Cost contribution arrangement: aimed at ringfencing funds or masking profit shifting? (2/18/20)

A multinational enterprise's intragroup transactions are not limited to goods and services. The group members can also deal with intangible property ("IP"), for example, transfer IP for a consideration (change of owner), grant the right to use IP in whole or in part, or use various types of agreements for reimbursing IP costs. This article explores IP and relevant agreements as well as the concept and purpose of a cost contribution arrangement.

Intangible property and relevant agreements

Intangible property basically means the right to something that has no physical substance. A Latvian economic dictionary issued in 2000 defines IP as the "right to possess, use and deal with intangible assets and long-term intangible investments. An individual or an organisation may acquire IP through creating it with their own labour or through buying it."

Companies use various types of IP licences and agreements likely to be classified according to the costing principle used, for example:

- licence agreements;
- research and development agreements;
- cost sharing arrangements;
- cost contribution arrangements ("CCA").

Let us now explore the concept and purpose of CCA in detail.

A CCA or an intragroup service?

The CCA members mutually agree to pool their financial or other resources for a joint project. All the members benefit from the CCA, and so the funds (expenses) incurred in carrying out the project are split between the beneficiaries according to their respective shares of the benefit, without adding a markup. A distinction must be made here between a CCA and mutual provision of services.

The figure below offers an overview of the main features that distinguish the CCA from traditional intragroup services according to a draft report prepared by the EU Joint Transfer Pricing Forum on CCAs for services not creating IP:

	Cost contribution arrangement	Intragroup service
1.	There is an agreement on the apportionment of costs, risks and benefits, under which all the members make a contribution in cash or in kind (in the form of services).	An intragroup service is limited to a service supplied or received by the parties. The risk of an unsuccessful or inferior service is typically assumed by its provider.
2.	If any members join or leave the CCA, their shares should be balanced under the arm's length principle.	Terminating or extending the service agreement with any of its parties typically leaves the other parties unaffected.

3.	A written agreement or some other appropriate documentation is crucial to the intention of implementing a CCA. For the tax authority to recognise the CCA, a written agreement is advisable. The national laws of certain OECD members require a written agreement.	In practice, a written agreement is not always available. The agreement is often limited to the direct relationship between the provider and the recipient of the service. However, the provider should be able to prove that the service has been supplied, and the recipient should be able to prove that the service gives him an economic benefit and improves his commercial standing.
4.	As all the CCA members make a contribution to their total activity, share the costs, and the contribution reflects their expected benefits, the contributions are typically measured at cost.	The provider does not use the service also for his own needs but rather carries on a business for which he should receive an arm's length consideration and make a profit.
5.	The cost apportionment is based on the benefit expected by each CCA member.	The cost apportionment is based on the extent to which each company has requested a service and has received or is entitled to a service.

The main difference is that the provider does not use the service also for his own needs but rather carries on a business for which he should receive an arm's length consideration and make a profit.

The purpose of a CCA

Although the CCA is a well-known concept globally launched several decades ago, it is important to note that using a CCA may involve a transfer pricing risk. Since 2018 the Latvian State Revenue Service has come to scrutinise any substantial IP agreement, with taxpayers being required to include information about such agreements in their master file for transfer pricing purposes under the Cabinet of Ministers' Regulation No. 802, paragraph 2.3.3, and to document them in their local file under paragraph 3.2.

Chapter VI (as amended in 2016) of the OECD Transfer Pricing Guidelines as the most influential source of transfer pricing guidance refers to special considerations in assessing IP transactions and transfer pricing risks because of potential cases of profit shifting.

So the taxpayer should take special care to verify that the CCA is not a means that enables the multinational group to mask profit shifting from one country to another. To mitigate this risk, the CCA should meet certain criteria, one of which is the ability to prove that this form of collaboration is mutually advantageous, i.e. each CCA member's share of the total expected benefit matches his share of the total contribution.

The expected benefits include both business development and performance results. This criterion in fact prevents potential abuse of the CCA as it keeps the members from using the CCA as a mechanism for shifting profits from one (contributing) member to another (benefiting) member.

In our upcoming article we will be exploring the advantages of a CCA and questions of how to assess its compliance with the arm's length standard, whether the CCA is used in Latvia, and whether the tax authority permits it to exist.