFC approach at the ultimate parent jurisdiction level has long existed as a mechanism to deem income to the ultimate parent, and tax that income, based on income earned by the CFC.\(^{55}\) Significantly, the primary rule would have to operate after application of normal transfer pricing rules and after the impact of any local country taxes, withholding taxes, and any other gross income inclusion under a CFC regime\(^ {56}\) with respect to that CFC to determine the effective tax rate on the CFC’s income. The transfer pricing ordering rule, the comprehensive approach mentioned above to determine the CFC’s effective tax rate, and any foreign tax credit mechanism in the parent jurisdiction, would minimize risks of double taxation. Accordingly, we endorse a suitably adjusted primary rule in Option 5 as a viable special measure. This special measure should—as referenced in the *Actions 8–10 PDD*\(^ {57}\)—be coordinated with that on Action 3 (strengthen CFC rules).

The secondary rule special measure in Option 5 should be rejected, for several reasons. The primary rule would only be justified if modified as described above, and then only if applied in the jurisdiction of the ultimate parent of a CFC, but not in the jurisdiction of any other direct or indirect owner of the CFC. The parent jurisdiction, as location of the ultimate owner of a


\(^{56}\) E.g., other provisions of U.S. Subpart F.

\(^{57}\) *BEPS Actions 8–10 PDD*, p. 38.
multinational group, has primacy of right in taxing “excess returns” of a CFC. Such parent jurisdiction may choose at any time to exercise its sovereign right to tax deemed income inclusions to a resident parent company of a CFC with excess returns, but it might also choose to defer taxation for a period of time (e.g., by only selectively deeming certain income of the CFC to be income of the ultimate parent). The parent jurisdiction’s deferral of taxation for a period of time shouldn’t create a free-for-all allocating rights to tax such excess returns to “other jurisdictions.” The secondary rule in Option 5 doesn’t specify what these “other jurisdictions” are, perhaps because it’s unclear what legal authority would justify an arbitrary “other jurisdiction” asserting authority to tax income earned by an arbitrary CFC. Certainly the arm’s length standard would not justify such allocation. Compounding this uncertainty is the unspecified “pre-determined rule” for allocating taxing jurisdiction over an arbitrary CFC’s excess returns. The ALP provides a principled way for jurisdictions of enterprises associated with the CFC for asserting taxing authority over returns properly earned at arm’s length by such associated enterprises, but what the secondary rule proposes is clearly different. Given the lack of specificity of the “pre-determined rule”—in effect, formulary apportionment—it’s unclear whether consensus could ever be reached among jurisdictions on what rule to choose. It’s equally unclear how double (or multiple) taxation could be avoided. The secondary rule special measure in Option 5 should accordingly be rejected.

**ii. Answers to framework questions for primary rule in Option 5**

[1] **Efficacy**—normal transfer pricing rules, which would operate before application of the primary rule, and the effective tax rate test (which would have to be determined after the impact of any local country taxes, withholding taxes, and any other gross income
inclusion under a CFC regime with respect to that CFC), would ensure alignment of transfer pricing outcomes and value creation.

[2] **Advantages/disadvantages**—Option 5 recognizes the primacy of a CFC’s home jurisdiction to tax income earned by the CFC. It’s based on a bright-line rule that can be further tailored to encourage or discourage CFC behavior.\(^58\) It directly addresses a primary BEPS concern of double non-taxation of income by ensuring a minimal level of taxation of CFC income.

[3] **Likely effect**—the primary rule would likely encourage behavioral changes, depending on the criteria used to trigger income inclusion (and taxation) in the parent jurisdiction. The primary rule as proposed would, for example, encourage operations in CFCs in jurisdictions such that the effective tax rates exceed the specified threshold.

[4] **Adaptation of TP rules**—as the primary rule would operate after application of the normal transfer pricing rules, no adaptation of such rules is needed.

[5] **Targeting**—Option 5 targets a primary BEPS concern of double non-taxation of CFC income. The measure provides a bright line rule for its application, based on effective tax rates, using a well-established approach. Agreement among tax administrations is unnecessary; only the tax administration in the ultimate parent’s jurisdiction is concerned with criteria for application—the tax administration in the CFC jurisdiction is unaffected.

\(^{58}\) See, e.g., proposed CFC rules in Prop. § 954(f) in H.R. 1, *Tax Reform Act of 2014*, 113th Cong., 2d Sess.
[6] **Tax advantage**—the measure makes no reference to tax attributes; criteria shouldn’t be included limiting the measure to circumstances where the arrangement results in a tax advantage to the group.

[7] **Ordering**—the measure should be applied after application of the normal transfer pricing rules.

[8] **Eliminating double taxation**—double taxation is unlikely to arise because (1) normal transfer pricing rules apply first (with a relatively low risk of resulting in double taxation); (2) the comprehensive approach mentioned above to determine the CFC’s effective tax rate; and (3) the tax credit mechanism in the parent jurisdiction should mitigate double taxation.

[9] **Excluding sectors**—no sectors should be excluded from application of the measure.

2. The special measures in Options 2–4 should be rejected

   a. **Options 2 & 3, targeting capitalization of subsidiaries**

   Some comments are warranted relating to the preamble to Options 2 & 3. The BEPS Action Plan called for “transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity **solely** because it has . . . provided capital.” The BEPS Action Plan thus signaled concerns about returns accruing to an entity that neither assumed risks nor performed functions relating to intangible property. By contrast, the *Actions 8–10 PDD* asserts, that “[t]he BEPS Project . . . sets out the need to consider the potential for inappropriate returns for providing capital.” The *Actions 8–10 PDD* thus inexplicably broadens the scope of

59 BEPS Action Plan, Action 9 (emphasis added).

60 *Actions 8–10 PDD*, p. 42.
the BEPS Action Plan special measure relating to capitalization, suggesting use of such a special measure even if an entity bears risks and performs functions relating to intangible property. The Actions 8–10 PDD asserts that application of [presumably, normal] transfer pricing rules “may determine that little or no return is due to [a] capital-rich, asset-owning company,” but that “[i]n other circumstances, however, the application of the arm’s length principle may be difficult and may not address the allocation of excess or unanticipated returns to the capital-rich, asset-owning company.” The thrust of this seems to be that the called-for special measure can be used by tax administrations to get tax revenue if normal transfer pricing rules fail to get it. It’s unclear what “excess” returns are—do they relate to residual returns earned by a capital-rich, asset-owning company after applying normal transfer pricing rules, or perhaps even to returns earned by such a company if the arm’s length principle is “difficult” to apply? “Unanticipated” returns presumably relate to hard-to-value intangibles, so can be dealt with using a suitably crafted variation of Option 1, as discussed above.

Options 2 & 3 should be rejected. Neither Option could be justified under the ALP.

Option 2 targets “circumstances where [a] capital-rich, asset-owning company depends on another group company to generate a return from the asset.” It proposes using as its touchstone an “independent investor” who considers which of the two companies offers a better investment opportunity, “taking into account expertise in conducting risk managed activities to generate a return on the investments and the level of risk and potential return.” It’s unclear how this constraint would apply in any fact pattern. How are the investment opportunities precisely to be determined? If the special measure is triggered, how much capital is deemed contributed to

61 Id. (Emphasis added).
the company providing the more rational investment opportunity? Is the capital-rich company entitled to keep any capital, and if so, doesn’t the same difficulty in choosing an “acceptable level” of capitalization arise? In a situation involving an asset-rich company owning many assets, how would its capital to be apportioned among its assets?

In any event, Option 2 seems designed to skew the result to yield an outcome favoring investment in companies performing functions rather than owning assets and bearing risks associated with those assets. There’s certainly no economic policy justification for an independent investor ignoring assets, and the bearing of risks associated with those assets, in favor of the performance of activities relating to the exploitation of any of those assets. An unconstrained investor might well choose to invest in a capital-rich, asset-owning company rather than a company used to generate returns from the assets on the grounds that the functions performed by the latter company—e.g., manufacturing and sales—generate only routine returns.

Aside from the lack of clarity and questionable policy underpinnings of Option 2, it suffers from lack of practicability. It focuses on an asset-by-asset approach. The determination of the deemed capital contributions would be exceedingly difficult in any situation in which many group companies perform activities relating to generating returns from a broad portfolio of intangibles. This would be the case with most large multinational enterprises.

Option 3 hinges on determining a level of “thick capitalisation.” But there’s no generally agreed-upon level of capitalization of a company, nor how one would choose criteria to determine the level to use. Option 3 is also opaque on which company would be treated as providing the excess income—is it the immediate, or ultimate, parent?
b. **Option 4, targeting minimal functional entities**

Option 4 proposes a special measure focusing on a threshold level of functionality in an entity that, where lacking, would cause the profits of that entity to be reallocated. This special measure should be rejected.

The TPG would allocate profits among associated enterprises in part according to the risks they bear and the functions they perform; in particular, functions relating to the development, enhancement, maintenance, protection, or enhancement of intangible property. Option 4 asserts that if one of the associated enterprises is a “minimal functional entity” then “[i]t may prove simpler and more effective” to adopt the special measure. Does this mean the special measure would be applied instead of normal transfer pricing rules in the TPG? If so, it amounts to a type of profit-split / formulary apportionment depending entirely on functions performed—such an approach was rejected in the TPG “in theory, implementation, [and] practice.”

If the special measure was intended to be applied following application of the normal transfer pricing rules, it would amount to an excessive weighting placed on functions for allocating profits, to the detriment of risks and assets.

