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APPENDICES TO LECTURE OUTLINE

APPENDIX 62 (COST SHARING)

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OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VIII, paragraphs 8.1-8.43

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Part 4. Qualifying Cost Contribution Arrangements (QCCA)

120. Subsection 247(1) of the Act defines a qualifying cost contribution arrangement (QCCA). In general terms, a QCCA is an arrangement whereby two or more parties share the costs and risks of producing, developing, or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement.

121. Each participant's expected benefit from a QCCA, for the purposes of apportioning the costs, consists of the benefits that the participant will derive from exploiting the results of the QCCA, and not from the actual activities of the QCCA. If the QCCA develops property such as an intangible, each participant in a QCCA is not

required to be a legal owner of the property, but each participant must enjoy substantially similar rights, benefits, and privileges as a legal owner (effective or beneficial ownership).

122. Frequently, a QCCA is concluded for the joint development of intangible property, with each participant being assigned an interest in the developed property. However, participants may also pool their resources to acquire any type of centralized services (e.g., accounting, computer technical support, human resources, or the development of an advertising campaign common to the participants' markets).

123. For a QCCA to satisfy the arm's length principle, each participant's contribution must be consistent with that which an arm's length party would have agreed to contribute under comparable circumstances given the benefit it would have reasonably expected to derive from the arrangement. Therefore, only persons who can reasonably be expected to derive a benefit from the results of a QCCA can be considered participants in that QCCA. The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful.

124. Under the arm's length principle, the value of each participant's contribution to a QCCA should be consistent with the value that arm's length parties would have assigned to that contribution in comparable circumstances. The application of the arm's length principle would take into account, among other things, the contractual terms and economic circumstances particular to the QCCA.

125. Where a participant to a QCCA, or a non-arm's length party to a participant to a QCCA, performs all or part of the QCCA activities, it would expect to be compensated on an arm's length basis. The arm's length compensation would be determined under the general principles discussed in this circular, including consideration of functions performed, assets used, and risks assumed. This compensation can include expected benefits from the QCCA.

126. The arm's length principle also applies to capital contributions of tangible or intangible assets to a QCCA. For example, where two parties intend to be equal participants in a QCCA, with the first party contributing property with a fair market value well in excess of its cost, and the other contributing cash, cost would not be an appropriate measure of the first party's contribution.

127. Under a QCCA, a participant's share of the overall contributions to the QCCA must be in proportion to the share of the overall benefits it expects to derive from the arrangement.

128. In theory, each participant's share of the benefits may be determined by directly estimating:

- the anticipated additional income that each participant is expected to generate as a result of its participation in the arrangement; or
- the anticipated cost savings they expect to gain as a result of its participation in the arrangement.

129. In practice, to indirectly estimate the additional income to be derived from the arrangement, the participants may use allocation keys such as:

- sales;
- units used, produced or sold;
- gross or operating profit;
- number of employees; or
- capital invested.

130. A taxpayer should choose allocation keys, taking into account:

- the nature of the QCCA; and
- the relationship between the allocation key and the expected benefits.

For example, projected sales of the end-products may not be an appropriate allocation key where:

- a particular component is developed within a QCCA; and
- the component is used by the participants in a variety of end-products that differ significantly in price.

The differences in the prices of the end-products will distort the relationship between the cost to the participants and their expected benefits. In this case, the number of components used by each participant may be a better measure of the expected benefits to the participants.

131. For tax purposes, the contributions by a participant to a QCCA will be treated as though they were made outside the scope of the QCCA to carry on the activities that are the subject of the QCCA (e.g., to perform scientific research and experimental development (SR&ED) or purchase a capital asset). The deductibility of the costs allocated to a particular taxpayer is determined in accordance with the Act. The fact that a charge for the costs is itself justified does not automatically make the costs deductible under the Act.

132. Where a participant's contribution to a QCCA is not consistent with its share of the expected benefit, a balancing payment may be

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required between the participants to adjust their respective contributions.

133. For tax purposes, the balancing payment should be treated as an addition to the cost of the payer and as a reimbursement of costs to the recipient. Where the balancing payment is more than the recipient's expenditures or costs, the excess will be treated as a taxable amount.

