USCIB
UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
Andrew Hickman
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(TransferPricing@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Actions 8: Revisions to Chapter VIII of the Transfer Pricing Guidelines on Cost Contribution Arrangements (CCAs)

Dear Mr. Hickman:

USCIB thanks the OECD for the opportunity to provide comments on its Discussion Draft on Action 8 of the Base Erosion and Profit Shifting ("BEPS") project pertaining to cost contribution arrangements ("CCAs") and Revisions to Chapter 8 of the Transfer Pricing Guidelines ("TPGs") issued on April 29, 2015 ("discussion draft").

General Comments

USCIB believes that the discussion draft misconstrues the purpose and application of a development CCA. USCIB believes that the purpose of a development CCA is to provide an elective regime that allows related parties to achieve a result comparable to that achieved by independent parties with respect to shared development arrangements and reduce the tax uncertainties inherent in other arrangements used to conduct these activities jointly.

To fulfil these purposes, development CCAs recognize that unrelated parties jointly engage in development activities by sharing **costs** and thus provide similar simplified mechanisms for associated enterprises to share the **costs** of their IP development. CCA rules for development provide a viable option for participation in joint development activities and are not intended to adopt the same tax requirements or produce the same tax results as would other options available to affiliates to jointly develop IP.

The economics of a CCA support these aims. In a CCA, a consolidated investment is divided into shares where each participant is entitled to the same economics as the economics of the consolidated investment. If the consolidated investment takes the form of a CCA, the **only** way to achieve the economically consolidated result is by splitting consolidated costs between participants proportionally to each participant's expected benefits (e.g. gross intangible income). Dividing the consolidated costs any other way results in two (or more depending on the number of participants) economically different investments with different operating leverage and thus different incremental costs of capital. Since the CCA is intended to permit participants to achieve this desired consolidated result without the necessity

of setting up a legal entity to pursue the joint development of intangible property, using value for contributions within the CCA fundamentally misunderstands the economics of the CCA.[1]

The conceptual flaw of the CCA proposals is to mandate equal treatment for the contribution of existing IP rights and future development activities. These are fundamentally different concepts and require different analysis and treatment. Pre-existing IP contributions' costs are sunk and therefore are contributed at arm's length to the CCA at value. Ongoing future development costs are fixed as incurred and affect the cost of capital of the participants. They should therefore be shared at cost to ensure that the allocation of the incremental cost of capital is the same for each participant. The US regulations[2] reach the correct answer on this issue.

The discussion draft essentially rejects cost as a basis for measuring a participant's contribution to the CCA and requires the use of value and calls this a "clarification"[3]. As explained above, this is definitely not a clarification; it would be a fundamental and detrimental change. Replacing "cost" with "value" as a measurement of a participant's contribution to a CCA is inappropriate for a number of reasons. First, requiring all contributions to be measured using value undercuts one of the main purposes for using a CCA: simplifying and ensuring certainty with respect to these arrangements. The discussion draft does not provide clear guidance on how the value of the contribution will be measured. Paragraph 22 of the discussion draft requires the value to be determined under the arm's length principle but is not clear whether, for example, an R&D service provider would be compensated as a service provider or whether the intangible created by the R&D would be valued (difficult or impossible to do until the R&D project is completed). Second, the TPGs are supposed to apply the arm's length standard. Independent parties enter into arrangements where ongoing **costs (not including stock based compensation)** are shared. This structure is seen in the oil and gas industry, the pharmaceutical industry, the movie industry, and the technology industry. These arrangements split costs proportionately. Ignoring this common practice essentially rejects the ALP. The discussion draft also proposes to eliminate the reference in the existing to TPGs to CCAs possibly including independent enterprises.[4] Query whether this reference is eliminated because the drafters believe the principles are not applicable between independent enterprises and independent enterprises would not enter into such an arrangement?

