



KPMG LLP
2001 M Street, NW
Washington, D.C. 20036-3310

Telephone 202 533 3800
Fax 202 533 8500

To Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
OECD

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From KPMG

Ref Comments to the OECD:
BEPS Action 8 – Revisions to
Chapter VIII of the Transfer Pricing
Guidelines on Cost Contribution
Arrangements

cc Clark Chandler, KPMG in the U.S.

Comments on the Discussion Draft on Cost Contribution Arrangements

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD's Discussion Draft titled "Public Discussion Draft: BEPS Action 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements" ("Discussion Draft"). KPMG commends the OECD for acknowledging the role of Cost Contribution Agreements ("CCAs") and providing guidance around their formation and use.

Why Cost Contribution Arrangements Are Important

There are a number of cases in which one or more members of a multinational enterprise ("MNE") group perform services that provide benefits to some or all other members of the group, either immediately (e.g., centralized administrative services) or in the future (e.g., by contributing to the development of intangibles). CCAs are contractual agreements in which different legal entities agree to share the costs that provide a common benefit in proportion to the benefits that each legal entity expects to receive from those costs. The two common forms of CCAs are (i) CCAs that are used to share the cost of developing intangibles (which are called Cost Sharing Agreements in the United States) and (ii) CCAs in which the cost of providing common services (e.g., administrative, IT, etc.) are shared.

Companies enter into CCAs to realize business efficiencies – it is often less expensive to carry out one research and development ("R&D") project whose benefits can be shared throughout the group than to have each group member fund that project on its own; it is often cheaper to provide certain administrative services centrally than to have each member of the group incur duplicative costs. In cases where such common benefits exist, CCAs can substantially simplify transfer pricing issues, as it is often much easier to measure the cost of providing services than to either determine the value of the intangibles that are produced based on that R&D or price specific individual elements of that service.

As a simple example to illustrate this point, consider an MNE that has five different subsidiaries,

each of which operates a steel rolling mill. One of the legal entities may be enhancing software that optimizes the operations of the steel mills, another may be pursuing an engineering project designed to lower energy costs, while yet another may be working with a particular customer to address certain quality issues that are lowering yields. Each of these three projects, if successful, may be useful to all five of the legal entities. Pricing the results of these projects on an individual basis is likely to be a very difficult task – should a new software product be priced at (i) the cost of developing it; (ii) the cost of developing it divided by 5 if all five legal entities use it but by 3 if only three use it; (iii) at a fixed price regardless of the different size of the mills owned by the five legal entities, (iv) at a variable cost based on sales? Not only are these questions complex with possibly multiple inconsistent answers, but they also require the taxpayer to put in place systems for determining when specific pieces of intangible property (“IP”) or services are transferred, and to whom. A CCA simplifies this process by allowing the taxpayer to simply add up the cost of the three projects, allocate these costs among the five legal entities based on expected benefits, and thereby avoid the entire issue of tracing what is transferred when and what price should be charged. This is also a relatively easy arrangement for tax authorities to audit.

KPMG welcomes the fact that the OECD has recognized the potential benefits of the CCAs (see Paragraph 6) and agrees with the statement in Paragraph 7 that “...the provisions of Chapters VI and VII, and indeed all the other chapters of these Guidelines, will continue to apply to the extent relevant, for instance in measuring the value of a contribution to a CCA...” As a general matter, the OECD’s Guidance around CCAs should focus on issues that are specific to sharing costs that benefit multiple legal entities in proportion to their relative benefits, and cross reference rather than replicate Guidance contained in other Chapters.

KPMG’s two primary concerns with the Discussion Draft are that (1) in some cases the specific guidance undermines the overall benefits of CCAs - e.g., simplification - when this is not needed to ensure the effective operation of the arm’s length principle and/or to avoid double non-taxation and (2) in some cases the guidance covers issues that are covered in other Chapters, raising the possibility of confusion and inconsistency. The latter is of particular concern with respect to the various references in the Discussion Draft to the valuation of intangibles and the treatment of uncertain forecasts – the valuation of intangibles and the treatment of uncertain forecasts should be the same for intangibles contributed to CCAs as for intangibles transferred from one legal entity to another legal entity.

KPMG’s specific comments with respect to these two general issues are set forth below.