134. The costs subject to allocation would be net of other QCCA receipts, (i.e., royalties from licenses or proceeds from the sale of research assets). Costs subject to allocation for SR&ED carried out in Canada under a QCCA will be calculated before deducting any tax incentives (i.e., SR&ED tax credits) earned with respect to the SR&ED, but after deducting subsidies granted by a government, unless there is evidence that arm's length parties would have done otherwise.

135. Under the arm's length principle, participants in a QCCA that transfer a part or all of their interests in the results of prior QCCA activities (such as intangible property, work in-progress, or the knowledge obtained from past QCCA activities) to a new participant should receive arm's length compensation from the new participant for that property (a buy-in payment). The amount of a buy-in payment should be determined, based on the price an arm's length party would have paid for the rights obtained by the new participant. This determination would take into account the proportionate share of the overall expected benefit to be received from the QCCA.

136. For tax purposes, a buy-in payment will be treated as if the payment was made outside the QCCA for acquiring the interest in the rights being obtained (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

137. Similar issues arise when a participant to a QCCA disposes of part or all of its interest in a QCCA. The effective transfer of property interests should be compensated according to the arm's length principle (a buy-out payment). However, taxpayers should exercise care in the event of either a buy-in or buy-out because the very nature of any intangibles in a QCCA may often make the buy-in or buy-out valuation difficult. This valuation is particularly difficult where the intangibles developed by a QCCA are valuable or unique.

138. For tax purposes, a buy-out payment will be treated as if the payment was made outside the QCCA for the disposal of pre-existing interests (e.g., an interest in intangible property already developed by the QCCA, work in progress, or the knowledge obtained from past QCCA activities).

TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Chapter VIII

Cost contribution arrangements

A. Introduction

8.1 This Chapter discusses cost contribution arrangements (CCAs) between two or more associated enterprises (possibly along with independent enterprises). There are many types of CCAs and this Chapter does not intend to discuss or describe the tax consequences of every variation. Rather, the purpose of the Chapter is to provide some general guidance for determining whether the conditions established by associated enterprises for a CCA are consistent with the arm's length principle. The tax consequences of a CCA will depend upon whether the arrangement is structured in accordance with the arm's length principle according to the provisions of this Chapter and is adequately documented. This Chapter does not resolve all significant issues regarding the administration and tax consequences of CCAs. For example, further guidance may be needed on measuring the value of contributions to CCAs, in particular regarding when cost or market prices are appropriate, and the effect of government subsidies or tax incentives (see paragraphs 8.15 and 8.17). Further development might also be useful regarding the tax characterisation of contributions, balancing payments and buy-in/buy-out payments (see paragraphs 8.23, 8.25, 8.33 and 8.35). Additional work will be undertaken as necessary to update and elaborate this Chapter as more experience is gained in the actual operation of CCAs.

8.2 Section B provides a general definition and overview of the concept of CCAs. Section C describes the standard for determining whether a CCA satisfies the arm's length principle. The discussion includes guidance on how to measure contributions for this purpose, guidance on whether balancing payments are needed (*i.e.* payments between participants to adjust their proportionate shares of contributions), and guidance on how contributions and balancing payments should be treated for tax purposes. Section C also addresses the determining of participants and the treatment of special purpose companies. Section D discusses the adjustments to be made in the event that the conditions of a CCA are found to be inconsistent with the arm's length principle, including adjustments of the proportionate shares of contributions under the arrangement. Section E addresses issues relating to entry into or

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withdrawal from a CCA after the arrangement has already commenced. Section F discusses suggestions for structuring and documenting CCAs.

B. Concept of a CCA

i) In general

8.3 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 CCA is a contractual arrangement rather than necessarily a distinct juridical entity or permanent establishment of all the participants. 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, bearing in mind that transfer pricing is not an exact science. Further, each participant in a CCA would be entitled to exploit its interest in the CCA separately as an effective owner thereof and not as a licensee, and so without paying a royalty or other consideration to any party for that interest. Conversely, any other party would be required to provide a participant proper consideration (*e.g.* a royalty), for exploiting some or all of that participant's interest.

