Documenting it right

International Tax | Large Corporate

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Paul Sutton provides guidance on what tax professionals should insist upon when documenting intercompany agreements for transfer pricing

Key Points

What is the issue?

Transfer pricing is widely regarded as one of the most significant and complex areas of tax risk affecting multinational groups. The recent case of Google highlights just how financially – and reputationally – damaging transfer pricing disputes can be.

What does it mean to me?

As with many areas of tax, transfer pricing is closely related to legal structures and the contractual terms upon which intra-group transactions are conducted. Groups which do not have appropriate, signed intercompany agreements in place are on the back foot in discussions with local tax authorities about their transfer pricing compliance.

What can I take away?

Putting in place and regularly updating intercompany agreements can seem like a complex and costly process. Failing to do so, however, is usually a false economy.

Transfer pricing is widely regarded as one of the most significant and complex areas of tax risk affecting multinational groups. It is also one of the main areas of focus for tax authorities and supranational organisations, such as the OECD. In 2016/17, the UK transfer pricing yield resulting from HMRC challenges was over £1.6 billion, nearly twice that of the previous year. The recent case of Google highlights just how financially – and reputationally – damaging transfer pricing disputes can be. The group has been embroiled in transfer pricing disputes for several years and recently made a €306m settlement with the Italian tax authorities, having previously settled with HMRC in the UK. Disputes are ongoing in France and Spain.

As with many areas of tax, transfer pricing is closely related to legal structures and the contractual terms upon which intra-group transactions are conducted. This has recently been underscored by the OECD in the latest edition of its Transfer Pricing Guidelines. The 2017 edition re-emphasises the fundamental importance of legal analysis and intercompany agreements as part of the resolution of transfer pricing issues. It is worth quoting verbatim what the 2017 guidelines say: ‘Importantly, ex ante contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialisation of risk outcomes. Such evidence is a very important part of the tax administration’s transfer pricing analysis of risks in commercial or financial relations, since, in practice, an audit performed by the tax administration may occur years after the making of such up-front decisions by the associated enterprises and when outcomes are known.’

Intercompany agreements (ICAs) are legal agreements between related parties. They define the legal terms on which services, products and financial support are provided within a group. ICAs can cover a wide range of matters, including head and back office services, revenue and cost sharing, intellectual property licences, and so on. The value of ICAs, like many compliance documents, often only becomes apparent when a group is required to respond to a tax or regulatory audit at short notice. Businesses frequently take the view that the relationship between corporate entities in a group is unlikely to come under scrutiny and so neglect to invest in clear, legally robust intercompany agreements. Even when such agreements do exist, they are often badly drafted, incomprehensible and out-of-date, so that they do not reflect the commercial reality of how the group operates. It is therefore beholden on tax advisers to international groups to ensure that legally binding intercompany agreements are in place and any transfer pricing risks minimised. Failing to do so is akin to giving tax authorities access to the group’s bank accounts so they can withdraw what they consider fair. The consequences of not having ICAs can be serious. Fundamentally, groups which do not have appropriate, signed ICAs in place are on the back foot in discussions with local tax authorities about their transfer pricing compliance. This is because they are unable to present a clear statement as to what intra-group supplies are being made (and for what price), how relevant assets are held, and how risks are allocated between group companies. In certain jurisdictions, corporates are routinely subject to fines and penalties, simply for failing to produce signed ICAs when requested. Other problems include expenses potentially being disallowed, post year-end ‘true up’ type adjustments being subject to challenge and local tax authorities attempting to re-characterise a transaction as something other than that claimed by the taxpayer.

While the tax reasons for properly drafted intercompany agreements are compelling enough, there are strong non-tax drivers, too. ICAs can be an important tool for regulatory compliance (such as complying with the new General Data Protection Regulation, or where one or more members of the group are regulated entities in the financial services and insurance sectors); ring-fencing assets and liabilities from risk; improving the corporate governance of companies throughout the group; reducing personal liability risks for directors; supporting the external and internal audit of group entities and ensuring that intellectual property rights can be enforced and monetised appropriately.