The proffered thresholds are problematic. The qualitative threshold mirrors a situation in readily addressed under the normal transfer pricing rules of the TPG, so it’s unclear that this approach is “simpler and more effective” than the TPG. A desire for simplicity does not justify departing from analyzing the facts and circumstances under the ALP. The quantitative thresholds are equally troublesome. An entity performing mainly routine functions with a small number of employees would likewise be unlikely to earn much profit based on those functions.

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62 TPG, ¶¶ 1.15–1.32.
under normal transfer pricing rules. The fact that “[a] substantial part of the company’s income is from arrangements with group companies” says nothing about functionality within the entity, even assuming that’s a valid criteria on which to solely special measure (it’s not). Likewise, looking at the ratio of a company’s assets to income, or its capitalization, says nothing about functionality.

Regarding reallocation of profits if the threshold wasn’t met, it’s unlikely that a “pre-determined factor” could be agreed upon for purposes of the “mandatory profit split” variant for allocating profits. The same concerns voiced in the TPG’s rejection of formulary apportionment are relevant here.63

63 E.g., “Even if some countries were willing to accept global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country's own revenue.” TPG, ¶ 1.23.
May 29, 2015

Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organization for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris
Cedex 16
France

OEC DISCUSSION DRAFT: BEPS ACTION 8, REVISIONS TO CHAPTER VIII OF THE TRANSFER PRICING GUIDELINES

Dear Mr. Hickman,

The Software Coalition thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 8 of the Base Erosion and Profit Shifting (“BEPS”) project pertaining to cost contribution arrangements (“CCAs”) and Revisions to Chapter VIII of the Transfer Pricing Guidelines (“TPG”) issued on April 29, 2015 (“Discussion Draft”).

We are submitting these comments on behalf of a representative body known as the Software Coalition. The Software Coalition is the leading software industry group dealing with US domestic and international tax policy matters. The Coalition was formed in 1990 and now comprises 23 companies which operate in the software and e-commerce sectors. Software Coalition members account for approximately $440 billion per year in total gross revenue. Member companies employ over 1.1 million individuals around the globe.¹

I. The Discussion Draft Proposes an Extreme and Overbroad Reaction

For many years, taxpayers and tax administrations have enjoyed the transfer pricing certainty and the audit efficiencies afforded by CCAs. CCAs have not been controversial as a matter of transfer pricing theory, as the paradigm that parties will share costs based

¹ The Software Coalition’s current membership comprises the following companies: Adobe Systems Inc.; Amazon.com, Inc.; Attachmate Corporation; Autodesk, Inc.; BMC Software, Inc.; CA, Inc.; Cisco Systems, Inc.; Citrix Systems, Inc.; Electronic Arts, Inc.; EMC Corporation; Facebook, Inc.; IBM Corporation; Mentor Graphics Corporation; Microsoft Corporation; Nuance Communications, Inc.; Oracle Corporation; PTC Inc.; Pivotal Software, Inc.; Salesforce.com Inc.; SAP America, Inc.; Symantec Corporation; Synopsys, Inc.; and VMWare, Inc.
on their relative expected benefits arising from incurring those costs is straightforward and is reflected in third party behavior.

The Discussion Draft’s proposal to require all contributions to a CCA to be measured by value essentially negates the entire concept of a “cost contribution” arrangement. We respectfully suggest that there is no need to discard entirely a transfer pricing structure which for decades has provided clarity to taxpayers and tax administrators on shared cost arrangements.

In particular, it is hard to see how service CCAs raise any significant transfer pricing policy issues. By definition, service CCAs involve services which produce a current benefit only. Allocating a pool of current period costs based on expected relative current period benefits would seem to produce appropriate results in the overwhelming majority of cases. We believe that the vast majority of CCAs in place within groups around the world deal with service CCAs, not development CCAs. Therefore, if these changes are adopted, there will be a significant increase in complexity and potential for controversy relating to service CCAs that have never created concerns under the arm's length principle.

The BEPS project is approaching its final months. It would be a shame to introduce for the first time substantial impediments and uncertainties into the operation of service CCAs around the world, in an effort to regulate the use of development CCAs in contexts where the application of the arm’s length principle to those cases can be adequately governed by national law. The prudent course at the moment would be to leave the existing Ch. VIII unchanged.

II. Application of BEPS Actions 8-10 Principles to Development CCAs

If, instead, the OECD prefers to revise Ch. VIII, we would like to offer the following thoughts as to how the current Discussion Draft could be improved to better coordinate Ch. VIII with the guidance being developed under Actions 8 - 10.

A. Guidance Should Specify When Contributions Valued at Cost Will Comply with the Arm’s Length Principle

We believe that it is clear that at arm’s length, parties enter into joint development programs in which each side’s contribution is valued at the costs they incur. Since these arrangements do exist at arm’s length, it must be the case that CCAs in which the contributions are valued only at cost must be accepted as complying with the arm’s length principle in many cases. Instead of precluding altogether the possibility of utilizing arrangements that exist at arm’s length, the TPG should provide taxpayers and tax administrators with guidance as to when those arrangements will be respected.

For cases which fall outside that guidance, taxpayers would be required to demonstrate that their arrangements comply with the arm’s length principle through the application of the normal comparability standards of the TPG. That would be more appropriate
guidance than a rule which deems a result, such as requiring that all contributions be measured at value. Only in rare cases could mandated results be regarded as appropriate analogues to how parties deal with each other at arm’s length.

B. Unique Element of Development CCAs - the Buy-in Payment

The Discussion Draft’s proposed requirement that all contributions be measured by value does not sufficiently recognize the role of the buy-in payment to compensate the parties for their initial contributions to the CCA. A buy-in payment constitutes an amount determined under the arm’s length principle that compensates the transferor for all property or other resources it may contribute to a CCA, under the particular circumstances of the parties to that CCA. As such, an appropriate determination of the amount of the buy-in payment should capture the value of the contributions of both parties from the beginning of the CCA, even if the parties have agreed to fund their joint development activity under a CCA with one party contributing only risk capital. Once the parties have been adequately compensated for their initial contributions to the CCA, the ongoing costs of development should be allocated to the parties in proportion to their anticipated benefits under the CCA as written. The ongoing performance of DEMPE functions relating to the CCA should not provide a basis for any adjustments between the parties to the CCA. In fact, there should be no further adjustments on the basis of relative values, unless one or more of the parties makes additional contributions to the CCA of property or other resources acquired or developed outside the CCA.

Accordingly, the next draft of a revised Ch. VIII should provide guidance as to the determination of a buy-in payment that will compensate a party for its contributions at the beginning of the development CCA, so that the ongoing CCA in which the parties’ contributions are valued at cost would be regarded as compliant with the arm’s length principle.

C. Application of Actions 8 - 10 Principles

The essential economic activity inherent in any development CCA is the shared undertaking of a significant development risk. The Ch. VIII guidance should identify under what circumstances each party to the CCA would be respected as bearing that development risk and therefore be entitled to its allocated share of the intangibles related return (along with the corresponding risk of loss). The two areas of guidance arising from the Actions 8 - 10 work which would be most relevant in this context would be the rules determining when a party should be entitled to the intangible related return, as being developed under Action 8, and when a transaction could be recharacterized, as being developed under Actions 8-10.

Drawing on the work in Action 8, a participant in a development CCA should be entitled to the expected intangibles related return (including potential of loss) if it performs any of the DEMPE functions, either directly or through contractors. Compensation for contributions to the CCA, such as pre-existing intangibles or an experienced development
team, should be handled through arm’s length buy-in payments. The contractual allocation of the benefits to be derived from intangibles developed under the CCA should be respected, with the aggregate costs incurred by the participants being allocated in proportion to each participant’s share of the anticipated benefits.

The participation in a development CCA which values contributions at cost should not be disregarded if “the actual transaction possesses the fundamental economic attributes of arrangements between unrelated parties, [even if] the same transaction [cannot] be observed between independent parties.” Unrelated parties, acting at arm’s length, do fund the costs of risky, intangibles-driven ventures. Therefore, an arrangement whereby a participant in a development CCA funds development costs does possess the fundamental economic attributes of an arrangement between unrelated parties, and therefore should not be disregarded. If the participant that provides funding does not perform any of the activities listed below to qualify it as entitled to its allocated share of the intangibles related return, it may be appropriate to limit such participant to a risk-adjusted rate of return on its funding commitment, but nevertheless it still should be respected as a participant in the CCA.

D. Proposed Qualification Tests

Based on the comments above, we respectfully suggest that the revised Ch. VIII should set out several circumstances where a development CCA participant would be respected as bearing that shared development risk and thus be entitled to its allocated return (and be obliged to share any resultant loss) from the intangible property being developed under the CCA, under the circumstances that all contributions other than the buy-in or other property transfers are valued at cost.

First, it should be clear that a party which undertakes any of the DEMPE functions should be respected as participating in a CCA, and should be entitled to its allocated rights in the developed property.

Second, a party should be entitled to its allocated share of the intangible related returns if it is engaged in the active conduct of a trade or business in which it expects to utilize the results of the development CCA. This principle is a direct analogue to many shared development programs conducted at arm’s length where the parties agree that only one of the parties would undertake the actual development work. Under the US cost sharing regulations, a party will be respected as a cost sharing participant as long as it “reasonably anticipates that it will derive benefits … from exploiting one or more cost shared intangibles.”

2 OECD, Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures), para. 84 (Dec. 19, 2014) (hereinafter “Recharacterisation Discussion Draft”).

3 Treas. Reg. §1.482-7(j)(1)(i).
sharing regulations. This rule is the most appropriate determinant of participation in a CCA as it is the closest analogue to arrangements at arm’s length.