Both the existing TPGs[5] and the discussion draft[6] accurately describe the reasons independent parties would enter into CCAs. Both documents provide:

"Independent parties at arm's length might want to share risks (e.g. of high technology research) to minimise the loss potential from an activity, or they might engage in a sharing of costs or in joint development to achieve savings, perhaps from the combination of different individual strengths and spheres of expertise."

This language recognizes that CCAs between independent parties are seeking consolidated results, rather than separate investments. That is, independent parties could not achieve savings from the

[1] One of the important simplifications of the CCA regime is that it allows taxpayers to achieve these results without the complexities of a joint venture or partnership arrangement.
[2] Treasury regulation 1.482-7(g)(4).
[3] Discussion Draft, unnumbered paragraph 4 of Box on page 3. It is disingenuous to call this a clarification. The change from cost to value would change principles that are fundamental to the concept of a CCA and would require significant redrafting to eliminate references to cost throughout existing Chapter 8. We are unaware of any existing CCA arrangement that is based on value.
[4] Paragraph 8.1 of the existing TPGs.
[5] Paragraph 8.8 of the existing TPGs.
[6] Paragraph 10 of the discussion draft.

combination of different individual strengths and spheres of expertise, if those where paid for at value because all of the benefit of would accrue to the party performing that activity. In order to achieve the consolidated result that is the intended benefit of the CCA, the parties must share costs proportionately to the expected benefit under the arrangement.

In all events, development CCAs, as defined by the TPGs, should not be the exclusive means of sharing costs. Rather they should be viewed as simplified mechanisms with taxpayers still being able to demonstrate that cost-only development arrangements meet the arm's length standard. USCIB believes that development CCAs are fundamentally different from shared service CCAs. Development CCAs are intended to attempt to create risky, uncertain future value, while shared services address highly certain current services that have known current value. . Because of these fundamental differences, a different set of rules are appropriate for development CCAs and services CCAs. The guidance on these arrangements should, therefore, be divided into separate sections. [7]

Finally, USCIB would like to propose an additional rule that would limit challenges to the CCA and the allocation of benefits among the participants to those governments in which a participant resides. As described above, a development CCA creates a consolidated investment in the intangibles that are the objective of the CCA. Thus, if value is ultimately attributable to those intangibles, then it is clear that the return from those intangibles is attributable only to the participants in the CCA and not to other non-participants. Thus, the governments of the participants could challenge the split among the participants, but other governments should not be able to do so.

Specific Comments

Paragraphs 6 and 7 of the Discussion Draft propose that all of the other rules in the TPG will apply with equal force to CCAs. As described above, USCIB believes that this requirement indicates a misunderstanding of the policy rationale underlying a CCA regime and would eliminate the usefulness of the CCA. CCAs should be considered a discrete and separate method within the TPG.

By eliminating any references to the "amount" of the contribution or references to cash[8], paragraphs 20 through 23 fundamentally change the nature of the CCA. The existing TPGs clearly permit "costs" to be shared. By denying taxpayers the ability to structure a CCA by sharing costs, and by requiring the outcome of a CCA to mimic the outcome of a series of transactions carried out under the other chapters of the TPG, the guidance under Chapter VIII is attempting to prohibit taxpayers from engaging in a CCA that has the same general terms and structure that uncontrolled parties would use to structure their co-development transactions because in similar uncontrolled co-development structures, parties do share costs and risks in proportion to benefits. Therefore, prohibiting such a structure is inconsistent with the arm's length standard.

Paragraph 13 requires all development CCA participants to control risks "in accordance with the definition of control of risks set out in Chapter I." USCIB has serious concerns[9] with the OECD's proposed guidance on risk as set forth in its December 2014 discussion draft. Fundamentally, the problem with those proposals is that they are based on the premise that investors are not willing to

[7] There is insufficient time to identify all of the ways that development CCAs should be distinguished from service CCAs, but this comment letter points out a number of places where distinctions should be drawn. Those distinctions emphasize the importance of separate rules.

