

**Cost Contribution Arrangements  
China and International Best Practice**

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# Cost Contribution Arrangements China and International Best Practice

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# Cost Contribution Arrangements China and International Best Practice

## 1. Introduction

This paper addresses the tax treatment in China of a cost contribution arrangement (CCA) in the light of the treatments in a selection of other countries, with the objective of ascertaining whether the law and practice in China conforms to international best practice. The paper arises out of concerns aired by a group of representatives, each from a multinational enterprise (MNE), which operates in China, about the prevailing Chinese law and State Administration of Taxation (SAT) practice with respect to CCAs. These concerns were raised at the International Research Seminar: Joint Research Project on Taxation held in Beijing by the Chinese International Taxation Research Institute and the International Bureau of Fiscal Documentation on 29-30 June 2005. The paper is intended primarily to provide an overview of various country practices in relation to CCAs as a basis for further discussion about the state of the relevant law and practice in China.

Increasingly, the globalisation of technology results in the need for constant innovation and hence higher costs for MNEs.<sup>1</sup> As a result, companies pursue cost-sharing strategies to optimize global business opportunities and minimise world-wide taxes.<sup>2</sup> Although CCAs are used for different types of joint endeavours, the most frequent type of CCA is an arrangement for research and development (R&D) of intangibles (such as designs, patents, or industrial processes).<sup>3</sup> It is common for MNEs to conduct their R&D either in a centralised way (for example, at the parent

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<sup>1</sup> Reumert, K., (2004) *Transfer Pricing Database: Denmark*, IBFD Publications, Amsterdam, § 3.2.

<sup>2</sup> Doonan, J., and Tien, J., “The best method for determining cost-sharing payments” (2002) *International Tax Review*, Vol. 13, Iss. 9, 37.

<sup>3</sup> Becker, H., “Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines: Cost Contribution Arrangements” (1998) *International Transfer Pricing Journal*, Vol.5, No. 2, March/April, 62, § 8.1.c. Since 1999 the German tax authority’s guidelines on CCAs extended the scope of a CCA for domestic tax law purposes beyond financing of R&D to encompass expenses incurred for the purchase of assets or the rendering of administrative or other services: see Kroppen, H. K., and Eigelshoven, A., (2005) *Transfer Pricing Database: Germany*, IBFD Publications, Amsterdam, § 3.4.1.

company), or via a special purpose company.<sup>4</sup> A CCA is used by subsidiaries of MNEs to divide the costs, and to share the revenue of work or developments, which are often too expensive, too inefficient or too risky for a single subsidiary to undertake on its own. In doing so, under a CCA, typically R&D is performed independently by a selected entity on behalf of other entities, which seek the results of the R&D. The latter entities are then entitled to their ownership share of the output of the R&D work undertaken by the former entity. Thus, under CCAs, the results of successful R&D are shared between the parties to the arrangement in accordance with that arrangement. From a purely business perspective, CCAs offer an attractive mechanism for a MNE to (i) obtain economies of scale; (ii) distribute risk among its constituent entities; (iii) manage cash within the MNE; and (iv) minimise the present value of global taxes.

As (a) Chinese investors progressively make investments in R&D outside China; (b) (of more immediate significance) as foreign investors increasingly make investments in R&D in China; and (c) entities in China contribute to the costs of other (non-R&D) joint activities conducted outside of China and from which those entities are entitled to draw benefits, the relationship of CCAs with China's tax law becomes a question of greater relevance. Essentially, there are two immediate questions, which are relevant for income tax purposes in China:

- (i) Are the contributions made by taxable entities in China tax deductible in China?
- (ii) Are contributions received by an entity operating in China towards the costs of R&D and the provision of other benefits in terms of a CCA taxable in China?

These two broad questions are examined in this paper in the context of the prevailing approaches internationally.

In order to promote a standard global approach for MNEs to follow when implementing CCAs in different countries, and to give guidance on some of the issues

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<sup>4</sup> Reumert, K., (2004) *Transfer Pricing Database: Denmark*, IBFD Publications, Amsterdam, § 3.2.

that arise from these arrangements from a tax perspective, in 1997 the Organisation for Economic Co-operation and Development (OECD) published Chapter VIII of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines). Chapter VIII deals specifically with CCAs. Most countries follow the OECD Guidelines. China, however, is one of few the countries that currently does not follow them.

This paper considers the different ways in which various countries have interpreted and incorporated the OECD Guidelines into their domestic tax laws and practice. The aim of this country analysis is to determine how the OECD Guidelines have been interpreted by different states and where they have been ignored.

Part 2 of the paper looks at the definition of a CCA and distinguishes this type of arrangement from other similar arrangements. Part 3 then considers the current tax treatment of CCAs by the China SAT. Part 4 describes the approach adopted in the OECD Guidelines. Part 5 contains a review of a variety of approaches different countries have taken to the OECD Guidelines. Part 6 then outlines some contentious issues, which have arisen as a result of different countries' interpretations of the OECD Guidelines. Finally, Part 7 draws some conclusions for China.

## **2. Cost Contribution Arrangement**

A CCA is defined in the OECD Guidelines as:<sup>5</sup>

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 interest of each participant in those assets, services, or rights.

CCAs typically involve joint development of intangible property and contributions towards a MNE's centralised services (such as for management, advertising or in-house legal counsel), which benefit the business entities that comprise the MNE. CCAs must be distinguished from other forms of obtaining and using intangible property, such as contract research (that is, outsourcing to a third

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<sup>5</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2001, Chap. VIII, § 8.3.

party) and *transfers* of the use and benefits of R&D or other results of the joint activity.

A critical feature of a CCA is that it is an *agreed framework*. Therefore, it does not automatically follow that a separate legal entity (or, indeed, a permanent establishment) of a participant exists in a particular country in which the R&D or other activity is carried out.<sup>6</sup>

Each participant's proportionate share of the overall contributions to the CCA must be commensurate with that participant's proportionate share of the expected benefits, which are determined at the commencement of the CCA. As the OECD Guidelines put it "resources and skills are pooled and the consideration received is, in part or whole, the reasonable expectation of mutual benefits."<sup>7</sup> Put another way, what distinguishes contributions to a CCA from an ordinary intra-group transfer is that part or all of the compensation intended by the participants relates to the expected benefits to each from the pooling of resources and skills.<sup>8</sup> By way of example, suppose that three members of a MNE, which are marketing a product in the same regional market in which consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the MNE helps develop the advertising campaign, but does not itself market the product. The fourth member will not be a participant in the CCA, both because it does not receive a beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm's length payment for the advertising services provided to the CCA.<sup>9</sup>

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<sup>6</sup> This is particularly important when determining rights and obligations under double taxation treaties: See Becker, H., "Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines: Cost Contribution Arrangements" (1998) *International Transfer Pricing Journal*, Vol. 5, No. 2, March/April, 62, § 8.3.d.

<sup>7</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2001, Chap. VIII, §8.5.

<sup>8</sup> Anderson, P., and Graham, P., "Cost Contribution Arrangements: Australia" (2001) *International Transfer Pricing Journal*, March/April, 46.

<sup>9</sup> New Zealand Inland Revenue Department, (2002) *IRD Tax Information Bulletin*, Vol. 12, No. 10, October, Appendix: Transfer Pricing Guidelines, 75.

Importantly, since each participant in a CCA is a direct, but separate, owner of the benefit arising from the CCA, it may obtain these benefits directly and for no consideration. In other words, the participant is not a licensee, which is obliged to pay a royalty to have the benefits transferred to it. Since, under the CCA, the participant is an owner of the benefits, there is no transfer of them to it. The participant has an immediate right to access its (share of) the property – tangible or intangible – which results from the activity carried out pursuant to the CCA.

## 2.1 Cost Sharing Agreement

In some countries, most notably the United States of America, the term “cost sharing agreement” (CSA) is used, rather than CCA. Although CSAs and CCAs are similar types of arrangements, they do contain different elements. A CCA is broader than a CSA (and can encompass other services, such as administrative services), whereas a CSA relates to specific agreements, most notably for the costs of the development of, and/or rights in, intangible property. The United States Treasury Regulations (US Regulations) define a CSA as:<sup>10</sup>

An agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.

The differences in the definitions of CCAs and CSAs, highlighted in Table 1 below, show that the two types of arrangements are different in six – albeit subtle – ways.

