Report of EU Joint Transfer Pricing Forum on Cost Contribution Arrangements on Services Not Creating Intangible Property

The EU JTPF published the final version of its Report on Cost Contribution Arrangements on Services Not Creating Intangible Property on 7 June 2012. This article analyses that report and views it from a critical perspective.

1. Introduction

Cost contribution arrangements (CCAs) are framework agreements that are primarily concluded between associated companies for the sharing of costs and risks in relation to centralized activities. Sizable amounts of costs are reallocated under these agreements. If they are not accepted by the involved tax administrations, the financial impact for taxpayers can be significant. Since 1997, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) have included a separate chapter on CCAs. The topic has also been on the work programme of the EU Joint Transfer Pricing Forum (EU JTPF) for several years. Recently, this led to the publication by the EU JTPF of a report on CCAs on services not creating intangible property. This article analyses that report and views it from a critical perspective.

2. Background

On 7 June 2012, the EU JTPF published the final version of its Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (the Report).1 The conclusions from the Report received full support from the European Commission in its Communication on the Work of the EU JTPF in the period July 2010 to June 2012.2 This Communication was adopted by the Commission on 19 September 2012 and was subsequently welcomed by the European Council on 4 December 2012.3

The Report is part of the work of the EU JTPF on CCAs, a topic that was carried over from the previous work programme of the EU JTPF on to its 2011-2015 work programme. The Report is intended to supplement the guidance of the EU JTPF on low-value-adding intra-group services and to complete its work on intra-group services. In order not to interfere with the current OECD project on the transfer pricing aspects of intangibles, the scope of the Report was deliberately limited to those CCAs that do not create intangible property.

3. Legal Status of the Report

Binding European harmonization in respect of direct taxes is generally possible only through Council directives, which require unanimous consent of all Member States. For situations in which unanimity is not achieved but at least nine Member States do wish to proceed, the Treaty of Nice introduced the possibility of “enhanced cooperation”. This allows for enhanced integration in an area within EU structures without the involvement of all Member States. However, it is still a cumbersome and politically complicated process.

As an alternative the European Commission often takes the initiative itself to position harmonization measures as mere recommendations. That is also the case in respect of the proposals included in the Report, which the Commission invites Member States to implement quickly in their national legislation or administrative rules. Although such invitation might place some pressure on Member States to adopt the recommendations, it does not help the Report to exceed the status of “soft law”.

4. Contents of the Report

4.1. Distinction between intra-group services and cost contribution arrangements

After an introductory section, the Report begins by clarifying the difference between the definition of intra-group services on the one hand and CCAs on the other. The OECD Guidelines make the same distinction, addressing intra-group services in chapter VII and CCAs in chapter VIII. The Guidelines define a CCA as “a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or

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1. EU JTPF, Report on Cost Contribution Arrangements on Services Not Creating Intangible Property (IP), JTPF/008/final/2012 /EN (June 2012), EU Law IBFD. References to paragraphs in these footnotes are to paragraphs of this Report.

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4. Compare, for example, the recent initiative of 11 Member States to introduce a financial transaction tax by means of enhanced cooperation.
rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights. The Report duplicates the OECD definition and goes on to list the distinctive elements of CCAs as compared to intra-group services. Among other things, it is stipulated that CCAs are aimed at not only sharing costs, but also risks and benefits of the activities covered. Under a CCA, all participants also share in the costs of unsuccessfully or insufficiently provided services, whereas under intra-group services the service provider generally bears the risk of failed or over-expensive projects.

Furthermore, a CCA allocates costs based on the expected benefits of participants, while in case of intra-group services the allocation is determined by the extent to which service recipients request services to be rendered. As a result, a company cannot be a participant in a CCA if the only benefit it expects consists of receiving a payment for the CCA activities it performs. Instead, such company would be regarded as a provider of intra-group services which should probably add a profit markup to its service fee.

While the EU JTPF’s position on the requirement of an expected benefit for each participant is very clear, it is more ambiguous where it concerns the minimum level of influence on decision-making required per participant in respect of the services covered by a CCA. The contributions of participants can be either in cash or in kind, and it is therefore not necessary for them to actively participate in the actual performance of these services. On the other hand, there might be some level of influence on decision-making required. Nevertheless, the Report goes no further than to state that this level can vary depending on the type of CCA, the expertise of the participants and the amount of costs being allocated to the respective participants.

Initially it was considered to include that each participant must be involved in strategic decision-making, but not necessarily in the day-to-day decision-making. However, that wording was left out at the request of the Dutch representatives at the EU JTPF and private sector members, because it was not regarded as relevant in respect of the services covered by the Report. As a consequence, the minimum influence on decision-making depends on facts and circumstances, which must be assessed on a case-by-case basis. That leaves open the possibility that CCAs may exist under which certain participants have no such influence at all. In the author’s opinion, it would have added to the clarity of the Report if the EU JTPF had explicitly included that for CCAs not creating intangible property, active involvement is simply not a required condition.