Third, a party should be entitled to its allocated share of the intangibles related return if the party being tested has paid an appropriate buy-in payment. As noted above, Ch. VIII could provide guidance as to when the buy-in payment would be regarded as compliant with the arm’s length principle in light of the nature of the expected initial contributions of each of the participants, including circumstances where only one party is expected to perform development activity.

Finally, a party should be entitled to its allocated share of the intangibles related return if it performs the financial and risk management activities described in the draft Example 4. We believe that such activities clearly are DEMPE functions, but if there is any doubt of that, those financial risk assessment activities nevertheless are entirely appropriate activities to qualify a participant as entitled to the intangible return under a CCA.

For purposes of identifying the functions, assets and risks performed by a CCA party, Ch. VIII should note that a partner or other owner of a transparent entity should be attributed the functions, assets and risks undertaken by the transparent entity.

E. Application of these Principles to Proposed Examples in the Discussion Draft

Example 4 should be revised to conclude that both parties are qualified participants in the development CCA and are entitled to their agreed share of the intangible related return. The risk management functions performed by Company A clearly either are DEMPE functions, or otherwise qualify as sufficient entrepreneurial contributions to justify respecting the CCA according to its terms.

We suggest that the proper conclusion in Example 5 is not that the CCA is disregarded, but that the party which contributes only risk capital should be allocated a risk-adjusted rate of anticipated return on its investment. According to the 2014 Action 8 Deliverable on the Transfer Pricing Aspects of Intangibles: “funding risk, without the assumption of any further risk generally would entitle the funder to a risk-adjusted rate of anticipated return on its funding, but not more.”\(^4\) According to the Recharacterisation Discussion Draft: “Where the same transaction can be seen between independent parties in comparable circumstances, non-recognition would not apply. Importantly, the mere fact that the transaction may not be seen between independent parties does not mean that it should not be recognised.”\(^5\) Since unrelated parties, acting at arm’s length, do provide funding for intangibles development in exchange for an ownership interest in such intangibles, the CCA in Example 5 possesses the fundamental economic attributes of an arrangement between unrelated parties and therefore should not be disregarded. An

\(^5\) Recharacterisation Discussion Draft, para. 84.
arm’s length result can be achieved by benchmarking the investor’s return to that of a financial investor in a similarly risky business.

We are grateful for the opportunity to provide these comments, and look forward to further participation in the BEPS process.

Sincerely,

Gary D. Sprague
Partner
(650) 856-5510
Gary.Sprague@bakermckenzie.com

Taylor S. Reid
Partner
(650) 856-5536
Taylor.Reid@bakermckenzie.com
29 May 2015

Via E-Mail
TransferPricing@oecd.org

Mr. Andrew Hickman
Head of Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
France

OECD Discussion Draft: BEPS Actions 8 - Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements

Dear Mr. Hickman

The business federation SwissHoldings represents the interests of 61 Swiss based multinational enterprises from the manufacturing and service sectors (excluding the financial sector). SwissHoldings is pleased to provide comments on the OECD Discussion Draft of the Proposed Modifications to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (hereafter referred to as “the Draft”).

SwissHoldings supports the objective to ensure that transfer pricing outcomes are in line with value creation as well as the Chapter VIII update and alignment with the most recent changes to the Guidelines.

Our comments to the Draft are as follows:

General

1. For both Services CCAs and Development CCAs, the contributions need to be determined based upon reasonable expected or actual benefits. The proposed purely value based approach is not in line with the principles of a CCA and the reason why companies (related or unrelated) enter a CCA. It is not in line with the arm’s length principle as it ignores the majority of the CCA cases for which the cost based approach results in arm’s length prices.

2. We want to highlight that CCAs are often not accepted (especially by non-OECD countries) and would appreciate any support for a wider acceptance to ensure that MNEs can globally implement CCAs without non-deduction and double taxation.

3. We would also appreciate any clarification that CCA payments are not subject to withholding tax.

Concept of a CCA

4. Par. 6 states that “CCAs can provide helpful simplification of multiple transactions…..a CCA can provide a mechanism for replacing a web of separate intra-group arm’s length payments with a more streamlined system of netted payments”. This is indeed an advantage of CCAs and reduces the already enormous compliance burden for taxpayers.
5. However, given mutual expected benefits, the main reason and purpose of entering into a CCA is sharing/pooling of resources and - in particular risks - between the parties on a contractual basis. Hence, we do not understand the introduction of the new “comparability principle” in the last sentence of par. 6 (i.e., that the transfer pricing outcome for the parties in CCAs should be the same as if they had made individual transactions outside of CCAs). For CCAs, this principle (covered also in par. 22) is not in line with the arm’s length principle as defined in Chapter 1 and the existing par. 8.14 of the TP Guidelines. This new principle disregards the contract concluded between the parties and the chosen function and risk profile of the parties.

6. Assuming that other factual and economic conditions (e.g., substance, actual conduct, etc.) are met, tax authorities need to respect the risk allocation of the parties according to the CCA (i.e., comparing CCAs with a non-comparable service agreement or another transaction is not in line with the arm’s length principle). CCAs are special business models where risk sharing is the key element. The closest comparable transactions or business models are joint venture situations. Also unrelated parties may enter into agreements to pool resources to combine the different individual strengths. In arm’s length joint ventures contributions are often calculated at costs while determining the value is arbitrary and parties are interested in the expected benefit of the joint efforts.

7. Hence, the last sentence in par. 6 needs to be deleted. As a consequence, corresponding adjustments in the other sections of the Draft are required.

**The value of each participant’s contribution**

8. For both Services CCAs and Development CCAs the contributions need to be determined upon reasonable expected or actual benefits.

9. According to par. 6 and par. 22, the Draft has introduced a new “value based approach” which is based upon a wrong comparability assumption. In the case of CCAs, there is no need to “value” or benchmark CCA activities. Instead, the purpose is to ensure that the budgeted or actual costs (subject to the terms of the CCA) are shared between the participants in line with the expected/actual benefits.

10. As mentioned in the second sentence of par. 15 and section C.3, the key transfer pricing challenge was (and remains) the determination of a comparable/arm’s length allocation key for the costs to be shared. There is no need to value the cost/activities/services as such in isolation (and enter indirectly into benchmarking services and/or applying the correct profit mark-up).

11. For Services CCAs the determination of the allocation key should in practice be easier (i.e., the expected benefit should be in line with the expected or actual (relative) consumption of the services).

12. As a consequence, respecting the function and risk profile of the parties and applying the correct comparability principles, all 3 services examples should lead to the same results. In line with the expected benefits (i.e., the relative budgeted or actual consumption of the services (here 50%)) both parties should contribute 2500, respectively, the net result would be a payment of 500 from company B to Company A.

13. Moreover, the correct application of CCAs does not require a differentiation between low-value-adding services and other services as all types of CCA contributions should be assessed in line with the expected benefit. A clarification would be welcome.
14. As described in section C3, prospective adjustment clauses can be added in CCAs to manage material changes of expected benefits over time. Assuming that the arm’s length standard is met, the actual terms of the CCAs need to be respected by the tax authorities.

Participants of CCAs

15. In terms of eligibility to qualify as a participant, the Draft seems to focus almost entirely on “capability and authority to control the risks”. Consequently, the Draft seems to virtually ignore other “important functions” related to the joint development, enhancement, maintenance, protection, and exploitation of intangibles or services. This interpretation limits the application of CCAs and is not in line with the arm’s length principle. This extreme interpretation and limitation is also not observed in joint venture situations.

16. From our perspective, it should be sufficient to demonstrate the mutual interests, expected proportionate benefits and active participation (substance) of the participants in the important functions mentioned above. In such a case, the actual control exercised by the leadership teams (e.g., BOD) of the parties should be sufficient to meet the “risk-control” requirement described in par. 13 and par. 26. A clarification would be welcome.

Documentation and Compliance

17. The proposed CCA documentation principles seem to go beyond the existing extensive documentation requirement as defined in BEPS Action 13. A clarification and reduction of requirements would be welcome.

18. In particular, the implementation of a value based approach for CCAs would significantly increase the compliance burden for MNEs (i.e., requiring more sophisticated documentation and costly expert guidance). The complex valuation principle would also increase the potential for controversy and double taxation for the MNE. Extensive documentation is (already) required to ensure tax deductibility of CCA payments, balancing payments or buy-in/buy-out payments.

19. CCAs covering low value-added activities should benefit from the reduced compliance requirements applicable to low value-added services. Accordingly, the Draft should include a clarifying statement in par. 42.

Hard to Value Intangibles

20. Par. 32.: We appreciate the reference to the guidance in Chapter VI on Hard to Value Intangibles but want to repeat the related comments to Chapter VI previously made by SwissHoldings:

- The term Hard-to-value Intangibles is not clearly defined. Without a clear definition, the implementation will fail and result in controversy and double taxation.
- With unrelated parties, the proposed price adjustment mechanism is the exception and not the rule, especially for the long term. Hence, making the exception to the rule for MNEs is not arm’s length and must therefore be dropped. However, as an alternative, if taxpayers choose this option and properly document the chosen set-up, then this must be respected by the tax administrations.

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We kindly ask you to take our comments and proposals into due consideration.

