Dennis Nijssen

Cost Contribution Arrangements in a Changing International Tax Environment

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Cost Contribution Arrangements in a Changing International Tax Environment

Why this book?

Technological advancement and globalization have dramatically impacted the business models of multinational enterprises (MNEs). They have opened new markets, enhanced international collaboration and increased the relevance of intangibles in value chains. All of this has undeniably contributed to more economic growth and global prosperity. It has, however, also substantially complicated the world of international tax law, posing complex challenges in day-to-day fiscal practice and causing public concern about aggressive tax planning and potential tax avoidance by MNEs.

Difficulties become especially apparent where companies belonging to the same multinational group collectively develop their most valuable (intangible) business assets or centralize the performance of critical group services. MNEs often structure such intragroup collaboration in legal agreements that foresee a joint ownership of results and that allocate the cost of the shared activities in proportion to each participant's anticipated benefits. These agreements are commonly referred to as cost contribution arrangements (CCAs) or cost sharing arrangements (CSAs). They are a pragmatic tool to allocate a significant part of the MNE's costs and income among the participating group companies. At the same time, and for the same reason, they are also frequently found to play a critical role in tax planning structures.

This study sets out to investigate why CCAs are accepted as a legitimate transfer pricing instrument, and it analyses the most relevant rules and regulations governing their tax and transfer pricing treatment. It further outlines how effective those rules are at facilitating bona fide CCAs as well as countering the use of CCAs for tax avoidance purposes.

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Preface

In my work as an in-house tax lawyer at a multinational company I have experienced at first hand how complex it can be to design, implement and maintain a system for allocating the costs and benefits associated with more or less centralized activities. Generally, the purpose of such exercise is to ensure tax deductibility in respect of costs and to avoid double taxation in respect of profits, while running a process that is practical enough to operate efficiently and transparent enough to explain to stakeholders. All of that not only requires a thorough understanding of the applicable tax rules and regulations, but also a deep insight in the business model of the company. To put it differently: it can offer a very interesting challenge!

Cost contribution arrangements (CCAs) are a specific type of agreements that is often used for purposes of the above. They have so far received relatively limited academic attention, despite their apparent importance to everyday fiscal practice. Over time that made me realize that they presented a great opportunity for a research project and I have not regretted selecting them as the topic for my PhD thesis ever since. This book is the result of that decision and my subsequent in-depth study into the tax treatment of CCAs. It examines how those arrangements relate to international transfer pricing standards, considers their position under changing international tax rules and regulations and ultimately draws conclusions about the future for CCAs in a world that is more and more critical about the tax strategies of multinational enterprises.

Materials have been included up to 1 May 2018.

This thesis was originally written and publicly defended under the title "An Analysis of Cost Contribution as a Legitimate Transfer Pricing Instrument and a Tax Avoidance Tool".

Chapter 1

Justification

1.1. Introduction

Over the last decades technological advancement and progressing globalization have (dramatically) changed the world economy. These developments have opened up many new markets and at the same time fundamentally changed the way in which multinational enterprises (MNEs) operate their businesses. Nowadays critical activities may take place online and MNEs might employ internationally organized, "*virtual*" teams of specialists, who can work together in digitalized environments from different locations across the world. There has also been a material impact on value chains, among others increasing the relevant importance of intangible assets like technology, know-how, brand names and trademarks.[1] Although these trends have clearly contributed to economic growth and global prosperity, they have also posed difficult to answer questions in the context of international tax law. It has become significantly more complex to determine how costs and business income are to be allocated among group companies. Meanwhile, MNE group companies will more often collaborate to jointly develop tangible or intangible assets or obtain services at their common expense and risk.

As a part of this collaboration more or less centralized departments perform activities for the benefit of the group. Centres of expertise perform marketing and research and development (R&D) activities that result in the group's most valuable intangible assets, while shared service centres provide relevant support services in a wide range of areas, such as general management, accounting, legal, human resource (HR), information technology (IT), etc. For tax purposes it will have to be established where the related costs are deductible and, perhaps even more importantly, where the additionally generated profit is subject to taxation. Much depends on the business model operated by the MNEs involved. Where the development of intangible assets is concerned, a group company performing most of the centralized marketing or R&D activities may, for example, come to own

1. The value chain is a set of activities that a company performs in order to deliver a valuable product or service for the market. The concept comes from business management and was first described by Michael Porter in 1985. *See* M.E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, Free Press, 1985.

those assets. It can then license them out to affiliates that use them in the course of their business in return for an appropriate royalty. When support services are provided, the group company providing these services could charge a business-like service fee to the benefiting group companies.

