A Comparative Study of Cost Contribution Arrangements: Is Active Involvement Required To Share in the Benefits of Jointly Developed Intangible Property?

Although there are transfer pricing guidelines and rules on cost contribution arrangements, views differ on the extent to which active involvement should be regarded as a prerequisite for the underlying cost contribution arrangement under the arm’s length principle. This article addresses the issue of active involvement and whether it should be a prerequisite for sharing in the benefits derived from joint intangible developments through a cost contribution arrangement or cost-sharing arrangement. The article explores how the arm’s length principle has been interpreted in the Dutch Decree on Cost Contribution Arrangements, and whether this interpretation differs from that of the OECD Transfer Pricing Guidelines, the relevant ATO Taxation Ruling and the IRS Final Regulations.

1. Overview

This article addresses the issue of whether “active involvement” by the group entities of a multinational enterprise is required for those groups to share in the benefits of jointly developed intangible property through a cost contribution arrangement (CCA) or a cost-sharing arrangement (CSA). This issue is addressed from the perspective of the Dutch tax authorities, the OECD, the Australian Taxation Office (ATO) and the Internal Revenue Service (IRS). The position taken by the Dutch tax authorities is compared with the positions taken by the above-mentioned bodies. Reference is made to the following documents:

– the Dutch Decree on CCAs, intra-group support services and contract research and development services, issued by the Deputy Minister of Finance on 21 August 2004, IFZ 2004/680M (Dutch Decree), and effective as from that date;

– the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) (OECD Guidelines);^2

– the ATO’s “Taxation Ruling, Income Tax: International Transfer Pricing – CCAs” (ATO Taxation Ruling) issued in 2004; and

– US Treasury Regulation section 1.482-7 (Methods to determine taxable income in connection with a CSA) IRS Final Regulation T.D. 9568, issued by the US Department of the Treasury (Treasury) and the IRS on 16 December 2011, and effective as from 22 December 2011 (IRS Final Regulations).

This article will explore whether the arm’s length principle as it relates to CCAs and CSAs has been interpreted differently in the Dutch Decree, the OECD Guidelines, the ATO Taxation Ruling and the IRS Final Regulations. It will look at whether the Dutch Decree’s interpretation of the requirement of active involvement departs from the OECD Guidelines and whether there are significant differences between the approach adopted in the Dutch Decree and that adopted in the ATO Taxation Ruling and IRS Final Regulations. The ongoing work of the EU Joint Transfer Pricing Forum (EU JTPF) on CCAs is also considered and referred to where necessary, in order to properly assess current developments on CCAs and CSAs.

The article will provide:

– background information on CCAs, CSAs and the arm’s length principle. This is followed by an explanation of active involvement;

– an overview of the major rules and guidance on CCAs or CSAs that are discussed in this article; and

– an in-depth comparative analysis of different rules and guidance on CCAs and CSAs.

1. Unless otherwise indicated, ‘active involvement’ refers to the functions performed by the group entities of a multinational enterprise in the context of a CCA or a CSA, in particular, the relatively important functions or the exercise of control over routine functions in the development of intangible property. The term ‘active involvement’ is used only in the context of intra-group transactions and does not cover third-party transactions, unless otherwise indicated. The terms ‘active involvement’ and ‘active participation’ are used interchangeably in this article, unless otherwise indicated. Reference documents listed above do not contain a precise definition of active involvement. The definition given above is an attempt by the author to create a definition on the basis of similar concepts used in the reference documents.

2. References are to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), International Organization’s Documentation, updated on 22 July 2010, unless otherwise indicated.
2. Introduction

2.1. Background

The concept of a CSA dates back to 1966, when the IRS and Treasury announced new regulations under section 482 which included extensive rules for CSAs. The concept of a CCA, on the other hand, is relatively new and first appeared in OECD guidance issued in 1997. The major difference between a CCA and a CSA is that a CSA may be entered into only with regard to joint intangible property development, whereas a CCA may be entered into for joint intangible property development as well as service arrangements that do not lead to intangible property. Generally speaking, CCAs and CSAs are primarily used by associated parties within a multinational enterprise to jointly develop intangibles and become economic owners of such intangibles. No royalties are paid when products are sold to customers, provided that the arrangement accords with the arm’s length principle.

The most common definition of a CCA is that given in the OECD Guidelines:

A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing, or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. A CSA is the OECD CCA equivalent of the IRS Final Regulations. The IRS Final Regulations define a CSA as follows:

A cost sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost-shared intangibles in proportion to their [reasonably anticipated benefit] shares.

CCAs and CSAs must comply with the arm’s length principle. The arm’s length principle is the internationally accepted standard for determining the transfer prices of transactions between affiliated parties. The arm’s length principle is defined in article 9 of the OECD Model Tax Convention on Income and on Capital (22 July 2010) (OECD Model).

2.2. Active involvement

For multinational enterprises, the creation and further development of intangible property can be a critical success factor in gaining a competitive edge in today’s increasingly global business environment. Intangible property can be developed either by one single controlling entity or through CCAs or CSAs where all participants share in the costs, risks and benefits of joint intangible property development.

Although there are transfer pricing guidelines and rules on CCAs and CSAs, views differ on the extent to which active involvement should be regarded as a prerequisite for the underlying CCA or CSA under the arm’s length principle. This article addresses the issue of active involvement and whether it should be a prerequisite for sharing in the benefits derived from joint intangible property development through a CCA or CSA. The article looks at how the arm’s length principle has been interpreted in the Dutch Decree and whether this interpretation differs from that of the OECD Guidelines, the ATO Taxation Ruling and the IRS Final Regulations.

3. An Overview of Major Rules and Guidance on CCAs and CSAs

3.1. The Dutch Decree

3.1.1. Introduction

The State Secretary of Finance issued the Dutch Decree on CCAs on 21 August 2004 (IFZ 2004/680M). The preamble states that tax audits of multinational enterprises have revealed that certain aspects of the transfer pricing policies within multinational enterprises are unclear and that the OECD Guidelines are interpreted differently by the tax authorities and multinational enterprises. As stated in the preamble, the main purpose of the Dutch Decree is to provide clarification on the OECD Guidelines and to facilitate a more flexible approach within the scope offered by these Guidelines. The Dutch Decree can therefore be regarded as providing further clarification of some aspects of the OECD Guidelines.

3.1.2. Overview of CCA rules

Section 4 of the Dutch Decree addresses CCAs. The preamble to section 4 begins by stating that the arm’s length principle as set out in the OECD Guidelines, in particular chapter VIII, should be used as a basis for CCAs. The Dutch Decree also states that under the arm’s length principle, fees paid for intercompany services are related to the functions performed (taking into account the risks assumed and the assets used). Therefore, fees paid to the CCA participants may not differ substantially from those paid to the entities concerned, or those that they would have received had they not worked together under a CCA.

The position of the Dutch tax authorities on the application of the arm’s length principle as stated in the Dutch Decree is as follows:

The [arm’s length principle] entails that each participant’s relative share in both the contributions to the CCA and the total expected benefits should be established based on the fair market value of these contributions and benefits. However, if reasonable proof is provided that the average relative added values of the individual performances of the various participants contribute to the CCA are roughly equal, then, according to the [arm’s length principle], the cost of the contributions may be used as a basis for determining whether each participant’s share in the total expected benefits is proportionate to their share in the contributions. 5

4. Para. 8.3 OECD Guidelines.
6. Preamble to section 4 of the Dutch Decree of 21 August 2004, IFZ 2004/680M. An unofficial translation of the Dutch Decree was used for the preparation of this article.
The Dutch Decree uses five examples (paragraphs 12-16) to explain how the CCA framework should be applied to joint R&D activities. This article will discuss in more detail the example provided in paragraph 15, which specifically addresses the requirement of active involvement in joint intangible property development through CCAs.

