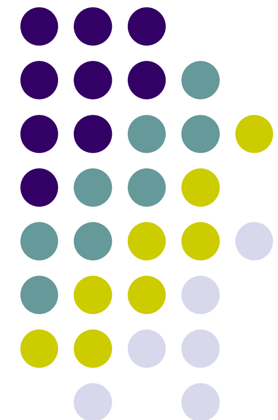
Deloitte
Haskins & Sells

Cost Contribution Arrangements in Transfer Pricing

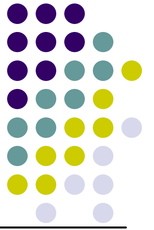
International Best Practices

Dr. Shanto Ghosh

December 2008



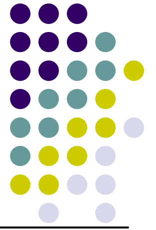
Contents



- **Overview**
- **Cost Contribution and cost sharing**
- **Cost Contribution for services**
- **Qualified Cost Sharing Arrangements – Requirements**
- **Key Issues in Cost Contribution/Cost Sharing Arrangements**

Deloitte Haskins & Sells

Cost Contribution Arrangement - Overview



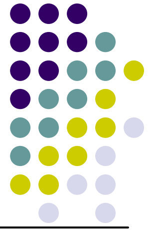
- **"A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights."**

  OECD Transfer Pricing Guidelines

- **While commonly observed for joint development of intangibles, CCA's can also exist exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services.**

Deloitte
Haskins & Sells

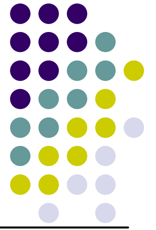
Cost Contribution Arrangements and Cost Sharing Arrangement



- U.S. Treas. Reg 1.482-7 describes cost sharing arrangement as an "…agreement under which the parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement."
- Can think of as a "joint venture"
- Interests often divided by territory

Deloitte
Haskins & Sells

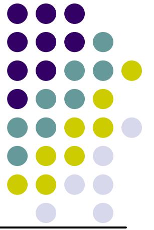
Cost Contribution Arrangement for Services



- Shared service center
  - Management services
  - Pooled services (procurement, etc.)
- Benefits usually measured through allocation key(s)
- Issue of markup – how "routine" are the services?
  - But what is the right measure of "costs" for the purposes of allocating costs?

Deloitte
Haskins & Sells

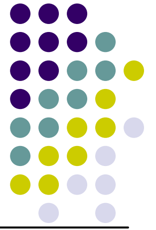
Qualified Cost Sharing Agreement



- Two parties required (related or not)
- Written agreement
- Designates division of intangible rights that each party will obtain through the arrangement
- Specifies method of sharing costs consistent with division of intangibles rights and expected benefits
  - Provide for adjustments to cost shares if circumstances change
- Buy-in/buy-out arrangement for pre-existing intangibles

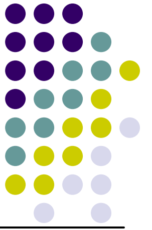
Deloitte
Haskins & Sells

Contemporaneous Documentation Requirements



- Controlled participants must timely update and provide information sufficient to
  - Identify cost shared intangibles
  - Establish that each controlled participant anticipates it will 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 of Reasonably Anticipated Benefits for each year
  - Describe external contributions, explain method used to determine payment for each contributed intangible
  - 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
  - Estimated arm's length values of external contributions as of the date of the PCTs
  - All information to be updated in timely manner

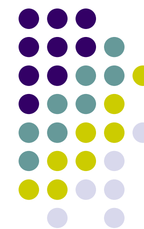
Cost Sharing - Issues



- What should be included in “costs”?
- How do you measure “expected benefits”?
- How do you “value” pre-existing intangibles?

Deloitte
Haskins & Sells

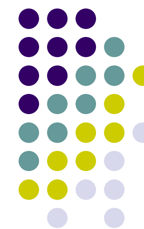
Definition of Costs



- Costs incurred related to the intangible development area ordinarily include expenses 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 cost sharing arrangement.
- All stock-based compensation that is granted to the employees during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost.