These scenarios imply a solution based on the recognition of segregated transactions covering individual activities. Alternatively, MNEs could choose a more holistic approach. Under certain conditions they could set up a framework agreement for any combination of joint activities that provides for an allocation of costs and risks among group companies proportionate to their relative share in anticipated benefits. Such framework agreements are referred to as cost contribution arrangements (CCAs) or, in the United States, as cost sharing agreements (CSAs), and they are the subject of this study.

1.2. Definition of a CCA

The OECD's Transfer Pricing Guidelines define a CCA as follows:

> A CCA is 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.[2]

The Transfer Pricing Guidelines then add to this:

> In accordance with the arm's length principle, at the time of entering into a CCA, each participant's proportionate share of the overall contributions to a CCA must be consistent with its proportionate share of the overall expected benefits to be received under the arrangement.[3]

The United Nations' Transfer Pricing Manual on the other hand defines a CCA as:

> [A]n arrangement between enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The arrangement set out

2. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017) para. 8.3, Primary Sources IBFD [hereinafter *OECD Guidelines*].
3. Id., para. 8.5.

> the responsibilities and risks of the participants and the nature and extent of the interest of each participant's assets, services or rights resulting from the arrangement.[4]

In my own words, a CCA is an arrangement under which the participating companies, generally members of the same multinational group, agree to jointly perform certain predefined activities aimed at collectively obtaining assets or services. The arrangement structures the collective ownership of the results of those activities and thus allows for the individual exploitation of those results by participants. It allocates the costs and risks associated with the activities performed among participants in proportion to their expected benefits from such exploitation.

A CCA can be open ended, if cost shared activities are performed continuously, or it can have a fixed term, if the activities are performed on a project basis. However, it generally does not involve an individually defined and ring-fenced request by a principal to a service provider. As a consequence, the associated costs and risks can theoretically be regarded the own costs of the CCA participants. Similarly, the results will be their collective effective ownership right from the very moment that they come to exist. That implies that participants have unrestricted access to any intangibles that might be developed under the CCA and they can exploit them without having to make any further compensation payments to other co-developers. In a US context, Shea and Lewis have worded this fundamental aspect of a CCA as follows:

> The principle US tax feature of such an arrangement is that, once the property is developed, its subsequent use by participating group members without charge will not result in reallocations of income....[5]

This unrestricted, unburdened access to cost shared results guarantees a free flow of knowledge and expertise throughout the group and therefore allows for a legal structuring of activities that is well aligned with how many MNEs prefer to organize their operations. At the same time, it can also reduce administrative complexity. These and other legitimate, non-fiscal benefits from operating a CCA are further discussed in Chapter 2, section 2.3.1.

4. UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2017), p. 636.
5. R.C. Shea & P.G. Lewis, *Section 482 Cost-Sharing Arrangements: An Agenda for Regulatory Guidance,* The Tax Executive, summer 1987, pp. 357-363.

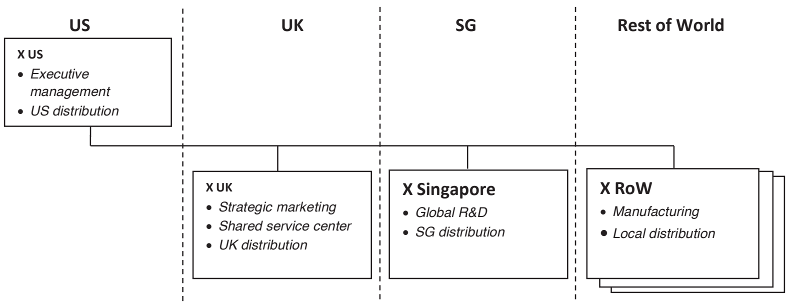
1.3. Example

The difference between an exchange of services, licensing arrangement and a CCA can be illustrated by the following example.

Example

The fictitious company X Electronics (“X”) is a multinational group that manufactures and sells consumer electronics. Its parent company is located in the United States (X US). The group has further established a number of manufacturing plants at logistically strategic locations and has local distribution subsidiaries in every country where it sells its products. Manufacturing and sales are considered the group’s primary business activities. Next to that X US takes care of the group’s executive management. The group’s global R&D centre is located in Singapore (X Singapore), while X UK coordinates the group’s strategic marketing activities and operates a shared service centre (SSC) that renders financial, legal and administrative support services to the other group companies. This results in the group’s organizational chart included as Figure 1.1.

Figure 1.1. X Electronics business model



Each of the group companies employs sufficiently qualified personnel to service its own national market and to independently manage its own operations. Manufacturers contribute to the group’s joint R&D effort, for example by sharing experiences with the implementation of new technology or by providing data on process efficiencies. In a comparable way the distributors facilitate the group’s joint marketing effort, for example by performing market analysis and testing the effect of global marketing strategies.