### 3.1.3. CCA rules regarding active involvement

From the perspective of the Dutch Decree, the requirement of active involvement in joint intangible property development through CCAs stems mainly from the example used in paragraph 15, the facts of which are as follows:

- **Group Company A** is engaged in R&D, manufacturing and the sale of products. Group Company B has two employees, both with an accounting and finance background;
- **Group Company A** performed the initial R&D for a new product. The market prospects for the product are good for continents A and B, but additional R&D needs to be performed before the product is ready for manufacture and sale; and
- the value of R&D results is expected to be the same for continents A and B.

In this example, group members A and B decide to enter into a CCA under the following terms and conditions as set out in Table 1.

<table>
<thead>
<tr>
<th>Measure</th>
<th>Group member A</th>
<th>Group member B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial contribution</td>
<td>Initial R&amp;D results</td>
<td>None</td>
</tr>
<tr>
<td>Costs of initial</td>
<td>EUR 5 million</td>
<td>None</td>
</tr>
<tr>
<td>contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value of initial</td>
<td>EUR 10 million</td>
<td>None</td>
</tr>
<tr>
<td>contribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active contribution</td>
<td>R&amp;D capacity and project management, including control and decision making</td>
<td>None</td>
</tr>
<tr>
<td>Cash contribution</td>
<td>50% of costs if they exceed estimated cost of EUR 5 million</td>
<td>EUR 5 million payment to A as a buy-in payment for A’s initial contribution and 50% of costs if they exceed estimated cost of EUR 5 million</td>
</tr>
</tbody>
</table>

Consequently, A and B intend to become the economic owners of the developed results in continents A and B, respectively, while A will become the sole legal owner of the developed results.

According to the Dutch Decree, A performs and independently manages all R&D activities, including the decision making on the type of research to be performed. Under the terms and conditions of the CCA, B will bear 50% of the risks and expenses related to these R&D activities. However, the Dutch Decree argues that because B does not have the required functional expertise to manage the risk it bears relating to the R&D activities and because A manages the entire risk, the entire risk should be allocated to A. The Dutch Decree suggests that A should be remunerated in line with the functions it performs and the risks it assumes, which is an essential requirement of the arm’s length principle in the context of transfer pricing. However, according to the Dutch Decree, the fee paid to A by B under the terms and conditions of the CCA remunerates A only for its initial R&D activities and not for its future R&D and management activities and the risks it will assume. Finally, the Dutch Decree concludes that the contractual terms between A and B are not in line with the arm’s length principle.

The Dutch tax authorities conclude from the above example that active involvement may provide an entitlement to the majority of the benefits derived from joint intangible property development through CCAs. Their conclusion is based on the arm’s length principle.

In summary, according to the Dutch tax authorities, funding or cash contributions are not, on a stand-alone basis, sufficient to claim the benefits of jointly developed intangible property through CCAs.

### 3.2. OECD Guidelines

#### 3.2.1. Introduction

Although this article refers to various chapters of the OECD Guidelines, the following chapters will be analysed in detail:

- chapter VI, including the Discussion Draft;
- chapter VIII; and
- chapter IX.

In addition, the ATO Taxation Ruling on CCAs will also be discussed.

#### 3.2.2. Overview of guidance on CCAs

##### 3.2.2.1. Introduction

The OECD published chapter VIII on CCAs in August 1997. Chapter VIII discusses CCAs between two or more associated enterprises (possibly along with independent enterprises). The purpose of chapter VIII is indicated in paragraph 8.1 of the OECD Guidelines as to provide some general guidance for determining whether the conditions stipulated by associated enterprises for a CCA are consistent with the arm’s length principle.

##### 3.2.2.2. Concept of a CCA

The OECD Guidelines contain a comprehensive definition of CCA that covers CCAs for services where there is

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7. Para. 15 Dutch Decree of 21 August 2004, IFZ 2004/680M.
8. On several occasions, chapter IX of the OECD Guidelines refers to chapter I. This article does not analyse chapter I in detail but, where necessary, reference will be made to chapter I.
no intention to develop intangible property and services for joint intangible property development. One noteworthy aspect of the definition is that it does not refer to functions performed by the participants of a CCA, but instead focuses on the costs borne and risks assumed.

The OECD Guidelines state that in a CCA each participant’s proportionate share of the overall contributions to the arrangement will be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement.\(^{11}\) The OECD Guidelines state that there is no single rule that could be universally applied to determine whether each participant’s proportionate share of the overall contributions to a CCA activity is consistent with the participant’s proportionate share of the overall benefits expected to be received under the arrangement.\(^{12}\) The OECD Guidelines further suggest that the goal should be to estimate the share of benefits expected to be obtained by each participant and to allocate contributions on the same basis.\(^{13}\)

3.2.2.3. Applying the arm’s length principle

The most important section of chapter VIII is that dealing with the application of the arm’s length principle to CCAs, as the arm’s length principle is decisive for allocating the benefits derived from joint intangible property development through a CCA. According to the OECD Guidelines, if a CCA is to satisfy the arm’s length principle, a participant’s contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances, given the benefits it reasonably expects to derive from the arrangement.\(^{14}\) The OECD Guidelines argue that independent enterprises enter into such cost- and risk-sharing arrangements when there is a common need from which they can all benefit.\(^{15}\)

To some extent, common sense would seem to dictate whether mutual benefits can be expected, and therefore they should not be difficult to identify. However, the application of the arm’s length principle to a CCA to determine each participant’s relative contribution and expected relative benefit is a complicated task. Paragraph 8.9 of the OECD Guidelines provides that each participant’s relative contribution to the joint activity could be in cash or in kind. In cases where all or part of the CCA activity, e.g. contract research and/or manufacturing, is outsourced to another company that is not a participant of the CCA, the OECD Guidelines provide that the separate company may be rewarded with an arm’s length cost-plus fee to compensate the company for the services it carries out for the CCA participants.\(^{16}\)

3.2.3. CCA guidance regarding active involvement

3.2.3.1. Chapter VIII: Cost contribution arrangements

Chapter VIII does not explicitly refer to active involvement being a prerequisite for an entitlement to returns from jointly developed intangible property. Paragraph 8.12 makes clear that functions performed, assets used and risks assumed should be considered when determining the arm’s length charge for the participants of a CCA. However, paragraph 8.9 provides for the possibility of contributing to the joint activity either in cash or in kind. As such, the OECD Guidelines seem to imply that active involvement in a CCA is not necessary.

Although paragraph 8.3 of the OECD Guidelines refers to the sharing of costs and risks, no further explanation is given. The reference to risks could be related to paragraph 1.49 of the OECD Guidelines, indicating that control over active involvement will also be required to share in the benefits of joint intangible property development. In the anticipated update of chapter VIII, the OECD should clarify what the relationship is between the risks mentioned in paragraph 8.3 and in paragraph 1.49.

3.2.3.2. Chapter IX: Transfer pricing aspects of business restructurings

Chapter IX of the July 2010 version of the OECD Guidelines introduced the concept of “control over risk”. Control over risk is first mentioned in paragraph 1.47 of chapter I of the OECD Guidelines, which states that the functions carried out will, to some extent, determine the allocation of risks between the parties, and therefore the conditions each party would expect in arm’s length transactions. According to the OECD Guidelines, a purported allocation of risk should be consistent with the economic substance of the transaction, and the parties’ conduct should generally be taken as providing the best substantiation for the true allocation of risk. In paragraph 1.49, the OECD argues that the economic substance of a purported risk allocation can be examined by comparing it with the consequences of such an allocation in arm’s length transactions. Paragraph 1.49 states that in arm’s length transactions, it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. Basically, this means that the risks assumed should follow the functions performed. It can therefore be concluded that if a party can sufficiently control high risks, it should be rewarded with relatively higher returns.