**Table 1**  
**Definitional differences between CCA and CSA**

	CCA	CSA
<b>Arrangement</b>	Framework	Agreement/arrangement
<b>Participants</b>	Business enterprises	Parties
<b>Burden</b>	Costs and risks	Costs
<b>Activity</b>	Developing, producing or obtaining	Development
<b>Output</b>	Assets, services or rights	Intangibles
<b>Allocation of benefits</b>	CCA determines the nature and extent of the interest of each participant	In proportion to shares of reasonably anticipated benefits from individual exploitation

<sup>10</sup> United States Treasury Regulations, Treas. Reg. Sec. 1.482-7(a)(1).

In all aspects, other than the nature of the participants, the definition of a CCA is broader than that of a CSA. Under a CCA, the participants are restricted to “business enterprises”; the broader term “parties” is used in the CSA definition. Nevertheless, from a practical taxation perspective, nothing of significance is likely to turn on this difference in terminology.

It should also be noted that reference to “risks” has been omitted from the definition of a CSA in the US Regulations. Unlike a CCA, where the contributing business enterprises share the risks of failure of the activity, it is not clear from the definition of a CSA who shares the risks. Typically, the risks are likely to be commensurate with the costs, and thus a member contributing to costs under a CSA shares the risks as well. Again, from a practical taxation point of view, the differences between the definitions of CCAs and CSAs in this respect may not be significant.

## **2.2 Agreements and Contracts**

It should be noted at the outset that CCAs are arrangements (by name) and agreed “frameworks” (by definition), rather than agreements or contracts. Contracts are peculiar to the law and require, at a basic level, offer, acceptance, consideration and intent to create legal relations.<sup>11</sup> Contracts are legally binding on the parties to them. On the other hand, parties to an arrangement are not required to fulfil the more onerous criteria of a contract. Importantly, in relation to CCAs, a company cannot put in place a contract between its head office and one of its branches or between its branches,<sup>12</sup> as it cannot contract with itself, a branch being part of the same legal entity as the head office or another branch. Thus, such arrangements between different parts of the same legal entity are not (legally enforceable) contracts, but are *non-binding*<sup>13</sup> agreements. On the other hand, legal contracts can be made between companies, including companies within the same group, because each company is a separate legal entity (with a power to contract in its own right). The legal difference

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<sup>11</sup> See, for example, *Rose & Frank Co. v J. R. Crompton & Bros., Ltd.*, [1923] 2 K.B. 261.

<sup>12</sup> Use of the term “branch” in this paper contemplates other sorts of permanent establishments as well, for the purposes of double taxation treaties and domestic taxation legislation that uses that terminology. See also footnote 6.

<sup>13</sup> In a legal sense.



between (i) arrangements and agreements, and (ii) contracts is the likely reason for the use of the terms “framework agreed”, “agreement” and “arrangement” in the definitions of CCA and CSA, rather than the use of the term “contract”. This points to contemplation of branches falling within CCAs, and not merely companies in a group.<sup>14</sup>

### 2.3 Joint Ventures and Partnerships

At a cursory glance, a CCA is similar in many ways to a joint development project or a partnership. A joint venture has been described in very broad terms as:<sup>15</sup>

a term used loosely to describe various forms of legal relationship between two or more parties set up to pursue a common business goal. A joint venture may take the form of a partnership or a jointly owned company *or be no more than a contractual arrangement between the parties*. Joint ventures are often (but not necessarily) entered into for a specific project or projects.

(emphasis added)

From this description, a CCA could be considered a type of joint venture. Indeed, in Australia, the Tax Office (ATO) describes a CCA as a form of “joint venture”.<sup>16</sup>

In a joint development project every member contributes know-how, manpower or other assistance, and the R&D is carried out jointly.<sup>17</sup> A CCA can be regarded as a variation of this notion in that only one entity (or very few of them) performs the process, and the others contribute funding or other resources. Essentially, like a joint venture, a CCA involves sharing of costs of inputs and risks, and ownership of outputs, so there is no transfer of rights in consideration for royalty

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<sup>14</sup> Some authors assert that a CCA is generally treated as a contract between the parties. See, for example, Turner, R. D. M., “Cost Contribution Arrangements: Canada” (2001) *International Transfer Pricing Journal*, May/June, 89. However, it is suggested in this paper that such use is colloquial and made without full consideration of the legal meaning of “contract”.

<sup>15</sup> Larking, B., (ed.) *International Tax Glossary*, IBFD Publications, Amsterdam, 2001, 4<sup>th</sup> ed., 207-208.

<sup>16</sup> Anderson, P., and Price, G., “Draft Guidance on Cost Contribution Arrangements” (2004) *International Transfer Pricing Journal*, January/February, 30.

<sup>17</sup> Reumert, K., (2004) *Transfer Pricing Database: Denmark*, IBFD Publications, Amsterdam, § 3.4.

payments.<sup>18</sup> However, in France if a CCA creates a joint venture a more complex tax regime applies.<sup>19</sup>

A partnership usually involves “a joint undertaking to conduct common or joint business activities with the terms of the respective rights and obligations of the partners, set out in a written partnership agreement”.<sup>20</sup> It is the intention of the parties to conduct business activities that is important, and in particular the parties’ intention to act jointly with a view to profit. Following this, a CCA would not give rise to a partnership for tax purposes unless it were the intention of the parties to conduct a business activity in partnership form.<sup>21</sup> A good comparison between a partnership and a CCA is given in the United States where partnerships occur where “affiliates share in the development costs of intangibles, jointly own all rights to the resulting intangibles, and jointly exploit the intangibles either through licensing or the use of the intangibles in manufacturing and selling products or in performing services.” In contrast, a CCA exists where affiliates share in the development costs of intangibles and each own separate rights to the resulting intangibles denominated by geographic territory or field of use.<sup>22</sup> Consequently, a “cost-sharing arrangement is not treated as a partnership under the US rules nor is a participant in a ... cost-sharing arrangement treated as being engaged in a trade or business within the United States only by reason of its participation in the cost-sharing arrangement.”<sup>23</sup>

Because undertaking a business in the form of a partnership presumes (i) a common name; (ii) each partner entering into binding contracts in the name of the partnership, such contracts binding all of the partners; (iii) each partner being personally liable for obligations of the partnership; and (iv) the assets of the partnership being claimable by its creditors, the Dutch perspective is that a CCA is not a partnership. A CCA, in the context of an international group structure, does not

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<sup>18</sup> *Idem.*

<sup>19</sup> Douvier, P., “Cost Contribution Arrangements: France” (2001) *International Transfer Pricing Journal*, May/June, 93.

<sup>20</sup> Casley, A., and Taylor, J., “Cost Contribution Arrangements: United Kingdom” (2001) *International Transfer Pricing Journal*, March/April, 65, 68.

<sup>21</sup> Turner, R. D. M., “Cost Contribution Arrangements: Canada” (2001) *International Transfer Pricing Journal*, May/June, 89.

<sup>22</sup> Dolan, D. K., “Final cost sharing regulations” (1996) *Tax Management International Journal* Vol. 25, Iss. 3, 147.

<sup>23</sup> Kelleher, M. F., and Wright, D. R., (2005) *Transfer Pricing Database: United States*, IBFD Publications, Amsterdam, § 3.3.3.

embody the above characteristics or initiatives: instead, it is simply a pooling of interests for the purposes of R&D or the provision of services from which the participants can draw their respective shares of the benefits.<sup>24</sup> Similarly, from the United Kingdom perspective, if the intention of the parties to a CCA is simply to share in the costs, the activities would not meet the requisite business profit test of a partnership.<sup>25</sup>

However, in Germany participants in a CCA “form a civil law partnership without, for tax purposes, becoming partners or forming a permanent establishment.”<sup>26</sup> Similarly, in Luxembourg CCAs are treated as partnerships if the participants are in a position similar to that of an individual entrepreneur, viz. that the participants must simply (i) bear the risk of an entrepreneur; (ii) have at least a partial interest in the assets; and (iii) share all items of profits, losses, deductions, expenses, credits or allowances, if any, for any period, pro-rated in accordance with their respective percentage of interests under the CCA.<sup>27</sup> The better view would seem to be that a CCA does not ordinarily contribute a partnership and, therefore, should not be taxed as a partnership.

In Canada, the legal structure of cost sharing arrangements (for example, in which legal title to the relevant property is held or registered) is not critical. Instead, the substantive rights of enjoyment of the property are a determining factor as to whether the arrangement is a CCA.<sup>28</sup>

### **3. Current Practice in China**

From China’s perspective, there are two issues concerning CCAs that can have tax impacts. The first issue concerns the deductibility of contributions that a Chinese

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<sup>24</sup> Verdoner, L., “Cost Contribution Arrangements: Netherlands” (2001) *International Transfer Pricing Journal*, March/April, 55.