Deloitte
Haskins & Sells

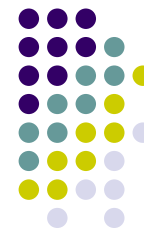
Estimating Expected Benefit



- Direct Method
  - Estimated additional income to be generated or costs to be saved by the use of covered intangibles
- Indirect Method (proxies)
  - Sales
  - Operating Profits
  - Gross Profits
  - Employees
  - Others?

Deloitte
Haskins & Sells

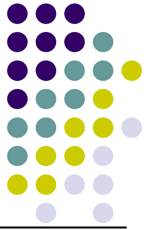
Time Period for Estimating Benefit



- Are significant changes expected in benefit shares over time?
  - If yes, do present value calculation and apply to all years
  - If no, may do year-by-year calculations
- Cost shares may be revised if expected benefits deviate from actuals by 20% (up or down)

Deloitte
Haskins & Sells

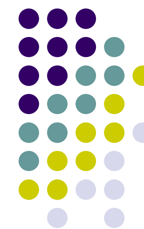
Cost Sharing Buy-In (Buy-Out)



- What is a buy-in payment?
  - Payment to CSA party by other CSA parties for the use of intangibles developed or acquired outside the CSA
- Payment can be [U.S. Treas. Reg 1.482-7(g)(7)]
  - Lump sum
  - Installment payments on lump sum, with arm's length interest under reg. 1.482-2(a)
  - "Royalties or other payments contingent on the use of the intangible by the transferee"

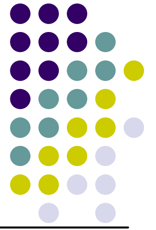
Deloitte
Haskins & Sells

Valuing Pre-existing Intangibles



- Buy-in payments must be based upon:
  - The interest share in the covered intangibles acquired by the joining member
    - Current commercial use
    - Payment for the “right” to do future R&D
  - The benefit-generating potential of the covered intangibles under consideration
  - Need to carefully determine the useful life and rate of decay for the existing technology

Valuing Contributed Intangibles: Methods



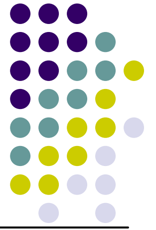
- Market Capitalization
- Discounted Cash Flow
- Residual Profit Split
- Declining Royalty
- Capitalized Expenditures

