
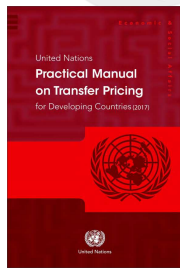
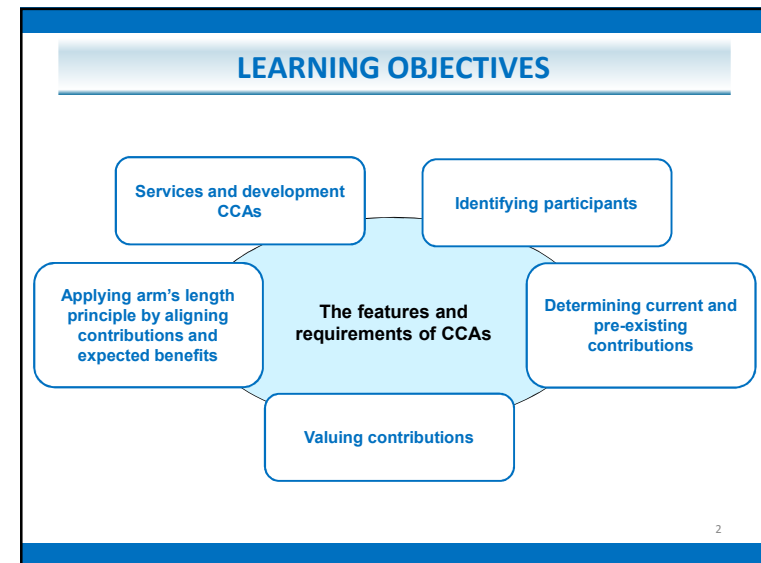

**UN-ATAF Workshop on Transfer Pricing
Administrative Aspects and Recent Developments**
 Ezulwini, Swaziland
 4-8 December 2017


**AFRICAN TAX
ADMINISTRATION FORUM**

**COST CONTRIBUTION
ARRANGEMENTS**

**Thursday, 7 December 2017
9.00am – 12.15pm**

DISTINCTIVENESS OF CCAs

The UN Manual (B.6) and the OECD Guidelines (Chapter VIII) each devote a separate section to CCAs.

Why?

CCAs involve parties transferring property or services, but are distinct from other transactions involving the transfer of property or services in that compensation for the transfer is not a fee but derives from each contributor's expectation of mutual and proportionate benefit.

Therefore, specific guidance is needed on how to determine whether a CCA involving associated enterprises is consistent with the arm's length principle.

Secondly, CCAs can be mis-used to attempt to make transfers cross-border at undervalue, and so guidance is needed on qualifying participants and other CCA requirements, on the valuation of contributions, and on documentation.

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DEFINITION OF CCA

an arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement sets out the responsibilities and risks of the participants and the nature and extent of the interest of each participant in the assets, services or rights resulting from the arrangement. (UN Manual page 636)

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 benefits for the individual businesses of each of the participants. (OECD Guidelines, page 25)

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IS THE FOLLOWING A CCA?

Scenario 1

Company A, part of Group XYZ, wishes to establish a new processing plant. Risks are minimised by adopting a design for the plant prepared by its parent company, and by using machinery specified and sourced by another group company. Company A expects to recover some of its investment by using around 40% of the new processing capacity to provide processing services to its affiliate, Company B.

Scenario 2

Company A and Company B, part of Group XYZ, agree to establish a new processing plant. Risks are minimised by adopting a design for the plant prepared by its parent company, and by using machinery specified and sourced by another group company. Company A expects to use 60% of the processing capacity, and Company B expects to use 40% of the processing capacity. Company A and B agree to contribute to the costs of the plant in the proportion 60:40 and to share interests in the plant in the same proportion.

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SCENARIOS 1 AND 2 INITIAL DISCUSSION POINTS

What are the key differences in commercial positions of Companies A and B between the two scenarios (consider risks, cashflow, interest in assets, transaction costs).

