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PwC's Comments on BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Introduction

PricewaterhouseCoopers LLP ("PwC" or "we"), on behalf of its international network of member firms, welcomes the opportunity to comment on the OECD *BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)* released on April 29, 2015 ("Discussion Draft"). As a global professional services organization with a worldwide network of firms, we have worked with tax authorities around the world over many years regarding the development of transfer pricing regulations that apply to the cross-border intercompany transactions of multinational entities ("MNEs"). As a result, we have accumulated extensive experience with the wide range of transfer pricing issues relevant to both taxpayers and tax authorities, including CCAs.

We have organized our comments on the Discussion Draft into two parts. We begin by providing general comments to be followed by more detailed comments on specific paragraphs of the Discussion Draft.

General Comments on the Discussion Draft

We appreciate the OECD's efforts to revise Chapter VIII of the Transfer Pricing Guidelines to make it consistent with the revisions to other chapters of the Guidelines under the BEPS initiative. However, we would like to stress that a revision of the framework relating to CCAs is a complex matter. Given that the first Discussion Draft was issued on April 29, 2015 and that the proposed revisions will need to be finalized for the G20 finance ministers meeting on September 4-5, 2015, we would urge caution in making fundamental revisions and that such revisions are consistent with the other changes to the Guidelines to be finalized later in 2015. Given that the final revisions to the Guidelines will significantly change from the existing Chapter VIII of the Guidelines, we recommend that the OECD allow for the grandfathering of existing CCAs.

The Discussion Draft proposes a fundamental change by requiring any participant in a CCA to have the "capability and authority to control the risks associated with the risk-bearing opportunity" under the CCA. This change is in line with the increased focus on substance introduced by the OECD when revising the relevant sections of the Transfer Pricing Guidelines. In this respect, the Discussion Draft achieves consistency with the concepts developed as part of the other Discussion Drafts on Intangibles, Risks, Recharacterisation, and Special Measures.[1]

We understand the OECD's intent to ensure that controlled entities are not established simply to participate in CCAs without performing any other meaningful function. However, we believe that the

[1] We refer to our comments on the Discussion Drafts on Intangibles and Risk, Recharacterisation and Special Measures for our views on the changes suggested to chapters I, III, and VI of the OECD Transfer Pricing Guidelines.

requirement for each CCA participant to have the "capability and authority to control the risks associated with the risk-bearing opportunity" broadly applied across every CCA participant would unnecessarily impair the usefulness of CCAs. More specifically, MNEs commonly centralize certain control and risk management functions to create valuable cost efficiencies. Therefore, in our view, outsourcing certain activities through engaging other MNE entities or even third parties to perform such functions would be commercially rational and in line with the other Chapters of the Transfer Pricing Guidelines. In addition, independent parties could very well accept risks they do not entirely manage and control, as long as they deem the return on the capital invested to be commensurate with the risk they undertake. Therefore, we suggest that the revised drafting of Chapter VIII does not require all CCA participants to perform similar functions in order to share equitably in the benefits of a CCA. Instead, a clarification is needed that any entity participating in a CCA must engage in an analysis prior to joining a CCA to demonstrate that it represents its best realistic alternative taking into account the effect, if any, of performing key functions itself or as a contractor to another party.

We also note that such a change will have collateral consequences. In particular, the current wording in the Discussion Draft is not consistent with existing U.S. rules on Cost Sharing Agreements (CSAs) (see Treasury Regulation Section 1.482-7). For example, the U.S. Regulations do not have a similar "capability and authority to control risk" requirement for CSA participants. If similar changes are not made to the U.S. regulations (or any other country's domestic legislation) in a consistent and coordinated manner, companies will face two sets of rules (i.e., domestic or OECD) in each respective country, something that may certainly trigger disputes.