[8] Compare, for example, the proposed guidance to the current *2010 OECD Transfer Pricing Guidelines*, sections 8.9 ("…each participant's relative contribution to the joint activity (whether in cash or in kind)…") and 8.15 ("…where all contributions are made solely in cash…").

[9] Explained in detail in our comment letter include link.

accept risks they do not control. This premise is simply wrong. As noted above, CCAs are structured to take advantage of different areas of expertise and to mitigate risk. Before entering into a CCA the parties will do due diligence to ensure that the parties have the capabilities to perform as expected, but once they have decided to invest they will rely on the other participant to perform as expected. In the movie industry, for example, a CCA may be set up to produce and distribute a movie with one party making all production decisions and the other providing funding and distributing the movie. Thus, the distributor will be agreeing to distribute even though it does not have **any** control over the quality of the movie because it has delegated all decisions to the producer. They will do this because the producer has the expertise to make the movie and involving the distributor in production decisions would slow down the process, making production more costly. Furthermore, their incentives are aligned. The producer and distributor both benefit from producing a movie that people want to see and that is distributed effectively. Most movies do not make money, so the downside risk is real and the distribution/financing entity has to be able to earn an entrepreneurial return or the business model would fail.

USCIB further notes that, as the OECD acknowledges, one of the reasons for entering into a CCA is "to share risks ... to minimise the loss potential from an activity".[10] Providing non-debt financing, even without control, shifts the risk of loss. This is what venture capitalists and private equity financiers do. In these arrangements, both parties share the entrepreneurial return – whether that return is a profit or a loss. In transactions between independent parties, the financing entity receives a share of the upside and downside proportional to its reasonably anticipated benefit ("RAB") share after funding the same RAB share of the intangible development costs. In the pharmaceutical/biotech sector research may require large upfront investments that a smaller company could not fund without a JV partner or CCA to provide funds and mitigate the risk. The funding entity would in all likelihood require a higher return because it **is** accepting risk. Ignoring this need for a higher return to account for the fact that risk is in fact shifted is inconsistent with the arm's length standard.

The OECD's recent guidance provides that persons that engage in the development, enhancement, maintenance, protection or exploitation of an intangible are entitled to a portion of the intangible related return. The discussion draft on risk provides that parties control risk, at least in part, by deciding whether to take on that risk. Thus a party that has the capability to assess an investment opportunity and decide whether to take on the risk should be considered to control that risk and ought to be entitled to an entrepreneurial return. In CCA arrangements between independent parties there will be due diligence concerning whether the investment is appropriate and whether the other party to the arrangement has the capability to perform the functions necessary to develop the intangible. Example 4 of the discussion draft provides that "Company A performs, through its own personnel, all the functions expected from an independent entity providing funding for a research and development project, including the analysis of the intangible at stake and the anticipated profits that can be derived from the investment, the evaluation of the funding risk, including the risk that further investment may be required to complete the project, and of the capacity of Company A to take that risk, and the making of decisions to bear, cover, or mitigate that risk." Development of intangibles includes the decision to pursue and fund that development. Control of risk includes the evaluation of these risks and the decision to accept them. These are the sorts of decisions that senior management makes and should be considered essential to continuing viability and profitability of an enterprise and managing these risks by deciding where to deploy capital to fund intangible development therefore should entitle the enterprise that makes these decisions to an entrepreneurial return. The conclusion in Example 4 is, therefore, incorrect based on the guidance provided by the other Action Items and arm's length behavior of

[10] TPGs paragraph 8.8, discussion draft paragraph 10.

independent parties in CCAs. USCIB also observes that Examples 4 and 5 are inconsistent with guidance that the OECD has already issued on Chapter VI of the TPG, which does allow for a risk adjusted return for pure funding activities.