To better understand what the OECD Guidelines mean by control, paragraphs 9.23 and 9.24 need to be studied in more detail, as do the examples provided in paragraphs 9.25, 9.26 and 9.27. According to the OECD Guidelines, “control” as referred to in paragraph 1.49 should be understood “as the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider”.\(^{17}\) According to paragraph 9.24, day-to-

\(^{11}\) Para. 8.3 OECD Guidelines.
\(^{12}\) Para. 8.19 OECD Guidelines.
\(^{13}\) Id.
\(^{14}\) Para. 8.8 OECD Guidelines.
\(^{15}\) Id.
\(^{16}\) Para. 8.12 OECD Guidelines.
\(^{17}\) Para. 9.23 OECD Guidelines.
Chapter IX provides some practical guidance by putting the theory behind "control over risk" to the test. It does so by way of the three examples given in paragraphs 9.25, 9.26 and 9.27. It can be concluded from these examples that the concept of control over risk may have different implications for different activities or in different industries. For example, control is understood in its strictest sense in cases where R&D activities are being performed, e.g. R&D of pharmaceuticals or chemicals. Paragraph 9.26 of the OECD Guidelines states that day-to-day activities can be performed by a contract R&D company and a principal company can still control the risk over the R&D activities through a number of activities, e.g. the decision to hire, the decision on the type of research, assigning objectives, determining budget and assessing ongoing progress and outcomes.

On the other hand, in the investor-fund manager example used in paragraph 9.25, control seems to be understood in a broader sense. The investor is able to control the risk through three decisions: the decision to hire (or terminate the contract with) that particular fund manager; the decision on the extent of the authority it gives to the fund manager and the objectives it assigns to the latter; and the decision on the amount of investment the fund manager is responsible for. The activities to be performed by the investor in order to control the risks are relatively easier to achieve than in the case of contract R&D activities. This is partly a result of the level of knowledge required to be able to control these activities.

3.2.3.3. Chapter VI: Special considerations for intangible property and the Discussion Draft

Chapter VI makes almost no reference to the necessity for active involvement in order to claim economic ownership or to be entitled to jointly developed intangible property-related returns. The OECD Guidelines make a passing mention of active involvement and ownership issues in section D of chapter VI (marketing activities undertaken by enterprises not owning trademarks and trade names) in its discussion of trademarks and trade names. Paragraph 6.36 asks whether the party which performs marketing activities for the benefit of another party should be compensated as a service provider with a routine cost-plus return or whether the marketer should share in returns attributable to the marketing intangibles. The OECD Guidelines raise the right issue in this respect, but unfortunately do not provide a conclusive answer with respect to effective ownership of marketing intangibles.

The OECD released its Discussion Draft, which is not a consensus document, on 6 June 2012. It contains two main elements, namely (i) a proposed revision of the provisions of chapter VI and (ii) a proposed revision of the annex to chapter VI containing examples illustrating the application of the provisions of the revised text of chapter VI. The OECD’s Discussion Draft appears to be strongly in favour of active involvement when it comes to economic ownership of jointly developed intangible property or entitlement to IP-related returns. Paragraph 29 of the Discussion Draft argues that in determining which members of a multinational enterprise are entitled to intangible property-related returns, one of the factors that should be considered is whether the functions performed, the assets used, the risks assumed and the costs incurred by members of a multinational group in developing, enhancing, maintaining and protecting intangibles, are in alignment with the allocation of entitlement to intangible property-related returns in the relevant registrations and contracts. This reference to functions regarding intangible property related returns developed through CCAs is not found in chapter VI and chapter VIII of the OECD Guidelines.

The Discussion Draft states that in determining which members of a multinational group are entitled to intangible property-related returns, it is important to examine whether the conduct of the parties is in alignment with the legal registrations and contracts, or whether the parties’ conduct indicates that the legal forms and contractual terms have not been followed. The Discussion Draft also suggests that the following actions be taken when evaluating the alignment between the contractual terms and the conduct of the parties:

- the functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles should be reviewed;
- all or part of the intangible property-related returns should be allocated to the entities that perform the functions, bear the risks and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles, where the conduct of the parties is not aligned with the contractual terms; and
- the parties’ conduct should be regarded as providing the best substantiation for the true allocation of entitlement to intangible property-related returns.

Paragraph 54 of the Discussion Draft states that if a member of a multinational enterprise wishes to be entitled to intangible property-related returns, it should, in substance:

- perform and control important functions related to the development, enhancement, maintenance and protection of the intangible property and control

18. While it is outside the scope of this article to address active involvement in the context of article 7 of the OECD Model Convention on Income and on Capital (22 July 2010), Models IBFD, according to the OECD Ctr. for Tax Policy and Admin., 2010 Report on the Attribution of Profits to Permanent Establishments (OECD 2010), paragraph 75, International Organizations’ Documentation IBFD, day-to-day involvement or day-to-day active decision making may be necessary to take on the risks in cases where a permanent establishment is involved.

19. The OECD Guidelines categorize commercial intangibles into trade and marketing intangibles, and in paragraph 6.3 further define trade intangibles as commercial intangibles other than marketing intangibles that are often created through risky and costly R&D activities.


22. Id.
other related functions performed by other parties that are compensated on an arm’s length basis;

– bear and control the risks and costs related to developing and enhancing the intangible property; and

– bear and control risks and costs associated with maintaining and protecting its entitlement to intangible property-related returns.

The last sentence of paragraph 54 further emphasizes the importance of performing and controlling important functions and bearing and controlling risk. According to this sentence, if a party is allocated intangible property-related returns under contracts and registrations, but fails to perform and control important functions; fails to control other related functions performed by independent or associated enterprises; or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible property-related returns.

Finally, example 1 of the Discussion Draft sheds more light on the type of activities that do not result in an entitlement to intangible property-related returns if the intangibles are developed through R&D activities for transfer pricing purposes. In this example Premiere is the parent company of a multinational group and performs ongoing R&D functions. Company S is a wholly owned subsidiary of Premiere and employs three lawyers to perform its patent administration work. Company S does not conduct or control any of the R&D activities of the Premiere group and has no technical R&D personnel, nor does it incur any of the Premiere group’s R&D expenses.

On the basis of these facts, the Discussion Draft concludes in paragraph 183 that Company S is not entitled to intangible property-related returns, but should receive an arm’s length payment from Premiere for its services, e.g. patent administration, because:

– company S neither bears nor controls risks related to intangible property development or enhancement; and

– it does not perform or control any functions related to intangible property development or enhancement and does not bear any expenses related to the development or enhancement of intangible property.

As a result, Premiere is entitled to all intangible property-related returns attributable to patents developed through Premiere’s R&D work.

3.2.4. The ATO’s interpretation of chapter VIII of the OECD Guidelines

3.2.4.1. Introduction

In 2004, an ATO Taxation Ruling was issued to explain how the arm’s length principle applies to international dealings in relation to CCAs for income tax purposes. The ATO Taxation Ruling accepts and builds on chapter VIII in addressing how the ATO considers the OECD Guidelines apply in the context of the relevant provisions of Austra-

lian income tax law. Therefore, the ATO Taxation Ruling can be regarded as a detailed interpretation of the OECD Guidelines which aims at making CCAs more comprehensible as well as administrable by a multinational enterprise doing business in Australia.

After listing several key characteristics of CCAs on the basis of paragraphs 8.3 and 8.6 of the OECD Guidelines, the ATO Taxation Ruling concludes that a CCA can best be described as a form of joint venture. According to the ATO Taxation Ruling, a CCA could be considered arm’s length if the terms and conditions of the CCA are in line with what independent parties, dealing at arm’s length, might have entered into in comparable circumstances.

