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VIEWPOINT

BEPS-Flavored Cost Contribution Agreements Leave a Sour Aftertaste

by Robert Robillard

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Public discussion draft ''BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contributions Agreements (CCAs)'' was released on April 29, 2015, and updates Chapter VIII of the OECD transfer pricing guidelines. This article provides some observations on the key components of the draft.

Public discussion draft ''BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contributions Agreements (CCAs)'' (the OECD draft) was released on April 29, 2015. As indicated by its title, the draft updates Chapter VIII of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (OECD transfer pricing guidelines) regarding CCAs. The rest of this article provides some observations on the key components of the draft, including the meaning and scope of a CCA, the determination and valuation of the participant's respective contributions, and the balancing payment mechanism.

Contributions Come Before Benefits

From the onset, every transfer pricing practitioner is aware that a CCA is the outcome of some types of cost allocations, whereas in other instances, it is based on the arm's-length values attached to the contributions of the parties. But with the recent ''discovery'' of the alleged base erosion and profit-shifting phenomenon, things have now slightly changed.[1] The BEPS mind-set has brought a new perspective on CCAs for transfer pricing purposes.

The introductory remarks of the draft indicate on page 3 a subtle but meaningful philosophical shift on the matter. In the BEPS era, the participant's contributions to a CCA are expected to be valued at arm's length rather than at costs 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.'' This may lead the reader to believe that the determination of the contribution of the participants ''at arm's-length value'' in a CCA instead of based on ''costs'' is a novelty. In fact, this blurred preference was already included in the OECD transfer pricing guidelines. Chapter VIII of the guidelines, originally released in August 1997, indicated in paragraph 8.14 that ''[u]nder 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 in comparable circumstances.''[2]

Of course, what independent enterprises would have concluded was left to the imagination of the reader, if the ''guidance in Chapters I through VII'' was followed. At the time, paragraph 8.15 subtly recognized

[1]*See* OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing.

[2]This idea is also found in new paragraph 22 of the draft.

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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.''[3] In short, since 1997 it had been signaled that costs were indeed an efficient way to determine the participant's respective contribution to a CCA from an arm's-length perspective.

What is new in this OECD draft is the explicit firmness on arm's-length values to determine the participant's respective contribution to a CCA according to paragraph 22 of the draft.

Admittedly, in the arm's-length world, it is expected that the respective contributions of the participants will be aligned with their projected shares of the benefits. In short, no party will contribute to a CCA without expecting a proportional share of the benefits.

To that effect, tax administrations around the world have been wary that multinational taxpayers may not reward at face value the respective arm's-length contributions of the participants to a CCA with arm's-length returns. Once again, that is to say that a given share of the contributions to a CCA should result in a corresponding share of the benefits.

With that clearly in mind, I would contend that the draft theorizes backward on the contribution analysis of a given CCA. For instance, paragraph 4 of the draft indicates that:

> In accordance with the arm's length principle, each participant's proportionate share of the overall contributions to a CCA must be consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement.[4]

This is a resumption of paragraph 8.3 of the July 2010 edition of the OECD transfer pricing guidelines. From an economic perspective, I would suggest that to be in accordance with the arm's-length principle, it is the ''participant's proportionate share of the overall expected benefits'' that should be consistent with the ''participant's proportionate share of the overall contributions to a CCA.'' Clearly, it is not the other way around.

In the United States, the wording provided in reg. section 1.482-7(b)(4)(i) is quite limpid to that effect. It states:

> Each controlled participant must be entitled to the perpetual and exclusive right to the profits from transactions of any member of the controlled group that includes the controlled participant with uncontrolled *taxpayers to the extent that such profits are attributable to such interest in the cost shared intangibles.* [Emphasis added.]

It is only with that specific perspective in mind that the ''value versus costs'' debate may make any sense in the determination of the contribution of the parties in a CCA. Each participant's proportionate share of the overall expected benefits then follows from the accurate determination of the value of the contributions.

What Is a CCA?

But before we proceed with this determination, what is a CCA? The following definition of a CCA is found in paragraph 3 of the OECD draft on new Chapter VIII:

> A CCA is 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 intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants.