Yours sincerely

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Christian Stiefel  
CEO

Dr. Martin Zogg  
Member Executive Committee

cc - SwissHoldings Board  
- Nicole Primmer, Senior Policy Manager, BIAC  
- William Morris, Chair of the BIAC Tax Committee  
- Krister Andersson, Chair BUSINESSEUROPE Tax Policy Group
Via Email: transferpricing@oecd.org

RE: Public Discussion Draft on BEPS Action 8: Cost Contribution Arrangements

Dear Mr. Hickman:

On 19 July 2013, the OECD published an Action Plan on Base Erosion and Profit Shifting (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries’ tax bases are being eroded or profits shifted improperly. Pursuant to Action 8 of the Plan, on 29 April 2015 the OECD published a public discussion draft entitled BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (hereinafter the Discussion Draft or Draft). The OECD solicited comments from interested parties no later than 29 May 2015. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD’s request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws,
at all levels of government. Our nearly 7,000 individual members represent over 3,000 of the largest companies in the world.¹

TEI Comments

Value of Contributions to CCAs

A focus of the Discussion Draft is the view that the proper “price” at which to measure a participant’s contribution to a CCA is the value of the assets or services contributed, rather than their cost.² The Draft states that “contributions must generally be assessed based on their value (rather than their cost) in order to be consistent with the arm’s length principle.”³ This is a departure from the existing OECD transfer pricing guidelines where actual costs incurred under a CCA or cost sharing arrangement were typically shared or allocated among the participants based on their proportionate expected future benefit. Moreover, in advancing the value approach the OECD appears to misapprehend to substance of CCAs. These arrangements are not intended to be service arrangements or ongoing sales or exchanges at value, but rather a sharing of risks. The fundamental risk is that the costs incurred will yield no future benefit – the same risk a party would undertake if it developed an intangible on its own outside of the CCA and licensed the preexisting intangibles it did not own.

The current OECD transfer pricing guidelines are more consistent with third party cost sharing arrangements where participants share in the actual costs incurred in return for expected future benefits. Participants often engage in cost sharing arrangements with one or more other parties to obtain access to expertise or cost efficiencies that they might not possess. If a participant must pay a higher hypothetical value, it erodes the benefit of the cost sharing arrangement and the arrangement’s business rationale. Moreover, cost sharing arrangements are often used for “hard to value intangibles” where comparables are not readily available; pricing these at their arm’s length value will substantially increase complexity and likely result in increased disputes with tax authorities.

Further, the Discussion Draft suggests transactions within a CCA should be compared to transactions outside of a CCA. In TEI’s view, the Draft does not recognise that the risks that CCA participants assume are not necessarily those that would have been agreed upon by the participants in the absence of a CCA. As noted, the assumption of risk is a key differentiator for participants in cost sharing arrangements versus other contractual arrangements. As such, transactions within a CCA are not necessarily comparable with transactions not covered by a

¹ TEI is a corporation organised in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).
² The Draft notes that cost may be used for certain low-value added services.
³ Discussion Draft, p.9.
CCA, as there will be differences in shared risks and activities, mutual cooperation, and assets owned. At the very least, in line with Chapter I of the OECD transfer pricing guidelines, the Discussion Draft needs to consider adjustments to reflect differences in CCA functional and risk profiles and asset ownership.

That said, TEI acknowledges that contributions of assets, such as pre-existing intangibles, should generally be measured at fair market value. However, this should not necessarily be the case for ongoing contributions of services, even for development CCAs. With respect to performing the actual research and development work, it would be problematic to determine value based upon something other than cost – especially in the absence of any reliable comparable uncontrolled transactions. Research and development activities typically only would be seen to add value at a late stage in the development cycle, often after significant costs have been incurred and at high failure rates. If all CCA participants are benefiting from research and development activities, having contributed to the arrangement via either skilled scientists or funding, the costs of such activities should be an acceptable measure of determining value. Moreover, it should be noted that where CCAs have gained widespread use, for example in the oil and gas industry, that services and access to intellectual property within a CCA are often rendered on a cost basis. The “at-cost” nature of such activities has been agreed to in production sharing contracts and similar arrangements between independent partners and government agencies.

To use a generic example, suppose Country A Parent and its Country B Subsidiary enter into a CCA to develop intellectual property. One or both of the parties contributes platform technology that is appropriately measured at fair market value. A proper “balancing payment” is made to even up any disparity between each party’s contribution and its expected future benefit. After the CCA is formed, Parent and Subsidiary each fund its share of on-going research and development based on its future expected benefit. In general, multi-national enterprises (MNEs) would expect this funding to be based on the cost of the research and development activities, not their “value.” The Discussion Draft, however, states that services “costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants, and the use of costs may lead to non-arm’s length results.”

Thus, CCA participants would need to find some way of measuring the value of research and development services. For this purpose, could the parties look to what a contract research and development provider might charge? If one participant has established a research and development center in another jurisdiction that charges cost plus 5% or 10%, could that be used as a basis for measuring research and development services performed under the CCA? The Discussion Draft is silent on how to measure value in such instances.

4 Id.
In addition, the Discussion Draft provides that low value-added services should be valued at cost for practical reasons and references low value-added services described in Chapter VII. The OECD BEPS discussion draft on low value-added services under Chapter VII, however, provides that taxpayers may use an elective simplified approach to allocate and determine the amount of low-value added costs. Under this simplified approach a profit mark-up of between two and five percent must be applied. How does this approach align with the Discussion Draft’s approach to CCAs for providing services (not development CCAs)? The Draft allows for no mark-up of low value-added services. These approaches should either be conformed or the reasons for the differences between them further explained.

An additional potential complexity in measuring contributions to CCAs at value rather than cost is that payments pursuant to CCAs are often exempt from withholding taxes because they are cost reimbursements. If cost contribution arrangements are now measured at an arm’s length fair market value, would withholding taxes be applied to a portion of the payment (i.e., value that is incremental over costs)? A similar issue arises with respect to buy-in/buy-out payments. Many countries do not have experience with CCAs or buy-in/buy-out payments. Thus, the statement in the Draft that “buy-in and buy-out payments should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) . . . applicable to the respective participants as if the payment were made outside a CCA as consideration for the acquisition or disposal of the interest in the results of the prior CCA activity” may not be useful. Thus, guidance on the general income tax treatment of buy-in/buy-out payments would be welcome, including differences (if any) between lump-sum payments and ongoing payments. Guidance on the applicability or non-applicability of withholding taxes to payments with respect to CCAs would also be welcome.

The Discussion Draft also does not address the treatment of tax credits or subsidies with respect to CCAs, which may raise complex valuation issues for tax purposes. For example, is a CCA to be net of the tax credits/subsidies? Or if balancing payments or adjustments to buy-in/buy-out payments are required, would the value be compared against the gross costs or costs net of tax credits/subsidies? Thus, we recommend the OECD state its preferred approach on how such credits should be accounted for in valuing contributions to a CCA if the cost of such contributions may not be used.


6 The Discussion Draft defines buy-in and buy-out payments as payments made to enter or exit a pre-existing CCA, respectively, and not payments made to enter into the CCA in the first instance, which are generally referred to as “balancing payments.”

7 Discussion Draft at 12.
Finally, it is worth noting that valuing service contributions to CCAs at “value” rather than cost will require greater compliance and administrative time and expense from both taxpayers and tax authorities than cost-valuation. It will also lead to greater controversy, both between taxpayers and tax authorities and among tax authorities themselves.

**Periodic Adjustments**

Paragraph 19 of the Discussion Draft addresses the potential need to make adjustments to the measure of the participants’ expected benefits. The Draft states that adjustments “may be necessary to account for differences between the expected and actual benefits received by the participants. Independent enterprises might include a clause in the agreement . . . allowing for periodic reassessment of contributions vis-à-vis actual benefits . . . .”\(^8\) This paragraph speaks in terms of “may” or “might,” implying that adjustments clauses do not necessarily need to be included in a CCA. Paragraph 42, however, lists the conditions that a CCA generally should meet and is phrased in terms of “would.” The Draft states that “[t]he arrangement would require balancing payments and/or changes in the allocation of contributions prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants.”\(^9\)

Periodic retroactive adjustments, however, are not a feature of arm’s-length agreements between unrelated parties. Many third-party agreements end up being much more advantageous to one side than originally anticipated, yet the agreements do not allow the disadvantaged party to renegotiate more favorable terms after the fact. TEI therefore recommends that the statement in paragraph 42(e) be removed from the list of conditions that a CCA is expected to meet.

If the statement is to remain in the Draft, then the final guidance should delineate the proper treatment of periodic adjustments as either ongoing balancing payments or as “buy-in” payments. This would be necessary because the tax consequences of ongoing balancing payments may differ from buy-in payments between jurisdictions.

**Recognising Participants in a CCA**

The Discussion Draft analyses when tax authorities may disregard a participant in a CCA for tax purposes. For this purpose, the Draft focuses almost exclusively on an associated enterprise having both the capability and authority to control risks before it will be recognised as a participant in a CCA. Consequently, the Draft virtually ignores other important functions related to the development, enhancement, maintenance, protection, and exploitation of

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\(^8\) _Id._ at 9.

\(^9\) _Id._ at 13.
intangibles that should be considered when determining whether an enterprise will be recognised as a CCA participant for tax purposes.

For example, paragraph 13 and Example 5 preclude an entity from being a participant in a CCA unless it has “the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA.” This would seem to exclude an entity with numerous employees and significant operational substance from qualifying as a participant in a CCA, and therefore potentially retroactively disregard the CCA itself, if the entity doesn’t have the proper mix of business development or strategic planning employees on its payroll. This result seems inconsistent with the view that a no-substance “cash-box” is the paradigm case of when ownership of intellectual property will not be respected for transfer pricing purposes. TEI recommends the OECD explain whether this reflects a change in its view of when an entity’s contractual arrangements – whether participating in a CCA or owning the intellectual property that results from the CCA – will be respected for transfer pricing purposes and, if not, why not. In addition, the consequences of disregarding participants in a CCA should be further explained. For example, does the arrangement become limited to the “regarded” participants or does the return on the arrangement attach to the participants who perform activities connected with the arrangement?