Which companies could participate in a CCA? Could any other companies participate, and under what conditions?

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IS THE FOLLOWING A CCA?

Scenario 3

Group XYZ has centralised accounting functions in three regional subsidiaries, Companies A, B, and C. Those Companies provide accounting services for Group affiliates in their region, and charge a fee to each affiliate based on the affiliate's share of total regional transaction volumes. The cost bases of Companies A, B, and C include regular reporting systems maintenance, fixes, and upgrades undertaken by each company individually.

Initial discussion points: Are there any CCAs here? Between Companies A, B, and C? Between Company A and its regional affiliates?

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IS THE FOLLOWING A CCA?

Scenario 4

The parent company of Group XYZ in Scenario 3 is concerned about the long-term robustness of its accounting systems. For historical reasons, Company C and the affiliates in its region use a different and older system to that used by Companies A and B and the affiliates in their regions, and maintenance costs for Company C are escalating. In addition, the process of consolidating data from Company C is cumbersome and expensive for the purposes of group reporting. Companies A and B use the same system and have used their experience over the years to tailor the system to meet the specific requirements of their affiliates. However, until now Companies A and B have not co-ordinated such system changes.

Companies A, B, and C decide to work together to implement a new group-wide reporting system. The regions they serve represent 50% 30% and 20% respectively of total transaction volumes, and they agree to contribute to the costs of the new reporting system in those proportions.

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SCENARIO 4: INITIAL DISCUSSION POINTS

Do Companies A, B, and C participate in a CCA? Could any other company in the group also be considered a participator?

What issues might arise from the method of sharing costs?

What complexities would arise if, as an alternative, Companies A, B, and C decided to work separately on system upgrades without a CCA, and to buy services from each other?

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UNPACKING THE CCA DEFINITION

A CCA is

- a specific contractual arrangement
- for the development, production, or obtaining of intangibles, tangible assets, or services
- through contributions made by the participants in the contractual arrangement
- which may be in the form of cash, intangibles, tangible assets, or services
- such that the participants do not (except for balancing payments) receive direct compensation from one another in return for their contributions
- but instead are entitled to benefit through a specified interest in the expected intangibles developed, tangible assets produced, or services obtained
- and for which interest no further fee (royalty, rent, service fee) is required (even if legal ownership is held by just one enterprise).

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HOW DOES ARM'S LENGTH PRICING APPLY?

Where the participants are associated enterprises, arm's length pricing applies to ensure that each participant's stated share of expected benefits is aligned with each participant's share of contribution.

If a participant's share of overall contributions is inconsistent with the participant's share of the expected benefits, the contributions of at least one participant is excessive and correspondingly, the contributions of at least one other participant will be inadequate. (Manual B.6.6.2 and 8.34 of Guidelines)

If Participant A has a 60% share in the resulting services obtained under a CCA (and Participant B has a 40% share), but has contributed only \$25m (and Participant B has contributed \$75m), then the arm's length price requires an adjustment of \$35m to bring Participant A's contribution to \$60m (and reduce Participant B's contribution by \$35m to \$40m). This is achieved through a balancing payment.

Balancing payments increase the value of the contributions of the payor and decrease that of the payee. They may be made by participants, or may be required by tax authorities to remedy an identified imbalance between contributions and expected benefits.

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APPROACH TO ANALYSING CCAS

Calling an arrangement a CCA does not change the basic pre-requisite of any transfer pricing analysis to properly understand the actual commercial or financial relations between the parties, including the functions, assets, and risks.

Such analysis may indicate that the accurately delineated transaction differs from the written terms of the CCA—in which case "a tax authority may disregard some of the terms of the CCA consistent with the determination of the accurately delineated transaction" (Manual B.6.6.6).

