Cost Contribution / Cost Sharing, Cost Allocation and Reimbursement of Expenses

Presentation for
Intensive Study Course on Transfer Pricing
Organised by WIRC and Andheri (W) CPE Study Circle

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What is Cost Contribution Arrangement / Cost Sharing Arrangement?

- A contractual agreement among business enterprises
- Joint funding or sharing of cost and risks for acquiring property or obtaining services
- Interests often divided by territory
- All parties to a CCA have the expectation of mutual benefit (unlike inter-group services)
  - Cost saving
  - Risk minimising
- Used to develop intangible property or obtain services
- In other words it occurs when a group of international affiliates pool resources to
  - Develop, produce or obtain assets (mainly the intangible assets) and
  - Provide services or rights
What is Cost Contribution Arrangement / Cost Sharing Arrangement?

- The U.S. rules provide that members of a group may enter into a cost sharing agreement (CSA) with respect to costs and benefits from the development of intangible assets.

- OECD Guidelines provide more generalized suggestions to tax authorities for enforcement related to cost contribution agreements (CCAs) with respect to acquisition of various types of assets.

- Both sets of rules generally provide that costs should be allocated among members based on respective anticipated benefits.

- Therefore it is expected from the CSAs or CCAs that inter-member charges should be made so that each member bears only its share of such allocated costs.
What is Cost Contribution Arrangement / Cost Sharing Arrangement?

**Definition:**

“A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights.”

*-OECD Transfer Pricing Guidelines (Para 8.03)*
Typical CCA

• A Co, B Co, C Co and D Co are participants located at various geographical locations
• A Co, B Co, C Co and D Co bring in consideration in return for the Technical knowhow they get R&D Unit
• A Co, B Co, C Co and D Co will share the cost & risk of the R&D unit
• When they enter a contractual arrangement it becomes a CCA.
It is essential to ensure that:

- the framework of the cost sharing arrangement CCA is established in a **written contract** and agreed by all the parties

- The formal agreement must **describe** each **participant’s rights** and **obligations**

- It should also clearly describe
  - Types of **development efforts** to be jointly funded
  - **Contributions** of each participant
  - **Rights** assigned to each participant **to exploit the result**
Advantageous to MNCs carrying out business globally

For example:

Consider large MNC group with manufacturing sites around the world

Having ownership of intangible assets vested in a number of different entities may be complex

It would necessitate complex system of cross charges such as royalties and also bring in complexities involved in the withholding taxes

Determination of royalty rates is a most difficult part in such scenario

In such case, cost sharing arrangement can be utilised by the MNC in two unrelated but different ways:

- Intangible under development
- Pre-existing intangible

(explained in next slides)
CCAs – How Beneficial?

Single IP holding company within the group

- Intangible owner in the group
- Royalty
- Provides know-how

- Entrepreneurial profit
- Normal / routine profit
- Manufacturing of the goods

Multiple IP holders having regard to CCA

- Participant 1: Only cost sharing
- Entrepreneurial profit from sale of goods to third parties
- Normal / routine profit
- Manufacturing of the goods

- Participant 2: Cost sharing
- Entrepreneurial profit from sale of goods to third parties
- Shared research activities

When a new intangible is being developed:

- CCA can be used as a manageable way to share cost and benefit
- Also can be used to minimise complex royalty arrangements
- Passive arrangement – to allocate the expenses (say of R&D) among all “participants” by reference to the anticipated benefits
- All members will have pre-determined rights to the intangible developed from the R&D activity
CCAs – In Case of Pre-Existing Intangible

- When a cost sharing arrangement is entered into in case of pre-existing intangibles, the arrangement becomes very complicated

- For example:
  - A Co, B Co and C Co already have entered into a CCA to develop a product
  - D Co intends to enter into that CCA
  - Since erstwhile members have an established CCA there is a possibility that an intangible exists due to their earlier efforts
  - Therefore, D Co may have to make a payment to recognise past investment in the R&D (‘Buy-in’ payments)
Transfer Pricing Issues

- What is the right measure of “Cost” and what should be included in it?

- How does one measure “expected benefits”?

- How do you “value” pre-existing intangibles?

- Determination of “buy-in” payments

- Appropriateness of allocation & contribution

- Consequences of a non-ALP CCA
In essence from a transfer pricing perspective it is relevant to ensure that:

- The contribution made by a participant within the group must be consistent with what an independent party would have agreed to contribute.

- What an independent party would agree to contribute would depend on what that independent party expected to be his benefit.
Determination of Cost Base

- **Definition of Cost**:
  - Costs associated with advertising, promotion, sales, marketing, warehousing, distribution and general administration, but excluding depreciation or amortization expense, plus the charge for the use of any tangible property made available to the qualified CCA.
  