The ATO Taxation Ruling then suggests assessing the following matters, to the extent that each is relevant in a particular case, in determining the arm’s length nature of a CCA:

– arrangements should make business sense;

– terms should accord with economic substance;

– terms should be agreed upfront;

– participants should have a reasonable expectation of benefit;

– the sharing of contributions should be consistent with the sharing of expected benefits; and

– entry, withdrawal and termination should be on arm’s length terms.

3.2.4.2. CCA rules regarding active involvement

Of the six factors outlined above, the most relevant for purposes of active involvement are that terms should accord with economic substance and that the sharing of contributions should be consistent with the sharing of expected benefits. These are examined in more detail below.

Terms should accord with economic substance

According to the ATO Taxation Ruling, the terms and conditions of a CCA must accord with the actual conduct of business. If the terms agreed by the participants do not accord with the commercial reality of the arrangement, they may be disregarded.

Sharing of contributions should be consistent with sharing of expected benefits

In general, for a CCA to satisfy the arm’s length principle, each participant’s proportionate share of the overall contributions to the CCA should be consistent with the participant’s proportionate share of the overall expected benefits. Taking into account the fact that the ATO Taxation Ruling follows chapter VIII of the OECD Guidelines, it is not surprising that it states that participants may contribute either in cash or in kind. However, in cases of contributions in kind, the ATO Taxation Ruling requires that
all contributions be valued on a consistent basis so as to reflect their relative fair market value.

The ATO Taxation Ruling also refers to the concept of the “opportunity cost” and correctly argues that the opportunity cost of cash contributions might be different from the opportunity cost of contributions in kind. It ties this concept into the discussion of different levels of risk being inherent to different forms of contributions. This can be traced back to one of the basic principles of economics, i.e. risk and return trade off. Naturally, different levels of risk will automatically attract different levels of expected returns in an arm’s length situation.

The ATO Taxation Ruling emphasizes the importance of control over R&D activity or control over entrepreneurial risk in example 3 (paragraphs 198 and 199). According to this example AusCo and ForCo, two members of a multinational group, enter into a CCA to develop new technology under the following terms and conditions:

- ForCo will contribute existing technology and cash and make all major decisions regarding performance of the CCA activity, e.g. the scope of R&D activity, whether particular research should be pursued or abandoned and the resourcing and budgeting of the CCA;
- AusCo will contribute by performing R&D services; and
- each participant is given an interest in the results of the CCA activity, and AusCo’s interest is the right to exploit the results of the CCA activity in Australia, although there is little likelihood of a commercially viable market for use of the technology in Australia.

Paragraph 199 raises the question as to whether the economic substance is of a contract R&D arrangement rather than a CCA, having regard to the conduct of the parties and what independent parties would have agreed in similar circumstances. The first issue, albeit less relevant for this article, is that AusCo cannot be considered a CCA participant because it does not have a sufficient expectation of benefit, given that there is little likelihood of commercial success in Australia. A more relevant conclusion to be drawn from example 3 relates to the control over the R&D activity and entrepreneurial risk. Example 3 concludes that given the level of ForCo’s control over the R&D activity, AusCo as an independent party might not be expected to have assumed any of the entrepreneurial risk of that activity, as it has no control over that risk and it is not in a position to manage that risk. Finally, the ATO Taxation Ruling concludes that if the commercial reality is of a contract R&D arrangement and not a CCA, ForCo would be treated as the sole owner of the results of the R&D activity, with AusCo being regarded as performing the activity at the risk of and for the benefit of ForCo.

3.3. IRS Final Regulations

3.3.1. Introduction

Section 7 of the regulations under section 482 of the IRC deals with methods to determine taxable income in connection with a CSA. The Treasury and IRS issued the IRS Final Regulations on CSAs on 16 December 2011, and they took effect on 22 December 2011.

3.3.2. Overview of CSA rules

The IRS Final Regulations provide guidance on the determination of and compensation for all economic contributions by all controlled participants in connection with a CSA in accordance with the arm’s length standard. According to the IRS Final Regulations, an arrangement can be characterized as a CSA if, and only if:

- substantive requirements are met, namely:
  - participants must commit to and engage in cost-sharing transactions;
  - participants must commit to and engage in platform contributions transactions; and
  - each controlled participant must receive non-overlapping divisional interests;
- administrative requirements as provided by the IRS Final Regulations are met;
- the controlled participants enter into a platform contribution transaction as from the earliest date on or after the CSA is concluded; and
- divisional interests are properly allocated to the participants, which means that each controlled participant receives a non-overlapping interest in the cost-shared intangibles without further obligation to compensate another controlled participant for such interest. The IRS Final Regulations use two common criteria in dealing with divisional interests:
  - territorial-based divisional interests; and
  - field of use-based divisional interests.

Two elements that are usually included in a CSA are a buy-in payment and a follow-up cost-sharing mechanism either in the form of cash or active participation. The buy-in refers to a payment by a new participant that compensates the owner of pre-existing intangibles rights to share the initial results. The follow-up cost-sharing mechanism involves sharing the costs and risks of future development of intangibles either in cash or in kind. The preamble to the IRS Final Regulations identifies the two main types of economic contributions that can be made by the participants in a CSA:

- cost contributions: mutual commitments to prospectively share intangible development costs in proportion to their reasonably anticipated benefits from exploitation of the cost-shared intangibles; and
- platform contributions: mutual commitments to provide any existing resources, capabilities or rights that are reasonably anticipated to contribute to developing cost-shared intangibles.

The concepts of platform and operating contributions are intended to encompass any existing inputs that are reasonably anticipated to facilitate developing or exploiting cost-shared intangibles at any time, including resources.

29. I.R.S. Final Regulation T.D. 9568, Preamble, supra n. 5.
32. Sec. 1.482-7(c)(1), I.R.S. Final Regulation T.D. 9568.
capabilities or rights, such as expertise in decision making concerning research and product development, manufacturing or marketing intangibles or services, and management oversight and direction.\textsuperscript{33}

In order to interpret the IRS Final Regulations correctly, it is important to understand that the rationale behind them is the determination of an arm's length remuneration for all types of contributions listed above. Therefore, from a US perspective, a CSA would in general involve complex valuation studies that aim to objectively calculate the subjective values of different types of contributions.

The IRS Final Regulations discuss the income method which is crucial in equating or comparing cost-sharing and licensing alternatives. This method evaluates whether the amount charged in a platform contribution transaction is at arm's length by reference to a controlled participant's best realistic alternative to entering into a CSA.\textsuperscript{34} In general, for the payer in a platform contribution transaction, the best realistic alternative to entering into a CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA.\textsuperscript{35} The IRS Final Regulations explain that the licensing alternative is based on a functional and risk analysis of the cost sharing alternative, but involves shifting the risk of cost contributions to the licensor.\textsuperscript{36}

Another important aspect of the IRS Final Regulations is the investor model. The investor model assumes that each CSA participant makes an aggregate investment in the CSA and each participant's investment should allow that participant to earn a return in line with its risk profile over the life of an intangible development. Questions have been raised as to whether the use of the investor model is a departure from the arm's length principle, as neither markets nor investors operate in line with the investor model.\textsuperscript{37}

\subsection{3.3.3. CSA rules regarding active involvement}

The CSA definition contained in the IRS Final Regulations would appear to suggest that active involvement is not a prerequisite for sharing in the benefits of a joint intangible property development, as it refers only to the "sharing" of costs and risks. The preamble to the IRS Final Regulations states that the arm's length analysis under section 482 begins with the factual and functional analysis of the actual transaction or transactions among the controlled taxpayers. However, after defining all the types of contributions that can be made by a CSA participant, the preamble goes on to state that these regulations provide guidance for determining the arm's length charge for all such contributions so that it clearly reflects the incomes of the controlled entities, and does not require participants to be actively involved in a CSA to share in the benefits of joint intangible property development. It can be concluded from the preamble that an arm's length charge for platform contributions, in addition to the funding of intangible property development costs, would be sufficient for a party to be regarded as a participant of a CSA. In this respect, consider the example provided in the IRS Final Regulations where a CSA participant's platform contribution of a particular research team's experience and expertise to intangible property development would, under a CSA, require an arm's length charge in addition to the controlled participants' sharing of the ongoing intangible development costs of the salaries of such researchers.\textsuperscript{38} The IRS Final Regulations also provide another example whereby the contribution of core entrepreneurial functions such as product selection, market positioning, research strategy and risk determinations and management requires an arm's length charge under these regulations.\textsuperscript{39}

The main purpose of the IRS Final Regulations in the context of CSAs is ensuring a proper share of costs and risks associated with the CSA. The IRS Final Regulations provide that the arm's length analysis should start with a factual and functional analysis, but this should not be interpreted as active involvement being a requirement for qualifying as a participant of a CSA.