8.4 Some benefits of the CCA activity will be known in advance, whereas other benefits, for example, the outcome of research and development activities, will be uncertain. Some types of CCA activities will produce benefits in the short term, while others have a longer time frame or may not be successful. Nevertheless, in a CCA there is always an expected benefit that each participant seeks from its contribution, including the attendant rights to have the CCA properly administered. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants, *e.g.* because legal ownership of developed intangible property is vested in only one of them but all of them have effective ownership interests.

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ii) Relationship to other chapters

8.5 Chapter VI and Chapter VII provide guidance on how to determine an arm's length consideration for an intra-group transfer of, respectively, intangible property and services. This Chapter's goal is to provide supplementary guidance where resources and skills are pooled and the consideration received is, in part or whole, the reasonable expectation of mutual benefits. Thus, the provisions of Chapter VI and VII, and indeed all the other chapters of these Guidelines, will continue to apply to the extent relevant, for instance in measuring the amount of a contribution to a CCA as part of the process of determining the proportionate shares of contributions. MNEs are encouraged to observe the guidance of this Chapter in order to ensure that their CCAs are in accordance with the arm's length principle.

iii) Types of CCAs

8.6 Perhaps the most frequently encountered type of CCA is an arrangement for the joint development of intangible property, where each participant receives a share of rights in the developed property. In such a CCA, each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications. Stated more generally, a participant uses the intangible property for its own purposes rather than in a joint activity with other participants. The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired.

8.7 While CCAs for research and development of intangible property are perhaps most common, CCAs need not be limited to this activity. CCAs could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services. For example, business enterprises may decide to pool resources for acquiring centralised management services, or for the development of advertising campaigns common to the participants' markets.

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C. Applying the arm's length principle

i) In general

8.8 For the conditions of a CCA 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. What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills. Independent enterprises do enter into arrangements to share costs and risks when there is a common need from which the enterprises can mutually benefit. For instance, independent parties at arm's length might want to share risks (*e.g.* of high technology research) to minimise the loss potential from an activity, or they might engage in a sharing of costs or in joint development in order to achieve savings, perhaps from economies of scale, or to improve efficiency and productivity, perhaps from the combination of different individual strengths and spheres of expertise. More generally, such arrangements are found when a group of companies with a common need for particular activities decides to centralise or undertake jointly the activities in a way that minimises costs and risks to the benefit of each participant.

8.9 The expectation of mutual benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills without separate compensation. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. To apply the arm's length principle to a CCA, it is therefore necessary to determine that all the parties to the arrangement have the expectation of benefits, then to calculate each participant's relative contribution to the joint activity (whether in cash or in kind), and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) is proper. It should be recognised that these determinations may bear a degree of uncertainty. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against

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the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA (see Section F).

ii) Determining participants

8.10 Because the concept of mutual benefit is fundamental to a CCA, it follows that a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity). A participant therefore must be assigned a beneficial interest in the property or services that are the subject of the CCA, and have a reasonable expectation of being able directly or indirectly (*e.g.* through licensing arrangements or sales, whether to associated or independent enterprises) to exploit or use the interest that has been assigned.

8.11 The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful. For example, research and development may fail to produce commercially valuable intangible property. However, if the activity continues to fail to produce any actual benefit over a period in which the activity would normally be expected to produce benefits, tax administrations may question whether the parties would continue their participation had they been independent enterprises (see the sections in Chapter I on business strategies (particularly 1.35), and losses (1.52-1.54)).

8.12 In some cases, the participants in a CCA may decide that all or part of the subject activity will be carried out by a separate company that is not a participant under the standard of paragraph 8.10 above. In such a case of contract research and/or manufacturing, an arm's length charge would be appropriate to compensate the company for services being rendered to the CCA participants. This would be the case even where, for example, the company is an affiliate of one or more of the CCA participants and has been incorporated in order to secure limited liability exposure in case of a high-risk research and development CCA activity. The arm's length charge for the company would be determined under the general principles of Chapter I, including *inter alia* consideration of functions performed, assets used, and risks assumed, as well as the special considerations affecting an arm's length charge for services as described in Chapter VII, particularly paragraphs 7.29 - 7.37.

