

TAX FLASH NEWS

OECD - BEPS Action Plan 8 – Draft Guidance on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements

Background

In July 2013, the Organisation for Economic Co-operation and Development (OECD) and G20 countries adopted a 15 point Action Plan to address Base Erosion and Profit Shifting (BEPS) and set deadlines to implement these actions. Recently, the OECD released Draft Guidance on Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs) (Discussion Draft/Draft). This Draft responds to the requirement under Action 8 to update the guidance on CCAs found in Chapter VIII of the OECD's Transfer Pricing Guidelines (TPG). It provides proposed text for an updated chapter and also contains certain examples to illustrate the guidance on CCAs. The key objective in revising the guidance on CCAs is to align the transfer pricing of intangibles under CCAs with the general guidance on the TP aspects of intangibles as contained in the revised Chapter VI. This Discussion Draft also takes into account Draft guidance on Chapter I of the TPG released for public comments in December 2014 (Discussion Draft on risk, recharacterisation, and special measures).

The Discussion Draft is divided into the following sections:

- Introduction
- Concept of a CCA
- Applying the arm's length principle
- CCA entry, withdrawal and termination
- Recommendations for structuring and documenting CCAs
- Annexure to Chapter VIII- Examples to Illustrate the Guidance on CCAs

The key elements of the Discussion Draft are discussed below:

A. Concept of a CCA

The Discussion Draft defines a CCA as *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.*

- The Draft sets out that each participant's interest in the results of the CCA activity should be established from the outset and lists out two types of commonly encountered CCAs namely:
 - Development CCAs - for the joint development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets;
 - Services CCAs - for obtaining services.

B. Applying the arm's length principle

This section of the Discussion Draft lays down that the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits which they reasonably

expect to derive from the arrangement. The Discussion Draft points out all the parties to the arrangement should have a reasonable expectation of benefit post which the value of each participant's relative contribution to the joint activity is calculated. The Discussion Draft also clarifies that the contributions allocated among CCA participants may result in an overstatement/ understatement of taxable profits in some countries and in such cases taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA. The Draft discusses certain aspects to be considered for an arm's length analysis which includes:

- 1. Determining participants** – Here the Discussion Draft talks about assigning an interest in intangible, tangible assets or services that are the subject of the CCA to each participant and there being a reasonable expectation of benefit from that interest. The Discussion Draft indicates that a participant must have the capability and authority to control the risks associated with the risk-bearing opportunity under the CCA.
- 2. Expected benefits from the CCA** – The shares of expected benefits might be estimated using relevant allocation keys such as sales (turnover); units used, produced, or sold; number of employees, etc. The Draft also talks about using projections to estimate participants' shares of benefits and how the use of projections may raise problems for tax administrations in verifying the assumptions based on which projections have been made and in dealing with cases where the projections vary from the actual results. The Draft also talks about adjustments being necessary to account for differences between the expected and actual benefits received by the participants.
- 3. The value of each participant's contribution** - The most important change in this Discussion Draft vis-à-vis the existing OECD chapter on CCAs is that the Draft talks about measuring the value instead of cost of each participant's contributions to the arrangement for the purpose of determining whether a CCA satisfies the arm's length principle. Under 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. Where the value (i.e. ALP) of services contributed to a CCA corresponds to the costs associated with providing those services e.g. low value-adding services, it is recommended for practical reasons to value contributions at cost. However, in all other circumstances the Draft emphasises that costs are unlikely to provide a reliable basis for determining the value of the relative contributions of participants.

- 4. Balancing payments** – The Discussion Draft also indicates that where the value of a participant's contributions under a CCA is not consistent with that participant's share of expected benefits under the CCA, adjustments that are required under the arm's length principle in the form of making or imputing a balancing payment. Balancing payments may also be required by tax administrations where the value of a participant's proportionate contributions or proportionate expected benefits have been incorrectly assessed.
- 5. Disregarding part or all of the terms of a CCA** – The Discussion Draft also indicates that in some cases, the facts and circumstances may indicate that the reality of an arrangement differs from the terms purportedly agreed by the participants or where over time there has been a substantial discrepancy between a participant's proportionate share of contributions and its proportionate share of expected benefits and here the tax administration may disregard part or all of the terms of a CCA.
- 6. The tax treatment of contributions and balancing payments** – The Draft indicates that contributions, including any balancing payments, by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) applicable to that participant if the contributions were made outside a CCA, to carry on the activity that is the subject of the CCA.