In examining a CCA, attention should be paid to:

- Whether the stated participants qualify as participants
- The objective of the CCA
- Whether the extent of the contributions of the participants have been fully considered
- Whether the contributions have been appropriately valued
- And whether there is an imbalance between a participant's contributions to the CCA relative to the participant's share of expected benefits

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PARTICIPANTS IN A CCA

A participant in a CCA must be assigned a specific interest in the intangibles, tangible assets or services that are expected to result from the CCA activity, and must have a reasonable expectation of being able to benefit from that interest. (Manual B.6.3.1 and Guidelines 8.14)

However, there is no requirement that the expected benefits of the CCA are in fact realised.

CCA activities may be carried out by one or more participants, or by another enterprise (for example, work to develop IT systems to be used by the CCA participants), but that enterprise cannot be a CCA participant unless it can benefit from an interest in the resulting outcome of the CCA (for example, the new IT system).

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PARTICIPANTS IN A CCA: ACTIVITIES

Do participants have to perform *any* of the CCA activity themselves?

Not directly answered in Manual, but B.6.3.3 may suggest there is no requirement. OECD Guidelines discuss outsourcing, and make it clear that all the participants have to control risks they assume under the CCA, at least one of the participants should exercise control over the outsourced functions, and where the objective of the CCA is to develop an intangible, at least one of the participants to the CCA should also exercise control over the important development, enhancement, maintenance, protection and exploitation functions that are outsourced (Guidelines 8.17).

Where CCA activities are outsourced to an associated enterprise, arm's length compensation is appropriate for the services or other contributions being rendered to the CCA participants (B.6.3.3 and 8.18).

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PARTICIPANTS IN A CCA: TRIVIAL INTEREST

Do participants have to have roughly the same interest in the CCA?
Does it matter if a participant has a relatively trivial share?

Manual suggests that trivial benefits for a participant whose contributions are significant may encourage conclusion that the enterprise is not a participant in a CCA (B.6.6.6).

OECD Guidelines explain: "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 pool resources and share risks or whether the appearance of sharing in mutual benefits has been constructed to obtain more favourable tax results" (8.39).

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PARTICIPANTS IN A CCA: CASH ONLY

Does it matter if a participant contributes only cash, whereas other participants contribute intangibles, tangible assets, or services?

Consider the following scenario:

Scenario 5

Group XYZ develops seeds and crop protection technology. Group Company A has developed hybrid maize seeds for many years, owns certain plant rights, and has amassed significant data and expertise about creating drought resistant varieties in parts of Africa. Group Company B in South America has developed technology which can speed up the testing and production process for soya crops, potentially allowing new varieties to be introduced to the market in a much shorter time period.

Group Companies A and B agree to pool their resources to develop through their joint efforts drought resistant maize hybrids more quickly than competitors, and they join with Group Company C in a CCA. In that CCA, Companies A and B share rights to resulting hybrids in southern hemisphere markets, and Company C has rights in northern hemisphere markets. The participants estimate that this allocation of rights shares total expected benefits to A, B, and C in the proportion 22.5%, 22.5%, and 55% respectively. Company C contributes cash only; as a result it makes significant balancing payments to Companies A and B.

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PARTICIPANTS IN A CCA: CASH ONLY

The OECD guidance states: “The existence of significant balancing payments arising from a material difference between the parties’ proportionate shares of contributions and benefits may also give rise to questions about whether mutual benefits exist or whether the arrangements should be accurately delineated, taking into account all the economically relevant characteristics, as a funding transaction” (8.39).

What would we need to know about Company C to determine whether it is a CCA participant or a source of financing for the CCA participants A and B?

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OBJECTIVE OF THE CCA

The Manual and the Guidance find it helpful to make two broad distinctions between CCAs based on objectives of the CCA (B.6.2.5 and 8.10):

- Arrangements for obtaining services
- Arrangements for development, production, or obtaining of intangibles or tangible assets

The distinction can be useful in that generally services CCAs can be less risky and involve current contributions and immediate benefits, whereas development CCAs can involve significant risk, involve pre-existing contributions created some time in the past, and benefits that may be realised, if at all, many years into the future.