4.2. Valuing contributions and expected benefits

As the EU JTPF operates within the framework of the OECD Guidelines, it makes sense that the Report requires the outcome of CCAs to be in line with the at arm’s length principle. This implies that third parties should – under similar circumstances – also have been prepared to enter into the CCA. As such, the value of each participant’s contribution should be consistent with its expected benefit.

4.2.1. Contributions

Contributions may be valued at market price or at cost. The OECD does not mandatorily prescribe either method. Instead, it recognizes that in this respect further guidance in addition to chapter VIII of the Transfer Pricing Guidelines might still be required. Limiting the Report to CCAs not creating intangible property offered the EU JTPF the opportunity to take an additional step and recommend that contributions generally be valued at cost. This is a practical approach, following the assumption that for the type of activities covered by these CCAs, there is in most cases only a small difference between the pricing at cost and at market value.

Of course, the next question concerns what costs should be taken into account. Since the Xilinx case, the relevance of this matter has been well recognized in the United States. The final cost-sharing regulations adopted by the US Internal Revenue Service in December 2011 include detailed wording on the topic. Unfortunately, the Report of the EU JTPF addresses it only in general terminology: “Contributions should include all relevant costs for the acquisition, maintenance or for securing the benefits derived from the arrangement.” This is stating the obvious. It would have been interesting to learn more about what costs the EU JTPF considers “relevant”.

4.2.2. Expected benefits

Expected benefits can consist of an increase in income, a saving in expenses, the possibility to maintain profit or the avoidance of losses. As already stated in the OECD Guidelines, a key element is that the participant should have been prepared to pay for the services or otherwise would have performed the services itself. For activities not creating intangible property, it is often possible to determine the benefit of individual participants by applying an appropriate allocation key to the group’s overall benefit. The earlier guidelines of the EU JTPF on low-value-adding intra-group services already provided allocation keys.
of common usage. All in all, the Report does not seem to add much to the existing guidance from other sources in respect of the benefit test. On the contrary, it could create some confusion by what appears to be a *circulus in pro-\emph{\textit{bando}}* where it is included in paragraph 30 that the allocation key chosen should reflect the expected benefit per participant, while paragraph 31 states that it should be able to derive the benefit per participant from applying an appropriate allocation key.

4.3. Buy-in and buy-out issues

If activities performed under a CCA lead to the creation of intangible property, such intangible property is commonly available to all participants free of any further charge. As a consequence, it makes sense that when a new participant joins the CCA, it must pay an arm’s length buy-in premium for existing intangible property. Similarly, a buy-out premium can become payable when a participant exits the CCA. By limiting the scope of the Report to CCAs on services not creating intangible property, the EU JTPF was able to minimize the section on participants joining and leaving a CCA. It does state that an adjustment of the proportionate share of costs to be borne by a participant might be required to ensure that the remaining arrangement is consistent with the arm’s length principle. However, the complicated issue of how buy-in and buy-out premiums are to be treated is avoided completely. When the OECD discussion on intangibles has further evolved, some additional guidance in this regard would still be useful. Until then, questions surrounding the appropriate valuation method of intangibles created under a CCA will remain unanswered and it will, for example also remain unclear when participants may deduct their share of an exit premium as cost in a single year and under what circumstances they should amortize such share over several years.

4.4. Documentation requirements

So far the work of the EU JTPF on transfer pricing documentation has not included specific guidance on CCAs. While the OECD Guidelines and the PATA Documentation Package did pay special attention to the subject, the EU JTPF’s Code of Conduct on EU Transfer Pricing Documentation, adopted by the European Council in 2006, did not specifically address it. The Report now fills in this lacuna. It provides a list of corroborative information on CCAs that a taxpayer should be able to make available to a tax auditor upon request. This covers information about the general set-up of the CCA, a list of its participants, the valuation of their expected benefits and the measurement of their contributions. Furthermore, the list includes documentation on the monitoring of the outcome of the CCA and the relationship with non-participants who might provide or receive CCA services.

Taxpayers seem to be afforded some flexibility when it concerns the format in which they may submit the information. The Report appears to equally value information from, for example, written agreements, a narrative and data from computer systems. However, all in all, the paragraphs on documentation requirements are not groundbreaking. Nevertheless, they do supplement the earlier work of the EU JTPF and the pragmatic approach in respect of formats might make some contribution to reducing the administrative burden on taxpayers – however modest that contribution may be.

4.5. Adjustments

According to the EU JTPF, tax administrations should not challenge the business choice of entering into a CCA or require an analysis from taxpayers defending such choice. At the same time, the terms and conditions of the CCA must be arm’s length, i.e. businesslike. Furthermore, the taxpayer must be able to explain the CCA within the overall context of its business in order to make understood the rationale for entering into it. If these requirements are not met, the outcome of the CCA is not consistent with the arm’s length principle and a tax administration may, under certain circumstances, make adjustments to a taxpayer’s taxable income.