Requirement that Contributions to CCAs Should be Based on Arm’s Length Value Rather than Cost

Paragraph 22 of the Discussion Draft makes it clear that contributions to CCAs are to be based on their arms’ length value rather than on their cost *per se*,¹ although Paragraph 23 softens this

¹ 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. That is, contributions must generally be assessed based

Guidance somewhat by noting that in some cases the arm's length value may be very close to costs. (See examples 1 through 3 at the end of the Discussion Draft). KPMG believes that the Discussion Draft should provide additional guidance on circumstances where sharing at costs may be appropriate. Unrelated parties enter into CCA arrangements based on costs in a variety of circumstances where the administrative simplicity of using costs outweighs any benefits to more detailed analysis and tracking of contribution value. In the case of CCAs between related parties, the benefits of such administrative simplicity accrue to tax authorities as well as taxpayers, and therefore use of such arrangements when they do not materially distort the allocation of taxable income across jurisdictions benefits all parties, and further mirrors the actual behavior of unrelated parties in such circumstances.

In the case of the MNE with 5 legal entities that own rolling mills set forth above, the Discussion Draft would clearly require an arm's length charge for the contributions that are made by the three legal entities that are carrying out projects that are cost shared. However, if each legal entity has 500 employees, but only 6 are engaged in software development, 8 are engaged in projects to look for ways of saving energy, and another 3 employees working to address an issue that will increase yields, the costs of deriving an arm's length charge (other than by marking up cost using a common 5% to 10% markup) is likely to be higher than any benefits from increased accuracy. The need to balance the additional complexity imposed by the use of arm's length pricing against the simplicity of simply sharing costs extends beyond taxpayers but also to tax authorities. The guidance in the Discussion Draft could certainly make auditing CCAs much more complicated and time consuming. Thus, it is important to weigh the benefit of this potential change because of the added complexity.

Therefore, we recommend that the OECD expand the Guidance for when sharing at cost is appropriate in a CCA. At minimum, sharing at cost should be allowed when the parties can document the existence of similar arrangements in similar circumstances between unrelated parties. (For example, it is relatively common in the oil and gas industry, in particular, for one member of a joint venture to provide even high value services at cost rather than market value, even though these contributions benefit all members of the joint venture equally.) In addition, the Guidance should include an explicit cross reference the OECD's proposed guidance on low value-adding services, and make it clear that cost can be treated as an arm's length value in the case of such low value-adding services. The existing Example 2 would then be modified so that it provided an example of that guidance. The Discussion Draft should also note the need to balance the additional complexity imposed by the use of arm's length pricing against the simplicity of simply sharing costs.

Capability to Control Risks

While the Discussion Draft states that costs should be allocated based on expected benefits (Paragraph 12), it also make it clear that all participants to the CCA must have substance and the

on their value (rather than their cost) in order to be consistent with the arm's length principle. In determining the value of contributions to a CCA, the guidance elsewhere in these Guidelines should be followed.

ability to exercise some form of control over their investments. Paragraph 13 of the Discussion Draft states that:²

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 in accordance with the definition of control of risks set out in Chapter I. In particular, this means that a CCA participant should have the capability to make decisions to take on the risk-bearing opportunity, to make decisions on how to respond to the risks, and to assess, monitor, and direct any outsourced measures affecting risk outcomes under the CCA....

Absent such substance, the CCA can be disregarded. (See Example 5.)

KPMG would like to make two key points with respect to the language contained in Paragraph 13. First, CCAs are – to quote the language used in Paragraph 3, “...a contractual arrangement among business enterprises...” Therefore, the key question is whether or not the CCA is a contract that would be entered into at arm’s length, and the requirements for this are set forth in other Chapters of the OECD Guidance on Transfer Pricing. The Discussion Draft should simply state that CCAs are contractual arrangements, and that the same considerations apply for respecting the terms of the CCA as any other intercompany contract.

Second, the evaluation of whether or not the contractual terms of the CCA are arm’s length should take the specific economic function of the CCA – to share costs that provide a common benefit, and thereby avoid incurring duplicative expenses while simplifying the transfer pricing structure – into account. Therefore, control over risk should reflect control over the *use* of the intangibles created by the CCA or the services provided through the CCA. In many cases it is much more efficient and practical to have one or a small number of legal entities specialize in the provision of a particular type of service, even though there are a number of different legal entities that may realize the benefits of that service. In the example of the MNE with five affiliates operating rolling mills given above, it may be much more efficient to have the R&D team focused on software improvements located in one specific legal entity, the team of engineers focused on generating energy cost reductions located in a different legal entity, and the engineering team working with a customer to overcome certain technical issues located in yet a third legal entity, even though the work carried out by these different groups is beneficial to all of the different legal entities. Indeed, the key benefit of a CCA in this case is to allow MNEs to organize in a way that best meets the needs of business (e.g., by using functional specialization) while allowing each of the legal entities to benefit from the output of these specialized groups without trying to track and price every enhancement that may or may not have been shared.