However, the analysis of a CCA should not be based on superficial distinctions: in some cases, a CCA for obtaining current services may also create or enhance an intangible which provides ongoing and uncertain benefits, and contributions to a services CCA may involve significant pre-existing contributions including intangibles.

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THE EXTENT OF CCA CONTRIBUTIONS

All contributions by participants to a CCA must be recognised (B.6.4.1).

Contributions may take many forms—cash, intangibles, tangible assets, services.

For services CCAs, contributions may consist primarily of services (B.6.4.2)

For development CCAs, contributions typically include the performance of development activities (e.g., research and development or marketing) and often include additional contributions such as other pre-existing intangibles that will contribute to the development of a CCA intangible. (B.6.4.2)

A participant may contribute use of (part of) business premises including tangible assets (B.6.4.8).

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WHAT CONTRIBUTIONS MAY BE MADE BY PARTICIPANTS IN SCENARIOS 4 & 5?

Scenario 4

The parent company of Group XYZ is concerned about the long-term robustness of its accounting systems. For historical reasons, Company C and the affiliates in its region use a different and older system to that used by Companies A and B and the affiliates in their regions, and maintenance costs for Company C are escalating. In addition, the process of consolidating data from Company C is cumbersome and expensive for the purposes of group reporting. Companies A and B use the same system and have used their experience over the years to tailor the system to meet the specific requirements of their affiliates. However, until now Companies A and B have not co-ordinated such system changes. Companies A, B, and C decide to work together to implement a new group-wide reporting system.

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VALUING THE CONTRIBUTIONS

Is *Cost Contribution* an incorrect description?

Revised drafting emphasises the value, not cost, of the contributions: "it is necessary to determine the value of each participant's contributions . . . taking into account the mutual sharing of risks" (B.6.4.1).

"Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises in comparable circumstances would have assigned to that contribution. That is, contributions must generally be assessed based on their value at the time they are contributed, bearing in mind the mutual sharing of risks, as well as the nature and extent of the associated expected benefits to participants in the CCA, in order to be consistent with the arm's length principle." (8.25)

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RELEVANCE OF "TAKING INTO ACCOUNT THE MUTUAL SHARING OF RISK"

Consider a development CCA in which Participant A contributes patented technology, and both Participant A and Participant B perform R&D activities, with the objective of creating an intangible.

The value of Participant A's technology, a pre-existing contribution, should be valued using the arm's length principle, and where appropriate using valuation techniques as outlined in B.5. The value will reflect the outcome of the risk Participant A incurred in developing or acquiring the technology.

The value of the R&D activity performed by both A and B is a current contribution, and should be based on the arm's length price for such functional activity in accordance with B.5.

The value of the R&D activity should not take into account the value of the resulting intangible that may be created. The value of the resulting intangible is reflected in (1) the value of the pre-existing technology and (2) the development risks shared by the participants.

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CAN COSTS BE USED INSTEAD OF VALUE?

Costs can be easier and more practical to use, particularly for current contributions, bearing in mind the objective is to determine relative value.

"In certain situations, current contributions may be valued at cost as a practical method of valuing the relative value of the current contributions, e.g. if the difference between value and costs is insignificant. However, if contributions involve a combination of tangible assets, intangibles and services measuring the current contributions at cost may be unreliable for valuing relative contributions and may result in non-arm's length results." (B.6.4.6)

However, if cost is used for pre-existing contributions, guidance recommends that "the value attributed to the pre-existing contributions should recover the opportunity cost of the *ex ante* commitment to contribute at cost resources to the CCA. For example, a contractual arrangement (i.e. the CCA) that commits an existing workforce to undertake work for the benefit of the CCA should reflect the opportunity cost of alternative R&D endeavours (e.g. the difference between the value of the next most valuable use of the research and development staff over anticipated research and development costs) if the research and development performed by the CCA is to be valued at cost. In making this determination it is important not to double count different contributions of value (e.g. the value of the work-force and the value of the intangible contributions)." (B.6.4.5)

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CONTRIBUTIONS AND GOVERNMENT SUBSIDIES

The Manual (B.6.4.9) notes alternative approaches when a participant benefits from government tax incentives or subsidies in respect of its activities (for example, for R&D activities).