If the actual benefits of participants differ from the expected benefits, the Report instructs tax auditors to first analyse the reasons for the difference before concluding whether the CCA can be regarded as arm’s length. To the extent that projections can be regarded as reasonable or the difference is not material, tax administrations should refrain from making adjustments. When testing the projections, a tax auditor should not make improper use of hindsight. Instead, the economic and commercial circumstances prevailing or reasonably foreseeable at the time of entering into the arrangement should be the primary focus. The question must be answered as to whether third parties under similar conditions would have also entered into the arrangement, would have negotiated the possibility to amend the agreement based on results or would not have signed it at all. Neither the Report itself nor the earlier guidance of the EU JTPF on low value-adding intra-group services clearly indicates how in respect of the pricing of these services the burden of proof is allocated between the taxpayer and the tax administration. This is left to the national law of the Member States. However, it is unlikely that the reallocation of costs for low value-adding services will be used for tax planning purposes. Therefore, provided of course that taxpayers meet their documentation requirements, it could, in the author’s opinion, have been considered by the EU JTPF to assign the burden of proof to the tax administrations.

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21. EU JTPF, supra n. 1, at para. 46.
23. EU JTPF, supra n. 1, at para. 25.
24. EU JTPF, supra n. 1, at para. 51.
25. EU JTPF, supra n. 1, at para. 16.
26. EU JTPF, supra n. 1, at para. 25.
27. EU JTPF, supra n. 1, at para. 17.
5. Relationship to the OECD’s Work on Intangibles

In light of the OECD’s current work on transfer pricing aspects of intangibles, it is understandable that the EU JTPF has limited the scope of the Report to CCAs on services not creating intangible property. As a consequence, one of the most complex aspects of CCAs, namely the possible entry and exit fees that are to be paid when a participant joins or leaves, did not have to be addressed in great detail. Instead, only general wording has been included on the valuation of work in progress as well as the rebalancing of cost shares in line with the arm’s length principle in case of changes in the group of participants. Although not having to tackle this issue might have accelerated the publication of the Report, it also undeniably limits its added value.

In the meantime, the outcome of the ongoing OECD discussions on intangibles is to be awaited. More than the current chapters VI and VIII of the OECD Guidelines, the discussion draft on the revision of chapter VI emphasizes that the entitlement to intangible-related returns should not be determined only by costs and risks borne, but also by functions performed.\(^{28}\) It also states explicitly that legal registrations and contractual arrangements are a starting point for determining such entitlement, but the actual conduct of taxpayers is regarded as being ultimately more important.\(^{29}\) These considerations could make it easier for tax administrations to step away from the legal reality laid down in a CCA and make transfer pricing adjustments as if some participants were nothing more than low-risk, low-value-adding service providers. Such a trend could potentially reduce the relevance of CCAs and make it questionable whether a separate chapter VIII on CCAs is still justified. It will be interesting to see in what direction these discussions further develop.

6. Conclusion

In the second to last paragraph of the Report, the EU JTPF concludes that: “Following the recommendations [included in the Report] would facilitate evaluation and acceptance that the [arm’s length principle] has been applied in the majority of the cases that fall within the scope of this report”\(^{30}\)

The European Commission is of the opinion that the Report addressed the key target of the EU JTPF of achieving a more uniform application of transfer pricing rules within the EU, while the European Council predicts that the Report will “contribute to reducing tax disputes related to intra-group services within the European Union and help improve the functioning of the internal market.”\(^{31}\) In this article, the conclusions of the EU JTPF as well as the positive reactions by the Commission and the Council were tested by considering to what extent the Report can actually be expected to help resolve CCA-related transfer pricing issues within the European Union.

In this context, it should first be recognized that with the Report the EU JTPF has attempted to make recommendations that contribute to a harmonization of the tax treatment of CCAs not creating intangible property within the European Union. Although the Report has the status of only “soft law”, this is of course a praiseworthy initiative.

Most notably, useful guidance is provided on who may participate in a CCA, how expected benefits and contributions per participant are to be valued and what documentation requirements taxpayers must live up to. Furthermore, the Report elaborates on the conditions under which tax administrations may adjust the outcome of a CCA.

Unfortunately, the overall level of detail of the Report is limited. The Report also fails to address the level of influence on decision-making required from participants and the identification of costs to be shared under a CCA. Furthermore, after limiting the scope to CCAs on services not creating intangible property, issues surrounding buy-in and buy-out premiums were not discussed. This means that at least three key elements of CCAs were bypassed. This will undeniably limit the contribution the Report can be expected to make to day-to-day fiscal practice. Tax issues in relation to CCAs manifest themselves at a highly detailed and specialized level. The Report in itself fails to reach this level, but, on the other hand, it would be unrealistic to expect that from a mere policy document.

\(^{28}\) OECD Ctr. for Tax Policy and Admin., Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions, (Discussion Draft) 6 June to 14 Sept. 2012, section B.

\(^{29}\) Id., para. 37.

\(^{30}\) EU JTPF, supra n. 1, at para. 55.

\(^{31}\) Council conclusions on the EU Joint Transfer Pricing Forum, supra n. 3.