\subsection{3.4. EU JTPF work on CCAs}

CCA work currently being carried out by the EU Joint Transfer Pricing Forum (EU JTPF) is an ongoing development which may also provide further guidance on CCAs. The work of the EU JTPF relates only to CCAs not creating intangible property. As this article covers only CCAs that are entered into for joint intangible property development, the documents published by the EU JTPF are not analysed in detail here, nor has a comparative analysis been carried out of the Dutch Decree and the work performed by the EU JTPF. However, some ideas from the ongoing work are worth discussing in the context of this article.

\subsection{3.4.1. Introduction}

The EU JTPF is looking into whether a common approach to CCAs could be developed within the EU. In doing so, it does not intend to duplicate or interfere with the work carried out by the OECD in this area.\textsuperscript{40} The EU JTPF argues that its work should be seen as supplementing the existing guidance and completing its work on low value-adding intra-group services.

After a series of consultation meetings with members of the EU JTPF, several working documents and various contribution documents by Member States were published on the EU JTPF website. Following the meeting held on 7 June 2012, the EU JTPF published its latest draft report on CCAs not creating intangible property (JTPF Draft Report).

\textsuperscript{33} I.R.S. Final Regulation T.D. 9568. Preamble, supra n. 5. \textsuperscript{34} Sec. 1.482-7(g)(2)(A), I.R.S. Final Regulation T.D. \textsuperscript{35} Sec. 1.482-7(c)(1), I.R.S. Final Regulation T.D. 9568. \textsuperscript{36} Secs. 1.482-7(c)(1), 1.482(g)(4)(I)(C), I.R.S. Final Regulation T.D. 9568. \textsuperscript{37} Timothy A. Reichert and Deloris R. Wright, Proposed Cost Sharing Regulations: A Departure from Arm's Length?, 13 Intl. Transfer Pricing J. 1 (2006), Journals-IBFD. \textsuperscript{38} I.R.S. Final Regulation T.D. 9568. Preamble, supra n. 5. \textsuperscript{39} Id. \textsuperscript{40} Para. 5 JTPF/013/2007/EN.
3.4.2. Relevant aspects of active involvement

The EU JTPF has addressed the issue of active involvement several times in its publications. It was first mentioned during the meeting held in Brussels on 26 October 2011, when the EU JTPF noted that it is not necessary for every participant to contribute actively, as contributions may be in cash or in kind. At the same time, it also pointed out that consensus had been reached on the fact that the level of influence in decision making will vary depending on the type of CCA, the expertise and the amount of costs allocated to the respective participant. \(^{41}\)

It seems that the EU JTPF has implicitly taken the view that active involvement (e.g. decision making or control) is required if a CCA is entered into for the joint development of intangible property.

The Secretariat’s note of 8 March 2012 on the EU JTPF working document on CCAs not creating intangible property states that the Netherlands has concerns about a lack of active participation or strategic decision making in the context of CCAs. The EU JTPF attempts to address these concerns in paragraph 16 of the JTPF Draft Report by referring to paragraph 9.163 of the OECD Guidelines. In brief, the EU JTPF report states that multinational enterprises should take into account the respective implications (e.g. on bearing risks) of each of the available alternatives when deciding whether services performed within the group will be charged, directly or indirectly, by way of intra-group services (including cost pools) or whether a CCA is considered as being more appropriate. The above-mentioned comparison between intra-group services arrangements and CCAs could also be made between a licensing arrangement and a CCA in respect of the rights to use intangible property.

In the author’s opinion, the Dutch representatives at the EU JTPF are not convinced by this explanation, at least as it applies to CCAs for joint intangible property development, as they raise this issue again in later documents. In the three examples of service CCAs submitted by the Netherlands, the Netherlands argues that all participants would be entitled to benefits generated through a CCA, provided that the CCA activity does not result in the creation of intangible property. \(^{42}\) Furthermore, example 3 also concludes that the fact that no intangible property is created seems to indicate that the services provided are of relatively low value. The main reason for the Netherlands not creating an issue out of non-active involvement in cases of CCAs on services not creating intangible property may be explained by the fact that the value of contributions in kind for the provision of low value-adding services would not be much higher than the cost of performing those services.

4. Comparative Analysis of CCA Rules and Guidance

The Dutch Decree, the OECD Guidelines, the ATO Taxation Ruling and the IRS Final Regulations take different positions on the requirement of active involvement for sharing in the benefits derived by joint intangible property development through a CCA or a CSA. This section will consider:

- a comparison of the Dutch Decree and the OECD Guidelines;
- a comparison of the Dutch Decree and the ATO Taxation Ruling; and
- a comparison of the Dutch Decree and the IRS Final Regulations.

4.1. The Dutch Decree and the OECD Guidelines: A comparison

4.1.1. The Dutch Decree and chapter VIII: A comparison

Although the Dutch Decree follows chapter VIII of the OECD Guidelines, there are some fundamental differences between the two with respect to active involvement. The Dutch Decree is rather firm on the requirement of active involvement for entitlement to jointly developed intangible property-related returns through a CCA. This position is demonstrated by the example provided in paragraph 15 of the Dutch Decree. In this example, A performs R&D functions, including strategic decision making as to which research will be done, and also independently manages the R&D activity. B does not perform any R&D-related functions and also does not have the required functional expertise to manage the R&D risk. In order to make both parties equal partners under the CCA, the contractual terms arrange an equal sharing of costs and risks between A and B. The arm’s length principle requires both parties’ compensation to be in line with functions performed, risks assumed and assets employed. However, the contractual terms described in the example do not require an equal allocation in terms of functions, because A performs all the functions, while B only makes cash contributions. In this case, A is remunerated only for its development activities, but not for the control and management of the R&D activity and the risks that those activities entail. Therefore, from the perspective of the Dutch Decree, the contractual terms between A and B do not conform to the arm’s length principle. The Dutch Decree does not provide guidance on whether in such cases an arm’s length remuneration should be determined for the activities performed by A or whether the CCA should be completely disregarded.

According to the Dutch Decree, active involvement should not be understood as including the performance of day-to-day routine types of activities. In the author’s view, this relates to employing people who have the necessary authority and knowledge to perform important functions, e.g. strategic decision making, and are therefore able to control the day-to-day routine activities. It can be argued that expecting even this level and type of active involvement for an entitlement to intangible property-related returns is not in line with the reality of today’s economic environment.

