

Implementation of a Cost Contribution Arrangement (CCA) Procedure for Intra-Group Services Based on OECD and EU Requirements

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Abstract

This paper addresses how multinational companies supplying the automotive industry establish transfer pricing between the entities that belong to company group for the different services they perform. These services must be regulated by the international laws and regulations established by the Organisation for Economic Co-operation and Development (OECD), as well as the relevant European ones agreed by the member states of the European Union (EU). This paper presents a procedure for the division of costs in a Cost Contribution Arrangement (CCA) between the members of a company group (associated enterprises) within the auxiliary automotive industry. Given that this paper is aimed at administrative services, the CCA is defined within the company as a service pool. It is more economical to share the service pool costs between the company group members than each member performs these functions for itself. This procedure has been developed empirically over the last few years and is based on compliance with the regulations mentioned previously and applied to a real case involving a multinational company with headquarters in Germany, where it has been corroborated. The model of methodology presented in this work can be seen in one of the sections of this paper.

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Introduction

The automotive manufacturing companies, known as an Original Equipment Manufacturer (OEM) have their production plants in many countries. Many of the companies supplying these OEMs have been installed in the same locations or nearby. As a result, there are numerous groups of international companies. Due to the fact that Germany is a major vehicle-producing country that, for example, between the years 2005 and 2014 manufactured 5 to 6 million units per year (OICA, 2015) there are numerous companies with their headquarters in Germany. Several of these have developed into groups of international companies. If international companies are associated enterprises the laws and regulations relating to transfer pricing must be applied.

According to the German Taxation Act on international relations (AStG, 2008, article 1), a company is an associated enterprise when:

- (i) this company has a direct or indirect shareholding (essential shareholding) in the taxable entity that reaches, at least, a quarter, or
- (ii) when one of them has its own interest in generating income on behalf of the other.

In each country, transfer pricing for services provided between the associated enterprises influences its economic result, in accordance with the Profit and Loss Plan (P&L) and consequently the taxes to be paid.

The objective is that the enterprises pay appropriate taxes in light of the functions performed taking into account assets used and risks assumed (BMF, 2005, chapter 3.4.11.1, p.31; OECD, 1995; OECD, 2010, chapter I, D.1.2.2, p.45-47; OECD, 2010, chapter VIII C.2, 8.12).

Based on the automotive industry, the research objective is to implement a procedure for dividing service pool costs between associated enterprises that intend to comply with the current laws and regulations relating to transfer pricing as much as possible. An appropriate division is tried, in light of the functions performed taking into account assets used and risks assumed. The proposed procedure's objective is to achieve a calculation for division aimed at a situation as near as possible to reality.

Background

The laws and regulations that deal with the issue, such as for example (AStG, 2008; FVerIV, 2008; GAufzV, 2007; BMF, 1999, p.1341; BMF, 2004; BMF, 2005; European Commission, 2005, chapter 2.1.1.15, p.7; OECD, 1995), lead to the transfer pricing policy in general being fixed by a group of companies and must be applied to all those following the same criteria (BMF, 2005, chapter 3.4.13, p.52).

The documentation that is created with the aim of dividing the service pool costs is included in the MASTERFILE. This document defines the transfer pricing policy for an entire group at international level (OECD, 2013, chapter 2.24, p.8; GAufzV, 2007, article 4), and is within

the EU-Transfer Pricing Documentation – EUTPD (European Commission, 2005, chapter 1.6, p. 5-6, chapter 1.7, p.6, chapter 4, p. 24-35, chapter 2.1.2, p.42-43). To implement it in each country the “Countryfile” document, or country-specific documentation (OECD, 2013, chapter 2.27, p.9) is prepared, following the spirit of the Masterfile and the aforementioned peculiarities.

The costs of the services to be divided must not rely on the different taxes to be paid in each country (OECD, 2010, chapter VIII C.1, 8.9). Orset (2014) shows that nowadays legislation does not clearly define the CCA’s structure. Dividing the costs is done subjectively. This leaves the matter subject to manipulations to shift profits to low-tax jurisdictions. The “Institut für Wissen in der Wirtschaft” (IWW, 2005) documents the risks from a tax perspective when applying CCAs. Regardless of the way in which the CCA has been drafted, the main question is whether the pool in itself must be treated as a company. This circumstance arises when the pool performs activities obtaining income, regardless of whether this income was foreseen or not (IWW, 2005).

