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OECD Releases Draft Guidance on Cost Contribution Arrangements

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The Organization for Economic Cooperation and Development (OECD) on April 29 released a non-consensus discussion draft on cost contribution arrangements (CCAs) that contains proposed revisions to Chapter VIII of the OECD's transfer pricing guidelines. The CCA discussion draft was issued in relation to the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan under Action 8 (transfer pricing valuation with respect to transfers of intangibles). Comments from the public are invited and due by May 29, 2015. A public consultation on this draft and other transfer pricing topics is scheduled for July 6-7 at the OECD's Paris headquarters.

The CCA discussion draft primarily updates the existing guidance to take into account guidance released under other BEPS action items, rather than take a fresh look at CCAs. The CCA discussion draft incorporates draft guidance on: (1) risk in Chapter I of the OECD transfer pricing guidelines released in December 2014 (the "Risk Draft"); and (2) taxation of transfers of intangibles in accordance with the value attributable to such intangibles in Chapter VI of the transfer pricing guidelines released in September 2014 (the "Intangibles Draft"). Thus, to the extent that the Risk Draft and the Intangibles Draft, including any changes on hard-to-value intangibles and special measures, undergo further revisions to reach consensus among OECD member countries, the CCA draft is likely to also undergo revisions to be consistent with the other discussion drafts.

Consistent with the current guidance, the CCA discussion draft applies to both service CCAs, in which participants share the cost of services, and development CCAs, in which participants share the costs and risk of developing property. The CCA discussion draft takes the position that the outcome of operating within the context of a CCA should be the same as if the CCA had not existed. Therefore, both initial contributions to the CCA and ongoing contributions must be measured by value rather than cost. The CCA discussion draft provides one exception to this rule for low-value services, for which valuation of contributions at cost is permitted. Example 2 in the Annex to the discussion draft illustrates this principle. The value of each participant's contribution is determined by reference to the other chapters of the OECD's transfer pricing guidelines, in particular Chapter VI for intangible development CCAs. The requirement that contributions be based on value rather than costs is more limiting than the current guidance, but aligns with the BEPS Action Plan and the increased emphasis on value splits. Nonetheless, the requirement to use value rather than cost is the change likely to have the greatest impact on existing CCAs.

The CCA discussion draft requires that a participant must benefit from the CCA activity. For development CCAs, every participant must be able to participate in controlling and managing the risk that is contractually assigned to it under the CCA. Thus, a "cash box" entity that only provides funding would not be allowed to be a participant in a development CCA, as discussed in Example 5. However, consistent with the Intangibles Draft, a participant that participates in control and management but only provides funding may have its returns limited to a risk-adjusted return on its funding activities. See Example 4.

Each participant's initial and ongoing contributions to the CCAs activities should be based on their reasonably anticipated benefits from the CCA activity (RAB). If the value of a participant's overall contributions is not equal to its overall expected RAB, a balancing payment is required to "top up" the value of the participant's contribution. For this purpose, both initial contributions and ongoing contributions are analyzed together to determine whether each participant's contribution is equal to its RAB. The guidance permits taxpayers to include in their CCAs an adjustment clause that enables taxpayers to make future adjustments to their contributions to adjust contributions to changes in RAB. The potential scope of an adjustment clause is unclear. For example, could the adjustment clause permit a downward adjustment to a participant's contributions if an intangible did not perform as well as projected both in the aggregate and relative to the other participants?

The guidance permits tax authorities to make an adjustment to a participant's contribution to "top up" a payment if contributions: (1) are not consistent with the actual RAB shares of each entity; or (2) are not consistent with the actual value attributable to the contribution. The CCA discussion draft is unclear on whether this analysis is to be based solely on *ex ante* information or whether adjustments may be made based on *ex post* information.[i] The CCA draft indicates that, in the case of development CCAs, it may be appropriate for tax authorities to consider multiple years rather than a single year's results in determining whether an additional balancing payment should be made to align contributions with projected RAB. The guidance appears to require exact alignment of contributions and RAB over time and does not provide a range of permitted deviations between contributions and RAB, which will undoubtedly occur over the course of a development CCA.

The CCA discussion draft contains recommendations for structuring and documenting a CCA that make only minor changes to the existing guidance. The guidance on documentation contains a detailed list of items that taxpayers should be prepared to provide tax authorities. However, the list is not coordinated with the new documentation requirements contained in Chapter V, which leaves open the question of what information regarding CCAs must be included in either the master or local files.

Multinational entities (MNEs) that have an entity that is a participant in a cost sharing arrangement (CSA) governed by the U.S. cost sharing regulations should be aware that the CCA draft takes a very different approach to the taxation of CCAs than the U.S. regulations in several ways:

- The "cash box" entity described in Example 5 would be allowed under the U.S. cost sharing regulations, because the U.S. rules do not have a control and management requirement;
- Under the U.S. cost sharing regulations, CSA participants share the intangible development costs related to the intangible development activity of the CSA "at cost" rather than "at value" as called for under the CCA draft;
- Initial contributions and ongoing payments are tested separately rather than combining the two; and
- Any commensurate with income-type adjustments are subject to safe harbors and other exceptions.

MNEs with CCAs governed by other local regulations should review the existing terms and conditions to identify potential differences with the CCA discussion draft, in particular regarding sharing "value" instead of "costs."

MNEs that have existing CSAs/CCAs in place -- in particular CSAs that comply with the U.S. cost sharing rules -- should be alert and watch for the final CCA rules to determine to what extent the final CCA guidance is inconsistent with existing local regulations, and to what extent additional actions may be required to address those inconsistencies.

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[1] Compare Par. 17 of the discussion draft, which states that the analysis should not utilize hindsight, with Par. 19, which requires adjustments based on actual benefits. It is unclear whether Par. 19 requires a U.S.-style "commensurate with income" (CWI) type of adjustment, but without any of the exceptions to such CWI adjustments that are found in the U.S. cost sharing regulations (in Treas. Reg. 1.482-7(i)(6)). If the OECD is going to implement such CWI-like adjustments, the concomitant safe harbors and exceptions to such adjustments to avoid adjustments for minor deviations that would be inconsistent with the arm's length standard should also be considered.

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