The Discussion Draft also places too little emphasis on funding the research and development in a CCA. In transactions between unrelated parties, it would be expected that the capital provider would share in at least some of the residual profits from the venture, and not merely receive a risk-adjusted fixed rate of return for providing capital to a CCA.

Recharacterisation

Paragraph 32 states that,

A tax administration may also disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA. In such a case, that participant might be entitled to an arm’s length compensation for the use of that interest by the other participants.\(^\text{10}\)

Re-characterisation or disregard of the terms of a CCA should be limited to extreme cases such as abuse or lack of substance. Such a remedy should not be available to tax

\(^{10}\) Discussion Draft at 11.
authorities merely because the participants’ expected benefits differ in a “substantial” manner from their contributions. Due to the significant uncertainty of research and development activities and the difficulty of forecasting expected benefits, results may often vary substantially from predictions and have little or nothing to do with base erosion and profit shifting concerns. Moreover, as noted, a later-period reallocation or adjustment of the benefits from a CCA among the participants is not a typical term of CCAs entered into between unrelated parties and therefore is generally inconsistent with the arm’s length standard.

Examples in the Discussion Draft

TEI commends the OECD for providing examples that illustrate the principles of the revisions to Chapter VIII of the OECD transfer pricing guidelines as set forth in the Discussion Draft. We note, however, that there is a wide spectrum of complexity when it comes to CCAs. It would thus be helpful if the OECD provided examples of circumstances where tax authorities of the participating states of the BEPS project have accepted practical and easy to implement CCAs. In other words, since the Discussion Draft illustrates complex arrangements or certain arrangements involving low substance, it would be beneficial if the Draft also provided examples at the other end of the spectrum. These could include situations where there is clearly no base erosion, highlighting an easy to implement, straightforward CCA, where the CCA is purely a business arrangement in which two or more related parties with full substance agree to share costs/risk/assets.

TEI is also concerned about the services examples 1 through 3 and the interplay with the principles in paragraphs 14 and 23. Those paragraphs seem to recognise “contract service providers” that are not a party to the CCA and situations where the value of services could be measured at the costs of providing the services. However, example 2 discusses low-value services but speaks in terms of the “value” of those services and thus could lead certain tax authorities to expect documentation in terms of “units of value” rather than costs in those cases. TEI recommends the example be clarified in final guidance. In addition, it would be helpful if at least one of the service examples was a bit less theoretical and provided a practical example of what constitutes a “unit of service,” as described in those examples (e.g., a full time employee, an hour of work, a day of work).

We also note that the Draft provides only “extreme” examples of development CCA scenarios, whereby all of the work to develop, enhance, maintain, protect, and exploit the intangibles is done by only one of the participants. Additional examples would be welcome which cover the “middle-ground.” Consider the following scenario:

1. Company A (based in country A) and Company B (based in country B) are members of an MNE and decide to enter into a CCA to develop and exploit intangibles.

2. Neither company contributes any pre-existing intangibles to the CCA.
3. Both A and B have experienced research and development staff and sufficient knowledge and resources to carry out the research and development required.

4. The MNE has a global research and development leadership team which, in conjunction with the CEO and its executive team, is responsible for defining the MNE’s research and development strategy. This includes determining what new projects to develop and invest in (including the decision to cease/start projects). The CEO and executive team as well as approximately 90% of the employees on the global research and development leadership team are employed by Company A and are based in country A. Approximately 10% of the global research and development leadership team is employed by Company B and is based in country B.

5. There are several other research and development teams within the MNE that are responsible for guiding the research and development portfolio, determining how the strategy will be carried out, and providing critical support to the global research and development leadership team. Approximately 65% of the members of these teams are employed by Company A and are based in country A, while 35% are employed by Company B and are based in country B.

6. The costs of the global research and development leadership team and other research and development governing bodies are already factored into the existing CCA contributions of A and B (albeit at cost as opposed to an arm’s length value). The contributions of the CEO and executive team have not been factored in to the CCA contributions.

7. Company B will have the exclusive rights to exploit the intangibles in country B. Company A will have the exclusive rights to exploit the intangibles in the rest of world.

8. The ratio of anticipated global sales (or profits) from exploitation of the intangibles is 25% in country B and 75% in the rest-of-world.

It is clear in this scenario that both A and B are “valid” participants in the CCA. This should be the case even if the majority of functions of controlling and managing the CCA’s activities and risks are conducted by Company A. Accordingly, Company B should be entitled to a share of residual profits from the intangibles developed under the CCA (i.e., more than just a risk-adjusted rate of return). Based on this scenario, 75% of the contributions required to develop the intangibles should be provided by Company A and 25% should be provided by Company B. Excluding the global direction and strategy, all research and development work performed by A and B is valued equally. Accordingly, as noted in part 3 above, the costs of such research and development work should be sufficient for determining the relative contributions made by A and B.
This leaves the question of what value is to be placed on the global direction and strategy (i.e., control and management of the CCA, which is referenced in paragraph 26 of the Draft). It is acknowledged that such contributions are likely to be important functions related to the CCA (as is also stated in the Draft). In the above example, since significantly more of these functions are performed by Company A, presumably Company B would need to make some amount of “balancing payment” into the CCA. However, the Draft does not provide any guidance as to how such control and management functions should be valued. It is likely to be very difficult if not impossible in practice to determine arm’s length value for such functions. One possibility would be to apply cost plus a markup, but determining an appropriate markup is also likely to be problematic. TEI therefore recommends including a “middle ground” example in the final guidance on CCAs under Action 8 and providing a methodology for valuing control and management in a scenario such as the one set forth above. For example, in most cost-sharing arrangements among U.S. MNEs, costs are shared on the basis of fully allocated costs under U.S. GAAP, which would include the costs of the research and development leadership team.

Conclusion

TEI appreciates the opportunity to comment on the OECD Discussion Draft regarding proposed revisions to Chapter VIII of the OECD transfer pricing guidelines under BEPS Action 8. These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, nickhasen@sbcglobal.net, or Benjamin R. Shreck of TEI’s legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,

Tax Executives Institute, Inc.

Mark C. Silbiger
International President
Andrew Hickman  
Head of Transfer Pricing Unit  
Center for Tax Policy and Administration  

26 May 2015  

Dear Mr. Hickman,  

RE: Taxand responds to the OECD Public Discussion Draft on BEPS Action 8: Revisions To Chapter VIII Of The Transfer Pricing Guidelines On Cost Contribution Arrangements (CCAs).  

Further to the publication of the OECD’s invitation for public comments on the Public Discussion Draft on BEPS Action 8: Revisions To Chapter VIII Of The Transfer Pricing Guidelines On Cost Contribution Arrangements (CCAs) (“the Discussion Draft”), Taxand is honoured to provide written comments based on the practical experience we have as tax advisors.  

The proposed updates are commendable for their clear approach to unifying the guidelines relating to CCAs in light of recent BEPS deliverables, particularly the amended Chapter 1 of the OECD Transfer Pricing Guidelines (“the Guidelines”) in respect of risk, and the amended Chapter VI of the Guidelines in respect of intangibles.  

We would like to salute the efforts of the OECD Committee of Fiscal Affairs for its continual and vast work on laying down the cornerstones for the ambitious and comprehensive Action Plan aimed at addressing base erosion and profit shifting in an open format that allows all stakeholders to provide their views.  

Taxand can confirm that we have no objections with posting the comments on the OECD website and that comments represent Taxand and are based on our experience working with multinationals worldwide.  

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and to participate in any further discussion on these matters.  

More information about Taxand is provided below. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.  

If you wish to discuss any of the points raised in this letter, please do not hesitate to get in touch with us directly via the contact details below.  

Yours faithfully,  
Taxand  

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<tr>
<td><strong>Laurie Dicker</strong></td>
<td><strong>Kieran Taylor</strong></td>
</tr>
<tr>
<td>Taxand USA</td>
<td>Taxand USA</td>
</tr>
<tr>
<td>T. +1 202 688 4215</td>
<td>T. +1 212 328 8665</td>
</tr>
<tr>
<td>E. <a href="mailto:ldicker@alvarezandmarsal.com">ldicker@alvarezandmarsal.com</a></td>
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ABOUT TAXAND

Taxand provides high quality, integrated tax advice worldwide. Our tax professionals, more than 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent—ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. Taxand ranked in the top tier in Chambers Global Guide 2014 global network rankings and in the International Tax Review’s (ITR) World Tax 2015, 41 Taxand locations were commended and a further 26 locations listed in ITR’s World Transfer Pricing Guide 2015. 31 countries were voted top in the ITR Transaction Tax Survey 2014 and 29 in ITR Tax Planning Survey 2013. Taxand has received 69 national awards and 15 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include Latin America Tax Disputes Firm of the Year, European TP Firm of the Year, European Indirect Tax Firm of the Year, Asia Transfer Pricing Firm of the Year, and Asia Tax Policy Firm of the Year. Full details of awards can be viewed at www.taxand.com/about-us

www.taxand.com
1. Introduction

Taxand would like to thank the OECD for the opportunity to provide the following comments to the Discussion Draft. Our comments below are intended to be practical and experience-based, as well as constructive, in our responsibility as global tax advisors to contribute to a more comprehensive debate on the important issues raised, and the concepts introduced.

