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Business Members' example of a CCA

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An annoyised example of an agreed Cost Contribution Arrangement

Please note that although this example is for illustrative purposes it is worth noting the substance of this arrangement mirrors quite closely an actual case which has been discussed and agreed, without any significant revisions, with the relevant tax administrations. Also whilst the following is an example of circumstances when a cost contribution arrangement might be appropriate for a group of high-tech engineering companies there are many other reasons for and methods of working cost contribution arrangements in different businesses.

1. Background to the X Group

The X group (headed by company X) manufactures high-tech precision engineered products (widgets) which it sells to third party manufacturers for incorporation into their products (super widgets). The selling price of a single widget is in the region of \$1 – 10m dollars and may account for 10% to 15% of the selling price of the super widget. The performance of the super widget is very much dependent on the performance of the widget. The buyers of the super widgets demand ever improving performance, particularly with regard to energy efficiency, and, hence, there is continuing pressure on the X group to improve the performance of existing widgets and to design and manufacture better performing new widgets. Coupled with performance, the super widget, and hence the widget, must be ultra-reliable and they must both meet stringent safety standards. X Group has a number of competitors and relies on its reputation for quality and technical innovation to maintain and increase its market share.

The X group therefore spends a considerable amount of money on R&D as a proportion of turnover and earnings

X has subsidiaries in countries A (XA) and B (XB). These were acquired some years ago by X. XA and XB were established, independent Widget manufacturers with ranges of products which were mainly complementary to, but in some cases overlapped, those of X.

2. Research and development in the X Group

X, XA and XB (together “the parties” or “party companies”, individually “a party” or “party company”) all have full research, design and manufacturing capabilities for widgets but, subsequent to X’s takeover of XA and XB, they now each address a different part of the widget market, and their products are mainly differentiated by size. From an X group perspective, X, XA and XB are together viewed as a global business but each has separate local management and, where they do trade physical products (mainly components) and services with each other, it is on an arm’s-length basis.

The senior management of X, XA and XB meet regularly on an ex-officio basis to determine, inter-alia, their combined strategy for the widget market so that there is a common group approach and so that there is minimal duplication of effort between them. While X, XA and XB address different parts of the widget market, much of the technology that goes into the design and manufacture of a widget is common to all three. Therefore, the combined R&D programme undertaken by X, XA and XB is devised and agreed by all three together to avoid unnecessary overlap and duplication. This applies to both “blue sky” research and to development of specific

technologies and materials used in product development. Because of the applicability of the technology developed by one party to the products of the others, management consider that it is essential that the results of one party's R&D is made available to and can be used by the other parties, to the extent that it is allowed, for example, by government export restrictions.

3. Rationale for the allocation of costs

The parties determined that the simplest and most effective way of doing this was for them to enter into a cost contribution arrangement, whereby the costs of R&D are allocated between them. This gives each a full right to incorporate the resulting technology in their own products, without further consideration passing. So if XA develops technology, it remains the legal and beneficial owner of that technology but X and XB have a perpetual royalty free licence to use that technology for their own products.

What is important to X, XA and XB is to be able to share knowledge freely with each other as and when required. Much of this knowledge can be accessed directly through the group's intranet. If a person is required to provide assistance in the knowledge transfer, the time spent by that individual in assisting the other company and the associated costs will be the subject of a separate charge.

4. Methodology

It is accepted that not all technologies developed by one party are as relevant to the other parties as others. For example "blue sky" research is likely to be relevant to all, as is the development of a database of advanced materials (alloys, composites, etc) that can be used in the manufacture of widgets and to increase their performance. However, the development for production of a component by X, which makes very large widgets, may be of less relevance to XB who makes very small widgets for specialised applications. The engineers of X, XA and XB have therefore devised a relevance matrix which breaks each party's research and development into generic tasks and analyses the relevance of those tasks to the other parties.

The costs of the relevant R&D of X, XA and XB are agreed by the parties and are combined. The combined costs are then allocated to each company using an appropriate allocation key. The parties have agreed that sales (turnover) of the widgets and related spare parts by each of the companies is the appropriate allocation key. The allocated costs are compared with the actual costs incurred and a payment or receipt results for each party.

Note that there is no attempt to value individual items of technology. It is the costs, the relevance and the allocation key which determine payments and receipts under the cost contribution arrangement. The relevance and sales turnover matrix is considered the closest proxy to the anticipated benefits expected under the arrangement. The party companies together agree these calculations on an annual basis. Payments are made monthly, based on agreed budgets and an adjustment is made as soon as possible after the year end, when the actual numbers are available.

Occasionally, one of the companies sells widget technology to a third party that makes complementary but not competing products. To some extent that technology will have been subject to the cost contribution arrangement. Therefore an adjustment is made by an agreed formula to ensure that the other two companies receive a proportion of the proceeds.

All the above is incorporated in a cost contribution arrangement that has been signed by each of the party companies.

5. Extension of the cost contribution arrangement to new group members

If another widget manufacturing company is subsequently acquired by the group, an assessment will be made as to whether their technology will be appropriate for inclusion in the arrangement. If it is, there will be an initial (buy in) payment either by or to the existing group members in respect of pre-existing technology that will be shared amongst all group companies. This is done by looking at relevant spending, applying amortisation rates and allocating the amortised amounts using an appropriate allocation key. Future spend will be subject to the terms of the cost contribution arrangement.

Again this is incorporated into the cost contribution arrangement to which the newly acquired company would become a signatory.

If a company leaves the cost contribution arrangement, then depending on the circumstances a buy out payment might be appropriate.

6. Other services

In addition to the R&D costs, the X group has also decided that costs relating to more generic services should also be subject to cost sharing. These generic services include services in support of the R&D and manufacturing activities performed as well as general support services such as finance, human resources, logistics and supply chain optimisation. The main driver for the X group is to avoid duplication, achieve economies of scale and to develop world class support services in centres of excellence that X, XA and XB would not have been able to develop at a standalone basis.