C. CCA entry, withdrawal or termination

The Discussion Draft in this section highlights about buy in and buy out payments when a reassessment of the proportionate shares of participants' contributions and expected benefits is done on the basis of the arm's length principle.

D. Recommendations for structuring and documenting CCAs

The Discussion Draft lays down a list of information that would be useful for determining the initial terms of a CCA but emphasises that the information described in this list is not exhaustive:

- a) A list of participants;

- b) A list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;
- c) The scope of the activities and specific projects covered by the CCA, and how the CCA activities are managed and controlled;
- d) The duration of the arrangement;
- e) The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;
- f) The manner in which any future benefits (such as intangibles) are expected to be exploited;
- g) The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined (including any budgeted vs actual adjustments) and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;
- h) The anticipated allocation of responsibilities and tasks, and the mechanisms for managing and controlling those responsibilities and tasks, in particular, those relating to the development, enhancement, maintenance, protection or exploitation of intangibles or tangible assets used in the CCA activity;
- i) The procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and
- j) Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

The Draft also indicates that over the duration of the CCA term, the following information could be useful:

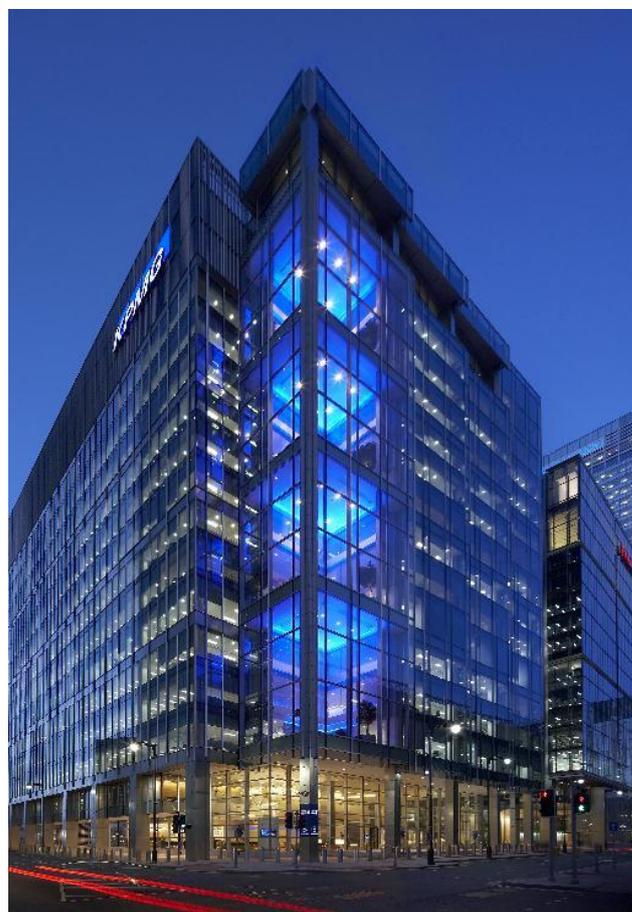
- a) Any change to the arrangement (e.g. in terms, participants, subject activity), and the consequences of such change;
- b) A comparison between projections used to determine expected benefits from the CCA activity with the actual results; and
- c) The annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined.

OECD has invited public comments on this Discussion Draft by 29 May 2015, post which a public consultation will be held on 6/7 July 2015.

Our comments

The most important clarification in this Discussion Draft is that contributions to CCAs are to be measured at value rather than at cost, which helps 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.

India's increasing participation in Global trade and the importance of intangibles has become the focus of attention with the Indian tax authorities. India is becoming a preferred location for the development of intangibles due to the availability of appropriate skill sets at affordable prices and tax incentives for research and development. In such a scenario, guidance on CCAs is very important from the perspective of both the taxpayers and the Indian tax administration especially because, the existing TP provisions in India do not have detailed provisions on CCAs as compared to TP provisions of developed countries.



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