<sup>25</sup> Casley, A., and Taylor, J., “Cost Contribution Arrangements: United Kingdom” (2001) *International Transfer Pricing Journal*, March/April, 65.

<sup>26</sup> Waldens, S., “Cost Contribution Arrangements: Germany” (2001) *International Transfer Pricing Journal*, March/April, 49, 50.

<sup>27</sup> Linz., S and Guilloteau., F “Cost Contribution Arrangements: Luxembourg” (2001) *International Transfer Pricing Journal*, July/August, 129, 130.

<sup>28</sup> Boidman, N., (2005) *Transfer Pricing Database: Canada*, IBFD Publications, Amsterdam, § 3.3.1.2.

entity may make as a participant of a CCA; that is, whether those contributions are deductible in China. This issue may arise, for example, if a subsidiary company is a resident in China and it makes cost contributions through a CCA to its parent company in the United States for the benefits of centralised services. Another example might be one group company, based in China, making cost contributions through a CCA to a R&D group company based in Vietnam for the expected benefits of that R&D.

Currently, deductibility of such cost contributions are governed by a variety of tax legislation in China. Under the Chinese taxation laws management fees paid to associated enterprises are not tax deductible.<sup>29</sup>

Administrative expenses incurred in connection with production and business operations are allocated proportionately between a foreign investment enterprise and its branches. Reasonable administrative expenses paid by a Chinese establishment or place of business of a foreign enterprise to its head office in the course of the production and business operations of the establishment or place of business may be deductible. To qualify for deduction, the taxpayer must have supporting documents from its head office certifying the expenses involved, the total amount, the basis and method of allocation, and a verification report issued by a certified public accountant.

The taxpayer is required to submit the supporting documents and information for deduction to the local tax authorities. The tax authorities may adjust the amounts of deduction if the supporting documents are found to be insufficient.<sup>30</sup>

Management fees paid by a foreign investment enterprise to its local (Chinese) partners are not deductible if no services were actually provided by the recipient. Such management fees would be deductible if incurred for genuine services, such as industry consultation, provision of market information, assistance in commodity trading, etc.<sup>31</sup> There are special rules for the deduction of management fees paid by branches of foreign banks in China.

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<sup>29</sup> Foreign Enterprise Income Tax Implementation Regulation, art. 58.

<sup>30</sup> Guo Shui Fa [2004] No. 80.

<sup>31</sup> Guo Shui Fa [1993] No. 469.

A branch of a foreign bank may claim a deduction for management fees allocated from its head office to the extent that the fees are related to managing the business operations of the branch. The permitted allocation methods for management fees are (i) the ratio of the revenue of the branch to total revenue; (ii) the ratio of the value of the branch's assets to the value of the total assets; (iii) the ratio of the profits of the branch to total profits; (iv) the ratio of the number of employees of the branch to total number of employees, or the total salaries of employees of the branch to total salaries of all employees; (v) the average of two or more of the above ratios; or (vi) other allocation methods upon application and approval by local tax authorities.

The same documentation requirements as above must be met. If a branch is unable to provide the required information, the local tax authorities may determine the amount of deductible management fees with reference to the industry average. Such a deemed amount is limited to 5% of the branch's gross income for the year in question if that year falls within the first three years from the date that the branch commences operations, and 3% for the fourth year onwards.

Management fees allocated by a related bank in carrying out management functions on behalf of the head office of a branch in China can be deducted subject to the approval of the tax authorities and confirmation by the head office that the function was carried out on its behalf.

The second important aspect of current taxation law and practice concerns the taxation of incoming revenue if a R&D company of a CCA is based in China. For example, as part of a CCA a parent company based in the United States contributes costs towards R&D undertaken in a Chinese R&D company. Under the current tax law and practice in China, contributions towards the costs of such R&D are treated as payments for services and are subject to the business tax, which is charged at a rate of 5% of the gross amount of the contribution.

#### **4. OECD approach**

Given the process of their formulation and the wide range of expert input, it is generally considered that the OECD Guidelines provide the best international practice

concerning the taxation effects of CCAs. This view is endorsed by the number of countries (both OECD and non-OECD) that largely comply directly or indirectly with the OECD Guidelines.

As noted above in Part 2 of this paper, Chapter VIII of the OECD Guidelines commences with defining a CCA. From this definition it follows that each participant's proportionate share of the overall contributions to the arrangement will be consistent with that participant's proportionate share of the overall expected benefits.<sup>32</sup> Thus, each participant in a CCA is entitled to exploit its interest in the CCA separately as an owner of that interest rather than a licensee.<sup>33</sup> Hence, as an effective owner in any property developed by a CCA there will be no need for the participant to make a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired.<sup>34</sup>

The OECD Guidelines also state that in a CCA there will always be an expected benefit that each participant seeks from its contributions.<sup>35</sup> Therefore, each participant's interest in the results of the CCA activity should be established from the outset.<sup>36</sup>

The OECD Guidelines examine different types of CCAs. As mentioned above, the most common type of CCA is one established for the joint development of intangible property. However, CCAs need not be limited to this type of R&D activity. Indeed, CCAs may extend to the pooling of resources for acquiring centralised management services or for such projects as the development of advertising campaigns.<sup>37</sup>

Importantly, the OECD Guidelines give guidance to tax authorities in setting out the criteria for application of the arm's length principle to the amount of a

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<sup>32</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2001, Chap. VIII, § 8.3.

<sup>33</sup> *Idem*.

<sup>34</sup> *Ibid.*, § 8.6.

<sup>35</sup> *Ibid.*, § 8.4.

<sup>36</sup> *Idem*.

<sup>37</sup> *Ibid.*, § 8.7.

contribution to a CCA as part of the process of determining the proportionate shares of the contributions.<sup>38</sup> For a CCA to satisfy the arm's length principle:<sup>39</sup>

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. What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part of all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills.

Contributing factors, such as contractual terms and economic circumstances particular to the CCA (for example, the sharing of risks and costs) must be considered in the application of the arm's length principle.<sup>40</sup>

Furthermore, the OECD Guidelines highlight that expectation of mutual benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills without separate compensation. Thus, each participant's proportionate share of the actual overall contributions to the arrangement needs to be consistent with the participant's proportionate share of the overall expected benefits.<sup>41</sup> As this mutuality concept is fundamental to a CCA, a party may not be considered a participant in a CCA if the party does not have a reasonable expectation that it will benefit from the CCA activity. Hence, that party must be assigned a beneficial interest in the property or services of the CCA, and have a reasonable expectation of being able to (directly or indirectly) exploit or use the interest that has been assigned.<sup>42</sup> It is important to note that the requirement of an expected benefit does not impose a condition that the activity of the CCA need be successful.<sup>43</sup>

The OECD Guidelines then go on to consider the value of each participant's contributions under a CCA. These contributions should be consistent with the value that independent enterprises would have assigned to the contribution in comparable

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<sup>38</sup> *Ibid.*, § 8.5.

<sup>39</sup> *Ibid.*, § 8.8.

<sup>40</sup> *Ibid.*, § 8.14.

<sup>41</sup> *Ibid.*, § 8.9.

<sup>42</sup> *Ibid.*, § 8.10.

<sup>43</sup> *Ibid.*, § 8.11.

circumstances.<sup>44</sup> In determining this, costs and market prices can be used as a measuring tool in order to value the contributions to arm's length CCAs.<sup>45</sup>

In order to determine each participant's expected benefits of the CCA an allocation key is frequently used in practice. Examples of allocation keys include (i) sales; (ii) gross or operating profit; (iii) units used, produced or sold; (iv) number of employees; and (v) capital invested.<sup>46</sup>

As to the tax deductibility of a participant's contributions, the OCED approach is that:<sup>47</sup>

Contributions by a participant to a CCA should be treated for tax purposes in the same manner as would apply under the general rules of the tax systems(s) applicable to that participant if the contributions were made outside a CCA to carry on the activity that is the subject of the CCA.