  - All stock-based compensation that is granted to the employees of CCA during the term and which is related at date of grant to the development of intangibles covered by the CCA arrangement is included as part of cost.

- **As per OECD Guidelines**
  - Any contribution into the CCA activity (except cash) must be at **market value**
  
  - Applying normal Transfer pricing principles
  
  - Must consider the rational that 3rd party cannot be expected to contribute to CCA activity on a non-arm’s length basis.

- Passing on R&D credits/other fiscal incentives by reducing the cost contribution - depends on whether independent entities in comparable circumstances would have passed on such savings
Determination of the Expected Benefit

- Allocation of intangible development expense among participants is based on the Allocation Key.
- Allocation key should be devised in line with the share of benefits to be obtained by each participant
  - **Direct Method**
    - Estimated additional income to be generated or costs to be saved by each participant as a result of the arrangement (using projected figures)
  - **Indirect Method**
    - Sales
    - Units used/produced/sold
    - Gross or Operating Profits
    - Number of employees
    - Capital invested
- Determination of cost allocation is an uncertain exercise as there is a possibility that the taxable profits in some countries might be overstated and vice versa. Hence taxpayer must be prepared to substantiate the basis of allocation key.
- Whatever is the allocation method, adjustments must be made for differences in the expected benefits to be received by the participants. e.g. in the timing of their expected benefits
Buy-In adjustments

What is a **buy-in payment**?

Payment to already existing CCA by other new participants for the use of intangibles developed or acquired outside the CCA

**Definition** :

“The term “buy-in payment” is limited to payments made by new entrants to an already active CCA for obtaining an interest in any results of prior CCA activity.”

- *OECD Transfer Pricing Guidelines (Para 8.31)*

**Treatment of Buy-in Payments / Receipts:**

- In the hands of payer - Treated for tax purpose as if payments were made outside the CCA framework for acquiring the interest
- In the hands of payer - Buy-in payment will not constitute as Royalty except where participant obtains right to use the IP and doesn’t get the beneficial interest in such IP
- In the hands of Recipient – Buy-in payment received will be treated as taxable income
The tax authorities may disregard part or all of the terms of a CCA or adjust the participant’s contribution by the technique of Balancing Payments under the following circumstances:

- Facts and circumstances indicate that the reality differs from the terms purportedly agreed by participants
- Substantial discrepancy or disproportion between purported contribution and benefits over time
- CCA is not based on a sharing of costs, i.e. in service situations
- Non-commerciality - CCA designed just for tax purposes
As per **OECD** the following information would be relevant and useful:

- A list of participants
- A list of any other associated enterprises that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity
- The scope of the activities covered by the CCA
- The duration of the arrangement
- The manner in which participants’ proportionate shares of expected benefits are measured, and any projections used in this determination
- The anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises
- The form & value of each participant’s initial contributions, and a detailed description of how the value of initial & ongoing contributions is determined & how accounting principles are applied consistently to all participants in determining expenditure and the value of contributions
- The procedures for & consequences of a participant entering or withdrawing from the CCA and the termination of the CCA
Documentation requirement

The participants should ensure that they maintain information adequate to:

- Identify intangibles
- Establish the benefit from exploiting cost shared intangibles
- Establish the amount of each controlled participant’s Intangible Development Costs for each year
- Describe method used to estimate each controlled participant’s share
- Describe external contributions
- Describe economic analysis, data, and projections relied upon in developing and selecting the method used to determine the PCT payment
- Explanation of alternatives considered and why not selected
- Choice of discount rate and explanation of why reasonable
- All information to be updated in timely manner
Cost Allocations
Term “intra-group services” could potentially refer to two broad categories:

- Management or administrative services
  - Staff functions
  - Virtually risk free
  - Relatively lower returns

- Commercial or income producing services
  - Line functions
  - Have associated risk
  - Command higher charge

Cost allocations may be a part of inter group services or may relate to third party cost borne by a group entity and allocated.
Growing importance

Tax authorities now-a-days placing inordinate attention on inter-group services and cost allocations to:

- Ascertain whether an intra-group service has in fact been provided
- Whether mark-up should be applied
- Determining the appropriate allocation keys
- Still no adequate documentation maintained nor justification of charges for such services
- Potential goldmine for adjustments from tax authority point of view
Section 92(2)

“Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm’s length price of such benefit, service or facility, as the case may be”
No specific guidance provided under the Indian transfer pricing regulations in respect of allocation of service charges

Typically reliance placed on OECD transfer pricing guidelines

However, an allocation should be generally acceptable under the Indian transfer pricing regulations as long as

- benefits are demonstrated and they are adequate
- proper workings
- use of appropriate allocation keys
- sound documentation and back-ups
OECD Guidelines

