# TAX EXECUTIVES INSTITUTE, INC.



28 May 2015

Andrew Hickman
Head, Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

**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]

**<u>TEI Comments</u>**

<u>Value of Contributions to CCAs</u>

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."[4] 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.[5] 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.[6] 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.[7] 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.

---

[5] *See* 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* (3 November 2014).

[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

---

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.

<u>Recharacterisation</u>

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.[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/risks/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

Mark C. Silbiger
*International President*