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The new transfer pricing landscape
A practical guide to the BEPS changes

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Cost contribution arrangements

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Cost contribution arrangements (CCAs) are contractual arrangements entered into to allow parties to share the contributions and risks involved in either (1) the development, production, or acquisition of intangible or tangible assets, or (2) the execution of services, with an expectation that the parties will enjoy the anticipated benefits to be derived from their contributions equitably.

The Organization for Economic Cooperation and Development's (OECD's) new transfer pricing guidelines released October 5, 2015, contain guidelines that may require participants that provide CCA funding to significantly increase substance around such arrangements and, in many cases, to change the method of valuing CCA contributions. Companies may find that the new guidelines mandate an increased administrative commitment to and extensive monitoring of CCAs.

The CCA final guidelines diverge somewhat from the draft guidelines issued earlier this year. Controversial aspects of the guidelines, such as the ability to use cost for the determination of contributions, the control and substance requirements, and the financing return requirements have been slightly modified but in large part remain consistent with those presented in the draft guidelines. The following sets out an overview of the new CCA guidelines, summarizes relevant points of departure from the draft guidelines, and identifies practical considerations for multinational enterprises considering entering into a CCA.

Overview of guidelines

The new guidelines address both asset-development and service-provision CCAs. The primary difference between an *asset-development* CCA and a *service-provision* CCA is the timing of expected benefits and the level of risk undertaken in each. An asset-development CCA is generally expected to deliver ongoing, future benefits, whereas a service-provision CCA is expected to deliver current benefits. An asset-development CCA generally entails significantly more risks than a service-provision CCA. The majority of the discussion in Chapter VIII of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* focuses on the more complex asset-development CCAs and provides limited commentary on service-provision CCAs.

The new guidelines aim to ensure (1) the consistency in transaction delineation and analytical evaluation when considering CCAs versus other transactions with similar attributes; (2) alignment of guidance on the valuation and pricing of intangibles whether or not they are associated with a CCA; and (3) consistency in the valuation of DEMPE (development, enhancement, maintenance, protection, and exploitation) functions, whether or not they are connected with a CCA. Consequently, the CCA chapter refers to other sections for specific guidance to ensure a common framework for analyzing economically relevant characteristics of an agreement (Section D, Chapter I), risks (Section D, Chapter I), intangibles transferred (Chapter VI), funding risk (Chapter VI), the identification of beneficial services (Chapter VII), and documentation requirements (Chapter V). The new guidelines in Chapter VIII caution that they are designed to provide supplementary guidance when a CCA, connecting multiple transactions and delivering shared benefits, is entered into.

Delineation of the CCA arrangement

CCAs continue to be evaluated based on the substance of the arrangement rather than the contractual form expressed. Thus, while the delineation of the transaction starts with the division of economically relevant risks, responsibilities, and beneficial interests *expressed* in the contractual arrangement, ultimately, only the actual risks, responsibilities, and expected beneficial interests of the CCA parties are relevant for valuing contributions. Accordingly, from a practical perspective, CCA parties should ensure that CCAs are maintained and updated as necessary to reflect an evolution of the arrangements based on changing business needs and opportunities.

Criteria for CCA classification

The fundamental CCA requirement that contributions reflect expected benefits, and that all CCA parties have a reasonable expectation of benefitting from the CCA objectives remain unchanged. However, under the new guidelines all participants must exercise control over the risks arising from the arrangement, must have the financial capacity to assume such risks, and must, at the outset of the CCA, have a clearly defined interest in the CCA output. In the event a CCA does not meet these criteria, the arrangement may be re-characterized by the tax authorities as a funding transaction, or in more extreme cases, may be disregarded. As a practical matter, a CCA will be disregarded only if, when viewed in its totality, it lacks commercial rationality.

Control

The guidelines state that a CCA participant "must have (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity presented by participating in the CCA, and must actually perform that decision making function, and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, and must actually perform that decision-making function." This can be interpreted to mean that each CCA party must have qualified technical personnel capable of analyzing the risk of the CCA opportunity and making an educated decision whether or not to partake in the opportunity. It is not necessary for a participant to perform day-to-day risk mitigation activities; however, the participant must at least be capable of contracting for qualified advice with regard to such decisions and determining the objectives of the risk mitigation activities to be performed by contracted third parties.