Under a first possible business model X Electronics would fully segregate all individual intercompany transactions. In this scenario X Singapore and X UK could be appointed principal companies for R&D and strategic marketing respectively. They could coordinate the associated activities and would have to appropriately compensate the other group companies for their contribution to the development and maintenance of intangible assets. In return they would become the full effective owners of the R&D and marketing intangibles. X Singapore could then provide a royalty-bearing licence in respect of R&D intangibles to the group's manufacturers, while X UK could provide a royalty-bearing licence in respect of the marketing intangibles to the group's distributors. Furthermore, X US and X UK would enter into separate service level agreements with all group companies and charge them a business-like service fee taking into account their benefit from executive management and support services.

As an alternative the group could opt to structure the global R&D, strategic marketing, executive management and support services in a CCA. In that case, all the group companies performing primary business activities would participate in a single, multilateral framework agreement, thus limiting the number of intragroup contracts. They would become the collective owners of the R&D and marketing intangibles developed as well as the services rendered. As a consequence, the group companies would have unrestricted access to those assets and services and could freely exploit them in the course of their own business. They would be allocated a proportionate part of the costs and risks associated with all joint activities in proportion to their expected benefits. This could be settled through so-called balancing payments under a netting system that credits or debits group companies for the difference between costs incurred and the costs allocated, thus minimizing the number and size of intragroup payments.

It is important to note that in both scenarios the intercompany transactions will determine to a large extent how the group's overall taxable profit is divided up among the different group companies. At the same time the qualification of those intercompany transactions for purposes of international tax law will determine in which country or countries the group companies have to pay tax on their part of the profit. Specifically, the allocation of ownership of R&D and marketing intangibles can have a material impact on the group's overall tax burden. If these intangibles are developed and owned by X Singapore and X UK, a substantial part of the group's profit will be transferred to those companies through royalty payments. If on the other hand the intangibles are jointly developed and co-owned under a CCA, the profit allocation will depend on the terms and conditions of that arrangement.

1.4. Relevance of research

1.4.1. Cost deductibility and effective ownership of intangible assets

International cooperation between group companies offers synergy benefits and economies of scale. However, it also results in a fiscal challenge, when it comes to appropriately allocating to those group companies the costs associated with the jointly performed activities. Benshalom worded this as follows:

> As business structures, MNEs flourish in those industries where the ability to operate an integrated business in numerous jurisdictions enables them to internalize efficiently a diversity of the group's (collective) costs – such as

> transaction costs, research and development costs, information obtaining costs and management costs. Hence, tax authorities find it difficult to directly assign MNEs' collective costs and profits to any specific corporate entity operating in a certain jurisdiction. This difficulty is particularly high with regard to horizontally integrated MNEs in which entities operating in different jurisdictions simultaneously utilize the same pool of resources to generate value.[6]

Tax authorities are not the only ones concerned. For MNEs themselves it is also crucial that they are able to share costs in a consistent and defensible manner. If cost reallocations are not accepted and the costs are not tax deductible, that obviously affects their net results significantly. On the other hand, a cumbersome administrative system of internal cost reallocation is inefficient and too expensive and would hurt their competitive position. Hoping to strike the right balance between these two considerations the MNE might opt for a CCA. This can have fiscal consequences beyond the allocation of costs, because it also outlines to what extent the participating group companies are entitled to the benefits from the joint activities. Quite relevantly the terms and conditions of the CCA will determine which group companies become the effective owner of centrally developed tangible and intangible assets. Specifically, ownership of intangibles is becoming ever more important, as research has shown that in the modern economy the relative contribution of intangibles to business profits has increased strongly. Shapiro and Pham for example have compared intangible intensive sectors to other industries looking at the value created per employee, the wages earned per employee and the development of the number of jobs. The results led them to conclude that "IP-intensive areas of manufacturing produce relatively much larger benefits, with the most IP-intensive industry, pharmaceuticals and biopharmaceuticals, generating the greatest such benefits".[7]

The trend is further confirmed by the results from an annual study performed by investment banking firm Ocean Tomo, which considers the market value of S&P 500 companies in comparison to the book value of their tangible assets while attributing the remainder to intangibles. Where intangibles represented approximately 17% of the market value of the considered companies in 1975, they accounted for approximately 84% of that value in

6. I. Benshalom, *Sourcing the "*Unsourcable*": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 Virginia Tax Review 3 (2007), Northwestern Public Law Research Paper No. 08-07, available at SSRN: https://ssrn.com/abstract=1115840 (accessed 1 May 2018).
7. R.J. Shapiro & N.D. Pham, *Economic Effects of Intellectual Property-Intensive Manufacturing in the United States*, July 2007, available at https://www.sonecon.com/docs/studies/0807_thevalueofip.pdf (accessed 1 May 2018).