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iii) The amount of each participant's contribution

8.13 For the purpose of determining whether a CCA satisfies the arm's length principle -- *i.e.* whether each participant's proportionate share of the overall contributions to the CCA is consistent with the participant's proportionate share of the overall expected benefits -- it is necessary to measure the value or amount of each participant's contributions to the arrangement.

8.14 Under the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances. Therefore, in determining the value of contributions to a CCA the guidance in Chapters I through VII of these Guidelines should be followed. For example, as indicated in Chapter I of these Guidelines, the application of the arm's length principle would take into account, *inter alia*, the contractual terms and economic circumstances particular to the CCA, *e.g.* the sharing of risks and costs.

8.15 No specific result can be provided for all situations, but rather the questions must be resolved on a case-by-case basis, consistent with the general operation of the arm's length principle. Countries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm's length CCAs. It is unlikely to be a straightforward matter to determine the relative value of each participant's contribution except where all contributions are made wholly in cash, for example, where the activity is being carried on by an external service provider and the costs are jointly funded by all participants.

8.16 It is important that the evaluation process recognises all contributions made by participants to the arrangement, including property or services that are used partly in the CCA activity and also partly in the participant's separate business activities. It can be difficult to measure contributions that involve shared property or services, for example where a participant contributes the partial use of capital assets such as buildings and machines or performs supervisory, clerical, and administrative functions for the CCA and for its own business. It will be necessary to determine the proportion of the assets used or services that relate to the CCA activity in a commercially justifiable way with regard to recognised accounting principles and the actual facts, and adjustments, if material, may be necessary to achieve consistency when

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different jurisdictions are involved. Once the proportion is determined, the contribution can be measured in accordance with the principles in the rest of the Chapter.

8.17 In measuring a participant's contribution, there is an issue regarding any savings arising from subsidies or tax incentives (including credits on investments) that may be granted by a government. Whether and if so to what extent these savings should be taken into account in measuring the value of a participant's contribution depends upon whether independent enterprises would have done so in comparable circumstances.

8.18 Balancing payments may be required to adjust participants' proportionate shares of contributions. A balancing payment increases the value of the contributions of the payer and decreases the value of the contributions of the payee by the amount of the payment. Balancing payments should maintain the arm's length condition that each participant's proportionate share of the overall contributions be consistent with its proportionate share of the overall expected benefits to be received under the arrangement. For the tax treatment of balancing payments, see paragraph 8.25 below.

iv) Determining whether the allocation is appropriate

8.19 There is no 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. The goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate contributions in the same proportions. The shares of expected benefits might be estimated based on the anticipated additional income generated or costs saved by each participant as a result of the arrangement. Other techniques to estimate expected benefits (*e.g.* using the price charged in sales of comparable assets and services) may be helpful in some cases. Another approach that is frequently used in practice would be to reflect the participants' proportionate shares of expected benefits by using an allocation key. The possibilities for allocation keys include sales, units used, produced, or sold, gross or operating profit, the number of employees, capital invested, and so forth. Whether any particular allocation key is appropriate depends on the

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nature of the CCA activity and the relationship between the allocation key and the expected benefits.

8.20 To the extent that a material part or all of the benefits of a CCA activity are expected to be realised in the future and not currently, the allocation of contributions will take account of projections about the participants' shares of those benefits. Use of projections may raise problems for tax administrations in verifying that such projections have been made in good faith and in dealing with cases where the projections vary markedly from the actual results. The problems may be exacerbated where the CCA activity ends several years before expected benefits actually materialise. It may be appropriate, particularly where benefits are expected to be realised in the future, for a CCA to provide for possible adjustments of proportionate shares of contributions over the term of the CCA on a prospective basis to reflect changes in relevant circumstances resulting in changes in shares of benefits. In situations where actual results differ markedly from projections, tax administrations might be prompted to inquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight.

8.21 In estimating the relative expected benefits accruing from R&D directed towards the development of a new product line or process, one measure sometimes used by businesses is the projected sales of the new product line or projected stream of royalties to be received from licensing the new process. This example is for illustration only and it is not intended to suggest a preference for the use of sales data for any particular case. Whatever the indicator, if benefits are expected to be realised in the future, care must be taken to ensure that any current data used are a reliable indicator of the future pattern of shares of benefits.