USCIB also believes that extending the risk guidance to CCAs demonstrates a misunderstanding of how intangible development often occurs and, therefore, would be inappropriate and inconsistent with the fundamental policy goal of promoting IP development. This rule would have a particularly negative impact on the ability of start-up companies to use CCAs. The proposed rules would require each participant to actually perform development activities in order to share in the entrepreneurial return. For example, under Example 4, to obtain more than a mere financing return, each CCA participant would need to have an R&D workforce in place in each relevant taxing jurisdiction (in addition to the R&D executives that are required to be in place in each taxing jurisdiction just to obtain the financing return with respect to the capital invested in R&D). In many situations, a small start-up company with a few scientists and engineers will develop an idea in one jurisdiction and then expand to other jurisdictions over time. In order to do this, the start-up will likely need capital to fund this gradual expansion. It takes time for a company to find qualified scientists in each relevant jurisdiction; they may never be available in many jurisdictions. This is difficult for all MNEs, but is especially difficult for small start up companies. This discussion draft would prevent such small start-up companies from enjoying the benefits of CCAs while simultaneously extending such benefits to a small percentage of the largest corporations that already have R&D facilities in many different jurisdictions. This discriminates against start-up companies when there is no identifiable policy rationale for such discrimination. Policy should encourage innovative start-ups; as the OECD has observed: "[i]nnovation [by start-up companies] is a major driver of productivity, economic growth and development."[11]

Application of Action 8 - 10 Principles to CCAs

As discussed above, the discussion draft's proposal to require all contributions to a CCA to be measured by value essentially negates the entire concept of a "cost contribution" arrangement. USCIB believes that the economics of a CCA drive the use of costs, despite changes to other aspects of the transfer pricing guidelines. Nevertheless, if the OECD wishes to integrate Chapter VIII more fully into the new guidance, USCIB believes that there is no need to discard entirely a transfer pricing structure which for decades has provided clarity to taxpayers and tax administrators as to how costs should be allocated between the parties. Instead, we suggest that any concerns that may have arisen in the past regarding the operation of CCAs could be addressed by enhancing the Ch VIII guidance as to when an arrangement that requires taxpayers to share their contributions at cost should be regarded as consistent with the arm's length principle, as elaborated by the other work underway under Actions 8 - 10, and when it cannot.

The discussion draft refers to two types of CCAs: development CCAs and service CCAs. It is hard to see in the case of service CCAs any significant risk of BEPS concerns. By definition, service CCAs involve services which produce a current benefit only. Allocating a pool of current period costs based on expected relative current period benefits would seem to produce appropriate results in the overwhelming majority of cases.

The guidelines on development CCAs allow related parties to choose to enter into joint funding arrangements that are analogous to arrangements seen between unrelated parties. Since these

[11] "Start-up Nation: An Innovation Story," *OECD Observer*, No. 285 (Q2 2011), available at: http://www.oecdobserver.org/news/fullstory.php/aid/3546/Start-up_nation:_An_innovation_story.html.

arrangements do exist at arm's length, it must be the case that CCAs in which the contributions are valued only at cost must be accepted as complying with the arm's length principle in many cases. Instead of precluding altogether the possibility of utilizing arrangements that exist at arm's length, the Guidelines should provide taxpayers and tax administrators with guidance as to when those arrangements will be respected.

With respect to development CCAs, the discussion draft's proposed requirement that all contributions be measured by value does not sufficiently recognize the effect of the buy-in payment to equalize the value of the contributions of the parties, even if one of the parties does not perform development activity itself. A buy-in payment constitutes an amount determined under the arm's length principle that compensates the transferor for all property it may contribute to a CCA, under the particular circumstances of the parties to that CCA. The net buy-in payment received by a transferor will be greater to the extent that the other party to the CCA is not also transferring property into the CCA. As such, an appropriate determination of the amount of the buy-in payment can equalize the value of the contributions of both parties from the beginning of the CCA, even if the parties have agreed to fund their joint development activity under a CCA with one party contributing only risk capital. It would be appropriate for the next draft of a revised Chapter VIII to focus in more detail on the effect of the buy-in payment to equalize the contributions of the parties from the beginning of the CCA, so that the ongoing CCA under in which the parties' contributions are valued at cost would be regarded as compliant with the arm's length principle.