2015.[8] Accepting the increased importance of intangibles for the value chain of multinationals implies that their effective ownership becomes a critical element determining in which jurisdiction a major part of the business profits is taxable.[9] This makes a good understanding of the fiscal merits of the arrangements under which they are developed of crucial importance. Those arrangements could very well be CCAs.

1.4.2. Base erosion and profit shifting

Further need for research into the tax aspects of CCAs is triggered by the recent concerns about their use in tax avoidance structures. Over the last years there has been much to do about the tax strategies of MNEs. The key concern is that the international orientation of MNEs places them in a position to minimize their tax charge at the expense of governments as well as the taxpaying man in the street. Stakeholders in this debate include politicians, non-governmental organizations, lobby groups, action committees, tax administrations, other taxpayers and, of course, MNEs themselves. More and more it has become clear to all of them that inadequate tax and transfer pricing rules are a substantial part of the problem. Tax professionals understand that the pricing of intercompany transactions is an abstract exercise rather than an exact science and that tax administrations will always be faced with a natural information disadvantage. Nevertheless, in the mainstream media as well as the political arena the understanding of the topic is limited. As a consequence, among journalists and politicians many oversimplified and populist arguments have been made, without the real bottlenecks being identified or practical measures being proposed. Over time, however, more serious international policymakers have also acknowledged the problem. This has led to various international initiatives at different levels. The European Commission issued an "*Action plan to strengthen the fight against tax fraud and tax evasion*"[10] and a "*Recommendation regarding measures intended to encourage Third Countries to apply minimum*

8. Ocean Tomo, *Annual Study on Intangible Assets Market Value 2015*, 4 March 2015, available at http://www.oceantomo.com/2015/03/04/2015-intangible-as-set-market-value-study/ (accessed 1 May 2018).
9. For a comprehensive analysis of the distribution of operating profits from IP value chains under US and OECD transfer pricing rules *see also* O. Torvik, *Transfer Pricing and Intangibles – US and OECD Arm's Length Distribution of Operating Profits from IP Value Chains*, Books IBFD.
10. European Parliament, Report on the Fight against Tax Fraud, Tax Evasion and Tax Havens (2013/2060 INI), 21 May 2013, OJ C55/7.

standards of good governance in tax matters".[11] The Commission set up a "*Platform for Tax Good Governance*" to monitor the progress made by Member States in this context, while the European Parliament issued a "*Report on the Fight against Tax Fraud, Tax Evasion and Tax Havens"* calling on Member States to half the uncollected tax gap calculated at EUR 1 trillion by 2020.[12] Furthermore, on 20 June 2016, the EU's Economic and Financial Affairs Council adopted an anti-tax avoidance package, the core of which consists of a directive requiring EU Member States to implement a wide range of anti-avoidance measures in their national law systems.[13]

The European Union's actions build on the measures agreed by OECD member countries and a number of other countries in the fall of 2015 under the so-called BEPS Project. This project was initiated 3 years earlier by the G20 Ministers of Finance at a 2012 meeting in Mexico with the intention to strengthen the international standards for corporate tax regimes. In early 2013 the OECD's first publication under the project was a Base Analysis Report on base erosion and profit shifting, which from that point on was also referred to as "BEPS".[14] This Report identified the key principles underlying taxation of cross-border activities that offer tax avoidance opportunities and recognized that under certain circumstances CCAs can be part of the problem. The most aggressive taxpayers might use a CCA to allocate the effective ownership of newly developed intangibles to so-called cash box entities located in tax havens. These entities pay part of development costs, but do not themselves perform any development activities nor house any expertise that would be required to do so.[15] Four detailed examples of how CCAs may be applied in tax avoidance structures are considered in Chapter 2, section 2.3.2. The OECD's Base Analysis Report continued to conclude that a comprehensive Action Plan was needed to provide countries with instruments aimed at better aligning taxing rights with real economic activity. This Action Plan was presented by the OECD 5 months later.[16] Among others it included an action to develop rules that better ensure

11. European Commission, Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, 6 December 2012, OJ 338/37.
12. European Parliament, *supra* n. 10.
13. European Council, Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, 12 July 2016, OJ L193/1.
14. OECD, *Addressing Base Erosion and Profit Shifting*, 12 February 2013.
15. Annex C to the OECD's Base Analysis Report includes two examples of tax planning structures involving the transfer of intangibles under a CCA.
16. OECD, *Action Plan on Base Erosion and Profit Shifting*, 19 July 2013.

that profits are taxed where value is created.[17] Following through on the different action points related to this topic the final reports published in September 2015 included an overall revision of the relevant parts of the Transfer Pricing Guidelines, including Chapter VI on intangibles and Chapter VIII on CCAs.[18] As will be discussed in Chapter 5, these revisions address the fundamental principles that determine the position of CCAs in everyday fiscal practice.