The nature of the contribution will depend on the type of activity undertaken in the CCA, and will determine how it is recognised for tax purposes.<sup>48</sup> Hence, often contributions will be treated as deductible expenses. Essentially, for tax purposes, R&D activity under a CCA must be treated as if it were performed in-house. As Becker has commented, "in-house R&D costs are not classified for tax purposes according to whether they give rise to an advantage or benefit. For tax purposes the only question is whether they are business expenses."<sup>49</sup>

In terms of income, the approach reflected in the OECD Guidelines is that:<sup>50</sup>

No part of a contribution in respect of a CCA would constitute a royalty for the use of intangible property, except to the extent that the contribution entitles the contributor to obtain only a right to use the intangible property belonging to a participant (or a third party) and the contributor does not also obtain a beneficial interest in the intangible property itself.

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<sup>44</sup> *Ibid.*, § 8.14.

<sup>45</sup> *Ibid.*, § 8.15.

<sup>46</sup> *Ibid.*, § 8.19.

<sup>47</sup> *Ibid.*, § 8.23.

<sup>48</sup> *Idem.*

<sup>49</sup> Becker, H., "Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines: Cost Contribution Arrangements" (1998) *International Transfer Pricing Journal*, Vol.5, No. 2, March/April, 62, § 8.3.1.

<sup>50</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 2001, Chap. VIII, § 8.23.



The OECD Guidelines also state the approach that should be adhered to regarding entry into, withdrawal from, or termination of, a CCA. With regard to entry (or buy-in) to a CCA, under the arm's length principle, any transfer of pre-existing rights from participants to a new member must be compensated based on an arm's length value of the transferred interest.<sup>51</sup> The new entrant's proportionate share of the overall expected benefits to be received under the CCA should be taken into account.<sup>52</sup> Like contributions, a "buy-in payment should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) ... applicable to the respective participants as if the payment were made outside a CCA for acquiring the interest being obtained."<sup>53</sup>

When a participant withdraws from a CCA (a buy-out), that participant may dispose of its interest in the results of past CCA activity (including work in progress) to other participants. Like buy-in transfers, the buy-out transfer should be compensated in accordance with the arm's length principle.<sup>54</sup> A buy-out payment is not dissimilar to a buy-in payment with regard to its taxation treatment: again, it should be treated in "the same manner as would apply under the general rules of the tax system(s) ... applicable to the respective participants as if the payment were made outside a CCA as consideration for the disposal of the pre-existing rights."<sup>55</sup> In addition, no part of buy-in or buy-out payments in respect of a CCA would constitute a royalty for the use of intangible property, except to the extent that the payment entitles the payer to obtain only a right to use intangible property belonging to a participant (or a third party, or departing participant) and the payer does not also obtain a beneficial interest in such intangible property itself.<sup>56</sup>

Upon termination of a CCA, each participant should receive a beneficial interest in the results of the CCA activity consistent with the participant's proportionate share of contributions to the CCA throughout its term, or a participant

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<sup>51</sup> *Ibid.*, § 8.31.

<sup>52</sup> *Ibid.*, § 8.32.

<sup>53</sup> *Ibid.*, § 8.33.

<sup>54</sup> *Ibid.*, § 8.34.

<sup>55</sup> *Ibid.*, § 8.35.

<sup>56</sup> *Ibid.*, §§ 8.33 and 8.35.

could be properly compensated according to the arm's length principle by one or more other participants for surrendering its interest in the results of the activity.<sup>57</sup>

Chapter VIII of the OCED Guidelines concludes with recommendations for structuring and documenting CCAs. As stated above, a CCA should be structured in accordance with the arm's length principle.<sup>58</sup> Each participant should have access to the details of the activities of the CCA, projections upon which the contributions are to be made and expected benefits to be derived, and budgeted and actual expenditure of the CCA activity.<sup>59</sup>

The OECD Guidelines also contain a suggested list of information that would be relevant for the initial terms of the CCA. This list includes (i) a list of participants; (ii) a list of other associated enterprises involved with the CCA activity; (iii) a scope of activities; (iv) the duration of the CCA; (v) the manner in which the participant's proportionate share of expected benefits are to be measured, and projections used in this determination; (vi) the form and value of each participant's contributions and the accounting principles that are to be applied in determining the expenditures and value of contributions; (vii) the anticipated allocation of responsibilities and tasks; (viii) the procedures for, and consequences of, buy-ins and buy-outs and termination of the CCA; and (ix) provisions for balancing payments or adjustments to the arrangement.<sup>60</sup>

As is shown in the following part of this paper, the approach adopted in the OECD Guidelines is widely accepted in international practice.

## **5. Country Surveys**

Individual countries have taken different approaches in interpreting and adopting the OECD Guidelines. For the purposes of this paper, rather than analysing each country on a pure country-by-country basis, the surveyed countries are grouped into two broad categories, based on the way they have implemented the OECD Guidelines.

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<sup>57</sup> *Ibid.*, § 8.39.

<sup>58</sup> *Ibid.*, § 8.40.

<sup>59</sup> *Ibid.*, § 8.41.

<sup>60</sup> *Ibid.*, § 8.42.

Category 1 is those countries that have essentially implemented the OECD Guidelines as a whole, although there may be a few (relatively minor) areas that differ from the OECD interpretation. This first category is split into two subsections, being those countries that have implemented the OECD Guidelines (or the concepts underlying them) into their domestic law, and those where the tax authorities follow the OECD Guidelines despite not being legally obliged to do so.

Category 2 covers those countries that have not implemented the OECD Guidelines. To the extent that the relevant data is available, each category addresses each country's approach with regard to the two primary questions stated in Part 1 of this paper, viz. deductibility of contributions made from the country and the assessability of contributions received in the country.

The countries surveyed are those for which CCA data available on the International Bureau of Fiscal Documentation's Transfer Pricing and Intellectual Property Taxation databases, together with Australia, Hungary, Luxembourg and the United States, for which data was available from other sources. In total, 30 countries (including China) were surveyed. They are Argentina, Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Germany, Finland, France, Hungary, India, Ireland, Israel, Japan, Korea (Rep.), Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Romania, Singapore, South Africa, Spain, Sweden, Switzerland, United Kingdom, and the United States. This part concludes with a tabulated summary of the approaches taken by the countries sampled.

## **5.1 Category 1 – Countries that have followed the OECD Guidelines in most respects**

### **5.1.1 Countries that include the OECD Guidelines in their domestic law**

The domestic laws of some countries specifically encompass the approach of the OECD Guidelines (with relatively minor variations) with respect to CCAs. These countries include Canada,<sup>61</sup> Spain<sup>62</sup> and the United Kingdom.<sup>63</sup>

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<sup>61</sup> Income Tax Act 1985, sec. 247.

<sup>62</sup> Law 43/1995, of 27 December, on Corporate Income Tax, art. 16

In **Canada**, contributions made directly under a CCA are evaluated to determine whether they would be deductible or capitalised under the general principles of the Income Tax Act.<sup>64</sup> No mark-up or profit element is allowed for deductible expenditure<sup>65</sup> because a R&D or service provider does not assume any business risk in undertaking the activity in accordance with the CCA. Receipts of contributions and output from the CCA activity drawn by a contributor are not taxed.

In **Spain**, contributions under a CCA are deductible if they are properly documented and worded, and produce an advantage for the contributor. A mark-up may be possible.<sup>66</sup> Again, receipts of contributions and output from the CCA activity drawn by a contributor are not taxed.

In the **United Kingdom**, contributions are deductible if they meet the general test of being made wholly and exclusively for the purposes of the contributor's trade. Mark-ups are generally not allowed. Buy-in payments may be treated as a capital amount (subject to amortisation over time) while buy-out payments are likely to be taxable in the recipient's hands under United Kingdom revenue law.<sup>67</sup> The mutuality principle renders receipt of the contribution and the contributor's share of the output in terms of the CCA non-taxable in the United Kingdom.

The **United States** has implemented the main *concepts* of the OECD Guidelines in its domestic law by regulation.<sup>68</sup> Although the US Regulations essentially follow the OECD Guidelines, there are differences in the two sets of rules. As noted in Part 2 of this paper, the definition of a CCA in the OECD Guidelines is more flexible than the definition of a CSA in the US Regulations. In particular, the OECD Guidelines apply to tangible and intangible property *and services*, whereas the US Regulations apply *only* to the development of intangible property. A further

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<sup>63</sup> Income and Corporation Taxes Act 1988, sch. 28AA.

<sup>64</sup> Turner, R. D. M., "Cost Contribution Arrangements: Canada" (2001) *International Transfer Pricing Journal*, May/June, 89, 91.