Paragraph 8 of the draft adds that two types of CCA are ''commonly encountered'': for the development of intangible property and for the rendering of services. In my opinion, this CCA definition is too broad to be practical for transfer pricing purposes, especially in the BEPS era.[5]

In the United States, reg. section 1.482-7(b) defines a CCA as an ''arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their RAB shares'' — reasonably anticipated benefits. I believe that this narrower definition of a CCA is better suited for transfer pricing purposes. It is what may be labeled as the ''legitimate definition'' of a CCA for cross-border transaction purposes.

In other words, CCAs should indeed be related to the development of intangible property for transfer pricing purposes. Other mechanisms available to ''share'' the benefits of non-intangible related arrangements are now in the CCA definition put forward by the OECD.

For instance, I fail to see how ''low value-added services'' would make it into the mix of functions and risks to determine the share of the benefits of the participants to a legitimate CCA, even if it was a service CCA. That is, unless the CCA would focus on the rendering of those specific services as implied in paragraphs 5 and 6 of the draft.

But it is difficult to comprehend why a basic application of the transactional net margin method or, according to the OECD's latest guidance, some types of profit-split methods would not be preferred in these

[3]This guidance is identical to what is found in the July 2010 edition of the guidelines in the same paragraph.

[4]The same logic is found in new paragraph 20.

[5]In Canada, a similar definition is found in paragraph 120 of IC 87-2R, ''International Transfer Pricing.''

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scenarios.[6] In fact, example 5 (paragraphs 62-63) of the draft seems to inadvertently propose the same argument since a company may not be ''regarded as a participant in the CCA'' when it doesn't ''make decisions'' or take on ''risk-bearing opportunities.'' Narrowing down the definition of what truly constitutes a legitimate CCA — that is, the development of intangible property — would more than likely increase the strength of the already challenging methodology presented in paragraphs 20-30 of the draft, which I briefly discuss below.

Valuation: Arm's-Length or at Cost?

The main novelty of the OECD draft compared to the August 1997 version of Chapter VIII of the OECD transfer pricing guidelines is the apparent effort to provide meaningful guidance on the ''determination of the value of each participant's contribution'' in the CCA. Paragraphs 20-26 of the draft provide more comprehensive guidance on that topic compared to the August 1997 version of Chapter VIII of the guidelines.

This guidance is supplemented with some contextual information on the consequential ''balancing payment'' mechanism in paragraphs 27-30 of the draft and five examples at the end of the draft (annex to Chapter VIII). These examples highlight how a CCA is expected to operate and then evolve through time. But in the end, this new guidance is not without its own noteworthy limitations.

The fundamental matter giving birth to the ''value versus costs'' debate found in the OECD draft regarding new Chapter VIII of the guidelines is to ensure that the respective contribution of the parties to the CCA are properly measured. In reality, when compared to reg. section 1.482-7, new Chapter VIII of the guidelines barely scratches the surface on this issue.

Paragraph 21 of the draft highlights the fact that ''contributions to a CCA may take many forms.'' Paragraph 22 suggests 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 25 of the draft highlights many types of ''contributions made by the participants to the arrangement.''

On the matter of legitimate CCAs, that is, for the purpose of developing intangible property, paragraph 23 explains that ''development CCAs costs will generally not provide a reliable basis on which to value contributions.'' In the United States, it is with this definite intent that reg. section 1.482-7(d)(1)(iii) indicates which costs should be included in the intangible development costs. Any cost ''incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles'' will be included. The sole issue, in the end, is on the actual evaluation of those costs: valuated at arm's length or simply costs incurred?

As a starting point to that adventurous journey, paragraph 26 of the draft indicates that ''important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets . . . should be valued in accordance with the principles set out in Chapter VI'' of the guidelines. In essence, the draft suggests that key functions, that is, functions that enable the creation, development, or maintenance of the intangible property, should be the main focus of the comparability analysis according to the OECD transfer pricing guidelines.

Example 4 at the end of the draft illustrates this process. Although relatively simple, the example suffices to demonstrate that the functional analysis must play a central role in the contribution analysis.