8.22 Whatever the allocation method, adjustments to the measure used may be necessary to account for differences in the expected benefits to be received by the participants, *e.g.* in the timing of their expected benefits, whether their rights are exclusive, the different risks associated with their receipt of benefits, etc. The allocation key most relevant to any particular CCA may change over time. If an arrangement covers multiple activities, it will be important to take this into account in choosing an allocation method, so that the contributions being allocated are properly related to the benefits expected by

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the participants. One approach (though not the only one) is to use more than one allocation key. For example, if there are five participants in a CCA, one of which cannot benefit from certain research activities undertaken within the CCA, then in the absence of some form of set-off or reduction in contribution the costs associated with those activities might be allocated only to the other four participants. In this case, two allocation keys might be used to allocate the costs. Also, exchange of information between treaty partners, the mutual agreement procedure, and bilateral or multilateral advance pricing arrangements may help establish the acceptability of the method of allocation.

v) The tax treatment of contributions and balancing payments

8.23 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 system(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 (*e.g.* to perform research and development, to obtain a beneficial interest in property needed to carry out the CCA activity). The character of the contribution, *e.g.* as a research and development expense, will depend on the nature of the activity being undertaken by the CCA and will determine how it is recognised for tax purposes. Frequently, the contributions would be treated as deductible expenses by reference to these criteria. 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 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.

8.24 Because a participant's proper contribution to a CCA is to be rewarded by the expected benefits to be derived from the arrangement and these expected benefits may not accrue until a later period, there is generally no immediate recognition of income to the contributor at the time the contribution is made. The return to the contributor on its contribution will be recognised either in the form of cost savings (in which case there may not be any income generated directly by the CCA activity), or obtained as the results of the activity generate income (or loss) for the participant, for instance, in the case of R&D. Of course, in some cases such as the provision of services the benefits

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arising from the arrangement may flow in the same period in which the contribution is made and would therefore be recognised in that period.

8.25 A balancing payment should be treated as an addition to the costs of the payer and as a reimbursement (and therefore a reduction) of costs to the recipient. A balancing payment would not 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) and the payer does not also obtain a beneficial interest in the intangible property itself. In some cases a balancing payment might exceed the recipient's allowable expenditures or costs for tax purposes determined under the domestic tax system, in which case the excess could be treated as taxable profit.

D. Tax consequences if a CCA is not arm's length

8.26 A CCA will be considered consistent with the arm's length principle where each participant's proportionate share of the overall contributions to the arrangement, adjusted for any balancing payments, is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. Where this is not the case, the consideration received by at least one of the participants for its contributions will be inadequate, and the consideration received by at least one other participant for its contribution will be excessive, relative to what independent enterprises would have received. In such a case, the arm's length principle would require that an adjustment be made. The nature of the adjustment will depend upon the facts and circumstances, but most often will be an adjustment of the net contribution through making or imputing a balancing payment. Where the commercial reality of an arrangement differs from the terms purportedly agreed by the participants, it may be appropriate to disregard part or all of the terms of the CCA. These situations are discussed below.

i) Adjustment of contributions

8.27 Where a participant's proportionate share of the overall contributions to a CCA, adjusted for any balancing payments, is not consistent with the participant's proportionate share of the overall expected benefits to be received

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under the arrangement, a tax administration is entitled to adjust the participant's contribution (although bearing in mind that tax administrations should hesitate from making minor or marginal adjustments). See paragraph 1.68. Such a situation may arise where the measurement of a participant's proportionate contributions of property or services has been incorrectly determined, or where the participants' proportionate expected benefits have been incorrectly assessed, *e.g.* where the allocation key when fixed or adjusted for changed circumstances was not adequately reflective of proportionate expected benefits. See paragraph 8.19. Normally the adjustment would be made by a balancing payment from one or more participants to another being made or imputed.