Another important change is the necessary measurement of all contributions based on value[2] rather than costs – as is accepted under the existing Transfer Pricing Guidelines.[3] That change is proposed "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." We assume that this comment is predominantly meant for development CCAs, as the Discussion Draft notes that in certain situations (service CCAs), contributions should be valued at cost.[4] However, if this assumption is correct, there would seem to be no need for a separate chapter in the Guidelines on CCAs if the same result could be achieved through application of provisions in other Chapters of the Guidelines. Moreover, by analogy, unrelated parties often engage in transactions through partnerships to share costs in return for a share of the benefits from their development activities, demonstrating that such sharing of costs of development is arm's length. Removing agreements to share costs in intangible development activities from qualification as a CCA under the Guidelines may simply drive taxpayers out from arrangements covered by the Guidelines into partnerships. (We note that a CCA is not meant to create a partnership in any event.)

We believe the Discussion Draft inappropriately applies this "value" requirement rather than cost requirement to all "contributions." It should be clarified whether it is development CCAs that are in focus, and possibly also service CCAs when the services cannot be qualified as low value-added. "Contributions" appears to be defined to cover both contributions of pre-existing intangibles (for which a "buy-in" payment would be required), as well as contributions of ongoing services required to develop intangible property.[5] While it may be appropriate to require contributions of pre-existing intangibles to be "assessed based on their value (rather than their cost)," it should remain possible (as it is under the current

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[2] See para. 22 in the Discussion Draft.

[3] See e.g. para. 8.3 of the 2010 OECD Transfer Pricing Guidelines, where in the sentence "A CCA is a framework agreed among business enterprises to share the costs and risks", the word "costs" has been replaced by the word "contributions" in the Discussion Draft. See also para. 8.15 of the 2010 OECD Transfer Pricing Guidelines, where it is mentioned that "Countries 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".

[4] See para. 23 in the Discussion Draft: "It is sometimes the case that the value (i.e. the arm's length price) of services contributed to a CCA corresponds to the costs associated with providing those services. It may also be the case that the difference between the value and costs is relatively modest, such as for low value-added services described in Chapter VII. In this case it is recommended for practical reasons to value contributions at cost".

[5] See paragraphs 21 and 25 of the Discussion Draft.

Guidelines) for CCA participants to share the "costs" (not value) of the ongoing services required to develop intangible property. That is entirely consistent with similar arrangements for sharing of costs related to intangible development between unrelated parties.

We see a problem with the current Discussion Draft requiring tax administrations to determine market value for the services provided as part of a development CCA. This bears the risk of confusing arm's length value with the value of the outcome from these services. This would almost certainly lead to double taxation and protracted disputes.

Additionally, the current draft includes some vague statements that may be subject to different interpretations. For example, it is mentioned that "direct benefits" are expected for a participant of a CCA (para. 3 in the Discussion Draft) without further clarification on what qualifies as "direct benefits". It is also mentioned that a participant's proportionate share of the overall contributions shall be consistent with the participant's proportionate share of the overall expected benefits "over a period of years" (para. 30 in the Discussion Draft); while a reference to the para. 3.75-3.79 of the Transfer Pricing Guidelines is included, it is not clear how to determine a reasonable "period of years" and whether such a period may vary depending on the activity at hand.

We are also concerned with the proposals for "disregarding" part or all of the terms of a CCA. In our view, this continues a troubling trend in other recent discussion drafts under Actions 8-10 of recharacterizing legitimate transactions. That will lead to a great deal of uncertainty and chaos, especially in the likely event that tax authorities take different views on when it is appropriate to exercise this expanded ability to disregard transactions. Subject to the presence of economic substance, we believe it makes far more sense to accept the transaction as set forth in contractual arrangements and simply make any appropriate adjustments to ensure arm's length pricing between related parties. Thus, we believe a comment would be helpful that before disregarding the entire CCA, an analysis should be performed of the costs shared between the participants and whether potential adjustments to the sharing of those costs might result in an appropriate arm's length outcome. This would also limit potential disputes.

