

Cost Contribution Arrangements

– An efficient tax-planning tool?

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Cost Contribution Arrangements (CCAs) is a framework for enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights. The assignment of costs depends on contributions and expected benefits. The valuation of these contributions and expected benefits relies on assumptions and subjective judgment that are prone to manipulation. By over and underestimating the value of contributions and expected benefits, CCAs can be structured to shift profits to low-tax jurisdictions. Current legislation does not sufficiently address the CCA structure, and controlling CCAs is an expensive and time consuming task for the tax authorities.

Tax planning has gained an important position in cost accounting and management control. Over the last two decades, the organization of multinational companies has changed dramatically. The development of global value chains has made intra-firm trade increase in importance. It is estimated that two out of three business transactions take place between related parties. Transfer pricing is an important part of tax planning and considered one of the most common techniques for shifting profits between jurisdictions. OECD considers it to be a severe problem as it undermines domestic tax systems and encourages tax competition among countries.

One transfer pricing technique less focused upon is the so-called cost contribution structure. The concept of Cost Contribution Arrangements (CCAs) has been controversial since it was first introduced. The CCA is a framework for enterprises to share costs and risks of developing, producing or obtaining assets, services or rights. In a CCA, participants pay their share of the costs for access to the service or asset developed. In comparison to other transfer pricing techniques, market prices are replaced by costs. The assignment of costs depends on contributions and expected benefits. The OECD framework, which in practice is ruling law in many jurisdictions, requires consistency between the participant's proportionate share of the overall contributions and the expected benefits to be received

from the CCA activity. An agreement between rational, unrelated parties would be structured in such a manner. The valuation of these contributions and expected benefits, however, relies on assumptions and subjective judgment. Consequently, these are prone to manipulation.

The CCA can be a tax efficient structure, but this does depend on a set of variables. The respective tax systems of the jurisdictions involved and the structure of the specific arrangement play an important role when determining which transfer price structure is the most beneficial. If R&D takes place in the high-tax jurisdiction, a CCA would usually be advantageous compared to royalties. This is because royalty payments, including a markup, are replaced by costs. The group as a whole would want to limit profits from being shifting to the jurisdiction that taxes corporate profits the most. In contrast, if R&D is situated in the low-tax jurisdiction, the decision depends on how royalties are treated for tax purposes. The question is whether the jurisdictions impose taxation on royalty income and whether royalty payments are tax-deductible.

The CCA structure relies heavily on estimates, predictions about the future and the valuation techniques chosen. When identifying and valuing contributions there are several issues that arises. Valuing contributions can be troublesome due to differing domestic regulation and practice as to what valuation method to employ. In the US contributions should be valued at cost, while the OECD recommends the arm's length principle, which usually imply a market based valuation. At the same time, regulation recommends consistency in valuation. If the concern for domestic regulation conflicts with the consistency principle, the process gets more complex. The contribution of intangibles is the most sensitive part of a valuation. Valuing contributions made in kind such as know-how can also be very difficult, and is thus easy to over- or underestimate.

Estimation of expected benefits is another difficult area. The economic life of the asset being developed must be decided. As this is based on predictions about the future, it is prone to manipulation. The allocation of the expected benefits depends on what measure the participants argue is most relevant. Both indirect and direct measures can be chosen, and the choice of method will further determine the allocation of cost and tax bases. The same difficulties arise when determining the amount of expected benefits. Furthermore, the valuation of expected benefits depends on the discount rate. As expected benefits should be

discounted to present values, the rate the MNE deems to be correct can affect the final allocation.

Yet another issue is related to restructuring of CCAs. For buy-in and buy-out payments the value of previous R&D activities will have to be estimated. The future benefit of prior R&D is an uncertain amount. It is also difficult to control in retrospect. Attributing future benefits to different elements in the total R&D process is a complicated task. For buy-outs another issue is which rights the departing participants get. The buy-out price must consider whether the participant will be using prior knowledge and technology developed in separate business activities. It is difficult to control whether knowledge from the CCA actually has been employed or not.

All of the issues mentioned permits CCAs to be employed as a tax planning tool. By over and underestimating the value of contributions and expected benefits, the CCA can be structured as to shift profits to low-tax jurisdictions. The fact that each case must be viewed in isolation from other cases makes the process of controlling CCAs an expensive and time consuming task for the tax authorities. Furthermore, if outcomes differ from predictions, it is difficult to prove that it is due to a tax minimization strategy. Thus, the tax administrators have limited ability to sanction MNEs for manipulating estimates.

Current legislation does not sufficiently address the CCA structure. Due to an increase in global value chains and transfers of knowledge and technology, it is probable that the structure will become more common. The tax authorities may benefit from taking a proactive approach and focus on improving the CCA framework before it becomes a severe problem. More research on this topic is therefore necessary.