<sup>65</sup> Boidman, N., (2003) *Transfer Pricing Database: Canada*, IBFD Publications, Amsterdam, § 3.3.1.1.

<sup>66</sup> Carreño, F., and Marco, R., "Cost Contribution Arrangements: Spain" (2001) *International Transfer Pricing Journal*, May/June, 96, 99.

<sup>67</sup> Casley, A., and Taylor, J., "Cost Contribution Arrangements: United Kingdom" (2001) *International Transfer Pricing Journal*, March/April, 65, 69.

<sup>68</sup> Internal Revenue Code, sec. 482 and Treas. Reg. Sec. 1.482-7.

fundamental difference between the US Regulations and the OECD Guidelines in practice concerns the use of hindsight when a tax authority challenges the allocation of costs to a taxpayer under a CCA.<sup>69</sup> Under the OECD Guidelines, the tax authority should only challenge allocation of costs under a CCA:<sup>70</sup>

where it concludes that the projections of anticipated benefits would not have been used by unrelated parties in comparable circumstances, taking into account all developments that were reasonably foreseeable by the parties at the time the projections were established and *without the use of hindsight*.

(emphasis added)

On the contrary, the US Regulations specifically permit the use of hindsight in such circumstances. Under these rules:<sup>71</sup>

a participant's cost allocation may be challenged by the Internal Revenue Service, and the actual benefits realized by the participant may be used as a basis for recomputing the prior year allocation, where the divergence between the projected benefit share and the actual benefit is greater than 20% of the projected benefit share for any controlled participant.

In other respects, the US regulations are, basically, compatible with the OECD Guidelines. In each case, the share of the costs of a CCA, which is allocated to a participant, and in respect of which a deduction is to be determined under the tax laws of the state of the contributor, must be equal to the participant's share of the reasonably anticipated benefits which the contributor will derive from its participation in the activity carried out in terms of the CCA.<sup>72</sup>

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<sup>69</sup> Prillaman, G. G., and Mantegani, B., "OECD Guidelines Governing Cost Contribution Arrangements: A Comparison with U.S. §482 Cost Sharing Regulations" *Tax Management Transfer Pricing Report*, 389, 390.

<sup>70</sup> *Idem*.

<sup>71</sup> This provision does not apply if the divergence was caused by an extraordinary event, outside of the control of, and which could not have been reasonably anticipated by, the participants (see Prillaman, G. G., and Mantegani, B., "OECD Guidelines Governing Cost Contribution Arrangements: A Comparison with U.S. §482 Cost Sharing Regulations" *Tax Management Transfer Pricing Report*, 389, 390). The main concept behind the US Regulations is that a CSA produces results consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (see "Treasury, IRS Announce Proposed Cost-Sharing Regs" (2005) *Accounting Today*, Vol. 19, Iss. 17, 10).

<sup>72</sup> The US Regulations "place tremendous emphasis on being able to project accurately anticipated benefits from a cost sharing arrangement. If there is more than a 20% divergence between a [participant's] projected anticipated benefits and its actual benefits, then the IRS may consider the projections to have been unreliable and ... make allocations necessary to equate the actual costs with the actual benefits." (see Dantzler, J. W., and Fuldieri, M., "Cost Sharing Arrangements: United States" (2001) *International Transfer Pricing Journal*, May/June, 101, 106.) Such an onerous requirement is not imposed by the OECD Guidelines.

### 5.1.2 Countries that apply the OECD Guidelines, but not through domestic law

Most of the countries surveyed fall into sub-category 2. The tax administrations of countries that fall into this sub-category allow a deduction for contributions to a CCA if the criteria in their domestic tax legislation are met. These countries follow the OECD Guidelines, despite not having explicitly incorporated them into their domestic law.

**Germany** follows the OECD Guidelines by means of a Ministry Decree: the Federal Ministry of Finance issued the *Administrative Principles of Cost Allocations* (German Principles) in late 1999,<sup>73</sup> which apply a “pool taxation” concept to CCAs. With respect to the scope of a CCA, the German Principles take a middle ground between the US Regulations and the OECD Guidelines. As mentioned above, the OECD Guidelines cover many types of CCAs, whereas under the US Regulations CSAs are limited to R&D of intangibles-type activities. The German Principles allow for a CCA for R&D and administrative services, but not for producing or obtaining tangible property.<sup>74</sup>

In addition, the German Principles include a wide definition of CCAs, which covers services and R&D cost sharing. Except on the above point, this is largely consistent with the OECD Guidelines.<sup>75</sup> Participation in CCAs is limited to “those parties that actually benefit from their services provided to the pool.”<sup>76</sup> On the contrary, under the OECD Guidelines parties that benefit directly or indirectly from a CCA may participate in it.<sup>77</sup>

The tax deductibility of costs allocated to a German participant in a CCA depends on German domestic law.<sup>78</sup> Subject to some specific prohibitions, contributions to a CCA are generally deductible as business expenses of the

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<sup>73</sup> Decree of the Federal Ministry of Finance dated 30 December 1999, BStBl. I 1999, 1122.

<sup>74</sup> Becker, H., “Commentary on Chapter VIII of the OECD Transfer Pricing Guidelines: Cost Contribution Arrangements” (1998) *International Transfer Pricing Journal*, Vol.5, No. 2, March/April, 62, § 8.3.e.

<sup>75</sup> Waldens, S., “Cost Contribution Arrangements: Germany” (2001) *International Transfer Pricing Journal*, March/April, 49, 50.

<sup>76</sup> *Idem.*

<sup>77</sup> *Idem.*

<sup>78</sup> *Ibid.*, 51.

contributor. Clear documentation is required.<sup>79</sup> No profit mark-ups on the cost allocations are permitted.<sup>80</sup> Contributions are not treated as income of the recipient.<sup>81</sup> No income arises on sharing in the results of a R&D project.

In **Portugal**, the *Report of the Committee of Experts on International Tax Issues 1999* and subsequent Ministry of Finance reports have recommended adherence to the OECD Guidelines.<sup>82</sup> These recommendations were subsequently embodied in a ruling issued by the Ministry of Finance.<sup>83</sup> However, before the adoption of these reports and the OECD Guidelines, there were contradictory court decisions in Portugal in this area, which “bred distrust between the tax authorities and confusion of concepts within the transfer pricing area.”<sup>84</sup> In particular, there was confusion in interpreting the exact nature of a CCA. As a result of these cases, it is crucial to distinguish a CCA from a mere intra-group services agreement.<sup>85</sup> The Portuguese experience appears to some extent to be mirrored by the current situation in China.<sup>86</sup>

In Portugal, the general rule regarding business expenses is that a deduction is allowed for “all expenses necessary for the production of taxable income or to maintain assets producing such income.”<sup>87</sup> Specifically, a deduction is available for (i) the purchase or production costs of goods or services on revenue account; (ii) administration costs; and (iii) costs of analysts, research and consulting.<sup>88</sup> In accordance with the OECD Guidelines, contributions to CCAs are to be treated in the same manner as would apply under the rules applicable to the contributing participant as if the contribution were made outside the CCA.<sup>89</sup>

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<sup>79</sup> *Idem.*

<sup>80</sup> *Ibid.*, 52.

<sup>81</sup> *Ibid.*, 54.

<sup>82</sup> de Sousa da Câmara, F., “Cost Contribution Arrangements: Portugal” (2001) *International Transfer Pricing Journal*, November/December, 215.

<sup>83</sup> Ruling 1446-C/2001 of 21 December 2001.

<sup>84</sup> de Sousa da Câmara, F., “Cost Contribution Arrangements: Portugal” (2001) *International Transfer Pricing Journal*, November/December, 215.

<sup>85</sup> de Sousa da Câmara, F., “Cost Contribution Arrangements: Portugal” (2001) *International Transfer Pricing Journal*, November/December, 215, 217.

<sup>86</sup> See also under Part 6 below.

<sup>87</sup> de Sousa da Câmara, F., “Cost Contribution Arrangements: Portugal” (2001) *International Transfer Pricing Journal*, November/December, 215, 218.

<sup>88</sup> *Idem.*

<sup>89</sup> Ministry of Finance, Ruling 1446-C/2001, 21 December 2001, art.11(5).