The focus of this paper on dividing costs relating to the service pool appropriately in light of the functions performed, taking into account assets used and risks assumed by each member of the group of associated enterprises is to our knowledge a proposed practice that opens possibilities through adaptations to be applied in other sectors.

The service pool is defined as a contract that associated enterprises sign in the long term to perform services together or have different services available (BMF, 1999, chapter 1.1, p.2) showing the participation of each member (OECD, 2010, chapter VIII B.1, 8.3). The OECD makes clear that this is not an exact science (OECD, 2010, chapter VIII B.1, 8.3), but indicates that there is a margin for interpretation (OECD, 2010, chapter VIII C.1, 8.9). Each member is defined as an effective owner and not as the party that pays the licence and therefore these payments are not considered (OECD, 2010, chapter VIII B.1, 8.3).

The services must be performed in the interest of the companies that receive these services (OECD, 2010, chapter VIII B.1, 8.4). The system consists of dividing costs incurred for performing these services depending on the profit attained by each company (BMF, 1999, chapter 1.1, p.2; OECD, 2010, chapter VIII C.1, 8.8). Assessing the division can be difficult (OECD, 2010, chapter VIII C.3, 8.16). There is the possibility of using various cost allocation keys (OECD, 2010, chapter VIII C.4, 8.22).

The procedure must show that costs are not charged twice to the members. Intangible property or know-how is not paid for if they are within reach of the members when performing the services using a service pool (BMF, 1999, chapter 1.5, p.4).

The composition of the charge for costs is the expenses that truly originate in the context of the performance of the services. These costs must be recorded according to the regulations of each country where these services are performed. The costs must be reduced through income, subsidies, etc. that are related to them (BMF, 1999, chapter 2.1, p.5).

Given that the pool follows a common interest and there is no business risk, from a tax viewpoint no surcharge on profit is acknowledged when recording the costs (BMF, 1999, chapter 2.2, p.6).

The managerial implications on transfer pricing have also been discussed in the literature. Thus, Chan y Lo (2004) provide an empirical study of the association between the management's perception of the importance of environmental variables and their choice of international transfer pricing (TP) methods in the context of a developing economy as China. Wolff (2007) study the effect of market price-based TP and shows on the basis of a study of individual production processes in 73 companies, that market price-based transfer price systems as opposed to those unrelated to the market price have a much stronger efficiency and motivation effect. Cools et al. (2008) study the impact of TP tax compliance on management control system (MCS) design and use within one multinational enterprise (MNE), which employed the same transfer prices for tax compliance and internal management purposes. Later on, Cools and Slagmulder (2009) investigate how TP tax compliance influences responsibility accounting when one multinational enterprise (MNE) uses a single set of transfer prices for both, tax compliance and management control.

The most appropriate method for division concerning the basis of the services provided must be selected (BMF, 1999, chapter 3.2, p.7). There can be numerous services to be performed, for example, the joint implementation of intangible property (OECD, 2010, chapter VIII B.3, 8.6).

A Cost Contribution Arrangement can be created for any activity that is financed jointly and costs and risks are divided in accordance with the members' participation (OECD, 2010, chapter VIII B.3, 8.7).

Luquet et al. (2004) shows the possibility in the US International Revenue Code of applying "Cost Sharing Agreements" which are limited to re-allocations of costs and not profits, explaining the differences between research agreements and implementation using pure CCA services. The authors name the regulations to be complied with and the problems that other countries outside the United States of America may have in recognising this method. In general, complying with the arm's length principle is seen as necessary.

The purpose of the research is defined as referring to an application within the automotive industry, in which the suppliers within a group of companies provide services between themselves. This proposed procedure tries to provide a solution on how a division of the service pool costs can be applied, complying with the previously explained requirements.

To carry out this research, it was necessary to examine each of the restrictions described under current regulations. The process of search and selection of the applicable regulation in each case was a painstaking and methodical process.

In order to attain the goals established, the empirical development of a project has taken place in recent years, one that has been applied to a multinational company with headquarters in Germany. The formulas detailed below have been made during the last few years.