The mechanics of how to practically apply the CCA rules are not covered by the Discussion Draft. For example, it is unclear how income that results from a joint ownership of IP developed under a development CCA should be handled: if one participant receives income from a user of the IP outside the CCA, it is unclear how transactions between the CCA participants with the purpose to share income shall be handled from other tax perspectives. It would be worth thinking about including a statement regarding joint ownership for such IP and about whether payments to share income between the owners shall be considered as transactions at all for other tax purposes. Another issue including potential for increased disputes is balancing payments. These payments might also trigger certain secondary tax consequences. It remains unclear if a balancing payment from an over/undercompensated CCA participant to another CCA participant can have any effect on payments made outside of the CCA to the participants. One interpretation could be that the payment coming from outside of the CCA is the reason for the recipient to be over/undercompensated, concluding that the payment was not at arm's length. It could therefore be clarified in the guidelines that there might be a need for balancing payments between the CCA participants due to incorrect income allocation among them but that the existence of balancing payments should not allow countries outside the CCA to challenge IP payments made towards any CCA participant for the use of the IP created by the CCA.

These comments highlight what we believe to be the most significant conceptual flaws in the Discussion Draft. Below are further details on the practical handling of CCAs which are needed for companies and tax authorities to have a more common view and predictable interpretation of how to handle CCAs for transfer pricing.

Comments and Recommendations to specific paragraphs in the proposed revisions to Chapter VIII of the Transfer Pricing Guidelines

Para. 3: "direct benefits"

The Discussion Draft states that "intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants". It is unclear why contributions in a CCA necessarily should have a "direct" benefit and could not have indirect benefits. In our opinion, when independent parties enter into transactions they may very well receive "indirect" benefits, or other types of benefits. It would be helpful including clarification upon the differences between "direct" and "indirect" benefits. An additional example could be included to make more clear what benefits are deemed as approvable direct benefits under a CCA, and what benefits are not. Last, the emphasis on "direct" benefits as opposed to the previous possibility to "indirectly"[6] benefit from the interest in a CCA is likely to increase the expectations of tax administrations when it comes to the income earned as a consequence of being a participant to a CCA.

Para. 6 and 33: "Netted payments" and "Eliminate complex cross-licensing"

It is mentioned (para. 6) that as one advantage of CCAs, "a web of separate intra-group arm's length payments" can be replaced with "netted payments", and "complex cross-licensing arrangements" can be eliminated. It is further mentioned (para. 33) that contributions to a CCA need to be treated under general local tax rules (respectively for each participant). At the same time, the existing Guidelines recommend, when possible, to segment transactions in order to avoid the aggregation of transactions as such an aggregation would make it more difficult to identify the remuneration of each transaction. Therefore, to avoid confusion, we recommend the final chapter VIII to link the guidance on "netted payments" to the existing guidance on segmented and aggregated transactions.

Moreover, we recommend considering whether it may be worth including clarification with respect to the need for considerations of netted or eliminated payments from other tax perspectives (e.g., VAT or withholding tax). A possible interpretation of a development CCA could be, for example, that the participants form a joint owner[7] with regards to the developed IP and that any payments between the partners of such partnership are not treated as transactions or exchange of services and consequently do not trigger any VAT or withholding tax consequences.

Para. 17: "Hindsight"

It is further stated under para. 17 that "tax authorities might be prompted to enquire whether projections [of benefits] made would have been considered acceptable by independent enterprises in comparable circumstances [...], without using hindsight."

We agree on this statement and stress the need to consider all of the developments that were reasonably foreseeable by the parties and not to use hindsight in the final revision of chapter VIII, so as to help mitigate the risk of disputes.

Para. 23: "Low value services"

We appreciate the suggestion to accept measuring contributions to "low value-added services" by costs. In order to mitigate the risk of disputes, we recommend including a link to the definition of low value services as is provided in the revised chapter VII. However, the Discussion Draft summarily concludes that costs will generally not provide a reliable basis on which to value contributions for development

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[6] See para. 8.10 of the 2010 OECD Transfer Pricing Guidelines.
[7] E.g. as an "undisclosed partnership" ("*Innengesellschaft*") in German tax law.

