



EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Direct Taxation, Tax Coordination, Economic Analysis and Evaluation
Unit D1 Company Taxation Initiatives

Brussels, October 2011
Taxud/D1/

DOC: JTPF/022/BACK/2011/EN

EU JOINT TRANSFER PRICING FORUM

Private sector example of Cost Contribution Arrangement on services not creating IP

Meeting of 26 October 2011

**Charlemagne building (CHAR)
170 rue de la Loi, 1040 Brussels**

Contact:

Jean-Marc Van Leeuw, Telephone (32-2) 29.58.936

Julia Topalova, Telephone (32-2) 29.59.311

E-mail: taxud-joint-transfer-pricing-forum@ec.europa.eu

COST CONTRIBUTION EXAMPLE

Below is a short description of how Information Technology (IT) is a low value but important service in a pharmaceutical group. Other examples could be given for any manufacturing group where multi-location manufacturing requires just-in-time coordinated movements of components, for the food industry where the movements of goods require the proof of uninterrupted chains of cold or hygiene or for the travel industry where the coordination of connecting flights with the tracing of the passengers and their luggage or simply the tracing of transported goods are key. These examples all have in common that IT is an ancillary part of the business, but not a core element. So far, no business got acquired because it had outstanding administrative or IT skills (except for the IT industry in the latter case).

1. The Pharmaceutical Value Drivers

In order to define the exact nature and significance of IT for a pharmaceutical company, it is important to describe first the main business value drivers of a pharmaceutical company, those that involve intellectual property (IP).

The key drivers are

- R&D: develop new patented ingredients and processes that lead to novel medications;
- Manufacturing processes: manufacturing processes including quality control and quality insurance, that are approved by the various national drug administrations, allow the medications to be safely sold;
- Critical supply chain elements such as exactly locating at any moment medications manufactured from batches of ingredients by supplier; secure logistics for medications involving narcotics, steroids, growth enhancers or other substances for which a non-medical and illegal usage must be prohibited, strategic minimal levels of inventory of certain Government mandated medications;
- A well organized sales and marketing network to bring the medications to the patients.

There may be other IP elements within a pharmaceutical company, but they are of no relevance in this example.

2. IT – An Ancillary Function

IT is in the context of the above key drivers an ancillary function:

- Data processing and storage at a local level,
- Internal data communication among R&D centers, manufacturing sites, the supply chain distribution points, the finance and other departments
- External data communication with external regulators, law enforcement and other Government agencies and departments

It is however an important ancillary considering all the stakeholders involved and for a pharmaceutical group it is important to have unified systems that match all the above requirements.

3. A Cost Contribution Project

Assume as a **starting point** an integrated pharmaceutical company that has fully integrated IT systems that let the information flow seamlessly among the key drivers and other stakeholders.

This pharmaceutical group decides to expand through the **acquisition** of another equally integrated pharmaceutical company. In the acquired group some software is from the same vendor, some is from different vendors.

Under normal circumstances the group's IT department would manage to build bridges between the different systems at key points in order to allow an orderly dataflow.

However, the European Commission and local competition authorities require that the pharmaceutical group **divests** a certain number of products in both the acquiring and the acquired group. This entails that entire manufacturing and sales locations with their IT infrastructure have to be divested. In addition, after the acquisition organizational synergies require some minor additional divestments.¹

From an IT standpoint, although all the holes could be plugged, the information flow is far from seamless and steady, especially as some acquired software is in-house made on a platform that will no longer be supported by the original developer.

Therefore the group then decides to reorganize its IT structure by acquiring various soft- and hardwares and to implement them worldwide.

To do so the group management:

1. Commissions a specialized advisory firm for the general planning,
2. Contracts with different specialized software vendors, one for the integrated data flows involving finance, one for the R&D information flows, one for the manufacturing and supply chain flows and one for the marketing and sales information flows
3. Commissions separate software implementation advisory firms specialized in each software.

The IT functions of the World Headquarters and the Regional Headquarters provide the required guidance to the third party vendors.

As it is not possible to implement the whole in a big bang mode (the advisors don't have sufficient knowledgeable personnel), the decision is taken to implement the softwares over 5 years by world area, starting with the World Headquarters and then by major country/location in each world area.

To finance the project the group is considering a CCA where the group members would share the cost of the project on a formulary basis (using size of the country and gigabits transmitted) considering that:

¹ In this example the disruption in the IT-structure is the result of external interventions (the competition authorities) in order to distinguish this IT reorganization from a pure company driven reorganization undertaken e.g. because the soft-or hardware was partly/totally outdated.

- There is no IP involved; all the IT relevant know-how is with the external vendors/advisors. As stated in the introduction of this example IT is an ancillary part of the business, but not a core element. By doing this reorganization, as an end result, the pharmaceutical company will not have acquired or created own proprietary IT intangibles. These rest with the vendors and are subject to a license agreement.
- The project is estimated as a multi-million EURO investment spent over 5 years. The various group members will capitalize their share and depreciate/tax effect it over the useful life of the investment.
- It is anticipated that the actual expense may be twice the budgeted number, but there will be a no retroactive charge to the first countries as they have been used a pilots (or alternatively there will be a retroactive charge to put everybody on equal footing in which case there will be a question on how to treat/tax effect the additional original investment)

The various countries/locations would contribute to the expense as the project goes life in their country but there will be no buy-in of the countries coming in later as they will have to share the excess of the originally budget (or alternatively there will be a buy-in to put everybody on an equal footing).