Chapter VIII will not be of much use to taxpayers if there are few circumstances where CCA contributions can be measured at cost. Accordingly, the purpose of Chapter VIII should be to describe those circumstances where a cost-based CCA will be regarded as compliant with the arm's length principle. Inherent in any development CCA is the shared undertaking of a significant development risk. In light of the work now being done in Actions 8 - 10 on risk and recharacterization, the question becomes what activities of the parties should be required in order for each party to be respected as bearing that development risk.

We respectfully suggest that the revised Chapter VIII could set out several circumstances where a CCA participant would be respected as bearing that shared development risk and thus be entitled to its expected benefit from the property being developed under the CCA.

First, it should be clear that a party which undertakes any of the DEMPE functions should be respected as participating in a CCA, and should be entitled to its anticipated benefit from the developed property.

Second, a party should be entitled to the benefits of the CCA if it is engaged in the active conduct of a trade or business in which it expects to utilize the results of the development CCA, even if those trade or business activities do not include DEMPE functions. This case is a close analogue to many shared development programs conducted at arm's length where the parties agree that only one of the parties would undertake the actual development work.

Third, a party should be entitled to the benefits if the CCA if the party being tested has paid an appropriate buy-in payment. As noted above, Chapter VIII could provide guidance as to when the buy-in payment would be regarded as compliant with the arm's length principle in light of the nature of the expected ongoing contributions of each of the participants.

Finally, a party should be entitled to the benefits of a CCA if it performs the financial and risk management activities described in the draft Example 4. We believe that such activities clearly are

DEMPE functions, but if there is any doubt of that, then those financial risk assessment activities are entirely appropriate activities to qualify a participant as entitled to the intangible return under a CCA.

We suggest that the proper conclusion in Example 5 is not that the CCA is disregarded, but that the party which contributes only risk capital should be allocated a risk-adjusted rate of anticipated return on its investment. There is no need to disregard the CCA altogether in this case. An arm's length result can be achieved by limiting the investor's return to that of a financial investor in a similarly risky business.

For purposes of identifying the functions, assets and risks performed by a CCA party, Ch VIII should note that a partner or other owner of a transparent entity be attributed the functions, assets and risks undertaken by the transparent entity.

Balancing Payments Paragraphs 27 through 30 discuss "balancing payments," which seem to be *ex post* adjustments similar to "commensurate with income" ("CWI") adjustments made under U.S. Treasury Regulation 1.482-7(i)(6). While it may be appropriate to make CWI types of adjustments in some limited circumstances, CWI adjustments should not be applied without some guidelines as to when such an adjustment is appropriate. If a tax jurisdiction has the authority to make CWI adjustments without any exceptions, it has a tool at its disposal that could completely undermine the *ex ante* analysis that is required for an analysis under the arm's length standard. Specifically, USCIB recommends adopting the following exceptions to the authority for a tax jurisdiction to make an ex post "balancing payment" type of adjustment:

a. If events occur that are beyond the control of the CCA participants and that could not reasonably have been anticipated as of the date of the transaction with respect to which the balancing payment adjustment is being made, then no balancing payment adjustment will be made;
b. If the actual ex post financial results (for the profits attributable to the intangible transaction that is the subject of the balancing payment) are within 67% to 150% of the CCA participants' ex ante financial projections for such results for a given tax year, then no balancing payment adjustment will be made for that year;
c. If the CCA participants can satisfy the requirement in 4(b) above for five years in a row, then there will never be any balancing payments made with respect to the original transfer of intangibles; and
d. If the CCA participants can submit a comparable uncontrolled transaction made under similar circumstances to the original transfer of intangibles (that is the subject of the balancing payment), where uncontrolled parties arranged for payment terms and amounts similar to that made by the CCA participants with respect to such transfer of intangibles, then no balancing payment will be made with respect to such transfer.