However, the Guidance on Transfer Pricing Aspects of Intangibles[7] clearly indicates that following the ''principles set out in Chapter VI'' may not be as easy as it looks in real life. New section B of Chapter VI (new paragraphs 6.32-6.69) on the ''ownership of intangibles and transactions involving the development, enhancement, maintenance, protection, and exploitation of intangibles'' seemingly advocates that the arm's-length determination of the participant's contributions to the CCA may be more than any team of in-house or external transfer pricing experts can ultimately chew.

The sheer complexity and overwhelming subjectivity of the analysis proposed on the matter cannot bode well regarding the ultimate determination of the respective arm's-length value of the contributions of the participants in the CCA. Terms and expressions like ''appropriately compensated,'' ''relative value,'' ''functions with special significance,'' and ''transfer pricing methods not directly based on comparables'' — all found in section B.2 of proposed Chapter VI — are worrisome for their deliberate subjectivity, noticeable uncertainty as to their true meaning, and for their latent litigation potential among tax administrations as well as between tax administrations and multinationals.

Moreover, new section D.3 of Chapter VI (paragraph 6.178-6.185) also recognizes the obvious shortcomings of the application of the arm's-length principle ''when valuation is highly uncertain at the time of the transaction.'' If the participation to a legitimate CCA for the development of intangible property is not an ''uncertain'' proposition, what may in fact be?

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[6] *See* ''BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains,'' released Dec. 2014; especially scenarios 1, 2, and 4.

[7] OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G-20 BEPS Project, OECD Publishing.

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New section D.3 of Chapter VI of the guidelines basically suggests, according to paragraph 6.178, that the solution to this problem may in fact revert back to ''what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.'' This brings us back to paragraph 22 of the draft: That is, that ''[u]nder 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.'' But then the draft posits 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.''

One gets the vague impression we are running in circles. First, the contribution analysis should be based on ''arm's length value'' rather than costs. Second, the functional analysis leading to that evaluation must follow the ''principles set out in Chapter VI.'' Third, ''when valuation is highly uncertain at the time of the transaction,'' which is usually the case as far as CCAs are concerned, other means than the arm's-length principle may be considered to carry out the process. Are we reverting back to valuation at costs after all?

On the one hand, it may be useful to clearly distinguish in the draft between the buy-in payments and the ensuing development and maintenance efforts of the participants to the CCA. Admittedly, case law has indicated that value at arm's length is becoming more relevant, if not mandatory, for the valuation of the buy-in payments into the CCA of the respective participant.

But on the other hand, the evaluation of the contributions of the participants at ''costs incurred'' might be much more useful and pragmatic than what is suggested by paragraph 26 of the draft in some instances. The analysis of the ''control of risks'' highlighted by paragraphs 13, 26, and 44 and examples 4 and 5 of the draft is basically mandatory to the whole contribution analysis of the CCA. This analysis of the control of risks according to new chapters I and VI of the guidelines[8] mostly pertains to the development and maintenance of the intangible property.

Arm's-length parties (that is, parties involved in commercial business dealings) are usually inclined to implement easily administered solutions instead of heavily skewed and assumption-filled verbiage. According to paragraph 6.178, already quoted above, ''costs incurred'' may indeed be ''what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction'' both for the development and maintenance of intangible property through a CCA.

[8]*See* the discussion on the ''control of risks'' in ''BEPS Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures),'' Dec. 1, 2014.

All this to say that considered from that perspective alone, section C.4 of the OECD draft on new Chapter VIII creates an ever more explicit compliance burden on any multinational that may be tempted by the CCA route. In order to comply with the requirements innocuously put forward in those seven paragraphs of the draft (that is, paragraphs 20-26), a multinational may be in for a dubious treat.

In the context of a legitimate CCA for the development of intangible property, the extraordinary challenges that will be generated by this growing compliance burden for the administration of the CCA itself will be exponentially compounded by the somewhat puzzling ''valuation process'' described in new Chapter VI of the OECD transfer pricing guidelines.

What About Balancing Payments?

Although these challenges regarding the design and proper implementation of a CCA may already be overwhelming, section C.5 on ''balancing payments'' offers more hurdles to CCA devotees.