The requirement that all parties must exercise control over the development risks may pose a challenge. In many current CCA arrangements, one party is primarily responsible for development and control over the CCA's technical direction and process. The party managing the R&D team typically will direct that team and make strategic decisions regarding the technical direction without input from or consultation with the other CCA parties. The new guidelines would require active development guidance from all CCA parties. This may not be immediately practical or feasible, especially if not all participants have senior technical resources.

Returns to funding

CCA parties should have the financial capacity to assume CCA risks. Thus, participant equity capital and debt and expected earnings (including the timing of the earnings) will need to be reconciled to the CCA financial commitment and risks. If a CCA participant's role is primarily that of funding, often referred to as a cash-box participant, the new guidelines limit the return available, unless the funder also manages and controls the risks associated with development, maintenance, enhancement, protection and exploitation (DEMPE) of the CCA intangibles. If the CCA participant controls the funding risk (a "smart" cash box), the return is limited on an ex ante basis to a risk-adjusted return on the CCA invested capital. This return should reflect the opportunity cost of using the funds in connection with the CCA, and the expected return on the hypothetical alternative investment. Such a return may be the company or industry weighted average cost of capital. If the provider of funds does not manage and control the funding risks (a "dumb" cash box) the funder cannot be a risk-invested participant and will likely be limited to a risk-free return.

Expected returns

At the outset, expected returns from the CCA must be determined for each participant based on projections. The general and broad standard to be applied, based on the new guidelines, is that CCA participants should determine "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." This is a challenging standard to comply with, given its qualitative and subjective nature. As a practical matter, a participant might consider formal business projections used for other business planning purposes or key macro and industry economic indicators, and how they correlate with the projections of the same period and with overall company results.

The expected returns identified at the outset of a CCA may differ significantly from those actually realized throughout the term of the CCA. The guidelines recognize that it may be difficult for tax authorities to verify the assumptions used to develop expected projections. These problems may be exacerbated when the CCA activity begins several years before the expected benefits actually materialize. Accordingly, the guidelines recommend that the CCA provide for periodic reassessments and possible prospective adjustments of proportionate shares of contributions to be made by each party in the CCA, to reflect changes in relevant circumstances triggering changes in relative shares of benefits. If the contributions to the CCA include "hard-to-value intangibles," discussed in section 4.D of Chapter VI, then those rules would be applicable to CCA contributions.

Valuation of contributions to a CCA

The guidelines are clear that all contributions—whether consisting of preexisting tangible or intangible assets or of current development services in the framework of the CCA—must be valued at the time they are contributed using the specific guidelines and valuation techniques provided in Chapters I, II, III, and VI of the OECD's Transfer Pricing Guidelines. In the case of an asset-development CCA, contributions may include services performed (such as R&D or marketing), tangible property, and intangible property. An important clarification included in the new guidelines is that the value of preexisting contributions will be based on the value those contributions are expected to produce in the context of the development activity. This implies that there may be an element of synergy value that needs to be captured when preexisting IP is contributed to a CCA. On the other hand, ongoing current contributions are to be based on the value of the function itself, not on the potential value of the current contribution in the context of the CCA and its developing intangibles.

Cost is generally not permitted as an approximation of value under the guidelines, unless cost is considered the arm's length price for the services (or function), or unless the value of any mark-up that is forgone is calculated and included as a preexisting contribution of value specific to that service function. Thus, R&D services or CCA management services performed by one CCA party, as current contributions, should be recorded based on the value of the functions, rather than at cost. For example, assume a CCA composed of two parties. Party A performs R&D development activities costing 100, with a value (considering them separately) of cost plus 20 percent. Party B performs IT development services costing 100, with a value (considering them separately) of cost plus 10 percent. If the CCA parties expect benefits of 2,000 each, then the CCA should reflect 50 percent of the contribution value being allocated to each party [(120+110) * 50%= 115] and thus a compensating payment of 5 should be made by Party B to Party A. Prior CCA rules would have permitted computing the cost contribution of 100 made by each of the parties and therefore, no adjustment would be needed to achieve proportionality with expected benefits

If the CCA parties choose to allocate costs for administrative convenience, then a preexisting contribution (equal to the net present value of the arm's length mark-up associated with the services, that is, the "opportunity cost of the ex ante commitment to contribute resources to the CCA") must be determined and accounted for in the CCA as a contribution. The guidelines, however, provide an exception in cases in which the difference between the value of the contributions and their costs is relatively insignificant. In those circumstances, cost can be used as a practical means to measure relative value of current contributions.