1.5. Purpose of research

1.5.1. Research objectives

Obviously, intangibles have specific characteristics that distinguish them from other business assets. They are relatively mobile and easy to reallocate. At the same time, they can be difficult to identify and value. Some MNEs consider these characteristics a tax planning opportunity and actively pursue attributing substantial profits to intangibles located in low-tax jurisdiction. Others will regard the complexity and the possible disagreements with tax authorities difficult to manage risk of double taxation.

This was confirmed when Walpole and Riedel in 2014 conducted 20 interviews with tax professionals at companies listed on the London Stock Exchange to gain insight into the extent to which tax is a motivator for MNEs to decide where to develop and ultimately locate valuable intangibles. They reported their findings in a working paper, in which they concluded that in some cases "multinational corporations deal with tax at the highest levels of management and tax transfer pricing involving IP is a 'main- stream' activity", while in other cases "the tax group is left to deal with the tax implications of commercial decisions that are taken by others".[19] In both instances MNEs might use a CCA for the development of intangibles, albeit with different intentions. In my opinion this divide should be taken into account, when rules determining the tax and transfer pricing treatment of CCAs are designed or applied in practice. While the BEPS initiatives have shown that there is a common consensus that tax avoidance

17. OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation*, 5 October 2015.
18. OECD, *supra* n. 16, Actions 8-10.
19. M. Walpole & N. Riedel, *The Role of Tax in Choice of Location of Intellectual Property*, 10 Nov. 2014, UNSW Business School, Research Paper No. 2014 TABL 1001, available at SSRN: https://ssrn.com/abstract=2522693 or http:// dx.doi.org/10.2139/ssrn.2522693 (accessed 1 May 2018).

has to be called to a halt, this should not be achieved at the expense of bona fide taxpayers. Taking that into consideration, the research objectives of this study are as follows:

(i) To examine the historical background and original purpose of CCAs and to establish how the conceptual thinking about these arrangements as a legitimate transfer pricing instrument and a tax avoidance tool evolved over the years.

(ii) To identify the legitimate business reasons for the use of CCAs, to determine the role of these arrangements in tax avoidance structures and to propose a categorization model that can facilitate a tax and transfer pricing analysis of their application in practice.

(iii) To analyse and compare the applicable transfer pricing rules and regulations governing CCAs as well as relevant case law, focusing primarily on the US Cost Sharing Regulations and OECD Transfer Pricing Guidelines.

(iv) To develop a step plan and a model legal contract facilitating the implementation of an arm's length CCA.

(v) To examine the position of CCAs under international tax law and to determine when this may result in a foreign tax liability of the CCA participants taking into account the qualification of the arrangement under tax treaties.

(vi) To consider how anti-abuse rules aimed at including income of controlled foreign corporations (CFCs) in the taxable base of their domestic parent (CFC rules) can be improved so that they more effectively counter the use of CCAs in tax avoidance structures.

(vii) To propose improvements to procedures for obtaining upfront certainty as well as for dispute resolution aimed at increasing their effectiveness in situations involving a CCA.

I will seek to answer these questions from an objective, legal dogmatic perspective. This should allow for a critical analysis from inside the juridical system itself, of those elements that have proven to cause uncertainty and disputes in everyday fiscal practice. Where appropriate, I will accompany my findings by concrete recommendations for improvement.

1.5.2. Limitations of scope

My research is intended as a contribution to the conceptual thinking, both in an academic setting and in everyday fiscal practice, about a very specific type of legal arrangement that is generally concluded by companies that are members of the same multinational group. It is not intended to provide an exhaustive analysis of each and every possible tax and transfer pricing aspect of CCAs. Instead, I have focused on the most common issues from a transfer pricing and international tax law perspective. There are three limitations of the overall scope that deserve explicit mention.

First, my research accepts and stays within the borders of the existing international framework of transfer pricing and international tax law. Such framework assumes that companies belonging to the same multinational group are to be taxed separately and that in determining their individual taxable income intercompany transactions among these companies should take place under arm's length terms and conditions, i.e. under terms and conditions that under similar circumstances would also have been agreed among unrelated parties. The background and merits of this so-called arm's length standard (ALS) as well as a substantiation of its status as a commonly accepted standard of international tax law will be further discussed in Chapter 3. Here, it should, however, already be mentioned that while this study in the context of the foregoing remark will include recommendations for improvement of the existing legal framework, it will not endeavour to propose radically innovative alternatives. As a consequence, I have, for example, not investigated the possibility to allocate income from intangible assets among group companies using a formula-based approach or the possibility to completely de-fiscalize such income.

