Cost contribution arrangement (CCA): how related parties can pool resources to benefit financially from joint projects (2) 3/35/23


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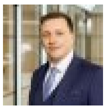
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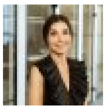
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This article wraps up what we wrote last week.

Corporate income tax (CIT) treatment

The CIT legislation makes no special conditions for describing and analysing CCA transactions (including service sharing arrangements). Only paragraph 19.4 of the Cabinet of Ministers' Rule No. 677 states that the OECD Transfer Pricing (TP) guidelines may be used as an auxiliary source in defending the economic substance and documentation of a particular controlled transaction (including a CCA) unless this is contrary to the statutory rights and duties of the taxpayer and of the tax authority. Chapter VIII of the OECD guidelines (as early as the 2010 version) refers to special considerations in assessing CCA transactions and TP risks.

According to our information, the Ministry of Finance as a leading tax policymaker issued a general opinion on CCA rules in 2022. The Ministry finds that the Latvian tax legislation permits a CCA that follows the core principles included in the OECD guidelines:

- A member's contribution matches his expected benefit.
- The contribution is measured at value, and only in exceptional cases may it be measured at cost.

In 2022, the State Revenue Service (SRS) said that a CCA is permitted for CIT purposes and the taxpayer must follow the arm's length principle in determining the taxable base. This means that any transactions between related parties should be compared with transactions between independent parties and assessed for arm's length compliance. Thus the SRS noted that joining a CCA may pose TP risk.

As regards supporting documents, the SRS made a general comment that any intragroup activities must be supported by a document drawn up according to the requirements of accounting legislation. CEOs are permitted to choose the form, content and preparation procedures for such supporting documents, unless this is governed by a particular piece of legislation.

Potential TP risks in a CCA

Although the global concept of CCA has been around for decades, it's important to note that using a CCA may pose TP risk. The goal of the CCA may not always be fully linked with the need to allocate resources for a project, and multinational enterprises may be exploiting the CCA to mask the practice of shifting profits from one country to another.

To mitigate TP risk, the CCA members should:

- Be able to demonstrate that this form of business is mutually beneficial, i.e. each member's proportion of the total expected benefit matches their proportion of the total contribution. The relative share of expected benefits can be calculated, for example, by reference to expected additional income each member receives as a result of the agreement.
- Be able to demonstrate that the value of each member's contribution matches its market value, i.e. the cost comes with an arm's length markup that is consistent with the functional analysis and the benchmarking study.
- Include information on the CCA in their TP file.

VAT treatment

In general, if a multinational group company supplies goods or services to a group company in Latvia, the supplier has to charge VAT. If services are rendered to a group company in another EU member state, the recipient has to apply reverse-charge VAT.

The CCA essentially involves making contributions to achieve a common goal. Accordingly, a contribution made under the CCA should not be treated as a supply of goods or services for a consideration within the meaning of the Latvian VAT Act. The contribution or cost mainly benefits the person that incurred the cost. The fact that the contribution has also benefited other CCA members has secondary relevance.

Certain justification for this VAT treatment may be found in the case law of the Court of Justice of the European Union (CJEU),[1] which states that any activity performed by a consortium member under the terms of the consortium agreement that matches the share allocated to that member is not a supply of goods or services for a consideration and is therefore not subject to VAT. However, if a consortium member does more than is provided for in the consortium agreement and receives a consideration from other consortium members, then this is considered a supply of goods or services for a consideration.

Neither the VAT Act nor the SRS website offers any public guidelines on the VAT treatment of CCAs. The opinion expressed by the SRS in 2022 implies that a CCA essentially involves its members making contributions towards a common goal, rather than providing services between related companies. Thus a contribution made under the CCA doesn't qualify as a supply of services for a consideration. According to the SRS, there is no legal relationship between the members with reciprocal performance and the fee received by the service provider is a real remuneration for services rendered to the recipient. When the members undertake an analysis of their contributions and make a comparison with the benefit received and find that a member's contribution is larger than that, they should calculate a balancing payment that qualifies as a consideration and a taxable supply under the VAT Act. A tax invoice should be duly issued for the balancing payment.

The Lithuanian VAT treatment of CCAs, which is similar to Latvian practice, is described in guidelines on the application of the Lithuanian VAT Act. We also have information that the Estonian tax authority's advance tax rulings confirm that only the balancing payment is taxable.

Companies operating in an industry where they make taxable supplies will deduct their input tax in full. However, if companies operating in sectors where services are exempt from VAT (e.g. financial services, gambling, and medical services) acquire services from another member state, then they must charge VAT but will have no right to deduct input tax or have only partial input tax deduction rights if the acquired services are used for making both taxable and exempt supplies. VAT costs may also prevent multinational group companies from operating more efficiently. Thus, if a multinational enterprise group could set up a CCA, this would reduce their VAT costs because VAT under the CCA would only be charged on the balancing payment, rather than on the entire amount of services, as would be the case with a contract for services.

Before starting the VAT treatment described above, the taxpayer should assess whether the activities to be carried out under the agreement and the methodology for calculating the contribution and the benefit meet the criteria for treating it as a CCA. The taxpayer should also find out how the CCA is charged to VAT in countries where the members will be based because the treatment may vary according to national rules.

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[1] CJEU ruling C-77/01 of 29 April 2004 (*Empresa de Desenvolvimento Mineiro SGPS SA (EDM) v Fazenda Pública*)