The specific response requested by the OECD within the Discussion Draft is whether the goal of consistency with other parts of the Guidelines is appropriate, and if so, whether the Discussion Draft achieves such consistency. In addition, Taxand offers general comments on the Discussion Draft itself, including on matters of general utility within certain sections.

2. Key points

Taxand's key comments in relation to the Discussion Draft are as follows:

- Taxand believes the aim of greater consistency between the CCA guidelines and the previously posited changes in other areas of transfer pricing is beneficial to taxpayers and tax administrations alike.
- The amended draft is successful at furthering such consistency (particularly with regard to concepts of risk and key intangible functions), however it represents a significant deviation from existing definitions of cost sharing, which allow participants to share costs in exchange for assuming risks associated with the ultimate cost-shared deliverable.
- In certain areas, these new CCA guidelines will create inconsistency with existing domestic legislation, which may create the potential for double taxation.
- A further example to highlight the process of determining the value of proposed benefits under a services based CCA may be useful for taxpayers.
- The point of Example 3 is that the overall contribution to be shared is one based on total value as opposed to total cost. We would recommend reinforcing this conclusion.

3. Consistency with other parts of the Guidelines

Taxand notes that the OECD has specifically requested comments in relation to the goal of consistency between the newly amended draft CCA guidelines and the other components of the Guidelines. Comments in relation to this area are outlined below:

- Taxand agrees that consistency between the redrafted CCA guidelines and the wider redrafting of certain elements of the Guidelines should be sought.
- Taxand believes the amended draft succinctly and clearly recharacterises the concept of CCAs. In particular, Taxand believes the OECD’s efforts to incorporate both the heightened concept of risk in relation to appropriate arm’s length returns, and the newly defined significance of development, enhancement, maintenance, protection and exploitation in relation to intangibles has been successful.
Risk, as the focus of paragraph 13 and Example 5 within the Discussion Draft, is of particular note to US-based advisors. Example 5 states that an entity providing funding into a CCA, without the ability or capacity required to “make decisions to take on or decline the risk-bearing opportunity represented by its participation in the CCA, or to make decisions on whether and how to respond to the risks associated with the opportunity” would be disregarded as a participant within a CCA. This is a deviation from US-based CCA or Cost Sharing Arrangement (“CSA”) regulations, where such an entity would remain within the CCA. While Taxand welcomes greater consistency with the wider changes in transfer pricing relating to risk, this deviation will cause concern for Taxpayers who may consider US participation in CCAs and further, this deviation may ultimately create the risk of double taxation.

The proposed “value” based contribution allocation method more closely aligns with the previously introduced importance of key functions over cost. OECD amendments to Chapter VI of the Guidelines have stipulated those entities performing the development, enhancement, maintenance, protection and exploitation functions will be entitled to a greater reward than entities purely paying for any of the above. Treating the contributions in terms of the value they provide to the CCA, as opposed to assessing their weight purely on cost is more closely aligned to assessing key functions when considering intangibles. However, this move to a value based model, while generating consistency within BEPS, moves the concept of cost sharing away from the traditional notion of the sharing of development cost and risk between participants, once initial value-based contributions are determined. This shift may make cost-sharing arrangements less appealing to taxpayers who valued the original approach for its core aim of truly sharing cost.

It is worthy of note, however, that the conceptual consistency with earlier BEPS deliverables may also lead to differences in treatment between regimes with regard to cost sharing. An example of such a difference would be the US, which continues to assess ongoing contributions to a CCA / CSA based on cost, hence a cost-share involving the US and an OECD territory implementing these rules could result in a divergence of treatment in either territory, and potential double taxation.

In general, Taxand welcomes the greater reference to the newly introduced key concepts of development, enhancement, maintenance, protection and exploitation with reference to intangibles. Underlining the importance of these key concepts will assist taxpayers in ensuring that the correct functions are allocated the appropriate reward when considering the “value” based contribution method introduced by this redraft.

Further, Taxand welcomes the distinction between development CCAs and services CCAs, aiding clarity in the difference of approach.

4. Comments on individual sections within the Discussion Draft

Taxand notes that the OECD has requested comments on the discussion draft in addition to those on general consistency. As such, specific points of note are outlined below concerning individual sections within the Discussion Draft:
In paragraphs 10 and 34, the OECD notes that a CCA may be used by a group to generate savings on behalf of the participants in a given area. Certain entities may be providing a service into the CCA (e.g. procurement staff, the use of office space, payroll functionality etc.), and numerous entities may receive benefits from the CCA in the form of cost savings (e.g. reduction in cost of IT equipment through a centralised procurement function). While this is a clear aim of certain CCAs, the newly emphasised concept of “value” may make the determination of the benefits of the CCA uncertain. Should, for example, the “benefits” of such a centralised procurement be valued at the arm’s length mark-up one would attribute to a procurement function, the reduction in spend achieved by the entities benefiting, or as a percentage of the total spend passing through such a procurement function. An example outlining a method, or route to choose a method to determine the value to be placed on services as an output of a CCA may be useful for taxpayers.

Further, Example 3 is intended to reinforce the point that contributions should be measured based on value rather than cost (i.e. including any arm’s length mark-up to be applied to such goods / services provided to a CCA). Even if the mark-ups applied to such services are the same for all participants, the example states post-mark-up ratios should still be used to determine any balancing payments due, instead of a pre-mark-up ratio. In such a scenario, when the mark-ups are the same, the value and cost ratios remain constant, and hence the use of one ratio over another ratio (as highlighted in the previous examples) is not relevant. The example should clarify that even though these ratios are the same, the balancing payments are determined based on total nominal (not ratio) value, not total nominal cost. As such, any balancing payment would be higher under the new CCA rules.

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We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further, and to participate in any further discussion on these matters.

More information on how to contact Taxand is provided above. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Yours faithfully,
Taxand

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May 29, 2015

VIA EMAIL
Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(TransferPricing@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Actions 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Dear Mr. Hickman:

USCIB thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 8 of the Base Erosion and Profit Shifting (“BEPS”) project pertaining to cost contribution arrangements (“CCAs”) and Revisions to Chapter 8 of the Transfer Pricing Guidelines (“TPGs”) issued on April 29, 2015 ("discussion draft").

General Comments

USCIB believes that the discussion draft misconstrues the purpose and application of a development CCA. USCIB believes that the purpose of a development CCA is to provide an elective regime that allows related parties to achieve a result comparable to that achieved by independent parties with respect to shared development arrangements and reduce the tax uncertainties inherent in other arrangements used to conduct these activities jointly.

To fulfil these purposes, development CCAs recognize that unrelated parties jointly engage in development activities by sharing costs and thus provide similar simplified mechanisms for associated enterprises to share the costs of their IP development. CCA rules for development provide a viable option for participation in joint development activities and are not intended to adopt the same tax requirements or produce the same tax results as would other options available to affiliates to jointly develop IP.

The economics of a CCA support these aims. In a CCA, a consolidated investment is divided into shares where each participant is entitled to the same economics as the economics of the consolidated investment. If the consolidated investment takes the form of a CCA, the only way to achieve the economically consolidated result is by splitting consolidated costs between participants proportionally to each participant’s expected benefits (e.g. gross intangible income). Dividing the consolidated costs any other way results in two (or more depending on the number of participants) economically different investments with different operating leverage and thus different incremental costs of capital. Since the CCA is intended to permit participants to achieve this desired consolidated result without the necessity
of setting up a legal entity to pursue the joint development of intangible property, using value for contributions within the CCA fundamentally misunderstands the economics of the CCA.¹

The conceptual flaw of the CCA proposals is to mandate equal treatment for the contribution of existing IP rights and future development activities. These are fundamentally different concepts and require different analysis and treatment. Pre-existing IP contributions’ costs are sunk and therefore are contributed at arm’s length to the CCA at value. Ongoing future development costs are fixed as incurred and affect the cost of capital of the participants. They should therefore be shared at cost to ensure that the allocation of the incremental cost of capital is the same for each participant. The US regulations² reach the correct answer on this issue.

The discussion draft essentially rejects cost as a basis for measuring a participant’s contribution to the CCA and requires the use of value and calls this a “clarification”³. As explained above, this is definitely not a clarification; it would be a fundamental and detrimental change. Replacing “cost” with “value” as a measurement of a participant’s contribution to a CCA is inappropriate for a number of reasons. First, requiring all contributions to be measured using value undercuts one of the main purposes for using a CCA: simplifying and ensuring certainty with respect to these arrangements. The discussion draft does not provide clear guidance on how the value of the contribution will be measured. Paragraph 22 of the discussion draft requires the value to be determined under the arm’s length principle but is not clear whether, for example, an R&D service provider would be compensated as a service provider or whether the intangible created by the R&D would be valued (difficult or impossible to do until the R&D project is completed). Second, the TPGs are supposed to apply the arm’s length standard. Independent parties enter into arrangements where ongoing costs (not including stock based compensation) are shared. This structure is seen in the oil and gas industry, the pharmaceutical industry, the movie industry, and the technology industry. These arrangements split costs proportionately. Ignoring this common practice essentially rejects the ALP. The discussion draft also proposes to eliminate the reference in the existing TPGs to CCAs possibly including independent enterprises.⁴ Query whether this reference is eliminated because the drafters believe the principles are not applicable between independent enterprises and independent enterprises would not enter into such an arrangement?

Both the existing TPGs⁵ and the discussion draft⁶ accurately describe the reasons independent parties would enter into CCAs. Both documents provide:

“Independent parties at arm’s length might want to share risks (e.g. of high technology research) to minimise the loss potential from an activity, or they might engage in a sharing of costs or in joint development to achieve savings, perhaps from the combination of different individual strengths and spheres of expertise.”