Second, I will not discuss exhaustively the issues related to valuations of intangible property. Such valuations belong more to the area of expertise of economists than to that of lawyers. Nevertheless, they can be crucial to determining taxable income and, by consequence, they are the frequent subject of disputes between taxpayers and tax administrations. As such, also tax lawyers cannot disregard the complexities of these valuation exercises altogether. Therefore, I will discuss the most relevant guidance provided in the US Cost Sharing Regulations and OECD Transfer Pricing Guidelines and consider its reasonableness and effectiveness in the context of CCAs.

Third, I will not discuss indirect tax aspects in my thesis. The most obvious of these is of course the treatment of payments under a CCA for purposes of value added tax (VAT), or similar indirect taxation. Generally, these payments should be considered a consideration for a service and, hence, can be subject to such taxation. However, the next question is then what specific rules apply, among others in respect of the place of supply of this service. In a European context under strict conditions a specific so-called cost sharing exemption can apply if an entity that is a member of an independent group of persons renders to the other group members services that are directly necessary for carrying out an activity that is exempt from VAT or an activity in relation to which the group members are not taxable persons.[20] This exemption is particularly relevant for exempt companies, as they would not be able to claim a deduction for input VAT, if that would be imposed. The workings of the exemption are not undisputed and have recently been the subject of different cases brought before the European Court of Justice (ECJ).[21] In those cases the Advocate General and then the ECJ concluded that the exemption was to be applied only very restrictively. These decisions were received critically in fiscal literature.[22] However, it should be noted that the cost sharing exemption in the VAT Directive is intended to accommodate very specific persons (those belonging to a group engaging in exempt activities), while it pertains to arrangements that may be similar to the CCAs that are the topic of my research, but are not necessarily identical. For one, the cost sharing exemption in the VAT Directive also appears to apply to designated service providers that do not themselves expect a benefit from the services other than a consideration in cash, while under CCAs all participants are required to expect a benefit that they will individually exploit (*see* Chapter 5, section 5.3.1.). In other words, the cost sharing exemption in the VAT Directive targets a broader group of agreements, but a more specific group of taxpayers. With that acknowledged, indirect tax matters are left outside the scope of my research and will therefore not be further discussed hereafter.

20. EU Council Directive 2006/112/EC on the common system for value added tax, art. 132(1)(f).

21. LV: ECJ, 21 Sept. 2017, Case C-326/15, *'DNB Banka' AS v. Valsts ieņēmumu dienests*, Case Law IBFD and PL: ECJ, 21 Sept. 2017, Case C-605/15, *Minister Finansów v. Aviva Towarzystwo Ubezpieczeń na Życie S.A. w Warszawie*, Case Law IBFD.

22. R.A. Wolf, *The End of Cost Sharing as We Know It?*, 28 Intl. VAT Monitor 3 (2017), Journal Articles & Papers IBFD and C. Amand, *DNB Banka and Aviva: Has the ECJ Followed Its Own Interpretation Methods and Respected the Objectives Pursued by the EU Legislature?*, 28 Intl. VAT Monitor 6 (2017), Journal Articles & Papers IBFD.

1.6. Methods and materials

1.6.1. Methodology

Any properly designed investigation into the tax treatment of CCAs will be of a multidisciplinary nature. Especially in respect of the transfer pricing aspects the topic has to be addressed from both the legal and economic perspective to accurately determine its position under both substantive and formal tax law. First, an insight in the legal consequences of the arrangements will have to be obtained. Key questions in this respect are related to the legal allocation of costs, risks and ownership of proceeds associated with the joint activities performed under the arrangements. Subsequently, the economic impact of this allocation has to be established. Only after all relevant characteristics of the situation have been economically analysed and the relative value of contributions, risks and benefits for each of the participants is reasonably clear, will it be possible to conclude whether the CCA has an acceptable outcome from a transfer pricing perspective. Subsequently, the qualification under tax treaties and the treatment from an international tax law perspective have to be determined. And in parallel to all of this, it can be necessary to consider how procedural fiscal law divides the burden of proof between taxpayer and tax authorities and provides means to obtain advance certainty or settle disputes.