On the other hand, chapter VIII of the OECD Guidelines leaves the question regarding active involvement open. As paragraph 8.9 of the OECD Guidelines provides for

\(^{41}\) Para. 4 JTPF/025/2011/EN

\(^{42}\) Section B. Examples of a service CCA submitted by the Netherlands, JTPF/006/BACK/2012/EN, at 6-7.
contributions in cash or in kind, it could be argued that chapter VIII is currently in conflict with the view adopted by the Dutch Decree. Chapter VIII does not make becoming a CCA participant conditional on active involvement. Furthermore, paragraph 8.12 provides that a separate company may perform all or part of the subject activity, e.g., contract R&D. According to the OECD Guidelines, in such cases, the contract R&D company should receive arm’s length compensation for the provision of contract R&D services for the benefit of CCA participants.

4.1.2. The Dutch Decree and chapter IX: A comparison

There has been a shift in the position taken by the OECD on active involvement, as evidenced by chapter IX. One of the most controversial issues during the drafting of chapter IX was the notion of control over risk. It was unclear what was meant by ‘control’, and many thought the concept too abstract. After lengthy discussion and several consultations at the OECD level, consensus was reached on the meaning of ‘control’. The OECD Guidelines state that control should be understood as the capacity to take decisions on risks (e.g. to decide to put the capital at risk) and on whether and how to manage the risk internally or use an external provider. The OECD Guidelines further provide that in order to be able to control the risk, one company would need to have real economic substance. The economic substance does not require the company to perform the day-to-day routine activities, but it needs to be in a position which allows it to assess the outcome of the day-to-day routine activities performed by a service provider. The OECD Guidelines further provide that the level of control needed and type of performance assessment would depend on the nature of the risk which is illustrated through three examples.

The example given in paragraph 9.26 of the OECD Guidelines fits into the context of CCAs discussed in this article. In this example, a principal hires a contract researcher to perform scientific investigation on its behalf. The arrangement between the parties is such that the principal bears the risk of failure of the research and will be the owner of the outcome of the research in case of success. The contract researcher is allocated a “guaranteed” remuneration, irrespective of whether the research is a success or a failure, and has no right to ownership of the outcome of the research. According to the example the following are required for the principal to be entitled to intangible property-related returns:

- the principal would be expected to make a number of relevant decisions in order to control its risk, e.g. the decision to hire (or terminate the contract with) that particular contract researcher, the decision on the type of research that should be carried out and objectives thereof, and the decision on the budget to be allocated to the contract researcher;
- the contract researcher would generally be required to report to the principal on a regular basis; and
- the principal would be expected to be able to assess the outcome of the research activities.

In the author’s view, this is in line with the position taken in the Dutch Decree on active involvement.

4.1.3. The Dutch Decree, chapter VI and the Discussion Draft: A comparison

The issues raised in chapter VI of the OECD Guidelines relate to the ownership of marketing intangibles developed as a result of marketing activities by enterprises not owning trademarks or trade names. Unfortunately, it does not provide clear guidance on how to deal with those issues. Moreover, there is no guidance with regard to active involvement in the development of trade intangible property.

The Discussion Draft, once finalized, will replace chapter VI. Although the current document is only an interim draft, it gives an idea of what the updated chapter VI might contain. Following completion of this project, it is expected that the OECD will also revise chapter VIII, in particular in respect of active involvement and the control of risks or functions relating to jointly developed intangible property under a CCA (see the foreword to the Discussion Draft, which states that there may be necessary modifications to chapter VIII as a result of the amendment of chapter VI).

In the author’s opinion, introducing the notion of control over risk in chapter IX made an update of chapter VIII inevitable. The OECD guidance provided in chapter IX on the notion of control has been extended to cover the analysis of which entity is entitled to intangible property-related returns in the Discussion Draft. The OECD seems to confirm its position on the control-over-risk concept and expands that to control over functions in the Discussion Draft. The author expects that chapter VIII will be updated by largely leveraging from the work performed during the drafting of chapter IX and the ongoing update of chapter VI.

The Discussion Draft regards contractual arrangements as the starting point for determining which members of a multinational enterprise are entitled to intangible property-related returns. The second step is the determination of functions, risks, assets and the cost aspects of the intangible property development. This would also help to verify whether the actual conduct of the business is in alignment with the terms of the contractual arrangements. The discussion of control over functions or risks in the Discussion Draft could be viewed as a further clarification of the premature notion of “control over risk” found in chapter IX. Like the Dutch Decree, the Discussion Draft also does not require one party to physically perform the day-to-day R&D-related activities in order to share in the jointly

43. Para. 9.23 OECD Guidelines.
44. Para. 9.24 OECD Guidelines.
45. Id.
46. It is noted in paragraph 9.26 that the contract researcher’s own operational risk (e.g. the risk of losing a client or of suffering a penalty in case of negligence) is distinct from the risk of failure borne by the principal.
47. OECD Ctr. for Tax Policy and Admin, supra n. 20, para. 30.
48. OECD Ctr. for Tax Policy and Admin, supra n. 20, para. 37.
developed intangible property-related benefits. The Discussion Draft follows a similar logic to the Dutch Decree and in paragraph 40 states that the functions that should be performed by the entities aiming to be entitled to intangible property-related returns (without performing day-to-day R&D activities) include design, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangible property and ongoing quality control over the functions performed.

The preamble to section B of the Discussion Draft (Identification of Parties Entitled to Intangibles Related Returns) states that Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used and risks assumed by the parties. The Discussion Draft goes on to state that the position taken by Working Party No. 6 suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within a multinational group to retain the benefits or returns with respect to intangibles. This view is reinforced in paragraph 47, where it is stated that bearing costs related to the development, enhancement, maintenance and protection of intangible property does not, in and of itself, create an entitlement to intangible property-related returns. This seems to eliminate the possibility of sharing in the benefits of intangible property development by funding only.

Example 1 in the Discussion Draft is similar to the example provided in paragraph 15 of the Dutch Decree. Both examples arrive at similar conclusions based on the fact that the company that would like to be entitled to intangible property-related returns does not have any personnel who can manage, supervise and control the R&D activities performed by the other entity and make strategic decisions.

The Discussion Draft also gives a series of examples, ranging in complexity, on the entitlement to returns derived from marketing intangibles. The most important criteria used in determining the owner of marketing intangibles are (i) the performance of important functions, (e.g. strategic decision making including sufficient control of functions) and (ii) incurring marketing expenditures. This can be briefly illustrated by the following example, which is similar to the examples provided in the Discussion Draft. Company A is a manufacturer in country A and markets its products under trademark A in country A and abroad. Company A decides to market its products under trademark B in country B. However, trademark A is new to country B. Company A establishes a subsidiary B in country B to market its products under trademark A. After a few years, trademark A becomes well known in country B as a result of marketing activities. In such case, the Discussion Draft concludes that:

- if company A is responsible for subsidiary B’s marketing strategy, continuously monitors subsidiary B’s marketing activities, provides ongoing strategic support and reimburses all of subsidiary B’s marketing expenses, subsidiary B will receive a cost-plus markup payment and will not be entitled to trademark-related returns; and
- if subsidiary B is required to develop its own marketing strategy to establish trademark A in country B and does not have its marketing expenses reimbursed, subsidiary B may be entitled to trademark-related returns in addition to its normal return.

One aspect that the Discussion Draft seems to overlook is whether the conditions stated above (i.e. (i) performing and controlling important functions and (ii) the direct or indirect reimbursement of marketing expenses) must both be met or whether meeting only one of them would be sufficient. In the author’s opinion, they are cumulative and therefore should both be met. Clarification on this point by the OECD would be useful.

4.2. The Dutch Decree and the ATO Taxation Ruling: A comparison

The ATO Taxation Ruling and the Dutch Decree were both introduced as a response to the lack of specific guidance on CCAs. Both the ATO Taxation Ruling and the Dutch Decree state that they adhere to the principles of the OECD Guidelines on CCAs, but their aim is to address how those principles should apply in the context of domestic income tax legislation.