Similar examples exist for CCAs that are designed to share in the cost of low value-adding services. For example, a back office services CCA may have only one or two legal entities that actually

² See also Paragraph 32.

perform the service, but all members of the MNE group may use and benefit from the service. While it is appropriate to evaluate whether the different legal entities would enter into a CCA at arm's length (e.g., would they commit to bearing the expected costs based on expected benefits), it is unrealistic to expect them to exert day-to-day control over the performance of the administrative activities.

KPMG welcomes the statement in Paragraph 14 that "In some cases, the participants in a CCA may decide that all or part of the subject activity will be carried out by a separate entity that is not a participant under the standards of paragraph 12 above. In such a case, an arm's length charge would be appropriate to compensate the entity for services or other contributions being rendered to the CCA participants."

Expected Benefits

Paragraphs 16 through 19 discuss general principles with respect to expected benefits. KPMG has three general concerns with the discussion set forth in these paragraphs.

First, Paragraph 17 and Paragraph 19, in particular, note various concerns about variations between expected and actual results. The discussion should be framed in terms of *relative* rather than actual benefits. The fact that a particular intangible development project is much more successful or much less successful than expected will clearly have an impact upon profits and lead to a difference between actual and projected results, but often may have very little impact upon *relative* benefits, and therefore will not change the way in which costs are allocated. To the extent that there are concerns with the impact of such disparities on the initial contribution of an intangible to a CCA, the OECD's Guidance on CCAs should simply cross reference its guidance on the valuation of intangibles when actual results differ from projections.

Second, while KPMG agrees with the specific point made in Paragraph 18 (e.g., that if a CCA is undertaking Projects #1 and #2, a participant that can only benefit from Project #1 should not share in the costs of Project #2), KPMG would like to note that in many cases CCAs are sharing costs as incurred rather than the value of services or intangibles as they are received. It may very well be the CCA that funds R&D on Projects #1 and #2, and that some members of the CCA choose to use the intangibles developed under Project #1 but not Project 2, or *vice versa*. For example, Project #1 may lead to a development that can lower labor costs while Project #2 leads to a development that may lower energy costs. It may cost 1.0 million Euros each to change the manufacturing line based on these new options. CCA Participant A may decide that it is worth the investment to adopt the results of Project #1 but not the results of Project #2, while CCA Participant B may make the opposite decision. As long as both had reasonable expectations of benefitting from the two projects, there should not be any need to retroactively recompute benefit shares.

In addition, KPMG believes that it is important to clarify that benefits of a CCA should be evaluated as a whole. For example, if there is a CCA whereby the participants are undertaking 50 projects, it is entirely possible that certain participants will know in advance that there will be specific projects they will not benefit from. Yet they would agree to the arrangement because the costs of segregating and tracking the separate costs outweighs any benefits of doing so. As long as

the costs as a whole are shared in proportion to expected benefits and, considering all the facts, the participants at arm's length could reasonably be expected to agree to the arrangement, it should be respected without detailed tracking of who expects to benefit from each project.

Balancing Payments

The Discussion Draft indicates that balancing payments should be made when one CCA participant receives a greater (smaller) proportion of benefits than it incurs in costs (arm's length value of its contributions). This is of course entirely appropriate – the entire purpose of a CCA is to allocate costs/the arm's length value of contributions on the basis of expected benefits.

Participants to CCAs should be able to make such balancing payments in whatever way is most administrable, provided of course that the balancing payments reach the correct arm's length amount. In this regard, the last sentence in Paragraph 29, which states that balancing payments would be "...from one or more participants to another..." should be amended to clarify that any reasonable arrangement that accumulates costs and re-distributes such costs in proportion to expected benefits is appropriate. The end result is the critical objective, not the specific approach used to reach that result.

Adjustments to balancing payments should re-allocate the value of contributions based upon expected benefits, and not reallocate benefits based on contributions. CCAs are not partnerships or joint ventures, where the benefits of an investments are allocated based on the relative share of investments. Instead, CCAs are essentially joint buying arrangements, in which several participants that need a common service share in the costs of acquiring that service.