In **Norway** there are no special rules for CCAs, but generally the tax administration follows the OECD Guidelines.<sup>90</sup> Norwegian case law supports a full deduction for contributions towards the actual costs of a R&D project, including when the research forms the basis of future activities, which benefits the contributor's business activity.<sup>91</sup>

Likewise, in **the Netherlands** the OECD Guidelines are nearly always followed, although there is no specific legislative requirement imposed upon the tax authority to do so.<sup>92</sup> Also, **Luxembourg** has no detailed rules governing CCAs in its domestic law, but arrangements in line with the OECD position are generally accepted by the tax authorities.<sup>93</sup> In the **Republic of Korea**, the Korean transfer pricing regime follows the OECD Guidelines.<sup>94</sup>

Other countries that have followed the OECD approach include **Sweden**, where through court cases, interpretation of CCAs has been consistent with the OECD Guidelines, but there is nothing specific in the Swedish tax legislation regarding the implementation of the OECD Guidelines.<sup>95</sup> The general statutory principles on the deductibility of costs are applicable to contributions under a CCA.

In **Switzerland**, where again nothing is incorporated into Swiss law, in practice the tax authorities follow the OECD Guidelines,<sup>96</sup> and even promote the use of CCAs as they are considered a more transparent alternative to licence contracts.<sup>97</sup> Since a CCA works on a cost sharing basis, which is risk-free from the point of view

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<sup>90</sup> Melson, G., and Gulsth, Ø. A., (2005) *Intellectual Property Taxation Database: Norway*, IBFD Publications, Amsterdam, § 27.

<sup>91</sup> Sollund, S., (2005) *Transfer Pricing Database: Norway*, IBFD Publications, Amsterdam; *Case law*, Court Case No. 1.

<sup>92</sup> Verdoner, L., (2001) "Cost Contribution Arrangements: Netherlands" *International Transfer Pricing Journal*, March/April, 55.

<sup>93</sup> Linz, S., and Guilloteau, F., "Cost Contribution Arrangements: Luxembourg" (2001) *International Transfer Pricing Journal*, July/August, 129.

<sup>94</sup> Kim, W.T., (2005) *Intellectual Property Taxation Database: Korea*, IBFD Publications, Amsterdam, § 27.1.

<sup>95</sup> Bäckström, P., (2005) *Intellectual Property Taxation Database: Sweden*, IBFD Publications, Amsterdam, § 27.1.

<sup>96</sup> Lehmann, D., and Sommer, B.I., (2005) *Intellectual Property Taxation Database: Switzerland*, IBFD Publications, Amsterdam, § 27.1.

<sup>97</sup> Merlino, N., and Morand, D., (2005) *Transfer Pricing Database: Switzerland*, IBFD Publications, Amsterdam, § 3.3.



of the recipient of the contributions, a Swiss taxpayer contributor is not allowed a deduction for costs that were not incurred.<sup>98</sup>

The **New Zealand** Inland Revenue Department fully endorses the OECD Guidelines (although not to the point of including them in New Zealand's income tax legislation). The Department closely follows the OECD Guidelines (including, specifically, Chapter VIII) in administering New Zealand's transfer pricing rules.<sup>99</sup> The New Zealand Transfer Pricing Guidelines supplement the OECD Guidelines, rather than supersede them.<sup>100</sup> Contributions are deductible in accordance with New Zealand tax law<sup>101</sup> and do not constitute taxable income in the hands of the recipient.<sup>102</sup> In addition, New Zealand specifically requires that the value of a participant's contribution and the expected value of its benefits must be commercially justifiable.<sup>103</sup>

There are no specific provisions in the domestic law of **France** dealing with CCAs for corporate income tax purposes. Therefore, when analysing these types of contracts, reference is made to the OECD Guidelines, as well as to the general tax rules of France.<sup>104</sup> Contributions by a French member of a CCA are deductible if they fit within the General Tax Code. This means that the costs are tax deductible if the following conditions are met: (i) the payments are in the economic interest of the payer; (ii) the payments are not for the creation or purchase of an asset; (iii) the payments are made in accordance with written accounting documentation; (iv) the CCA is not imposed on the members; (v) there is a written contract; and (vi) no "stewardship expenses" are covered under the CCA.<sup>105</sup> A participant's share of the expenses must be proportionate (on a global basis) to its share of the expected benefits. That the participants may not receive immediate benefits would not be an

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<sup>98</sup> *Idem.*

<sup>99</sup> Inland Revenue Department, "Transfer Pricing Guidelines", (2000) *Tax Information Bulletin*, Vol. 12, No. 10, October, Appendix, 1. The OECD Guidelines are also adopted for service agreements (see Dawson, J., (2005) *Intellectual Property Taxation Database: New Zealand*, IBFD Publications, Amsterdam, § 27.1.).

<sup>100</sup> *Idem.*

<sup>101</sup> *Ibid.*, § 591.

<sup>102</sup> *Ibid.*, §§ 571, 593.

<sup>103</sup> *Ibid.*, §§ 587, 594 and 597.

<sup>104</sup> Escaut, P., (2004) *Transfer Pricing Database: France*, IBFD Publications, Amsterdam, § 3.3.1.3.

<sup>105</sup> Douvier, P., "Cost Contribution Arrangements: France" (2001) *International Transfer Pricing Journal*, May/June, 93.

issue, provided that the future benefits may be expected and that in the long term such benefits do materialise.<sup>106</sup> What happens if the benefits do not materialise, or if the participant in a CCA reasonably expected future benefits to materialise but they do not? In these circumstances, according to Douvier, a limit exists in that if at the end of a “given” period, the activity does not produce any real advantage, one must ask whether independent enterprises would have continued participating in such an arrangement.<sup>107</sup> As there are no transfers of technology between participants in a CCA (the contributors jointly financing the development of R&D and becoming co-owners of the technology developed), the receipt of a contribution in France would not be regarded as income.<sup>108</sup>

**Belgium** endorses the OECD Guidelines. Contributions by a participant to a CCA are treated for tax purposes in the same manner as would apply under the general rules of the Income Tax Code.<sup>109</sup> For a contribution to be deductible, it must be incurred for the ultimate benefit of the payer and be connected with the payee’s business activity.<sup>110</sup> The mere participation of a foreign company in a CCA with a Belgian counterpart does not create a taxable presence of that contributor in Belgium.<sup>111</sup> Generally, no mark-up is allowed on the contributions.

**Japan’s** transfer pricing regulations do not include any specific rules or regulations for CCAs.<sup>112</sup> However, according to Fujieda and Matsuda, because there are no specific rules it is likely that the OECD Guidelines are taken into account by the tax authority when determining cost contributions in Japan.<sup>113</sup> Ordinarily, no profit element can be attached to the costs.<sup>114</sup>

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<sup>106</sup> Escaut, P., (2004) *Transfer Pricing Database: France*, IBFD Publications, Amsterdam, § 3.3.1.3.

<sup>107</sup> Douvier, P., “Cost Contribution Arrangements: France” (2001) *International Transfer Pricing Journal*, May/June, 93, 95.

<sup>108</sup> Escaut, P., (2004) *Transfer Pricing Database: France*, IBFD Publications, Amsterdam, § 3.3.1.3.

<sup>109</sup> Verlinden, I., Boone, P., and van den Bussche, A., “Cost Contribution Arrangements: Belgium” (2001) *International Transfer Pricing Journal*, May/June, 85, 86.

<sup>110</sup> *Idem.*

<sup>111</sup> *Idem.*

<sup>112</sup> Fujieda, A., and Matsuda, S., (2005) *Intellectual Property Taxation Database: Japan* IBFD Publications, Amsterdam, § 27.1.

<sup>113</sup> The Japanese, in following the approach of the United States, refer to CCAs as CSAs. *Ibid.*, § 27.2.

<sup>114</sup> Campbell, M. T., Okawara, K., and Gruendel, K., (2005) *Transfer Pricing Database*, IBFD Publications, Amsterdam, § 3.3.4.