At first glance, the Dutch Decree and the ATO Taxation Ruling seem to share similar views with respect to active involvement. However, a closer look shows some major differences. The Dutch Decree makes an entitlement to jointly developed intangible property-related returns under a CCA conditional on active involvement, whereas the position of the ATO Taxation Ruling is unclear. This is further explained below.

The ATO Taxation Ruling uses 17 examples to provide practical guidance with regard to different aspects of CCAs. The third example is similar to that provided in paragraph 15 of the Dutch Decree. In example 3 of the ATO Taxation Ruling, one entity contributes existing technology and cash to the CCA (ForCo), while the other entity performs the R&D activities knowing that there is little probability of success in its own market (AusCo). ForCo makes all the important decisions on the CCA. The example ends in the conclusion that because AusCo does not expect material benefit from the CCA, and because ForCo performs sufficient control over the R&D activity, the arrangement would be characterized as a contract R&D arrangement rather than a CCA. The fact that AusCo does not expect material benefit is an important factor in characterizing the arrangement as a contract R&D and not a CCA. However, for the purposes of this article, the most significant factor in this example is the fact that the ATO Taxation Ruling also refers to active involvement, i.e. control over R&D activity and entrepreneurial risk, in arriving at

49. A fundamental difference between the two examples is that in example 3 of the ATO Taxation Ruling one of the CCA participants, i.e. purported contract R&D entity, does not see a significant interest for itself in its market which may automatically result in disregarding that entity from being a CCA participant.
its conclusion. In the author’s opinion, the ATO Taxation Ruling should have provided more guidance on control over the R&D and its relevant implications, other than discussing the example in a somewhat less relevant context.

Overall, the ATO Taxation Ruling does not seem to make an issue of the question whether contributions to a CCA must be in cash or in kind, or whether active involvement is required by each CCA participant to be entitled to intangible property-related returns. The main objective of the ATO with regard to active involvement is apparent from example 7 of the ATO Taxation Ruling. In example 7, the ATO Taxation Ruling provides that if any CCA participant performs the R&D activity while others contribute only cash, the costs and risks of that R&D activity should be jointly shared among participants consistent with their share of the expected benefits from the activity. The author’s understanding is that the ATO, when considering a CCA, will generally take into account whether there is a proper share of costs and risks between the participants. It may be argued that the ATO is not consistent in its position on active involvement, because it uses the same argument in characterizing an arrangement as a contract R&D activity under example 3.

Having said this, the ATO Taxation Ruling makes a distinction between costs and risks inherent to contributions in cash and in kind. Costs are distinguished by reference to the opportunity cost. In cases where a participant contributes cash, the opportunity cost thereof would, in all likelihood, require refraining from lending the cash against an interest rate that would carry a default risk depending on the risk profile of the borrower, or investing the cash in an alternative investment which may carry a different type of risk. On the other hand, for the participant that contributes by actively performing the CCA activity, the opportunity cost would entail the relinquishing of profits that it could have derived from alternative uses of the contributed property or personnel, for expected benefits to be derived from successful completion of the CCA. In the author’s view, the ATO Taxation Ruling contends that, ceteris paribus, active involvement would generally have a higher opportunity cost than contributions in cash.

Risks are distinguished by the different forms of contribution. The ATO Taxation Ruling provides that the risk of loss associated with a CCA may not simply be the risk that the CCA activity will be unsuccessful, so that the participants do not recover the cost of their contributions and receive a return on their investment; but can also involve risks such as an accident during R&D activities conducted under a CCA for the development of hazardous chemicals which may result in fines and civil damages for environmental pollution (paragraph 82). According to the ATO Taxation Ruling, in order for a CCA to be considered arm’s length, such risk should be allocated among CCA participants in line with the benefits they expect to receive from the CCA results.

It seems that the ATO Taxation Ruling gives some consideration to the importance of control over R&D activity or control over entrepreneurial risk in the context of CCAs in example 3, but from a different perspective than that of the Dutch Decree. In light of the explanations given above, if the share of costs and risks including “the share of costs and risks of the R&D activity” are allocated among the CCA participants based on their expected benefits, it is unlikely that the ATO would conclude that such a CCA does not accord with the arm’s length principle.

4.3. The Dutch Decree and IRS Final Regulations: A comparison

The definition of CSA contained in the IRS Final Regulations reflects the IRS position on active involvement. A CSA is defined as an arrangement by which controlled participants share the costs and risks of developing cost-shared intangibles in proportion to their reasonably anticipated benefit shares. The definition makes no reference to functions performed, functional involvement or strategic decision making.

The IRS Final Regulations need to be examined in more detail in order to understand the IRS approach to CSAs involving active participants and passive participants jointly developing intangible property and sharing in the intangible property-related benefits. These Regulations state that if a controlled participant devotes, in whole or in part, any existing resource, capability or right to intangible development for the benefit of another controlled participant, whether by transfer or licence to the other controlled participant, or by leveraging such resource, capability or right within the context of the CSA, then the regulations require an arm’s length charge for such platform contribution, in addition to the funding of intangible development costs. In this respect, the IRS does not tell multinational enterprises how to organize their businesses either through CCAs or licensing arrangements, but instead urges them to ensure that each participant’s active participation and the risks thereof are remunerated in accordance with the arm’s length principle. The preamble to the IRS Final Regulations states that these Regulations require an arm’s length charge for one controlled participant’s platform contribution commitment of a particular research team’s experience and expertise to intangible development under a CSA, in addition to the controlled participants’ sharing of the ongoing intangible development costs of the salaries of such researchers. According to the IRS, as long as the party that actively participates in the CSA is remunerated through a separate arm’s length charge for its active participation, or as long as the terms and conditions of a CSA are at arm’s length, the cash con-

51. Para. 76 ATO Taxation Ruling TR 2004/1.
52. Para. 80 ATO Taxation Ruling TR 2004/1.
53. To clarify the risk of performing R&D activity, reference is made to the Deepwater Horizon (BP) oil spill, which occurred in 2010 in the Gulf of Mexico and resulted in the deaths of a number of workers and large-scale environmental pollution due to the resultant oil slick. The disaster resulted in significant financial and reputational damage for BP.
54. I.R.S. Final Regulation T.D. 9568, supra n. 5.
55. I.R.S. Final Regulation T.D. 9568, Preamble, supra n. 5.
The study "Present Law and Background Related to Possible Income Shifting and Transfer Pricing" prepared by the Joint Committee on Taxation, as a result of a public hearing before the House Committee on Ways and Means on 22 July 2010, gives six case studies of various tax and transfer pricing matters, including CSAs. One of the six cases involves Foxtrot, which has become a prominent case in international taxation. According to the study, Foxtrot US was initially engaged in R&D activities in the United States and was the sole owner of intangible property rights worldwide, but later decided to have Foxtrot Bermuda become the owner of intangible property rights outside the United States by entering into a CSA with Foxtrot Bermuda. In this case, Foxtrot Bermuda made a buy-in payment for pre-existing intangibles and going-forward shared costs and risks of developing intangible property rights associated with its future expected benefits, but was not actively involved in the R&D activities. The R&D activities continued to be performed by Foxtrot US. In this case study, the IRS focused on the arm’s length calculation of buy-in payments for pre-existing intangibles and an arm’s length share of costs and risks of intangible development in line with the share of expected benefits by the participants. The non-active involvement of Foxtrot Bermuda in the R&D activity does not seem to be an issue for the IRS.