This language recognizes that CCAs between independent parties are seeking consolidated results, rather than separate investments. That is, independent parties could not achieve savings from the

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¹ One of the important simplifications of the CCA regime is that it allows taxpayers to achieve these results without the complexities of a joint venture or partnership arrangement.

² Treasury regulation 1.482-7(g)(4).

³ Discussion Draft, unnumbered paragraph 4 of Box on page 3. It is disingenuous to call this a clarification. The change from cost to value would change principles that are fundamental to the concept of a CCA and would require significant redrafting to eliminate references to cost throughout existing Chapter 8. We are unaware of any existing CCA arrangement that is based on value.

⁴ Paragraph 8.1 of the existing TPGs.

⁵ Paragraph 8.8 of the existing TPGs.

⁶ Paragraph 10 of the discussion draft.
combination of different individual strengths and spheres of expertise, if those where paid for at value because all of the benefit of would accrue to the party performing that activity. In order to achieve the consolidated result that is the intended benefit of the CCA, the parties must share costs proportionately to the expected benefit under the arrangement.

In all events, development CCAs, as defined by the TPGs, should not be the exclusive means of sharing costs. Rather they should be viewed as simplified mechanisms with taxpayers still being able to demonstrate that cost-only development arrangements meet the arm’s length standard. USCIB believes that development CCAs are fundamentally different from shared service CCAs. Development CCAs are intended to attempt to create risky, uncertain future value, while shared services address highly certain current services that have known current value. Because of these fundamental differences, a different set of rules are appropriate for development CCAs and services CCAs. The guidance on these arrangements should, therefore, be divided into separate sections.  

Finally, USCIB would like to propose an additional rule that would limit challenges to the CCA and the allocation of benefits among the participants to those governments in which a participant resides. As described above, a development CCA creates a consolidated investment in the intangibles that are the objective of the CCA. Thus, if value is ultimately attributable to those intangibles, then it is clear that the return from those intangibles is attributable only to the participants in the CCA and not to other non-participants. Thus, the governments of the participants could challenge the split among the participants, but other governments should not be able to do so.

**Specific Comments**

Paragraphs 6 and 7 of the Discussion Draft propose that all of the other rules in the TPG will apply with equal force to CCAs. As described above, USCIB believes that this requirement indicates a misunderstanding of the policy rationale underlying a CCA regime and would eliminate the usefulness of the CCA. CCAs should be considered a discrete and separate method within the TPG.

By eliminating any references to the “amount” of the contribution or references to cash, paragraphs 20 through 23 fundamentally change the nature of the CCA. The existing TPGs clearly permit “costs” to be shared. By denying taxpayers the ability to structure a CCA by sharing costs, and by requiring the outcome of a CCA to mimic the outcome of a series of transactions carried out under the other chapters of the TPG, the guidance under Chapter VIII is attempting to prohibit taxpayers from engaging in a CCA that has the same general terms and structure that uncontrolled parties would use to structure their co-development transactions because in similar uncontrolled co-development structures, parties do share costs and risks in proportion to benefits. Therefore, prohibiting such a structure is inconsistent with the arm’s length standard.

Paragraph 13 requires all development CCA participants to control risks “in accordance with the definition of control of risks set out in Chapter I.” USCIB has serious concerns with the OECD’s proposed guidance on risk as set forth in its December 2014 discussion draft. Fundamentally, the problem with those proposals is that they are based on the premise that investors are not willing to

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7 There is insufficient time to identify all of the ways that development CCAs should be distinguished from service CCAs, but this comment letter points out a number of places where distinctions should be drawn. Those distinctions emphasize the importance of separate rules.

8 Compare, for example, the proposed guidance to the current 2010 OECD Transfer Pricing Guidelines, sections 8.9 (“...each participant’s relative contribution to the joint activity (whether in cash or in kind)...”) and 8.15 (“...where all contributions are made solely in cash...”).

9 Explained in detail in our comment letter include link.
accept risks they do not control. This premise is simply wrong. As noted above, CCAs are structured to take advantage of different areas of expertise and to mitigate risk. Before entering into a CCA the parties will do due diligence to ensure that the parties have the capabilities to perform as expected, but once they have decided to invest they will rely on the other participant to perform as expected. In the movie industry, for example, a CCA may be set up to produce and distribute a movie with one party making all production decisions and the other providing funding and distributing the movie. Thus, the distributor will be agreeing to distribute even though it does not have any control over the quality of the movie because it has delegated all decisions to the producer. They will do this because the producer has the expertise to make the movie and involving the distributor in production decisions would slow down the process, making production more costly. Furthermore, their incentives are aligned. The producer and distributor both benefit from producing a movie that people want to see and that is distributed effectively. Most movies do not make money, so the downside risk is real and the distribution/financing entity has to be able to earn an entrepreneurial return or the business model would fail.

USCIB further notes that, as the OECD acknowledges, one of the reasons for entering into a CCA is “to share risks ... to minimise the loss potential from an activity”. Providing non-debt financing, even without control, shifts the risk of loss. This is what venture capitalists and private equity financiers do. In these arrangements, both parties share the entrepreneurial return – whether that return is a profit or a loss. In transactions between independent parties, the financing entity receives a share of the upside and downside proportional to its reasonably anticipated benefit (“RAB”) share after funding the same RAB share of the intangible development costs. In the pharmaceutical/biotech sector research may require large upfront investments that a smaller company could not fund without a JV partner or CCA to provide funds and mitigate the risk. The funding entity would in all likelihood require a higher return because it is accepting risk. Ignoring this need for a higher return to account for the fact that risk is in fact shifted is inconsistent with the arm’s length standard.

The OECD’s recent guidance provides that persons that engage in the development, enhancement, maintenance, protection or exploitation of an intangible are entitled to a portion of the intangible related return. The discussion draft on risk provides that parties control risk, at least in part, by deciding whether to take on that risk. Thus a party that has the capability to assess an investment opportunity and decide whether to take on the risk should be considered to control that risk and ought to be entitled to an entrepreneurial return. In CCA arrangements between independent parties there will be due diligence concerning whether the investment is appropriate and whether the other party to the arrangement has the capability to perform the functions necessary to develop the intangible. Example 4 of the discussion draft provides that “Company A performs, through its own personnel, all the functions expected from an independent entity providing funding for a research and development project, including the analysis of the intangible at stake and the anticipated profits that can be derived from the investment, the evaluation of the funding risk, including the risk that further investment may be required to complete the project, and of the capacity of Company A to take that risk, and the making of decisions to bear, cover, or mitigate that risk.” Development of intangibles includes the decision to pursue and fund that development. Control of risk includes the evaluation of these risks and the decision to accept them. These are the sorts of decisions that senior management makes and should be considered essential to continuing viability and profitability of an enterprise and managing these risks by deciding where to deploy capital to fund intangible development therefore should entitle the enterprise that makes these decisions to an entrepreneurial return. The conclusion in Example 4 is, therefore, incorrect based on the guidance provided by the other Action Items and arm’s length behavior of.

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10 TPGs paragraph 8.8, discussion draft paragraph 10.
independent parties in CCAs. USCIB also observes that Examples 4 and 5 are inconsistent with guidance that the OECD has already issued on Chapter VI of the TPG, which does allow for a risk adjusted return for pure funding activities.

USCIB also believes that extending the risk guidance to CCAs demonstrates a misunderstanding of how intangible development often occurs and, therefore, would be inappropriate and inconsistent with the fundamental policy goal of promoting IP development. This rule would have a particularly negative impact on the ability of start-up companies to use CCAs. The proposed rules would require each participant to actually perform development activities in order to share in the entrepreneurial return. For example, under Example 4, to obtain more than a mere financing return, each CCA participant would need to have an R&D workforce in place in each relevant taxing jurisdiction (in addition to the R&D executives that are required to be in place in each taxing jurisdiction just to obtain the financing return with respect to the capital invested in R&D). In many situations, a small start-up company with a few scientists and engineers will develop an idea in one jurisdiction and then expand to other jurisdictions over time. In order to do this, the start-up will likely need capital to fund this gradual expansion. It takes time for a company to find qualified scientists in each relevant jurisdiction; they may never be available in many jurisdictions. This is difficult for all MNEs, but is especially difficult for small start up companies. This discussion draft would prevent such small start-up companies from enjoying the benefits of CCAs while simultaneously extending such benefits to a small percentage of the largest corporations that already have R&D facilities in many different jurisdictions. This discriminates against start-up companies when there is no identifiable policy rationale for such discrimination. Policy should encourage innovative start-ups; as the OECD has observed: “[i]nnovation [by start-up companies] is a major driver of productivity, economic growth and development.”

Application of Action 8 - 10 Principles to CCAs

As discussed above, the discussion draft's proposal to require all contributions to a CCA to be measured by value essentially negates the entire concept of a "cost contribution" arrangement. USCIB believes that the economics of a CCA drive the use of costs, despite changes to other aspects of the transfer pricing guidelines. Nevertheless, if the OECD wishes to integrate Chapter VIII more fully into the new guidance, USCIB believes that there is no need to discard entirely a transfer pricing structure which for decades has provided clarity to taxpayers and tax administrators as to how costs should be allocated between the parties. Instead, we suggest that any concerns that may have arisen in the past regarding the operation of CCAs could be addressed by enhancing the Ch VIII guidance as to when an arrangement that requires taxpayers to share their contributions at cost should be regarded as consistent with the arm's length principle, as elaborated by the other work underway under Actions 8 - 10, and when it cannot.