Furthermore, USCIB believes that the discussion draft should be clarified with respect to whether balancing payments will be based on both the initial contribution and the subsequent contributions or whether each kind of contribution should be tested separately and balancing payments determined separately. We believe that because initial contributions should be evaluated based on value and the ongoing contributions on cost, that the evaluation should be done separately (although of course any actual balancing payments could be netted). Separate evaluation will be simpler for taxpayers and tax administrators to implement.

Paragraphs 31 and 32 provide special rules for disregarding CCAs when the actual RAB shares of the CCA's participants differ substantially from the projected RAB shares. USCIB believes that disregarding a

CCA should only be a measure of last resort. USCIB believes it would be more reasonable for tax authorities to make periodic adjustments to a CCA participant's RAB share than to simply invalidate the CCA. Furthermore, USCIB notes that there is no safe harbour for minor deviations of actual RAB shares from projected RAB shares. We note and support the discussion draft commentary that it might not be appropriate or useful for tax authorities to make RAB share adjustments every single year when actual RAB shares are not in line with the projected RAB shares. The USCIB agrees with this comment and recommends that the OECD adopt a safe harbour whereby actual RAB shares are deemed to be acceptable for a tax year if they are within a range of 80% to 120% of the projected RAB shares for that tax year.

Paragraph 19 provides for payment adjustment clauses. USCIB believes that this is very helpful and consistent with the arm's length standard because uncontrolled parties often incorporate payment adjustment clauses into the signed legal agreement among the parties. USCIB believes that it would be even more helpful if the OECD specified that such payment adjustment clauses may be self-initiated and self-administered by CCA participants to obtain both prospective and retroactive modification of payment terms.

Paragraph 8 of the discussion draft states that: Chapter VIII applies to "intangibles, tangible assets, and services." USCIB believes that services CCAs are fundamentally different from intangible development CCAs. Therefore, the USCIB recommends that the OECD publish separate guidance with respect to intangible development CCAs and services CCAs. We are unaware of any use of CCAs for the development of tangible property; therefore, it is not clear that such rules for the development of tangible property are necessary. However, if the OECD believes that such rules are necessary, then they should be considered with intangible property since development is inherently speculative and any tangible property that requires a CCA to fund development is likely to be a multi-year enterprise with costs and benefits divided among different taxable periods.

One way that service CCAs might differ from development CCAs is that value might, in certain limited instances be an appropriate method for dividing the RAB for services. That is, in a development CCA, a participant would not give up a right to the entrepreneurial return for a modest reduction in the cost of developing that intangible. Rather than doing that, the participant would develop the intangible itself. On the other hand, in a services CCAs, the participants might well consolidate services without regard to the entrepreneurial return because these agreements are not about entrepreneurial return, but rather about minimizing, routine variable costs. Paragraph 16 suggests that the number of employees may be an acceptable allocation key for allocating benefits among the CCA participants. USCIB disagrees with this assertion for intangible development CCAs. It should not be an acceptable allocation key for intangible development CCAs because the number of employees in different jurisdictions has no relevance to splitting the profits attributable to intangible development. This is another example of where a different rule would be appropriate for development and services CCAs.

In paragraphs 33 and 34, all references to royalties and R&D have been removed (from existing paragraphs 8.23 and 8.24 of the TPG). USCIB believes that these references were helpful and should be retained.

The discussion draft proposes to delete a paragraph (paragraph 8.17 of the existing TPG) that deals with subsidies and tax incentives. Deleting these references seems to imply that these should not be taken into account, which does not seem appropriate. USCIB recommends keeping these references in the guidance.

USCIB notes that there are no grandfathering provisions or transition rules for existing CCAs that qualify under the existing TPG. Should the OECD proceed with these proposals, USCIB believes that it is extremely important that there should be appropriate grandfathering and transition rules for existing CCAs. By analogy to the agreement reached on patent boxes, any transition period should be 5 years. As stated above, we are unaware of **any** existing CCAs that use value to account for contributions. Thus, all CCAs will need to be restructured either by eliminating the CCA or reconfiguring the CCA.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 450
Washington, DC 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org