Multinational enterprises doing business in the United States have long been arranging their CSAs in a similar fashion to Foxtrot without the IRS raising any significant questions in respect of active involvement. A typical example of such a CSA would be where a US company initially performs all R&D activities and the management functions, as well as assuming all the significant risks. The US company would initially own the worldwide intangible property rights. The sales and marketing activities of the US company would be carried out through local distributors responsible for local sales and marketing activities located in different countries worldwide. In due course, the US company would look for ways to develop a more tax efficient operating structure. One of the most common ways would be to sell the non-US intangible property rights to a newly established affiliate in a low- or zero-income tax jurisdiction, e.g. usually referred to as an intangible property company or foreign principal. The newly established intangible property company would buy into pre-existing intangible property rights and share the costs and risks of future development of those rights. The intangible property rights of the non-US intangible property company would primarily be based on sales to markets outside the United States. Again, the IRS seems to have not made an issue out of the non-active involvement of the non-US intangible property company in the R&D activities in deciding whether it should be entitled to intangible property-related returns earned through a CSA. The IRS is more concerned with the proper valuation of a buy-in payment by the non-US intangible property company.

For the pre-existing intangible property rights of the US company and the follow-up cost-sharing mechanism, as it argues that any type of involvement or risks would be compensated through such a buy-in payment and follow-up cost-sharing mechanism.

The IRS Final Regulations might be justified in not requiring active involvement by CSA participants to share in intangible property-related returns generated through a CSA, because CSAs can be viewed as being similar to joint ventures between third parties where one party may contribute knowledge and expertise, while the other makes only cash contributions. The fact of the situation is that multinational enterprises might require the IRS to follow such an approach in applying the arm’s length principle to a CSA. There may be cases where a party has an idea and knows how to implement it, but may not have sufficient funds to put the idea into practice. One option would be to borrow money from a financial institution, while another option would be to agree to share the expected benefits of the idea with a third party in return for funding. If a similar transaction can be identified between two third parties, it would be a tedious task to argue that such a transaction is not at arm’s length, provided that the share of the participants’ costs and risks is consistent with their future expected benefits. As participants’ fair market returns from CSAs are calculated in accordance with the arm’s length principle, the essential requirement behind the arm’s length principle should not be overlooked, and that essential requirement is to identify and analyse transactions that take place between third parties. If the terms and conditions of a CSA between related entities are also used in a comparable situation by third parties, it can be concluded that the arrangement entered into is at arm’s length.

When determining an arm’s length remuneration for the CSA participants, the IRS Final Regulations seem to focus on the following two aspects:
- the share of the costs and risks associated with a CSA without creating a link between functions performed and risks assumed; and
- a fair valuation of buy-in payments.

5. Conclusions and Recommendations

5.1. Conclusions

The position of the Dutch tax authorities, the OECD, the ATO and the IRS with respect to active involvement as understood throughout this article can be summarized as follows:
- the Dutch Decree regards active involvement as necessary to share in the benefits of jointly developed intangible property through CCAs. In this respect, the Dutch Decree does not seem to require day-to-day active involvement by the CCA participants in order to be entitled to intangible property-related returns, but it requires the CCA participants to have sufficient control over the CCA activity;
- chapter VIII of the OECD Guidelines mainly refers to the sharing of the costs and risks of developing intangible property, and does not provide conclusive guid-

56 Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (20 July 2010), at 1.
The Discussion Draft shies away from the use of the term ‘economic ownership’ and instead refers to ‘entitlement to IP related returns’.  

Based on the findings of this article, Table 2 summarizes key decision factors along with the positions of the Dutch tax authorities, the OECD, the ATO and the IRS on CCAs or CSAs with respect to the ownership of jointly developed intangible property.  

In light of the above, it is clear that positions differ with regard to the requirement of active involvement or control over functions and risks in order to share in the benefits of jointly developed intangible property through CCAs or CSAs. From an international tax and transfer pricing perspective, this is an unwelcome outcome, as it creates uncertainty on the tax positions of multinational enterprises involved in CCAs or CSAs. International disputes are therefore likely to increase in this area, in particular with regard to the recent developments at the level of the OECD, which could lead to mismatched risks or opportunities (e.g. a deductible royalty payment in the country of the payer might not be taxable in the country of the recipient or vice versa). From the taxpayers’ perspective, advance pricing agreements may provide the required certainty on these issues to seek to avoid double taxation, but such procedure can be costly.

5.2. Recommendations

As CCAs are steadily gaining in importance and are increasingly being concluded by multinational enterprises, they are also coming under increased scrutiny by tax authorities worldwide. One of the main issues for multinational enterprises and tax authorities continues to be a lack of guidance and a clear set of rules on how to deal with CCAs. The complex nature of CCAs and CSAs means that substantial capital investments are usually involved, which can have adverse tax consequences for multinational enterprises if...
a CCA or a CSA is not properly managed from a tax and transfer pricing perspective. In principle, a company would typically be hesitant to put large amounts of capital at stake in the absence of clear guidance that provides a degree of certainty in terms of its tax positions. Local CCA rules were introduced to provide multinational enterprises with more guidance, partly because of a lack of detailed guidance on an international level. However, in the absence of international consensus on CCAs, local rules may not be sufficient for multinational enterprises involved in CCAs or CSAs to mitigate their potential risks in the long term.

The existing OECD Guidelines have provided a framework to apply the arm's length principle to CCAs. However, the OECD Guidelines on CCAs have been criticized by specialists in the field and the business community for not dealing with many of the difficult issues surrounding CCAs, and hiding behind the "the right answer is what independent parties would do at arm's length." In light of the different positions taken on CCAs and CSAs by the OECD and tax authorities such as the Dutch tax authorities, the ATO and the IRS, there is an urgent need for further clarification. Recommended points of action can be summarized as follows:

- the author anticipates that the OECD will align the wording of chapter VIII with the wording of chapter IX and the Discussion Draft (once finalized) in its anticipated revision of chapter VIII. However, the OECD should pay additional attention to explicitly defining the required active involvement in CCAs beyond existing guidance, as such arrangements are generally complex;
- in order to increase certainty in compliance with transfer pricing rules, more definitions should be added to the OECD Guidelines. The author would therefore strongly recommend including a definition of "active involvement" for the purposes of CCAs in chapter VIII that is similar to the definition of active involvement used in this article. The key elements to be taken into account for such a definition could include the type and complexity of the activity performed, relevant industry specifics and whether the activity is easily substitutable or not;
- the approach adopted by the Dutch Decree and the guidance provided by the OECD in the Discussion Draft may not be in line with the actual business conduct of multinational enterprises in today’s increasingly global and competitive business environment. For instance, not all participants to a CCA would necessarily be required to be actively involved in third-party situations. It is not uncommon for unrelated parties to share in the ownership of intangible property, where one participant with the required functional expertise actively develops the intangible property, while the other participant only provides the funding. In such a situation, under the existing OECD Guidelines and the Discussion Draft, the participant providing the funding would not be entitled to share in the intangible property-related returns. The author therefore recommends an escape clause, whereby all participants would not need to be actively involved if the taxpayer can demonstrate that such arrangements exist between independent parties. An alternative solution in dealing with this issue could be to ensure a fair valuation of contributions in kind and contributions in cash by providing further guidance in this respect; and
- the OECD is to assess the reasons behind the approach adopted by the IRS, which does not require active involvement in order to become a participant of a CSA. It should seek to reach a consensus on CCAs and CSAs with the IRS and other tax authorities that hold a similar position to the IRS on CCAs and CSAs, so that multinational enterprises can be given more certainty when dealing with CCAs and CSAs from a tax and transfer pricing perspective.

The OECD has already made considerable progress in providing further clarification on active involvement in chapter IX and the Discussion Draft. Following the update of chapter VI, it would be a good opportunity for the OECD to leverage from the work already performed in addressing how active involvement should be considered in the context of CCAs.


60. The Discussion Draft requires that in order for an entity to be entitled to intangible property-related returns, the entity must perform directly through its employees the key functions related to the intangible property.