Parameters and Formulas

This Section shows the formulas that describe the variables and the calculation for the procedure.

RS_p represents the relevant sales for ordinary function, expressed in Eq. 1, where RS are the relevant sales, p is the ordinary function and i the number of countries from 1 to n .

$$RS_p = \sum_{i=1}^n RS_{pi} \quad (\text{Eq. 1})$$

$SA_{p\alpha\beta}$ represents the service A cost concerning p at the company α related to the cost centre β . $RS_{pSA\beta i}$ represents the relevant sales of service A cost concerning p related to the cost centre β at the country i .

$SA_{p\alpha\beta i}$ represents the service A cost concerning p at the company α related to the cost centre β at the country i . It can be expressed as follows (Eq. 2):

$$SA_{p\alpha\beta i} = \frac{RS_{pSA\beta i}}{\sum_{i=1}^n RS_{pSA\beta i}} * SA_{p\alpha\beta} \quad (\text{Eq. 2})$$

$SB_{p\alpha\beta}$ represents the service B cost concerning p at the company α related to the cost centre β . $RS_{pSB\beta i}$ represents the relevant sales of service B cost concerning p related to the cost centre β at the country i .

$SB_{p\alpha\beta i}$ represents the service B cost concerning p at the company α related to the cost centre β at the country i . It can be expressed as (Eq. 3):

$$SB_{p\alpha\beta i} = \frac{RS_{pSB\beta i}}{\sum_{i=1}^n RS_{pSB\beta i}} * SB_{p\alpha\beta} \quad (\text{Eq. 3})$$

$DC_{p\alpha\beta i}$ represents the direct cost concerning p at the company α related to the cost centre β at the country i .

$TC_{p\alpha\beta i}$ represents the total cost of service category p at the company α related to the cost centre β at the country i . It can be expressed as (Eq. 4):

$$TC_{p\alpha\beta i} = SA_{p\alpha\beta i} + SB_{p\alpha\beta i} + DC_{p\alpha\beta i} \quad (\text{Eq. 4})$$

TC_{pi} represents the total cost for service category p related to country i , expressed in Eq. 5, where α is the number of companies from 1 to z , and β is the number of cost centers from 1 to y .

$$TC_{pi} = \sum_{\alpha=1}^z \left(\sum_{\beta=1}^y TC_{p\alpha\beta i} \right) \quad (\text{Eq. 5})$$

The same procedure to be done for categories q (turnover related to customers) and r (turnover related to product areas).

TC_i represents the total cost for all service categories related to country i . It can be expressed as seen in Eq. 6, $\forall i \in (1, n)$:

$$TC_i = TC_{pi} + TC_{qi} + TC_{ri} \quad (\text{Eq. 6})$$

R_i represents the reminder to be paid for the service pool, expressed as follows (Eq. 7), $\forall i \in (1, n)$:

$$R_i = TC_i - S_i - P_i \quad (\text{Eq. 7})$$

where S_i are the services provided to service pool, and P_i are the payments on account service pool.

Case Study

Services Categories

The problem exists in the definition of a calculation method that attempts to comply with the previously explained requirements. Above all, it must be taken into account that only the members that benefit from the services performed by the service pool contribute to them. If administration services are performed both for the service pool and outside the pool these must be identified.

The services are classified into three categories:

- (i) Category 1: Guaranteeing ordinary function and capacity for the group's future.
- (ii) Category 2: Generating sales originating from customers.
- (iii) Category 3: Generating sales originating from products.

The costs relating to the different categories are recorded in individual cost centres. The "MASTERFILE-Determination of Internal Costs" summary that is explained later on, shows the relevant cost centres with regards to the services provided to the members of the service pool. The three categories are defined below:

Category 1: Guaranteeing ordinary function and capacity for the group's future (p)

Activities that each member of the service pool has to perform for the process and higher measures and investments, as well as activities that ensure competitiveness and capacity for the companies' future before customers and competitors, both at a technological level and technical production processes level.

