

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

To pick up where we left off, let us now examine the advantages of a cost contribution arrangement ("CCA") and questions of how to assess its arm's length compliance, whether the CCA concept is practised in Latvia, and whether the tax authorities allow it to exist. This article explores how the CCA can be used in cases involving the creation and development of intangible property ("IP").

What is a CCA?

In practice, companies within a multinational enterprise ("MNE") group can take part in a joint project by entering into a CCA, creating and developing IP to become its end users (beneficiaries), providing funds (making contributions) according to their expected part of the benefit, and splitting functions – costs (without a markup) incurred in implementing the project, and risks.

The CCA can also be used for any joint MNE project to share expenses and risks, e.g. the MNE companies can pool their resources to receive centralised marketing, legal, accounting, IT and other services that do not create IP.

The CCA advantages

The MNE decision to use a CCA can be based on a number of valid reasons, such as:

- using the pool of know-how and expertise of the members;
- minimising duplication of functions;
- increasing operational efficiency;
- improving financial performance;
- considerable administrative advantages;
- synergies – economies of scale;
- mitigating IP royalty risk.

The MNE members of the CCA can agree to pool their skills. For example, they can decide that IT activities will be carried out by the member in a low-cost country who has established himself as an international IT leader. In this case, the centralised IT activities will provide the CCA members with access to high quality IT solutions, and the CCA will help them save costs.

Assessing prices set under the CCA

Independent companies enter into a CCA to share their costs and risks if there is a common necessity from which the members can mutually benefit, such as sharing risks associated with researching certain technology to minimise potential financial losses.

Each CCA member pays his share of the cost of accessing the IP that has been created. The cost split depends on their contributions and expected benefits whose assessment is based on the members' assumptions and subjective assessments. The members do not need to rely on specialised commercial

databases in supporting their CCA price or value because in the case of a CCA, market prices are replaced with contributions. For the value of a contribution specified by the CCA to be arm's length, each member's contribution must be equal to what an independent company would have agreed to contribute in comparable conditions if it were to receive benefits it would reasonably expect from the CCA.

Accordingly, it is important to conduct an assessment and identify all the contributions each member has made to the CCA, including any assets and services used under the CCA. To estimate their relative contributions, we need to define and gather information on types of costs incurred by the members that are associated with performing certain functions and will be included in the cost base, as well as information on total costs to be incurred in carrying out the activities covered by the CCA. These contributions should then be split between the beneficiaries according to their expected proportion of benefit and funds spent on particular functions, such as personnel management, accounting or IT (costs without a markup).

The CCA should lay down rules for adjusting costs if it were found that one of the members has incurred excessive costs that need compensation by adjusting his contribution.

The CCA should also stipulate that all the members have the right to expect benefits, and it should describe how a new member can join the CCA after paying for access to any IP created or to be created under the CCA, and how a member can leave the CCA after paying a compensation.

Using the CCA concept in Latvia

Although globally the CCA concept has been used for several decades, it is not yet commonly practised in Latvia. We expect, however, that it will become increasingly popular in the future, as taxpayers planning to implement a CCA have applied to the Finance Ministry and the State Revenue Service for their opinion on using the CCA.

Below are key conclusions to be drawn from our communication with the tax authorities:

- The existence of CCA transactions is admitted;
- When a CCA's compliance with the Corporate Income Tax Act is examined, paragraph 19 of the Cabinet of Ministers' Rule No. 677 provides that the OECD Transfer Pricing Guidelines can be used as an auxiliary source to assist in applying the transfer pricing methods for determining the market price or value of a transaction (including a supply of goods, services, intangible property or any other subject matter) and techniques of economic analysis mentioned in the Cabinet Rule, and to understand the examples of those methods and techniques;
- Intragroup activities must be supported by a document prepared according to the Latvian accounting rules, i.e. paragraph 41 of the Cabinet of Ministers' Rule No. 585;
- The VAT treatment in each particular case can significantly differ, considering all circumstances capable of affecting it – whether payments made by the CCA members are taxable supplies under the VAT Act, i.e. whether they are made in the course of each company's business.

None of the Latvian laws contain separate provisions for applying the CCA concept.