CCA's, drawing a contrast in effect with service CCAs. This is not always the case in which one or more components of the contributions to any CCA are comprised of low value-added services.

Para. 26 and example 4: "Important functions"

Para. 26 mentions that, "For development CCAs, contributions in the form of controlling and managing the CCA, its activities and risks, are likely to be important functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles or tangible assets and should be valued in accordance with the principles set out in Chapter VI." Such functions need to be remunerated above a limited return. We suggest clarifying the fact pattern of Example 4. On the one hand, Example 4 states that Company A should receive a risk-adjusted rate of anticipated return on its funding commitment including extensive analysis and risk interpretation as well as a judgement of the other participant's risk handling capacity. In our view it is unclear whether these functions include certain "important functions". If this is the case, Para. 26 may be fully in line with Example 4 of the Discussion Draft. Another interpretation of Example 4 could be that Company A performed the functions described under Para. 58 for its own development activities only before entering the CCA, but under the CCA only provides the funding (financial capacity) without performing the functions listed. Such differing interpretations suggest clarification of Example 4 would be beneficial.

Further clarification should be provided as to the term "important functions". A reference to the definition provided in the revised chapter VI might be helpful, especially given the goal of achieving consistency with the other amendments to the OECD Transfer Pricing Guidelines. Moreover, the determining factors of an appropriate risk-adjusted return are not explained; guidance in that respect would help prevent disputes.

Para. 29: "Incorrect determination of values"

Under para. 29, "Balancing payments may also be required by tax administrations where the value of a participant's proportionate contributions of property or services has been incorrectly determined, or where the participants' proportionate expected benefits have been incorrectly assessed."

As it will often be difficult to perform precise valuations of contributions (e.g., how to value "control of functions") and that the Discussion Draft does not provide concrete guidance on how to perform such valuations, we see an increased risk for disputes resulting from the tax authorities requiring balancing payments. A reference to the existing methods for evaluating contributions would be helpful. It should also be kept in mind that potential disputes might affect more than one/two countries, since potentially all the participants to a CCA may be affected by claims from their residence countries.

Para. 42: "the arrangement would require balancing payments"

The Discussion Draft seems to require that balancing payments are made on a regular basis and potentially for an undefined period of time during the length of the CCA given the apparent assumption that the proportionate shares of expected benefits among the participants necessarily varies with time (Para. 42(e) of the Discussion Draft). Although possibly correct from a theoretical perspective, this assumption would certainly trigger disputes as tax administrations may easily challenge the extent or the lack of balancing payments. The need for and the extent of balancing payments would become a highly subjective matter. Therefore, we would suggest replacing the word "would" with "may", and to add the word "possible" before the word "changes" at Para. 42(e) of the Discussion Draft. Such amendments would not impinge the theoretical need to make balancing payments, while at the same time preventing unreasonable claims from tax administrations. Such amendments would also, in our opinion, be consistent with the guidance provided at Para. 27-30 of the Discussion Draft.

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Considering the aspects previously mentioned, we further advise that the Discussion Draft, as to be revised prior to the G20 finance ministers meeting on September 4-5, 2015, is finalized in a manner fully consistent with the other relevant BEPS Action Items and changes to the OECD Guidelines. Furthermore, given that the final revisions to the Guidelines will significantly change existing Chapter VIII of the Guidelines, we recommend that existing CCAs be grandfathered from these changes as to the ongoing operation of such existing CCAs.

On behalf of the global network of PwC Member Firms, with the contribution of our colleagues Henry An, Ian Dykes, David Ernick, Marios Karayannas, and Jérôme Monsenego, we respectfully submit our response to the OECD BEPS Action 8: Discussion Draft on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs). We welcome the opportunity to participate in the public consultation on these and other transfer pricing issues on July 6-7, 2015. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

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