8.28 If a CCA is otherwise acceptable and carried out faithfully, having regard to the recommendations of Section F, tax administrations should generally refrain from making an adjustment based on a single fiscal year. Consideration should be given to whether each participant's proportionate share of the overall contributions is consistent with the participant's proportionate share of the overall expected benefits from the arrangement over a period of years (see paragraphs 1.49-1.51)

ii) Disregarding part or all of the terms of a CCA

8.29 In some cases, the facts and circumstances may indicate that the reality of an arrangement differs from the terms purportedly agreed by the participants. For example, one or more of the claimed participants may not have any reasonable expectation of benefit from the CCA activity. Although in principle the smallness of a participant's share of expected benefits is no bar to eligibility, if a participant that is performing all of the subject activity is expected to have only a small fraction of the overall expected benefits, it may be questioned whether the reality of the arrangements for that party is to share in mutual benefits or whether the appearance of sharing in mutual benefits has been constructed to obtain more favourable tax results. In such cases, the tax administration may determine the tax consequences as if the terms of the arrangements had been consistent with those that might reasonably have been expected had the arrangements involved independent enterprises, in accordance with the guidance in paragraphs 1.36-1.41.

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8.30 A tax administration may also disregard part or all of the purported terms of a CCA where over time there has been a substantial discrepancy between a participant's proportionate share of contributions (adjusted for any balancing payments) and its proportionate share of expected benefits, and the commercial reality is that the participant bearing a disproportionately high share of the contributions should be entitled to a greater beneficial interest in the subject of the CCA. In such a case, that participant might be entitled to an arm's length compensation for the use of that interest by the other participants. In circumstances that indicate an attempt to abuse the rules governing CCAs, it may be appropriate for a tax administration to disregard the CCA in its entirety.

E. CCA entry, withdrawal, or termination

8.31 An entity that becomes a participant in an already active CCA might obtain an interest in any results of prior CCA activity, such as intangible property developed through the CCA, work in-progress and the knowledge obtained from past CCA activities. In such a case, the previous participants effectively transfer part of their respective interests in the results of prior CCA activity. Under the arm's length principle, any transfer of pre-existing rights from participants to a new entrant must be compensated based upon an arm's length value for the transferred interest. This compensation is called a "buy-in" payment. The relevant terminology varies across jurisdictions, and so sometimes any contribution (or balancing payment) made in recognition of the transfer of pre-existing property or rights is called a buy-in payment, whether or not it is made by a new entrant to the CCA. For purposes of this Chapter, however, the term "buy-in payment" is limited to payments made by new entrants to an already active CCA for obtaining an interest in any results of prior CCA activity. Other contributions, including balancing payments, are addressed separately in this Chapter.

8.32 The amount of a buy-in payment should be determined based upon the arm's length value of the rights the new entrant is obtaining, taking into account the entrant's proportionate share of overall expected benefits to be received under the CCA. It is possible that the results of prior CCA activity may have no value, in which case there would be no buy-in payment. There may also be cases where a new participant brings already existing intangible property to the CCA, and that balancing payments would be appropriate from the other participants in recognition of this contribution. In such cases, the

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balancing payments and the buy-in payment could be netted, although appropriate records must be kept of the full amounts of the separate payments for tax administration purposes.

8.33 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) (including conventions for the avoidance of double taxation) applicable to the respective participants as if the payment were made outside a CCA for acquiring the interest being obtained, *e.g.* an interest in intangible property already developed by the CCA, work in progress and the knowledge obtained from past CCA activities. No part of a buy-in payment 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) and the payer does not also obtain a beneficial interest in such intangible property itself.

8.34 Issues similar to those relating to a buy-in could arise when a participant leaves a CCA. In particular, a participant who leaves a CCA may dispose of its interest in the results of past CCA activity (including work in progress) to the other participants. If there is an effective transfer of property rights at the time of a participant's withdrawal, the transfer should be compensated according to the arm's length principle. This compensation is called a "buy-out" payment.

