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BEPS Action 8: OECD Releases Draft Guidance on Cost Contribution Arrangements

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 29 May 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 The CCA discussion draft incorporates draft guidance on: (1) risk in Chapter I of the OECD transfer pricing guidelines released in December 2014 (the "Risk Draft"); and (2) taxation of transfers of intangibles in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 (RAB) from the CCA activity. 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[1]. 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 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;

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

- 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”.

(1) China Comments

In China, the current Circular 2 - Special Adjustments Implementation Measures (Trial Implementation) ("Circular 2") issued by the State Administration of Taxation ("SAT") allows for the use of CCA. However, it does not provide detailed guidance on the implementation. While the OECD CCA discussion draft provides significant updates of the existing global guidance, there remain a number of uncertainties as to how it can be successfully implemented in China.

1) Valuation of Contribution in form of Intangibles

China’s current tax laws and regulations do not provide specific guidance regarding the valuation of intangible property for transfer pricing purposes. Chapter 7 of Circular 2 provides the administrative guidance concerning CCA, but it does not provide specific guidance regarding the applicability of methods for CCA purpose.

With respect to the valuation standards on intangible properties, in practice, tax authorities often refer to the valuation analysis prepared by appraisal firms submitted by taxpayers, most of which would adopt China’s standards of valuation. There is a convergences between China’s standards of valuation and the international valuation standards, however, there are still differences remaining such as the scope of application, practicability of principles, the detailed principles regarding specific assets, etc.

2) Possible Application of Benefit Tests

Given the increasing scrutiny regarding intragroup outbound payment, the SAT may also apply benefit tests similar to those introduced in the Bulletin on Enterprise Income Tax Issues Concerning Outbound Payments to Overseas Related Parties ("Bulletin 16") when reviewing a service CCA involving Chinese participants. For example, the SAT may focus particularly on the review of the determination/classification of the cost pool (e.g. whether stewardship and non-beneficial expenses have been inappropriately included – "benefit test"), how the participants are determined (whether the participants have made a contribution and benefit from the CCA, especially for those participants located in low-tax jurisdictions – "benefit test", "value creation test"), etc.

3) Operating Losses related to CCA Business in China

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. This part is in fact consistent with both the overall BEPS Actions with respect to intangibles and value contribution as well as SAT's stated positions on the subject[2]. However, does this also mean that the SAT will accept situations where operating losses are driven by current year CCA related activities since the relevant China entity will in

2 The SAT's views have been repeated in the UN Manual (released on 2 October 2012) and Administration Plan for International Taxation Compliance in 2014-2015, by Jiangsu Provincial Office of SAT in April 2014. The SAT put emphasis on functions performed, assets used and risks incurred at local Chinese entities and transfer pricing outcome should be in line with value creation.

effect be a (co-) entrepreneurial entity (for CCA related business) and not be subject to loss limitation such as those outlined in Circular 363?[3]

4) Location-Specific Advantages

Currently Circular 2 does not address issues on location-specific advantages ("LSA"). However, as the SAT has repeatedly stressed its view that LSA shall be taken into consideration in the transfer pricing analysis, it is expected that the revised Circular 2 may include certain requirements in relation to LSA under CCA, in order to allow for adjustments on the undervalued R&D contribution of China participants due to low labor costs; or on the market premium resulted from special purchasing power in China; or on special market environment in China leading to product prices being higher than the general market prices. Also, these factors may affect SAT's view on tax treatments in relation to buy-in, buy-out and balancing payments under CCA involving intangibles.

5) General China Tax Implications of CCA Payments

The tax consequences of CCA transactions are ultimately determined in accordance with applicable local tax laws and regulations. With respect to buy-in/buy-out transactions in relation to intangible development CCA, Article 72 of Circular 2 classifies them as "purchase or disposal of intangible assets" for China domestic corporate income tax purpose. That is, buy-in payment is treated as the purchase of intangibles which may be subject to amortization for China domestic taxation purposes, while buy-out payment is treated as the disposal of intangibles such that capital gain or loss from the disposal will be recognized for China domestic taxation purposes.

In the event that the cross-border buy-in/buy-out transactions are carried out between China and overseas entities, the respective withholding income tax and indirect tax implications are summarized from a China perspective as below.

<table>
<tr><th></th><th>Buy-in</th><th>Buy-out</th></tr>
<tr><td>Withholding income tax</td><td>Whether the overseas entity (ies) are subject to China income tax for the buy-in payment received from China entity are uncertain. If the tax authorities consider that the buy-in transaction is a form of "royalties" or "license fee", the payment could be liable for withholding tax; however, if the transaction is treated as the "purchase of intangible", it may be argued that withholding tax is not applicable.</td><td rowspan="2">Whether the buy-out payment received by China entity from overseas entity (ies) are liable for income tax/indirect tax in counter country (ies), will be subject to the domestic tax law / regulation in counter country (ies) and/or the tax treaty between China and counter countries, if any.</td></tr>
<tr><td>Indirect tax</td><td>The overseas entity (ies) could be exempt from VAT/Business Tax ("BT") liabilities in China, if the subject intangibles are qualified for VAT/BT exemption and relevant approvals are granted by in-charge tax authorities and Science and Technology Commission.</td></tr>
</table>

(2) Conclusion

MNEs that have existing CSAs/CCAs in place -- in particular CSAs that comply with prevailing cost sharing rules in local countries -- should keep an eye on the final CCA rules to determine if any modifications to the existing arrangement are needed and also if there is any application/approval for the arrangement required going forward.

3 Guo Shui Han [2009] No. 363 - The Notice issued by SAT to strengthen the supervision and investigation of cross-border related party transactions

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