Approach A is to value the participant's contribution and disregard the subsidy.

The alternative, Approach B, is to reduce the contribution by taking into account the subsidy.

What are the consequences of the different approaches?

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CONTRIBUTIONS AND GOVERNMENT SUBSIDIES

Consider a CCA where two participants are expected to share equally in the outcome and they both make equal contributions of R&D activities (valued at 100 each). One participant receives a government subsidy equal to 50% of its R&D costs.

Under Approach A there is no effect of the subsidy on the CCA, and the participant retains full benefit of the subsidy.

Under Approach B the total costs of the CCA activity are reduced, and both participants benefit. But in addition, although the total costs have reduced to 150, one participant now contributes 50, while the other contributes 100 as before. The participant benefiting from the subsidy may now have to pay a balancing payment of 25 to align contributions with benefits.

The conclusion in the Manual is vague.

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CHANGES IN CCAs

CCAs may envisage activity under the CCA for a period of several years.

During that time, changes may occur in the share of expected benefits, and in the participants

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CHANGES IN EXPECTED BENEFITS

The Manual sets out principles that expected benefits should be based on "objective projections" and a tax authority should not use hindsight in reviewing projections. In addition, the Manual states that CCAs should provide for adjustments to be made to contributions during the course of the CCA *on a prospective basis* to reflect changes in the ratio of the expected benefits of the participants. (B.6.5.3)

However, the Manual includes the following example of changes to shares in expected benefits.

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CHANGES IN EXPECTED BENEFITS

Example: Development of new technology

Assume that Company A and Company B enter into a CCA in Year 1 to develop new technology. At the inception of the CCA it is projected that the development process will take five years and that once the new technology is commercialised in Year 6 Company A will receive 75% of the benefits and Company B will receive 25% of the benefits. Total development costs are 100 each year.

In years 1, 2 and 3, Company A pays 75 in CCA related costs and Company B pays 25 in CCA related costs. At the end of Year 3, regulatory changes take place in the expected market for the new technology in Company A's territory. As a result of those changes, it is projected in year 4 and thereafter that Company A will derive 50% of the total benefits and Company B will also derive 50% of the projected benefits over the useful life of the technology being developed. As a result of the changes in total projected benefit shares, Company B should make balancing payments to Company A equal to 75 (the difference between 25% and 50% of the costs incurred in Years 1, 2 and 3). This balancing payment should be made in Year 4. Also in Year 4 and Year 5, based on the new benefit ratio calculation, Company A and Company B should each pay 50 of the current annual CCA related costs.

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CHANGES IN EXPECTED BENEFITS

Thus, at the end of the development period, both Company A and Company B would have paid 50% of the CCA development costs and each would anticipate receiving 50% of the benefits of exploiting the new technology, as follows:

| Year 1 | Year 2 | Year 3 | Balancing Payment Year 4 | Year 4 | Year 5 | Total |
|--------|--------|--------|--------------------------|--------|--------|-------|
| 75 | 75 | 75 | (75) | 50 | 50 | 250 |
| 25 | 25 | 25 | 75 | 50 | 50 | 250 |

Do you agree with this analysis? Is it possible to take a different view?

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CHANGES TO PARTICIPANTS IN A CCA

From time to time new participants may join the CCA, and participants may withdraw from the CCA.

When an associated enterprise joins a CCA, that CCA may already reflect contributions of pre-existing value made by other participants or the realised benefits of the CCA created by existing participants, including, for example, intangibles, other rights and work-in-progress.