Paragraph 27 of the draft basically indicates the need for an ''adjustment'' when the share of the benefits of a participant is not proportionate with its share of the contributions to the CCA: ''[s]uch balancing payments increase the value of the contributions of the payer and decrease that of the payee.'' Paragraph 28 adds that ''[b]alancing payments may be made by participants to 'top up' the value of the contributions when their proportionate contributions are lower than their proportionate expected benefits.''

This guidance must also be read keeping in mind paragraph 19 of the draft, which explains that ''periodic assessments'' of the participant's contributions may be required in light of the ''actual benefits'' coming from the CCA over time.

These clarifications therefore raise an interesting methodological topic regarding the fact that the arm's-length value of a participant's contribution is now the preferred apportionment mechanism according to section C.4 of the draft, rather than the costs incurred.

Clearly, the balancing payment mechanism is envisioned in the draft through the lenses of every participant's contribution. It is formulaic in nature, to say the least. The influence of the commensurate with income rule found in reg. section 1.482-4(f)(2) is palpable. The adjustment relates to participants' contributions rather than their respective benefits. In fact, this is the only way the balancing payment mechanism is ultimately applicable according to paragraph 27 of the draft, since it ''increases the value of the contributions of the payer and decreases that of the payee.''

However, the increase or decrease of the value of a participant's contribution, which is already deemed at arm's-length value according to the draft, would openly infringe with the prior determination of the value of that particular contribution. If it is indeed grounded on the arm's-length principle, the balancing payment

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mechanism should instead directly increase or decrease the respective share of the benefits of the participants, when and if applicable.

This nuance is not theoretical or simply rhetorical. On the one hand, it is required when the whole CCA contribution analysis is based on the determination of arm's-length value of each participant contribution to the CCA. The arm's-length values assigned to each participant's contributions result from the CCA contribution analysis according to the OECD transfer pricing guidelines. The balancing payment should not modify these arm's-length values.

On the other hand, the need to adjust the participant's share of the benefits might indicate that the prior arm's-length determinations of the participant's respective contributions were inaccurate or that they require some comparability adjustments. But even then, balancing payments should not replace the proper evaluation of the arm's-length value of the contribution of the participants.

Just like comparability adjustments in Chapter III of the OECD transfer pricing guidelines (paragraph 3.47-3.54) do not revise the conclusions of the comparability analysis in Chapter I of the OECD transfer pricing guidelines, the balancing payment mechanism should not modify the outcomes of the contribution analysis for the purpose of the CCA if it is based on the arm's-length principle.

Comparability adjustments pertain to the quantitative outcomes ensuing from the comparability analysis. In the same vein, the balancing payment mechanism should affect the respective share of the benefits of the CCA's participant rather than the contributions deemed at arm's-length according to the guidance included in the draft.

In short, if the participant's contributions are arm's-length values, no formulaic mechanism should arbitrarily modify these values. Comparabilitylike adjustments should be limited to the outcomes — that is, the respective shares of the participant's benefits — and subsequently, the contribution analysis conclusions may have to be revised if each participant's share of the benefits is not coherent with the purported arm's-length value of those participants' contributions.

From this brief examination of the balancing payment mechanism, examples 1, 2, and 3 of the annex to Chapter VIII should be revised accordingly, if the definition of a CCA according to the OECD will still include ''services CCA.''

Conclusion

Like many other recent drafts put forward by the BEPS initiative, this draft unfortunately adds more complexity to an ever-increasing number of codes, rules, and principles all alleged to ''realign international standards with the current global business environment.''[9]

From a practitioner perspective, this specific OECD draft clearly signals that the compliance burden of designing and administering a CCA has once again increased. The approach advocated in this draft will likely create more uncertainty and more tax litigations.

As a side note to the authors of the draft, paragraph 2 of the draft should likely read (last few sentences):

> *Section D* addresses the determination of participants in the CCA and issues related to the entry or withdrawal of participants, and the termination of CCAs. Finally, *Section E* discusses suggestions for structuring and documenting CCAs.

Considering all the above, I would hope that this will not be the only modification made to the final version of new Chapter VIII of the guidelines before its release in the coming months. ◆

[9] *Supra* note 1, at p. 9.

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