- The OECD recognises that there is no fixed rule that could be universally applied to determine whether each participant’s proportionate share of the overall contributions is consistent with the participant’s proportionate share of the overall benefits expected to be received under the arrangement.
- The goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate contributions in the same proportion.
- Although OECD guidelines are adopted worldwide, countries sometimes differ in their interpretation.
Categories of services

- In accordance with the benefit conferred and "true" beneficiary
- Services that meet an identified need of a particular group member directly
  - Eg: debt service, technical services
- Service that benefit the group as a whole
  - Eg: legal, human resource
- Services that are undertaken for the benefit of the group’s shareholders
  - Eg: organising shareholder meetings, issuing shares, consolidation of financial statements, raising funds for acquisition of its participants
‘Benefit’ Test and ‘Willingness to pay’ test

• “Benefit test” is by far the most important factor
• Objective of “benefit rule”
  • Determine the quantum of benefit
  • Relative proximity of benefit
• Use of proximate and direct standard
• Exclusive purpose / single recipient – easy to determine benefit
• Services resulting in joint benefit – difficult to establish actual / perceived benefit
  • Basis or allocation / allocation key would be of prime importance
• Whether an inter-group service has been rendered?
  • Activity / services provides economic / commercial value
  • Enhances commercial interests
• Determination by considering whether an enterprise, in comparable circumstances would have:
  • Been willing to pay for the activity (if performed by an independent, arm’s-length enterprise); or
  • Performed the activity in-house by, and for, itself
Pricing of inter-group services

Typical methods applicable

- Comparable Uncontrolled Price (‘CUP’) method
- Cost Plus Method (‘CPM’)
- Transactional Net Margin Method (‘TNMM’)

Determination of arm’s length price

*Direct charge Method*

- Where services can be specifically identified

*Indirect charge method*

- Incorporated along with other transactions
- Services are not easily identifiable
- Often necessitates a degree of estimation or approximation
- Choice of allocation key made after considering the nature and use made of service
Cost allocation keys

- Should be revealed through functional analysis to reflect the economic benefit resulting from the service
- Should be a basis that can be measured and documented in a reasonable manner
- Use of turnover without further consideration of alternative allocation triggers may well be challenged
- Easily traceable to the original accounting records of the company
Facts:

- The taxpayer is an Indian subsidiary of Gemplus SA, France.
- Gemplus is an MNC engaged in providing smart card solution for telecommunication industry, financial services and other business segments.
- Functions under the regional headquarters of Gemplus Singapore.
- During the year, the taxpayer had certain international transactions with its associate Gemplus Singapore including availing the management services.
- The transaction of payment of management fees of Rs.1, 44, 98,000/- was questioned.
- The transfer pricing officer (‘TPO’) observed and contended that:
  - Cost apportioned by Gemplus Singapore to different country centers was on a mutually agreed basis and not on the basis of actual services rendered.
  - The assessee has not derived any specific benefit from the management services.
- The CIT (A) also dismissed assessee's appeal.
Assessee’s contention:

- In further appeal before the Tribunal, the assessee company argued that
  - It had achieved a good amount of sales turnover due to the services provided by Gemplus Singapore on the basis of the services agreement
  - PLI used by the taxpayer was justified in the nature of business carried on by it

Revenue’s contention:

- The Department argued that the assessee could not actual rendering of the services
- The assessee company has qualified personnel and has already incurred expenditure for similar services
Ruling:

• The Tribunal held that the TPO is justified in making a pertinent observation that the expenses are apportioned by Singapore affiliate among different country centers on the basis of their own agreements and not on the basis of the actual services rendered to the individual units.

• The TPO has made a clear finding that there are no details available on record in respect of the nature of services rendered by Singapore affiliate to the assessee company. Therefore, the TPO is justified in making the adjustment of Arms length price under Section 92CA of the Income-tax Act 1961.
Key Takeaways

- Sufficient and appropriate documentation will be required to prove the following conditions:
  - The need for services or intangibles is established
  - The services or intangibles have actually been received
  - The benefit from services or intangibles is commensurate with the charge
- The onus to satisfy the above conditions and to build necessary documentation lies with the assessee
- The assessees with similar transactions should review their existing intra-group agreements, policies and other relevant documentation to evaluate the need to either prepare or improve and strengthen the same
Reimbursements
Reimbursements

- Whether on cost to cost
- Is there a service element?
- How to determine arm’s length remuneration in case of the service element is involved
- Assessment experience
- Case laws:
  - DCIT vs Cheil Communications India Pvt Ltd:
  - ACIT vs M/s Chrys Capital Investment Advisors India Pvt Ltd
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<th>Abbreviations &amp; Acronyms</th>
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<td>Arms Length Price</td>
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Thank You

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