Notwithstanding the relevance of the economic analysis, this study primarily adopts the traditional legal dogmatic approach. Economic aspects are addressed always in the context of their impact on the legal system. It is recognized that CCAs are a specific type of arrangements with unique legal and fiscal consequences. The following chapters aim to provide a comprehensive overview and analysis of the most important rules and regulations governing these arrangements. It is investigated how these rules and regulations interact and construe a system that foresees in a consistent tax and transfer pricing treatment of CCAs. This study is performed from an internal legal perspective allowing for, firstly, a normative analysis of the present law system and, secondly, proposals for clarification and improvements thereof.

1.6.2. Sources of information

Over the years various international organizations have published guidance on transfer pricing and the tax treatment of CCAs. Most notably this includes the Organisation for Economic Co-operation and Development (OECD). Established in 1961, the Paris-based OECD today counts

34 Member countries, has a budget of approximately EUR 350 million and employs a secretariat staff of approximately 2,500. It aims to promote policies that improve the economic and social well-being of people around the world. Its Committee on Fiscal Affairs (CFA) provides a forum in which government representatives can work together, share experiences and seek solutions to common problems. In 1979 the Committee published a report entitled *Transfer Pricing and Multinational Enterprises*.[23] This included guidance on the appropriate tax treatment of CCAs. It was supplemented in 1984 by a second report entitled *Transfer Pricing and Multinational Enterprises – Three Taxation Issues*.[24] In 1995 the Committee revised its position by publication of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (hereafter also referred to as "the OECD Transfer Pricing Guidelines" and "the Transfer Pricing Guidelines").[25] These guidelines were later supplemented by separate chapters on intangible property, services, CCAs and the transfer pricing aspects of business restructurings as well as various annexes. The CFA renders a continuous effort to keep the guidelines up to date and improve them where possible.

Parallel to the OECD's efforts, the United Nations' Economic and Social Counsel since 1968 has had a group of tax experts working to enhance and promote international tax cooperation. This group focuses on developing countries and countries with economies in transition. In 2004, ECOSOC renamed the group Committee of Experts on International Cooperation in Tax Matters. The Committee's *Transfer Pricing Practical Manual for Developing Countries* intends to provide developing countries with clearer guidance on the interpretation and application of transfer pricing standards. It should assist both tax authorities and taxpayers, and also specifically addresses the topic of CCAs.

Meanwhile, the European Union has set up the EU Joint Transfer Pricing Forum (EUJTPF) to assist and advise the European Commission in respect of transfer pricing tax matters. It operates within the framework of the OECD's Transfer Pricing Guidelines and aims to propose to the Commission pragmatic, non-legislative solutions to transfer pricing issues. The EUJTPF consists of representatives from each EU Member State as well as experts from the private sector and an independent chairman. It was

23. OECD, *Transfer Pricing and Multinational Enterprises*, 1979.
24. OECD, *Transfer Pricing and Multinational Enterprises – Three Taxation Issues*, 1984.
25. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995).

set up and first met in 2002, although its position was only formally confirmed in 2006.[26] The EUJTPF has divided its work into activities related to the EU Arbitration Convention and activities related to other transfer pricing issues. So far, its efforts have among others resulted in a Code of Conduct on the Implementation of the Arbitration Convention,[27] a Code of Conduct on Transfer Pricing Documentation,[28] guidelines on APAs[29] and guidelines on low-value-adding intra-group services.[30] Furthermore, the 2011-2015 EUJTPF Work Program announced "an intention to explore the possible scope and degree to which a common approach to CCAs could be developed within the EU". In order not to duplicate or interfere with the ongoing OECD's work on the transfer pricing aspects of intangibles, the EUJTPF focused on services not creating intangibles. This resulted in the *Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP)* published on 7 June 2012. It was adopted by the European Commission in its communication of 19 September 2012.[31]

In addition to the European efforts, the tax authorities of the United States, Canada, Japan and Australia united in the Pacific Organization of Tax Administrators (PATA) published guidelines on bilateral APAs and mutual agreement procedures (MAPs). Furthermore, the PATA has provided standards under which taxpayers can create uniform transfer pricing documentation. Inter alia, the *PATA Documentation Package* includes detailed instructions on how to document a CCA.[32]

Next to the materials from the above-mentioned intergovernmental organizations, there are various other sources of information taken into account in this research. This includes the national tax law of many different countries,

26. European Commission, Decision setting up an expert group on transfer pricing, 22 December 2006, OJ L32/189.
27. Revised Code of Conduct for the effective implementation of the Arbitration Convention, 30 December 2009, OJ C322/1.
28. European Council, Resolution on a code of conduct on transfer pricing documentation for associated enterprises in the EU, 28 July 2006, OJC176/1 (EUTPD).
29. European Commission, Report on the work of the JTPF in the field of dispute avoidance and resolution procedures and on APAs in the EU, 26 February 2007, COM(2007)71.
30. European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals 1. Guidelines on low value adding intra-group services and 2. Potential approaches to non-EU triangular cases, 25 January 2011, COM(2011)16.
31. European Commission, Communication on the work of the EU Joint Transfer Pricing Forum in the period July 2010 to June 2012 and related proposals 1. Report on Small and Medium Enterprises and Transfer Pricing and 2. Report on Cost Contribution Arrangements on Services not creating Intangible Property (IP), 19 September 2012, COM(2012)516.
32. PATA Transfer Pricing Documentation Package, 12 March 2003, IR-2003-32.