8.35 In some cases, the results of prior CCA activity may have no value, in which case there would be no buy-out payment. In addition, the amount of the buy-out payment under the arm's length principle should consider the perspective of the remaining participants. For example, in some cases a participant's withdrawal results in an identifiable and quantifiable reduction in the value of the continuing CCA activity. Where, however, the value of a remaining participant's interest in the results of past CCA activity has not increased as a result of the withdrawal, a buy-out payment from that participant would not be appropriate. A buy-out payment should be treated for tax purposes in the same manner as would apply under the general rules of the tax system(s) (including conventions for the avoidance of double taxation) applicable to the respective participants as if the payment were made outside a CCA as consideration for the disposal of the pre-existing rights (*e.g.* an interest in intangible property already developed by the CCA, work-in-progress and the knowledge obtained from past activities undertaken within the CCA). No part

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of a buy-out payment 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 the departing participant and the payer does not also obtain a beneficial interest in the intangible property itself.

8.36 There may be instances in which the absence of buy-in and buy-out payments is not a problem. For example, such provisions would not be required where the arrangement is solely for the provision of services that participants jointly acquire and pay for on a current basis and the services do not result in the creation of any property or right.

8.37 When a member enters or withdraws from a CCA, it may also be necessary to adjust the proportionate shares of contributions (based on changes in proportionate shares of expected benefits) for the increased or reduced number of participants who remain after the entry or withdrawal.

8.38 There may be cases where, even though the CCA does not contain terms addressing the consequences of participants entering or withdrawing, the participants make appropriate buy-in and buy-out payments and adjust proportionate shares of contributions (reflecting changes in proportionate shares of expected benefits) when changes in membership have occurred. The absence of express terms should not prevent a conclusion that a CCA exists in respect of past activities, provided the intention and conduct of the parties involved is otherwise consistent with the guidelines contained in this Chapter. However, ideally such arrangements should be amended to address future changes in membership expressly.

8.39 When a CCA terminates, the arm's length principle would require that each participant 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 (adjusted by balancing payments actually made including those made incident to the termination). Alternatively, a participant 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 CCA activity.

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F. Recommendations for structuring and documenting CCAs

8.40 A CCA should be structured in a manner that conforms to the arm's length principle. A CCA at arm's length normally would meet the following conditions:

a) The participants would include only enterprises expected to derive mutual benefits from the CCA activity itself, either directly or indirectly (and not just from performing part or all of that activity). See paragraph 8.10;

b) The arrangement would specify the nature and extent of each participant's beneficial interest in the results of the CCA activity;

c) No payment other than the CCA contributions, appropriate balancing payments and buy-in payments would be made for the beneficial interest in property, services, or rights obtained through the CCA;

d) The proportionate shares of contributions would be determined in a proper manner using an allocation method reflecting the sharing of expected benefits from the arrangement;

e) The arrangement would allow for balancing payments or for the allocation of contributions to be changed prospectively after a reasonable period of time to reflect changes in proportionate shares of expected benefits among the participants; and

f) Adjustments would be made as necessary (including the possibility of buy-in and buy-out payments) upon the entrance or withdrawal of a participant and upon termination of the CCA.

8.41 As indicated in Chapter V on Documentation, it would be expected that application of prudent business management principles would lead the participants to a CCA to prepare or to obtain materials about the nature of the subject activity, the terms of the arrangement, and its consistency with the arm's length principle. Implicit in this is that each participant should have full access to the details of the activities to be conducted under the CCA, projections on which the contributions are to be made and expected benefits

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determined, and budgeted and actual expenditures for the CCA activity. All this information could be relevant and useful to tax administrations in the context of a CCA and taxpayers should be prepared to provide it upon request. The information relevant to any particular CCA will depend on the facts and circumstances. It should be emphasised that the information described in this list is neither a minimum compliance standard nor an exhaustive list of the information that a tax administration may be entitled to request.

8.42 The following information would be relevant and useful concerning the initial terms of the CCA:

a) a list of participants;

b) a list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;

c) the scope of the activities and specific projects covered by the CCA;

d) the duration of the arrangement;

e) the manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;

f) the form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;

g) the anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises;

h) the procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and

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i) any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

8.43 Over the duration of the CCA term, the following information could be useful:

a) any change to the arrangement (*e.g.* in terms, participants, subject activity), and the consequences of such change;

b) a comparison between projections used to determine expected benefits from the CCA activity with the actual results (however, regard should be had to paragraph 1.51); and

c) the annual expenditure incurred in conducting the CCA activity, the form and value of each participant's contributions made during the CCA's term, and a detailed description of how the value of contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions.

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