As the new participant acquires an interest in such benefits, the arm's length principle requires the participant to make an arm's length payment for this transfer from the other participants that created the pre-existing value.

The sum payable for pre-existing benefits by a new participant on entering the CCA is called a "buy-in" payment. (B.6.7.2)

If the work of a pre-existing CCA has been fruitless and a change in approach is being considered, there may be no buy-in payment as the new participant is not acquiring an interest in tangible assets or intangibles, rights or work-in-progress.

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CHANGES TO PARTICIPANTS IN A CCA

The new participant may also be making a contribution to the CCA in the form of intangibles or other pre-existing tangible assets. The items being contributed would have to be valued under the arm's length principle and a balancing payment made to make up differences if the buy-in payment required is greater than the value of the items being contributed by the new participant. Alternatively, if the value of the intangibles exceeds the required buy-in amount, a balancing payment will be required from the existing participants to the new participant. This may involve a netting of the buy-in payment and the balancing adjustment. (B.6.7.3)

When a participant leaves a CCA a "buy-out" occurs in which the departing participant sells its interest in the tangible assets, intangibles and rights under the CCA to the remaining participants. The buy-out amount should be the arm's length value of the departing participant's interest in the CCA.

In some cases, the CCA's efforts may not have resulted in any realised benefits and consequently, the payment of consideration to the departing participant is unnecessary. (B.6.7.5)

Changes to the membership of a CCA will generally trigger a reassessment of the proportionate shares of participants' contributions and expected benefits.

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SUMMARY OF CCA REQUIREMENTS

- a) The participants would include only enterprises expected to derive mutual and proportionate benefits from the CCA activity itself (and not just from performing part or all of that activity).
- b) The arrangement would specify the nature and extent of each participant's interest in the results of the CCA activity, as well its expected respective share of benefits.
- c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the particular interest or rights in intangibles, tangible assets or services obtained through the CCA.
- d) The value of participants' contributions would be determined in accordance with the OECD Guidelines and, where necessary, balancing payments should be made to ensure the proportionate shares of contributions align with the proportionate shares of expected benefits from the arrangement.
- e) The arrangement may specify provision for balancing payments and/ or changes in the allocation of contributions prospectively after a reasonable period of time to reflect material changes in proportionate shares of expected benefits among the participants.
- f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.
(B.6.8.2 and 8.50)

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DOCUMENTATION

Documentation standards apply to CCAs, and in particular should include information on

- the participants;
- any other associated enterprises which will be involved;
- any other associated enterprises that may be expected to benefit from the CCA;
- the activities of the CCA;
- the duration of the CCA;
- the measurement of the participants' shares of expected benefits;
- the contributions of each participant;
- the consequences of a participant entering the CCA, leaving the CCA or of termination of the CCA; and
- balancing payments and adjustments to the terms of the CCA to reflect changes in economic circumstances of the participants.

In addition, the OECD Transfer Pricing Guidelines encourage participants to monitor the operation of a CCA and:

- record changes to the arrangement;
- compare projections on expected benefits with realised benefits; and
- record the annual expenditure of the participants to the CCA, the form of cash contribution and the valuation methods used, and the consistent application of accounting principles to the participants.

(B.6.8.3 and 8.52)

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CCAs: SUMMARY

CCAs are useful for businesses since they can replace a web of separate intra-group arm's length payments for services with streamlined net payments based on aggregated benefits and aggregated costs associated with the services.

Similarly, a CCA for sharing in intangibles development can eliminate the need for complicated cross-licensing payments and replace it with a more streamlined sharing of contributions and risks, effectively achieving joint ownership of the resulting intangible. (B.6.1.3)

However, CCAs carry their own requirements and complexities, and must be accurately delineated like any other controlled transaction, and analysis undertaken under the arm's length principle to ensure:

- Participants include only those expected to derive benefits
- Contributions are properly identified and valued
- And proportionate shares of contributions are aligned with proportionate shares of expected benefits, achieved by balancing payments as appropriate.

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