regulations published by tax administrations, tax treaties, case law and a wide range of academic publications.[33] Most notably, quite detailed guidance is outlined in the Cost Sharing Regulations published by the US Treasury and IRS under section 482 of the Internal Revenue Code, which regulations were updated several times over the years. Furthermore, it also deserves to be explicitly mentioned that some interesting considerations can be found in Indian case law, which traditionally is very instructive and can provide for an interesting, alternative, non-Western view on tax matters.[34]

1.7. Contents

This study is made up of four parts:

– *Part 1 is an introduction on the topic of CCAs:* It is made up of two chapters. This Chapter 1 provides for a scientific justification for the research. It explains the purpose and methodology of the research and outlines its structure. Chapter 2 evidences the concept of a CCA as an established instrument for intra-group cooperation. Going back to the origin of this concept it can be determined with what purpose tax legislators first introduced these arrangements as a transfer pricing instrument for MNEs. Furthermore, this chapter aims to give a better insight in the application of CCAs in fiscal practice for both legitimate purposes and in tax avoidance structures. To facilitate distinguishing between both types of use, I will present a categorization method that helps to better understand the taxpayer's motives for concluding a CCA.

– *Part 2 examines the transfer pricing aspects of CCAs:* Consisting of five chapters this part focusses on the relevant OECD guidance and the applicable US rules, laid down in the OECD Transfer Pricing Guidelines and the US Cost Sharing Regulations. Before those are addressed, Chapter 3 provides some relevant general transfer pricing considerations. It discusses the legal status and further interpretation of the international standard for setting intercompany prices, the so-called arm's length standard (ALS), and considers some general aspects of its application in general as well as in situations involving CCAs specifically. Chapter 4 provides additional historical background on the US Cost Sharing Regulations and looks at the two most disputed cost sharing issues in the United States: buy-in payments and the sharing of

33. For a comprehensive list of all consulted publications, *see* the attached Bibliography.
34. A list of official publications and case law is also attached.

stock-based compensation expenses. Chapter 5 then discusses the guidance from Chapter VIII of the OECD Transfer Pricing Guidelines. The analysis is structured around five main focus areas to also give the reader a better insight in what a CCA is and how it works. Among others, the substance requirements imposed on participants will be addressed. Those requirements are decisive for the access of cash box entities to CCAs and therefore determine the effectiveness of use in tax avoidance structures. A second crucial aspect to be discussed is the valuation of contributions. Should they be valued at cost or at market price and, if the latter is true, then how should such market price be determined? Although an exhaustive analysis of valuation techniques is not intended, the most relevant valuation issues are addressed. This includes the valuation of contributions that consist of making pre-existing intangible assets available, contributions that consist of providing cost shared services or development activities and contributions that merely encompass the passive funding of cost shared activities. Next, Chapter 6 discusses the EUJTPF's fairly modest contribution to the debate consisting of its Report on services CCAs not resulting in the creation of intangible property. Finally, Chapter 7 completes the transfer pricing part of this study by outlining formal aspects. It features general remarks about the division of the burden of proof in transfer pricing matters and considers the documentation requirements imposed on taxpayers.

– *Part 3 analyses the treatment of CCAs under international tax law:* This part is made up of three chapters. First, Chapter 8 looks at the tax treaty qualification of CCAs and the situations in which a participation in a CCA can cause a foreign tax liability. For example, can it cause a participant to have a foreign PE or can balancing payments be subject to source state withholding tax? Chapter 9 subsequently discusses the potential role of CFC rules in the fight against tax avoidance structures, while Chapter 10 critically reviews the existing possibilities to obtain upfront certainty from tax administrations about the tax treatment of CCAs as well as the procedures for dispute resolution and suggests some improvements to those processes.

– *Part 4 summarizes conclusions and recommendations:* This part is comprised of only one chapter, Chapter 11, which reflects on the most relevant findings of the research. It features a comparison between the US Cost Sharing Regulations and the OECD Transfer Pricing Guidelines and then provides an example of a valid arm's length CCA contract as well as a step plan for its implementation. It also summarizes the recommendations for improvements to various rules of international law that are crucial to the tax treatment of CCAs and verifies their effectiveness.

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