KPMG also recommends that the OECD keep the following existing guidance around balancing payments that is in Chapter VIII that clarifies that a balancing payment would not constitute a royalty for the use of intangible property (paragraph 8.25). Therefore, the following language from the existing paragraph 8.25 should be inserted:

A balancing payment should be treated as an addition to the costs of the payer and as a reimbursement (and therefore a reduction) of costs to the recipient. A balancing payment would not constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property belonging to a participant (or a third party) and the payer does not also obtain a beneficial interest in the intangible property itself. In some cases a balancing payment might exceed the recipient's allowable expenditures or costs for tax purposes determined under the domestic tax system, in which case the excess could be treated as taxable profit.

Disregarding the Terms of a CCA

Paragraphs 31 and 32 discuss situations in which tax authorities can disregard all or some of the terms of a CCA. KPMG has concerns that the following language may be used by tax authorities to re-characterize CCA arrangements inappropriately:

- Paragraph 31: “... Although in principle the smallness of a participant’s share of expected benefits is no bar to eligibility, if a participant that is performing all of the subject activity is expected to have only a small fraction of the overall expected benefits, it may be questioned whether the reality of the arrangements for that party is to share in mutual benefits or whether the appearance of sharing in mutual benefits has been constructed to obtain more favorable tax results.”
- Paragraph 32: “A tax administration may also disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant’s proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater interest in the subject of the CCA”

As stated in KPMG’s initial comments, CCAs are contractual arrangements among related parties, and the same standard for respecting such contractual arrangements should apply to CCAs as to any other contractual arrangement. More specifically, services CCAs in particular often have a limited number of legal entities that perform services that are beneficial for a large number of legal entities. The language in Paragraphs 31 and 32 could be interpreted to say that such CCAs should not be respected and that charges made under such arrangements are therefore not deductible even in cases where the CCA is being used solely to realize corporate efficiency and to allocate costs that generate common benefits based on those benefits. KPMG believes that other sections of the OECD’s guidance – e.g., those that require a certain level of substance in the form of decision making to be in place in order to respect a CCA and the requirement that contributions be valued at their arm’s length value rather than cost – should be sufficient to address the concerns set forth in Paragraphs 31 and 32.

Required Documentation

While listing the types of documentation that tax authorities may need is helpful, KPMG would note that:

- 1) Given that a CCA is a contractual arrangement that is, in principle, no different than other contractual arrangements, the required documentation should be no different from that expected in other arrangements; namely a requirement to document that its terms are consistent with an arm’s length arrangement and that the participants adhere to the terms of the arrangement; and
- 2) There are a number of CCAs, and in particular CCAs involving low value-adding services that may have a large number of participants that benefit from the service and where the administrative burdens of maintaining documentation at the detailed level implied in the Discussion Draft may be high.

Mutual Agreement Procedures (“MAP”) and CCAs

The Discussion Draft’s explicit recommendation that in most cases contributions to a CCA have to be valued at their arm’s length value rather than at cost has the potential to increase the number of

disputes related to CCAs. Moreover, these disputes may be procedurally complex in cases where there are more than two participants to the CCA. While a detailed discussion of MAP issues is clearly beyond the scope of this Discussion Draft, the OECD should make it clear that participants to a CCA should have access to MAP, and that MAP procedures should be flexible enough to incorporate the procedural complications that may arise as a result of CCAs.

Indirect Tax Implications of CCAs

It would be extremely useful for the OECD to include guidance on how CCA payments should be treated for VAT purposes. Specifically, we think that in Paragraph 6 the OECD should state that where a streamlining of flows has been achieved through a system of netted payments that are arm's length and within a compliant CCA then this should eliminate the VAT / GST charge that would otherwise arise if the parties were charging each other based on a web of separate intra-group arm's length payments. There may still be a potential VAT/GST charge on any balancing payments that are required to be made under the terms of the CCA.

Examples

The Discussion Draft provides five examples of how companies can determine the value of the contributions in both Development CCAs and Services CCAs. KPMG has the following comments with respect to these examples.

We suggest that the OECD should include an example that shows that contributions to a CCA are deductible expenses even in cases where one or more participants incurs a loss. Companies operating at arm's length continue to invest in the development of intangibles and continue to need low value-adding services even when they are incurring losses, and costs that are incurred through a CCA should be treated no differently than if they were incurred directly by the CCA participant.

Example 1

Example 1 provides a clear description of the principle that contributions should be based on arm's length value rather than cost. However, KPMG believes that footnote 2 should be deleted, as it can be interpreted as *requiring* that the markup (or the difference between arm's length value and cost) be included as part of an initial up-front payment. This is generally not something that is observed at arm's length, and would require taxpayers to use projections of expected future benefits and contributions even though the OECD has repeatedly expressed concerns over the reliability of such projections.