Although in **Finland** CCAs are rare, a subsidiary company is allowed a tax deduction if the transaction for R&D or services complies with certain tests. The OECD Guidelines are generally followed in Finland despite them not having been implemented through Finnish tax legislation, and thus not being legally binding. The principles and concepts of the OECD Guidelines are mainly followed through court decisions, although they are not mentioned specifically in the cases. The method for determining arm's length CCA contributions is that a "participant's arm's length contribution must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances".<sup>115</sup> This usually means a benefit test. The same test is applied to services in that the taxpayer must be able to prove that the services have actually been provided, the benefits received from the services correspond to the remuneration paid, and the costs have actually been incurred by the company rendering the services.<sup>116</sup>

The OECD Guidelines are not legally binding in **Hungary** (where CCAs are becoming increasingly popular because of favourable tax incentives), but are important in practice and are the generally accepted rules by the Ministry of Finance.<sup>117</sup> Expenses in general are deductible for corporate tax purposes if they are incurred in the interest of the business activity of the company.<sup>118</sup> Payments made by Hungarian participants in a CCA are treated in the same way as if the contributions were made outside the CCA for the activity that is the subject of the CCA. Generally, expenses are only deductible for corporate tax purposes if they are incurred in the interest of the company's business activity.<sup>119</sup>

In **Australia**, the OECD Guidelines have substantially been followed with respect to CCAs by means of an Australian Tax Office (ATO) ruling.<sup>120</sup> Anderson and Price state that "the ATO's view of CCAs is highly consistent with the OECD,

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<sup>115</sup> Torkkel, T., and Silviu, T., (2005) *Intellectual Property Taxation Database: Finland* IBFD Publications, Amsterdam, § 27.2.

<sup>116</sup> *Idem.*

<sup>117</sup> Dozsa, M., "Cost Contribution Arrangements: Hungary" (2001) *International Transfer Pricing Journal*, July/August, 124.

<sup>118</sup> *Ibid.*, 125.

<sup>119</sup> *Idem.*

<sup>120</sup> Australian Tax Office, Ruling TR 95/29.

but with some small differences in interpretation and application.”<sup>121</sup> The interpretation in Australia is that CCAs are a form of joint venture, which is either arrangements for developing, producing or obtaining assets or rights, or pure service arrangements.<sup>122</sup> In Australia, a “CCA is considered to be arm’s length by the ATO if it accords with what independent parties dealing at arm’s length would have agreed in comparable circumstances.”<sup>123</sup> In assessing the arm’s length nature of a transaction, the ATO looks to whether (i) the arrangements make business sense; (ii) the terms of an arrangement accord with economic substance; (iii) the terms are agreed up-front; (iv) the participants have a reasonable expectation of benefit; (v) the sharing of contributions are consistent with the sharing of expected benefits; and (vi) the entry, withdrawal and termination is on arm’s length terms.<sup>124</sup> These requirements fit well with the OECD Guidelines.

Contributions by a CCA participant are deductible to the extent that the Australian tax law would allow a deduction if the contributions were made outside the CCA to carry on the activity that is the subject of the CCA. The character of the contribution (that is, of a capital or revenue nature) will determine its tax deductibility.<sup>125</sup> The ATO has determined that, for consistency with the arm’s length principle, a mark-up is required if the activities of a CCA are performed by a separate Australian entity.<sup>126</sup> Buy-in and buy-out payments are generally treated as non-deductible capital payments.<sup>127</sup> In the case of a genuine CCA, the ATO does not consider that contributions received under the CCA are income. The contributions are not for the supply or transfer of know-how; they are for the joint acquisition of an asset on the joint undertaking of a task.<sup>128</sup>

In **Denmark**, a cost contribution payment is “deducible as if the paying entity has performed the R&D itself.”<sup>129</sup> In principle, a mark-up is not allowed since the

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<sup>121</sup> Anderson, P., and Price, G., “Draft Guidance on Cost Contribution Arrangements” (2004) *International Transfer Pricing Journal*, January/February, 30.

<sup>122</sup> *Idem.*

<sup>123</sup> *Idem.*

<sup>124</sup> *Idem.*

<sup>125</sup> Anderson, P., and Graham, P., “Cost Contributions Arrangements: Australia” (2001) *International Transfer Pricing Journal*, March/April, 46, 47.

<sup>126</sup> *Ibid.*, 49.

<sup>127</sup> *Ibid.*, 48.

<sup>128</sup> *Ibid.*, 47.

<sup>129</sup> Reumert, K., (2004) *Transfer Pricing Database: Denmark*, IBFD Publications, Amsterdam, § 3.4.

aim of a CCA is to reimburse costs only.<sup>130</sup> Costs related to general management services are not deductible by a subsidiary company.<sup>131</sup> This is because “services relating to the control and supervision of a subsidiary are regarded as carried out for the benefit of the parent company and not the subsidiary.”<sup>132</sup> However, other service costs are deductible; for example, group-wide advertising and costs relating to general computer networks.<sup>133</sup> The benefit test is used to determine whether services are deductible for tax purposes; that is, the question is whether the member has derived (or is expected to derive) a benefit in consideration for the contribution. The reimbursement of costs is taxable income of the receiving entity, which is allowed a deduction for an equal amount<sup>134</sup> (representing expenditure for which the cost reimbursement payment was made).

Contributions by a **Singapore** participant under an approved CCA for R&D activities are treated as capital expenditure, but may be amortised over a five-year period. Singapore does not treat such contributions as income.<sup>135</sup>

**Ireland** prohibits a deduction for any expenditure that is not made wholly and exclusively for the purpose of a trade. A contribution made under a CCA is therefore deductible if the purpose is to benefit the trade of the contributor.<sup>136</sup>

**Austria** allows deductions for the costs of services if the taxpayer can prove that they should be allowed a deduction. Austria seems to follow the OECD Guidelines and would appear to allow a deduction for cost contributions if the expenditure is properly documented.<sup>137</sup>

The OECD Guidelines are important and influential in **South Africa** in determining its approach to transfer pricing, despite South Africa not being a member

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<sup>130</sup> *Idem.*

<sup>131</sup> *Ibid.*, § 3.5.

<sup>132</sup> *Idem.*

<sup>133</sup> *Idem.*

<sup>134</sup> *Ibid.*, § 3.4.

<sup>135</sup> Kwong, L. Y., and Ee, T. L., (2005) *Transfer Pricing Database: Singapore*, IBFD Publications, Amsterdam, § 3.6

<sup>136</sup> McAvoy, J., (2005) *Transfer Pricing Database: Ireland*, IBFD Publications, Amsterdam, § 3.6.

<sup>137</sup> Zöchling, H., and Halwachs, C., (2004) *Transfer Pricing Database: Austria*, IBFD Publications, Amsterdam, § 7.

country of the OECD and CCAs not being common there.<sup>138</sup> There is no guidance on CCAs in the South African domestic law. Therefore, authors like du Toit recommend that taxpayers follow the OECD Guidelines.<sup>139</sup> Under South African domestic tax law, the South African Revenue Service considers R&D expenses to be capital in nature or not incurred in the production of income, and therefore not deductible.<sup>140</sup>

CCAs for joint development of intangibles are rare in South Africa because “exchange controls have historically prevented intangible property developed by a resident entity from being transferred outside of South Africa to related parties ...”.<sup>141</sup> Therefore, in South Africa CCAs are most commonly used for sharing costs of support services.<sup>142</sup> For a taxpayer to obtain a deduction for a cost contribution, it would need to show that (i) the contribution is deductible in terms of normal tax principles; and (ii) the income received has been calculated on an arm’s length basis.<sup>143</sup> Additionally, the taxpayer would need to prove that the costs borne are actually incurred in the production of income for the purpose of a trade, and are not of capital nature.<sup>144</sup>

In **Israel** the tax law does not refer to CCAs. Revenues and costs under CCA arrangements are shared on a geographical basis as they arise. Cost contributions are deductible in terms of Israeli tax law. Contributions are not regarded as income in the hands of the recipient.<sup>145</sup>

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<sup>138</sup> Miller, K., and Lerner, D., “Cost Contribution Arrangements: South Africa” (2001) *International Transfer Pricing Journal*, March/April, 61.

<sup>139</sup> du Toit, C.P., (2005) *Intellectual Property Taxation Database: South Africa*, IBFD Publications, Amsterdam, § 27.1.

<sup>140</sup> Miller, K., and Lerner, D., “Cost Contribution Arrangements: South Africa” (2001) *International Transfer Pricing Journal*, March/April, 61, 62.

<sup>141</sup> *Ibid.*, 61-62.

<sup>142</sup> *Ibid.*, 62.

<sup>143</sup> *Ibid.*, 61-62.

<sup>144</sup> Income Tax Act 1962 (South Africa), ss. 11(a) and 23(g).

<sup>145</sup> Harris, L., (2005) *Intellectual Property Taxation Database: Israel*, IBFD Publications, Amsterdam, § 27.

## 5.2 Category 2 – Countries that have not followed the OECD Guidelines

Countries that fall within this category are countries that have elected not to follow the OECD Guidelines, and those that have not considered the issues as at October 2005.

