IBDT

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Panel

Cost Contribution Arrangements
Cost Sharing Agreements

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COST CONTRIBUTION ARRANGEMENT

- **Cost Sharing Agreements (CSAs) and Cost Contribution Arrangements (CCAs) are arrangements under which parties agree to share the costs and risks related with developing assets, producing rights and acquiring services on the basis of the participants' benefit**

- **They should be distinguished from intra group services and cost pools where risk is borne by the service provider and where the provider charges a mark up because he does not share profits with the recipients. The repartition is not based on expected benefits but on the notion that each recipient uses the services**

R&D

- CCA's and CSA's may be entered into to perfom research and development or to produce or acquire intangible assets and rights. The risk of joint R&D (benefit or loss) is shared by the participants. In case of success, worthy intangibles will be acquired at a relatively low cost. Individually, the participants would not have been able to achieve it because of high costs, lack of skills and lack of finance
- An exemple is the development of a web-marketing tool while attributing intellectual property to members
- Besides, R&D expenses may enjoy a favorable tax treatment under the form of an investment credit or deduction

SHARING OF SERVICES

Participants may also share costs in order to benefit from shared services. Shared services will be acquired from a common service center at a lower cost than the price which would be charged by a third party. Little risk is borne

CSA's and CCA's

- A CSA is an agreement under which parties share the cost of development of intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of their future interest in the intangibles

- A CCA is an agreement proper, i.e. an arrangement between business enterprises to share the costs and risks of developing, producing or obtaining assets, services, rights and to define the interest of each participant in them

- A CCA is generally a framework agreement

JOINT VENTURE

- CCA- CSA's are development only joint ventures limited to sharing costs and risks. Joint ventures extend to income and benefit of participants under the arrangement. A CCA-CSA can give rise to a joint venture
- Each participant in a CCA is entitled to exploit his interest separately not as a licensee, i.e. without paying a royalty
- A CCA must not be qualified as a partnership. Parties do no share in each other's business success or failure

GUIDELINES ARM'S LENGTH PRINCIPLE

- CCA's are of an arm's length nature. A CCA is consistent with what an independent enterprise would have agreed to contribute. Expected profits must be estimated independently. No universal rule exists in that respect

- One should consider estimated income or cost savings derived by each participant or consider prices charged for sale of comparable assets and services under the OECD Guidelines

ALLOCATION KEY

- The allocation key may be defined in steps
- It should be commensurate to expected benefits or estimated costs which will be saved by each participant
- A substantial discrepancy between costs incurred and benefits expected could lead to disregarding the CCA taxwise, thereby denying the deduction of costs or taxing the participants on the gratuitous benefit granted to a related party

Change of parties in the course of the agreement

- An entity which cannot reasonably expect a benefit should not enter in a CCA
- The terms of the agreement should be agreed upon from the beginning. Changes should reflect correlation of interest in the expected benefits
- The division of costs should not be geared to the past using hindsight
- Economic ownership is more important than legal ownership. Legal ownership will influence the legal method used to share costs. If the contribution by a participant is excesive in view of the benefit he derives, a balancing payment may be foreseen, to be treated as an additional cost to payer or reimbursement of cost by payee
- The agreement must foresee the possibility of a buy-in under which a party joining the CCA and obtaining an interest in a prior result should be charged or of a buy-out under which a party leaving the CCA and its results may be entitled to a payment

Measurement of benefits

- Referring to IRC § 1.482-7 (e) (1), benefits may be measured by

1. Units used, produced or sold, provisions for the reduction of utility consumption or an increase in sales

   Participants may operate in the same market , for instance, replacement of powder by effervescent tablets

2. The measurement may refer to operating profits

   The CAA influence profitability , for instance because a new pharma is now produced in a non-regulated market

3. Other methods may be considered, for instance in the case of a variation of paper load by new manual number of documents

4. The valuation of participant companies may be a factor

   The most frequent allocation key is turnover

RELEVANT COSTS

- Under IRC § 1.482-5 (d) (3), the relevant costs are

- Operating expenses ;
- Depreciation and amortization of assets ;
- Expenses associated with assets used, for instance
  - Leasing expenses ;
  - What about employee stock-options ? Are they a cost to the firm or do they relate to a transaction between shareholders ?

- IRC § 1.482 7 (d)(2)
- IFRS 2
- IAS 14
- Xilinx (2009) 9th Cir., it was held that ..;
- In unrelated parties would not compensate cost of options related parties must because arm's length standard applies
- Under New regs (2003) stock-based compensation must be included

CONTENTS

- The written Agreement should include

  - an explanation of economic interest of each participant ;

  - a list of participants ;

  - a description of the benefit of the project including retainers

  - a description of resources at the disposal of each participant to contribute. It should provide for the reconciliation of MNE's transfer pricing policy with services including the CCA

  - the benefit expected by each participant and way to measure them

  - the type of services included in CCA

  - the form and value of each participant's contribution

  - the allocation of responsibilities and tasks between participants and indicating the company eventually centralizing services performed, the confidentiality clauses, the access to subcontractors and the duration of the agreement should be specified

SOME REMARKS

- **If a provision of services to non participants is foreseen, the benefit of non participant to be valued at arm's length**
- **Mark up is in principle not included, if a mark up is justified, it should be small**

  « A true CCA should not provide any mark-up »

- **Withholding tax**

  The contribution of a member is generally not the use of an intangible justifying a royalty. CCA allows the pooling of resources and avoids the creation of tax-inefficient royalty flows

PERMANENT ESTABLISHMENT

- A PE will normally not be generated by CCA activities as a CCA is no partnership
- For example, in the Portuguese Shell case, the Portuguese subsidiaries paid to Shell International a proportion of the latter's cost to all patents and inventions of Shell International. The expected benefits were not sufficiently identified in the agreement. The payments were qualified as royalties and not reimbursement of costs

SPREADING OF INTELLECTUAL PROPERTY

The spreading of intellectual property may be tax inefficient. Several countries have developed attractive regimes of taxation of IP (« Patent box »). It may be advisable to create an intellectual property vehicle centralizing contractual relations with third parties and to leave the participating entities to supply ancillary services in a favorable location offering a safe haven mark up, such as a Belgian Service Center

LEGAL DEFINITION

- **Authorities had a tendency to rely on general rules ; they now issue more sophisticated regulations**
- **Canada defines a qualifying cost contribution arrangement**
- **A reasonable effort to establish a framework for determining the basis of contributions is required**
- **It applies to property or services whereas the US Regs, are concerned only to the development of intangible property**
- **(§ 1.482-7 (a)(1))**

NEW US REGS

- The new US regs follow an investor model
- Payment for preexisting intangibles is an external contribution (PCT). The payment for ongoing RD costs is a cost sharing transaction (CST)
- The payment for acquisition of intangibles after the cost sharing arrangement begins is post formation acquisition (PFA)