For example, legal entities A and B may enter into a CCA with the initial expectation that A will do 60% of all R&D and B will do 40%. If both parties expect equal benefits, B will have to make a balancing payment to A so that they share in the costs (based on the arm's length value) of their activities equally. Several years later, due to a change in circumstances or other good business reasons, this may be reversed with A doing 40% of R&D and B doing 60%. If benefits are still 50:50, the direction of the balancing payments will be reversed. If the difference between arm's length value and cost is incorporated in the annual charges, this shift in relative responsibilities is automatically addressed by changes annual balancing payments. However, if a tax authority has required that the difference between arms' length value and cost has to be included in an upfront

payment, logic suggests that there needs to be a second payment in the opposite direction once the relative shares of R&D have changed. This adds administrative complexity while also lowering reliability due to the inherent uncertainty about future projections.

Examples 4 and 5

KPMG recommends that Examples 4 and 5 be deleted as they concern issues that are addressed elsewhere in existing or forthcoming OECD guidance, and further are problematic as written.

Example 4 is extremely problematic for two reasons: (1) it presumes that, if one of two CCA participants contributes cash while the other contributes an intangible, the best measure of the value of the intangible is *necessarily* equal to the total value of profits created under the CCA less the other party's contribution, rather than valued using the most appropriate (reliable) method; and (2) opens up without addressing very significant issues regarding use of *ex ante* (expected) vs. *ex post* (actual) profits in computation of subsequent balancing payments.

Example 4 as written is inconsistent with the principles advanced elsewhere in this Discussion Draft. Paragraphs 20 through 22 of this Discussion Draft emphasize the importance of valuing each participant's contributions to the CCA as the arm's length value based on guidance elsewhere in the Guidelines. But Example 4 does not present any discussion of the arm's length value of intangibles contributed by Company B. Instead, in paragraph 61 the balancing payments are calculated as if the total value of the contributions is equal to the total expected benefit of the parties.³ What happens, for example, if the participant to the CCA that is contributing the intangibles acquired them a few days earlier for a specific price – is that information to be ignored? Or perhaps the participant contributing the intangibles are a similar arrangement with a third party that provide a specific royalty rate or price – is that information to be ignored? If Example 4 is retained, it should state that the value of the IP that Sub A is contributing to the CCA should be determined using the most appropriate method as determined based on the transfer pricing guidance given with respect to intangibles in other parts of the OECD Guidance. The fact that the IP is being contributed to a CCA should not change the valuation method and there is no need for the OECD to suggest that contributions to CCAs should be valued in a special way.

Paragraph 61 also raises significant issues regarding the treatment of *ex ante* expected benefits vs. *ex post* actual results. For example, is the \$110 million per year “risk adjusted” return for Company A for years 6 to 15 an *ex ante* expected amount? How would that return be adjusted as actual results differ? Should deviations of actuals from forecasts create any need to “top up” balancing payments?

³ Contrast paragraph 10 of the Discussion Draft “What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected mutual and proportionate benefit from the pooling of resources and skills” – so valuing contributions as equal to expected benefits contradicts the Discussion Draft statement of the distinguishing characteristic of a CCA that expected benefit exceeds the value of the contributions.

KPMG does not see any advantage to addressing any of these issues in the CCA chapter as they are appropriately addressed elsewhere in the Guidance on intangibles. As we do not believe Example 4, properly modified to emphasize consistency with other guidance on intangibles valuation, addresses any issues specific to CCAs, we recommend that it be deleted.

Similarly, Example 5 does not seem to serve any useful purpose. The standards to disregarding/re-characterizing a CCA should be the same as those that apply for any other contract, and the results of disregarding the contract involving intangibles and intangible development should be addressed under whatever special measures that the OECD adopts. Having said that, the OECD should make it clear in its guidance that disregarding a transaction should not allow a tax authority the right to tax income related to functions, risks, or assets outside of its jurisdiction. For example, considering the facts of Example 5, the tax authorities of Country X, upon auditing related Company X that is paying a royalty to a Company A, may determine that the CCA lacks substance and should be disregarded. However, the royalty deduction allowed to Company X should be an arm's length payment for the intellectual property used by Company X. Under the Example 5 facts as stated, absent the CCA the rights to the royalty payment should revert to Company B. Allowing the tax authority of Country X to unilaterally disallow the deduction of the royalty payment, quite possibly without providing for access to MAP, places taxpayers at a high risk of double taxation and is inconsistent with the arm's length principle and the principle of taxing income where value is created.

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