Consistent with prior guidelines, the new guidelines state that costs should include those incurred directly and solely in connection with the CCA activity, as well as those that support the CCA activities (indirect costs). Indirect costs may include the use of buildings, information technology systems, and administrative support costs. These support costs must be allocated to the CCA cost pool in a commercially justifiable way, taking into account treatment specified by recognized accounting principles. The allocation of indirect costs may create some challenges if the local accounting principles vary significantly between the countries of the CCA participants.

The key for existing CCAs will be whether countries will adopt a consistent set of grandfathering rules to limit the impact of the control requirement and the requirement that contributions be at value.

Budget versus actual costs

If cost is permitted and used in determining the value of a CCA current contribution, as discussed above, the parties generally would be expected to use budgeted costs as long as there is agreement between the parties as to what factors are to be taken into account in setting the budget and how unforeseen circumstances affecting the actual costs are to be addressed. The guidelines also state that, "where cost is found to be an appropriate basis for measuring current contributions, it is likely to be sufficient to use actual costs as the basis for so doing."

Balancing payments

The guidelines state that a CCA is consistent with the arm's length principle if the value of each participant's proportionate share of the overall contributions is consistent with the share of expected benefits. If the overall contributions are materially inconsistent with the actual benefits or a reevaluation of expected benefits occurs, then prospective balancing payments are required to correct the level of contribution by each party. The CCA agreement should include a requirement to make prospective balancing payments in these circumstances.

The guidelines also provide that tax authorities may require balancing payments if they determine that the value of the participant's proportionate contribution was incorrectly determined at the time it was made, or when CCA expected benefits have been incorrectly assessed. These balancing payments, whether initiated by the CCA parties or by the tax authorities, are treated as an addition to the contribution of the payor and as a reduction in the contribution of the recipient. The character and tax treatment of balancing payments will be determined in accordance with domestic tax law.

The guidelines raise questions as to how the rules will apply in practice. For example, the guidelines require that CCA contributions must be consistent with the share of benefits at the time they are made, and that changes in contributions based on differences between expected versus actual benefits must be made prospectively. Future contributions must therefore take into account all contributions over time. Thus, future contributions will not necessarily be consistent with the share of benefits at the time they are made.

Buy-in and buy-out payments

The guidelines remain unchanged regarding the tax treatment and valuation of buy-in and buy-out payments resulting from changes in the membership of a CCA. The amount of the buy-in payment will be based on the value of the interest in the intangible or tangible assets the new entrant obtains, taking into consideration the value of the assets that new entrant may bring to the CCA and its proportionate share of the overall expected benefits to be received under the CCA. In the event the new participant makes a contribution to the CCA, the value of the buy-in payment would be netted against the contribution. Similar rules apply to the buy-out of a participant.

Documentation requirements

The guidelines set out details of documentation to be prepared in connection with a CCA, referencing detailed documentation provisions in Chapter V. The documentation is largely consistent with the original guidelines, and overlaps considerably with the US cost sharing documentation requirements.

The guidelines also contain a list of recommendations for initial terms within the CCA and a list of information that will be useful to maintain over the term of the CCA.

The latter list includes changes to the arrangement, a comparison between projections used to determine expected benefits and actual benefits achieved, and annual expenditures incurred in connection with the CCA activities, including the form and value of, and method used to determine, each participant's contribution to the CCA.

Implications

The new CCA guidelines largely follow previously issued CCA guidelines. However, the few changes to the rules are likely to cause significant challenges to CCA participants. In particular, the new substance and control requirements; the restrictions introduced for using cost as a basis for valuing preexisting and current contributions; the need to account for risk-weighted financing; the limited guidance regarding what constitutes a rigorous process for determination of the expected benefits; and the expectation that the CCA will contain periodic reassessment provisions with balancing adjustments to account for certain differences between expected and actual benefits, will all present significant practical challenges in developing new CCAs or maintaining existing ones.

Conclusion

The new guidance on CCAs adopts the principles of the changes to Chapter I on delineation of the transaction and risk, and the changes to Chapter VI on intangibles. Countries are currently considering these guidelines and how to adopt them. One significant question for companies now managing existing CCAs will be whether adopting countries will align their grandfathering rules, particularly around the sensitive area of cost-based contributions, and control requirements. If grandfathering rules are not adopted, or if the adopted grandfathering rules are inconsistent, MNEs with existing CCAs will need to review these guidelines carefully to determine the implications jurisdiction by jurisdiction for their CCA and determine specific structural changes that will need to be made.

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