Category 2: Generating sales originating from customers (q)

The customers' main offices (place where decisions are taken on allocating orders and/or project management) of the group of companies (for this example) are usually in Germany. The exceptions are Seat (Spain) and Skoda (Czech Republic). However, because they belong to the Volkswagen Group, important commercial and technical decisions are usually taken in Wolfsburg (HQ for the VW Group located in Germany). Both generating sales and the management (reports) of the projects in process or in the commissioning phase make a personal presence in the same location as the client an essential condition. This requires a high investment in time and costs (especially in personnel and travelling costs). In addition, in-depth knowledge (oral and written) of the German language, which makes negotiation possible, is required.

The end customers have several production plants distributed throughout the world. Due to the range of products of the group of companies (*for this example*) that are mainly modules of great volume and high complexity, high logistics costs are generated.

The CMs (Customer Management departments), with the related allocation of clients, are (*in this example*):

CM 1: OEM 1

CM 2: OEM 2

CM 3: OEM 3

CM 4: OEM 4

CM 5: OEM 5

CM 6: Suppliers of modular systems (1), seats

CM 7: Suppliers of modular systems (2), cockpit

OEM: total OEM (CM 1 + CM 2 + CM 3 + CM 4 + CM 5)

System: total suppliers for modular systems (CM 6 + CM 7)

Category 3: Generating sales originating from products (r)

The circumstances relate to those explained in category 2.

To confront this challenge, technical teams will be formed. In view of the range of products from the group of companies, the technical teams are organised in accordance with the strategic product departments, which for this example are defined as:

PA: Bodywork structure product department

PB: Floor structure product department

PC: Cockpit/chassis product department

With regards to categories 2 and 3, it is especially worth emphasising that the main responsibility for service provision is not carried out in person in situ at the client's company, but at the headquarters of the Group's parent company, through the preparation and subsequent processing of the issues.

Determining and recording the services to be provided

In the course of operational planning for the following year the cost centre's manager calculates, together with the related controller, the forecast amounts (guided in accordance with past values) for each cost centre, based on sales planning. These data are recorded using software (currently EVM Portolan – *in this example*) and are compacted into an "operation closing sheet" known in German as "Betriebs-Abrechnungs-Bogen" (BAB).

All the cost centres that are allocated to services categories 1, 2 and 3 are included in the "MASTERFILE - Determination of Internal Costs" summary.

The amounts are adjusted to the current situation in the forecasts prepared during the course of the financial year; in other words, possible variations are corrected and documented with regards to the initial planning.

Each cost centre manager is responsible for monitoring the correct allocation of the invoice amounts.

Monitoring and possible corrections are made in the prepared forecasts during the financial year, but at the latest on the definitive settlement date for all the real costs, until preparing the settlement balance for each year.

Subsequent Integration, Early Cessation and Termination

Given that the services included in this service pool contract are services related to administration, a company that may become involved in the contract at a later date would not have to make any type of membership payment.

Making payments due to cessation is not provided for, given that the subject of the contract only includes services that service pool members acquire jointly and for which they continuously pay (e.g. monthly).

Conclusions

This paper presents a procedure aimed at compliance with the laws and regulations in question, so that each member of a group of companies shares appropriately in the division of service pool costs. Using the calculation method, the proposed system enables the suppliers in the automotive industry to apply this procedure. The system itself enables it to be applied in other sectors, by adjusting the service categories, without having to change the base calculation and therefore it can comply with the requirements that are listed in Section 2.

The demonstrated procedure can be adjusted to requirements. The company improves its competitiveness by optimising its administrative costs. If they integrate more production plants they increase relevant sales. The service pool costs do not necessarily have to increase and in all events not in the same proportion as the relevant sales. This signifies that by integrating a new plant, competitiveness in the existing plants automatically improves, given that the cost is now divided among higher relevant sales. In this way both parties, the taxpayer and the authorities, participate. Companies improve their results and the tax-collection entities receive more taxes.

The proposed procedure can help in strategic decision making for guiding the group of companies towards the future. Analysing the costs and income for different customers and their respective generated costs according to the customer manager and those costs originating from the technical teams with regards to the different product departments gives indications about with which customer or product future activities must be implemented, such as the creation of new plants, product development, etc.

Following the proposed procedure avoids possible consequences by the tax-collection entities if it does not accept performed tasks that fail to comply with the regulations in question.

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