Top Down Approach

Bottoms Up Approach

Deloitte
Haskins & Sells

Cost Sharing Agreements: Recent Developments

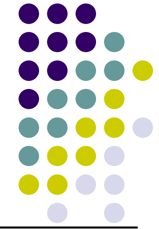


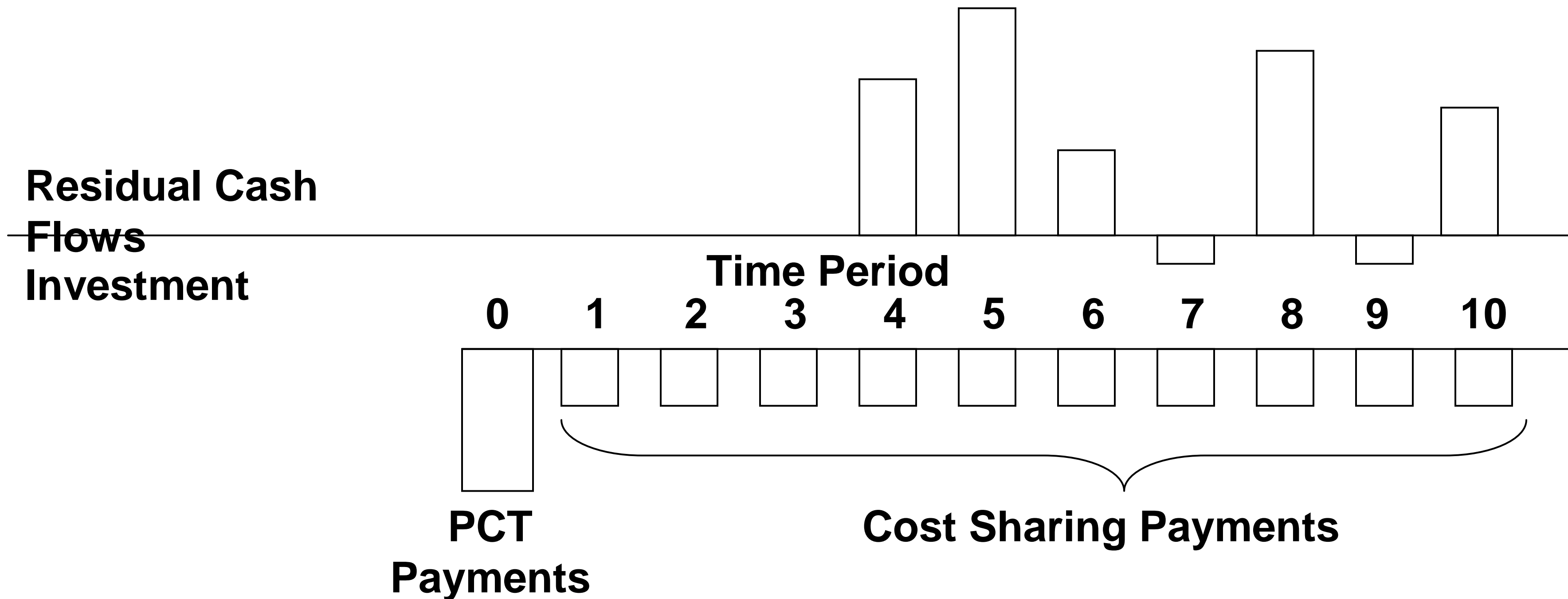
- IRS introduced revised proposed cost sharing regulations in 2005
- Formally introduced methods to value pre-existing intangibles (“Preliminary or Contemporaneous Transaction” or PCT)
- Investor Model:
  - From perspective of “principal” or “contributor”, valuation of external contributions not appropriate if return is less than return available from an alternative investment, e.g. licensing
  - From the perspective of “investor” or “participant”, return on its investment (payments for external contributions and cost sharing payments) should not exceed an “appropriate” discount rate

Deloitte
Haskins & Sells

© 2008 IBFD International Tax Academy

Investor Model

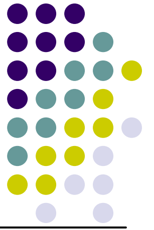




Under "investor model", at the "appropriate discount rate", NPV of investment (PCT and Cost Sharing Payments) less NPV of residual cash flows equal zero

Deloitte
Haskins & Sells

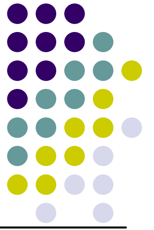
Comments



- Proposed regulations can be viewed as attributing entire residual to external contributions
  - Is this realistic if, for example, 6 months of “seed” R&D is followed by 6 years of “follow on” R&D

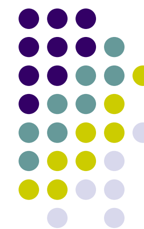
- Original rationale of CS was to provide certainty with respect to intangible property value
  - Does allowing the Commissioner to make “periodic adjustments” for 10 years create certainty, or uncertainty?

Comments (Contd.)



- **Proposed regulations assert that all residual value is attributed to external contributions; should not they require that this conclusion be demonstrated; i.e. to factually determine what created premium or unexpected value?**

- **Appears to be preference for using a discount rate based on company-specific data, e.g. WACC. Is this appropriate for valuing a particular project? Would a company pursue an investment if it (only) expected to earn WACC?**



Deloitte.

*As used in this document, "Deloitte" means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Deloitte
Haskins & Sells