**Argentina** has incorporated the arm's length principle into its income tax law. However, there is no mention of the OECD Guidelines in its legislation or in any tax administration guidelines.<sup>146</sup>

Likewise, the law of the **Czech Republic** does not provide for any special rules on CCAs.<sup>147</sup> Although the approach of the Czech Republic has been open to CCAs, there are no specific rules about tax deductions for contributions, the tax treatment of contributions received, nor adherence to the OECD Guidelines.

**India** does not have any specific rules covering CCAs. It seems that the issue has not been considered in any depth there.

In **Romania**, the tax authority typically has not accepted payments made under CCAs, which are discouraged. Anghel suggests that a cost sharing formula might be acceptable in Romania if some correspondence with the future benefits to be derived by each contributor can be established.<sup>148</sup>

Table 2 gives a summary of the positions adopted by the countries surveyed above in relation to the OECD Guidelines.

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<sup>146</sup> Asorey, R.O., (2004) *Transfer Pricing Database: Argentina* IBFD Publications, Amsterdam, §§ 3.3 - 3.4.

<sup>147</sup> Navrátilová, H., and Pospisilová, P., (2005) *Intellectual Property Taxation Database: Czech Republic*: IBFD Publications, Amsterdam.

<sup>148</sup> Anghel, S. A., (2004) *Transfer Pricing Database : Romania*, IBFD Publications, Amsterdam, § 3.3.

**Table 2**  
**Summary of approaches in countries surveyed**

	Deduction allowed to participant for contributions	Contributions not taxable income of recipient
<b>DOMESTIC LAW</b>		
Canada	✓	✓
Spain	✓	✓
United Kingdom	✓	✓
United States of America	✓	✓
<b>OECD FOLLOWED</b>		
Australia	✓	✓
Austria	✓	-
Belgium	✓	-
Denmark	✓	✓*
Germany	✓	✓
Finland	✓	-
France	✓	✓
Hungary	✓	-
Ireland	✓	-
Israel	✓	✓
Japan	✓	-
Korea (Rep.)	✓	-
Luxembourg	✓	-
Netherlands	✓	-
New Zealand	✓	✓
Norway	✓	-
Portugal	✓	-
Singapore	✓	✓
South Africa	✓	-
Sweden	✓	-
Switzerland	✓	-
<b>OECD NOT FOLLOWED</b>		
Argentina	-	-
Czech Republic	-	-
India	-	-
Romania	-	-

This table shows that out of the 29 countries sampled, nearly all countries (25) allow a deduction for contributions by participants to a CCA. Where the data was available, 11 countries did not treat the receipt of the contribution as income in the hands of the recipient. In the remaining cases, the data was silent about the taxability of the receipt, which appears to imply (both conceptually and legally) that the receipts were not taxable income of the recipient. This seems almost certainly to be the case for countries that follow the OECD Guidelines. Furthermore, if the receipts were taxable, the expectation is that the data would have included a specific statement to

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\* The contribution is treated as income, but an offsetting deduction is allowed.



that effect. Arguably, where this point was not mentioned in the data, it may have been because the absence of a tax effect was considered obvious. As Pedersen puts it “[i]n most cases, there will [be] no basis for taxing non-resident members of a CCA.”<sup>149</sup>

## 6. Contentious issues

It is evident from the tax treatment currently applied in China<sup>150</sup> that China does not regard contributions made under a CCA as payments made under true cost-sharing arrangements for which no assets or service is transferred to the contributor in return for its contribution. Rather, China regards such payments as payments for services (or for an asset) to be supplied to the payer. This interpretation is inconsistent with the concept of a true CCA and the generally accepted international view (enunciated by the OECD and the countries that adopt the OECD approach or a similar approach) of what a CCA is and what the nature of contributions in respect of it are. The consequence is that payments made under CCAs are, in practice, considered service fees or royalties by SAT and are therefore subject to the business tax or the foreign enterprise income tax in China.<sup>151</sup> As explained in Part 1 of this paper, the problem of the current approach in China is that China does not recognise that the nature of a CCA is one of pooling resources already owned by contributors and their drawing of the benefits of the activity undertaken by a representative of them. That representative merely incurs expenditure on behalf of the contributors and returns to them what is already theirs. The difficulty with the Chinese interpretation can be illustrated by the following analogy: assume that two friends go out for a meal, and Friend #1 pays the total bill after the meal. Friend #2 pays Friend #1 his half of the bill the next day. In doing so, it is not logically feasible to suggest that Friend #1 has rendered services (viz. the provision of a meal) to Friend #2 and therefore half of the amount of the cost of the meal is taxable income of Friend #1. In reality, no services (in the form of providing a meal) have been rendered at all by Friend #1. He has not derived any income and certainly has not made any gain.

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<sup>149</sup> Pedersen, B. M., “Cost Contribution Arrangements: Denmark” (2001) *International Transfer Pricing Journal*, November/December, 208.

<sup>150</sup> See Part 3 of this paper.

<sup>151</sup> See generally minutes of discussion at the International Seminar: Joint Research Project on Taxation, 29-30 June 2005.

Friend #2 has simply contributed his share of the costs to an activity, carried out by a third party, in proportion to the benefit that Friend #2 derived from it. In other words, the costs levied by the third party on Friend #1 and Friend #2 together have simply been shared by each of them.

A further issue relates to valuation, whether or not the payment is indeed income. This is essentially a transfer pricing issue. In the context of CCAs, the concern in this respect from China's perspective is that deductible expenses of the Chinese entity are not artificially inflated.

As for any country, more generally there may also be an absence of a definite means of appraising the extent to which the services will actually benefit the contributor and, accordingly, difficulties with the selection of an appropriate allocation key. Benefits may be realised in the future, but they are not guaranteed. An extension of this problem is when costs have been contributed to a R&D activity, but nothing has resulted from that activity. For example, when an oil exploration consortium drills for oil, the discovery of oil is by no means guaranteed. There is a right to exploit the benefits of the drilling. The benefits (if they do occur) will, at least initially, not arise in the same years that the participants in the consortium made their contributions. It is also possible that oil will never be found, such that the expected benefits never arise. As stated in Part 5, the French address such problems by imposing a – albeit very loosely defined – time limit by which ascertainment of benefits should be made.

To achieve a degree of certainty, it has also been suggested that, upon setting up a CCA, a participant requests a binding ruling or advance pricing agreement in order to eliminate the risks of not complying with a domestic tax authority's interpretation and tax treatment of the CCA.<sup>152</sup> This would be helpful for taxpayers operating in China. However, unless rulings are issued on a timely basis, the period that a tax authority takes to issue the rulings can inhibit the underlying economic efficiency of the taxpayer entering into the CCA. This issue provides a further reason

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<sup>152</sup> de Sousa da Câmara, F., "Cost Contribution Arrangements: Portugal" (2001) *International Transfer Pricing Journal*, November/December, 215, 219.

for China to consider the introduction of a binding rulings regime, in a broader context.

## **7. Conclusion**

This paper has presented, as a basis for further discussion, an examination and explanation of the notion of a CCA. It has outlined the international best practice of the income tax treatment of the payment and receipt of contributions by participants under a CCA, as enunciated by the OECD Guidelines and the US Regulations.

A survey of 30 countries (including China) indicates that the OECD approach to tax deductibility of a participant's contributions to a CCA is overwhelmingly adopted. Furthermore, conceptually, contributions received under a CCA should not be treated as income of the recipient, given the nature of a CCA. All of the countries surveyed, for which the data addressed the question, did not treat such receipts as income. For those countries where the data was silent about the question of taxability of a contribution receipt, it seems reasonable to conclude that the contribution is not assessable income if the country follows the OECD Guidelines.

International best practice has been contrasted with the current law and practice in China. The survey results demonstrate that the current practice in China, with respect to CCAs, is not consistent with the correct interpretation of the concept of a CCA, and therefore inconsistent with the best international practice of the income tax treatment of contributions made under CCAs.

The Chinese tax authorities and taxpayers can learn much from the way in which CCAs are treated in other jurisdictions. This is not to advocate that the OECD Guidelines should be blindly adopted. As the country survey shows, most countries apply the thrust of the OECD Guidelines but often adapt some of their detail to fit the particular country's circumstances, such as the United States' use of a hindsight test.

It is recommended that China quickly adopts the OECD Guidelines' approach to the international taxation of CCAs, possibly incorporating such variations to detail mentioned above, in order to avoid the Portuguese-type experience of distrust

between MNEs and the tax authorities, emanating from different understandings of the nature of a CCA.

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