The discussion draft refers to two types of CCAs: development CCAs and service CCAs. It is hard to see in the case of service CCAs any significant risk of BEPS concerns. By definition, service CCAs involve services which produce a current benefit only. Allocating a pool of current period costs based on expected relative current period benefits would seem to produce appropriate results in the overwhelming majority of cases.

The guidelines on development CCAs allow related parties to choose to enter into joint funding arrangements that are analogous to arrangements seen between unrelated parties. Since these

arrangements do exist at arm's length, it must be the case that CCAs in which the contributions are valued only at cost must be accepted as complying with the arm's length principle in many cases. Instead of precluding altogether the possibility of utilizing arrangements that exist at arm's length, the Guidelines should provide taxpayers and tax administrators with guidance as to when those arrangements will be respected.

With respect to development CCAs, the discussion draft's proposed requirement that all contributions be measured by value does not sufficiently recognize the effect of the buy-in payment to equalize the value of the contributions of the parties, even if one of the parties does not perform development activity itself. A buy-in payment constitutes an amount determined under the arm's length principle that compensates the transferor for all property it may contribute to a CCA, under the particular circumstances of the parties to that CCA. The net buy-in payment received by a transferor will be greater to the extent that the other party to the CCA is not also transferring property into the CCA. As such, an appropriate determination of the amount of the buy-in payment can equalize the value of the contributions of both parties from the beginning of the CCA, even if the parties have agreed to fund their joint development activity under a CCA with one party contributing only risk capital. It would be appropriate for the next draft of a revised Chapter VIII to focus in more detail on the effect of the buy-in payment to equalize the contributions of the parties from the beginning of the CCA, so that the ongoing CCA under in which the parties' contributions are valued at cost would be regarded as compliant with the arm's length principle.

Chapter VIII will not be of much use to taxpayers if there are few circumstances where CCA contributions can be measured at cost. Accordingly, the purpose of Chapter VIII should be to describe those circumstances where a cost-based CCA will be regarded as compliant with the arm's length principle. Inherent in any development CCA is the shared undertaking of a significant development risk. In light of the work now being done in Actions 8 - 10 on risk and recharacterization, the question becomes what activities of the parties should be required in order for each party to be respected as bearing that development risk.

We respectfully suggest that the revised Chapter VIII could set out several circumstances where a CCA participant would be respected as bearing that shared development risk and thus be entitled to its expected benefit from the property being developed under the CCA.

First, it should be clear that a party which undertakes any of the DEMPE functions should be respected as participating in a CCA, and should be entitled to its anticipated benefit from the developed property.

Second, a party should be entitled to the benefits of the CCA if it is engaged in the active conduct of a trade or business in which it expects to utilize the results of the development CCA, even if those trade or business activities do not include DEMPE functions. This case is a close analogue to many shared development programs conducted at arm's length where the parties agree that only one of the parties would undertake the actual development work.

Third, a party should be entitled to the benefits if the CCA if the party being tested has paid an appropriate buy-in payment. As noted above, Chapter VIII could provide guidance as to when the buy-in payment would be regarded as compliant with the arm's length principle in light of the nature of the expected ongoing contributions of each of the participants.

Finally, a party should be entitled to the benefits of a CCA if it performs the financial and risk management activities described in the draft Example 4. We believe that such activities clearly are
DEMPE functions, but if there is any doubt of that, then those financial risk assessment activities are entirely appropriate activities to qualify a participant as entitled to the intangible return under a CCA.

We suggest that the proper conclusion in Example 5 is not that the CCA is disregarded, but that the party which contributes only risk capital should be allocated a risk-adjusted rate of anticipated return on its investment. There is no need to disregard the CCA altogether in this case. An arm's length result can be achieved by limiting the investor's return to that of a financial investor in a similarly risky business.

For purposes of identifying the functions, assets and risks performed by a CCA party, Ch VIII should note that a partner or other owner of a transparent entity be attributed the functions, assets and risks undertaken by the transparent entity.

Balancing Payments Paragraphs 27 through 30 discuss “balancing payments,” which seem to be ex post adjustments similar to “commensurate with income” (“CWI”) adjustments made under U.S. Treasury Regulation 1.482-7(j)(6). While it may be appropriate to make CWI types of adjustments in some limited circumstances, CWI adjustments should not be applied without some guidelines as to when such an adjustment is appropriate. If a tax jurisdiction has the authority to make CWI adjustments without any exceptions, it has a tool at its disposal that could completely undermine the ex ante analysis that is required for an analysis under the arm’s length standard. Specifically, USCIB recommends adopting the following exceptions to the authority for a tax jurisdiction to make an ex post “balancing payment” type of adjustment:

a. If events occur that are beyond the control of the CCA participants and that could not reasonably have been anticipated as of the date of the transaction with respect to which the balancing payment adjustment is being made, then no balancing payment adjustment will be made;

b. If the actual ex post financial results (for the profits attributable to the intangible transaction that is the subject of the balancing payment) are within 67% to 150% of the CCA participants’ ex ante financial projections for such results for a given tax year, then no balancing payment adjustment will be made for that year;

c. If the CCA participants can satisfy the requirement in 4(b) above for five years in a row, then there will never be any balancing payments made with respect to the original transfer of intangibles; and

d. If the CCA participants can submit a comparable uncontrolled transaction made under similar circumstances to the original transfer of intangibles (that is the subject of the balancing payment), where uncontrolled parties arranged for payment terms and amounts similar to that made by the CCA participants with respect to such transfer of intangibles, then no balancing payment will be made with respect to such transfer.

Furthermore, USCIB believes that the discussion draft should be clarified with respect to whether balancing payments will be based on both the initial contribution and the subsequent contributions or whether each kind of contribution should be tested separately and balancing payments determined separately. We believe that because initial contributions should be evaluated based on value and the ongoing contributions on cost, that the evaluation should be done separately (although of course any actual balancing payments could be netted). Separate evaluation will be simpler for taxpayers and tax administrators to implement.

Paragraphs 31 and 32 provide special rules for disregarding CCAs when the actual RAB shares of the CCA’s participants differ substantially from the projected RAB shares. USCIB believes that disregarding a
CCA should only be a measure of last resort. USCIB believes it would be more reasonable for tax authorities to make periodic adjustments to a CCA participant’s RAB share than to simply invalidate the CCA. Furthermore, USCIB notes that there is no safe harbour for minor deviations of actual RAB shares from projected RAB shares. We note and support the discussion draft commentary that it might not be appropriate or useful for tax authorities to make RAB share adjustments every single year when actual RAB shares are not in line with the projected RAB shares. The USCIB agrees with this comment and recommends that the OECD adopt a safe harbour whereby actual RAB shares are deemed to be acceptable for a tax year if they are within a range of 80% to 120% of the projected RAB shares for that tax year.

Paragraph 19 provides for payment adjustment clauses. USCIB believes that this is very helpful and consistent with the arm’s length standard because uncontrolled parties often incorporate payment adjustment clauses into the signed legal agreement among the parties. USCIB believes that it would be even more helpful if the OECD specified that such payment adjustment clauses may be self-initiated and self-administered by CCA participants to obtain both prospective and retroactive modification of payment terms.

Paragraph 8 of the discussion draft states that: Chapter VIII applies to "intangibles, tangible assets, and services." USCIB believes that services CCAs are fundamentally different from intangible development CCAs. Therefore, the USCIB recommends that the OECD publish separate guidance with respect to intangible development CCAs and services CCAs. We are unaware of any use of CCAs for the development of tangible property; therefore, it is not clear that such rules for the development of tangible property are necessary. However, if the OECD believes that such rules are necessary, then they should be considered with intangible property since development is inherently speculative and any tangible property that requires a CCA to fund development is likely to be a multi-year enterprise with costs and benefits divided among different taxable periods.

One way that service CCAs might differ from development CCAs is that value might, in certain limited instances be an appropriate method for dividing the RAB for services. That is, in a development CCA, a participant would not give up a right to the entrepreneurial return for a modest reduction in the cost of developing that intangible. Rather than doing that, the participant would develop the intangible itself. On the other hand, in a services CCAs, the participants might well consolidate services without regard to the entrepreneurial return because these agreements are not about entrepreneurial return, but rather about minimizing, routine variable costs. Paragraph 16 suggests that the number of employees may be an acceptable allocation key for allocating benefits among the CCA participants. USCIB disagrees with this assertion for intangible development CCAs. It should not be an acceptable allocation key for intangible development CCAs because the number of employees in different jurisdictions has no relevance to splitting the profits attributable to intangible development. This is another example of where a different rule would be appropriate for development and services CCAs.

In paragraphs 33 and 34, all references to royalties and R&D have been removed (from existing paragraphs 8.23 and 8.24 of the TPG). USCIB believes that these references were helpful and should be retained.

The discussion draft proposes to delete a paragraph (paragraph 8.17 of the existing TPG) that deals with subsidies and tax incentives. Deleting these references seems to imply that these should not be taken into account, which does not seem appropriate. USCIB recommends keeping these references in the guidance.
USCIB notes that there are no grandfathering provisions or transition rules for existing CCAs that qualify under the existing TPG. Should the OECD proceed with these proposals, USCIB believes that it is extremely important that there should be appropriate grandfathering and transition rules for existing CCAs. By analogy to the agreement reached on patent boxes, any transition period should be 5 years. As stated above, we are unaware of any existing CCAs that use value to account for contributions. Thus, all CCAs will need to be restructured either by eliminating the CCA or reconfiguring the CCA.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)