When putting together intercompany agreements of transfer pricing, tax advisers should bear in mind the following:

- If systems for creating and maintaining intercompany agreements are not established on a holistic, cross-functional basis, there is a high risk that different functions within a group will create contradictory sets of documentation which do not take into account the needs of all stakeholders. Tax advisers should therefore urge their clients to ensure that all relevant stakeholders are involved in the creation and maintenance of intercompany agreements.
- It is important to achieve the governance and transfer pricing benefits of having robust legal documentation for intra-group supplies. In relation to any given intra-group supply, the relevant intercompany agreements obviously need to be consistent with the group's transfer pricing policies as regards the nature of the supply, the terms of supply (including the allocation of risk) and the pricing of the supply. They also need to be consistent with the reality of how the arrangements are operated and managed in practice. Complicated change control or reporting provisions which have been imported from an arms' length commercial contract will do nothing to enhance a group's transfer pricing position if they are not followed in practice.
- The terms of the intercompany agreements must be consistent with the legal and beneficial ownership of any relevant assets and the commercial reality of intra-group transactions. For example, an intra-group agreement where a company purports to grant a license over intellectual property which it does not actually own, may be likely to create confusion and misleading accounting entries, rather than promoting the group's transfer pricing and other commercial objectives.
- The legal agreements should reflect an arrangement which the directors of each participating company can properly approve as promoting the interests of that particular company. This means that some proposed arrangements can be problematic – such as arrangements which would involve a particular entity incurring ongoing losses; being exposed to liabilities or cashflow demands which it does not have the financial resources to meet (such as indemnities for product liability, or an obligation to repay loans on demand); or 'giving away' assets or value, especially if it is to a parent undertaking. Although these considerations should be addressed in the functional and economic analysis required for transfer pricing, often they are not.

- Finally, the intercompany agreements must be capable of being legally binding, which means that the key terms of the arrangement must have ‘legal certainty’. This principally applies to the description of what is being supplied and the price of the supply, so that those provisions must be objectively ascertainable from the terms of the agreement. We see a lot of intercompany agreements where there is no price stated or the price is set by some vague reference to comparable turnover or net profits of the subsidiary. This approach can raise issues from the point of view of legal certainty and from a transfer pricing compliance perspective. Other common mistakes include agreements being too complicated; not matching ownership and flow of IP; not adequately reflecting group structures; failing to guard against inappropriate termination provisions; and overlooking the importance of making provisions for allocation of cost between multiple service recipients.

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TEN-POINT CHECKLIST FOR REVIEWING INTERCOMPANY AGREEMENTS

The following checklist can be used for reviewing an intercompany agreement, whether it is a new arrangement being put in place or an existing agreement that may need to be updated.

1. Parties: Are the parties correctly described? It is generally better to use company registration numbers in addition to the company names, as names may be more likely to change.
2. Consistency with functional analysis: Check that the terms of the agreement are aligned with the functional analysis underlying the transfer pricing policies which the group intends to operate. This includes:
   - Subject matter: the nature of the goods, services or finance to be provided;
   - Warranties and indemnities: including service levels, warranties as to standard of care or specification of goods, etc; and
   - Limitations on liability: the presence or absence of any limitations on the recourse of one party against the other.
3. Term and termination: Check the proposed commencement date for the agreement, and any termination date or provisions for terminating the arrangements on notice. Pay particular attention to any attempt to ‘backdate’ arrangements. Review the provisions for terminating the arrangements on notice. Notice periods should achieve an appropriate balance between allowing the group flexibility to vary the structure in the future, while also reflecting arrangements which are commercially justifiable for all participating entities (see further item 10 below).
4. Legal ownership of pre-existing intellectual property: If the agreement deals with or relies on pre-existing intellectual property (such as rights in technology or trademarks), ascertain where the legal and beneficial ownership of that intellectual property actually resides. Make sure that the terms of the agreement are consistent with that position.
5. Legal ownership of intellectual property created in the performance of the agreement: Check that this is clearly stated, and that the identity of the owner is consistent with the group’s intellectual property objectives.
6. Vertical consistency: Where the agreement forms part of a chain of supplies of goods, services or licences, check that the draft agreement is consistent with what is happening in the chain above and below the agreement. This includes the ultimate supply of goods, services or IP licences to customers where relevant.
7. Horizontal consistency: Where the pricing of the supply being made under the agreement needs to be aligned to, or differentiated from, other similar supplies, make sure that the terms of the agreement are appropriately similar or differentiated, as the case may be. This applies particularly to internal comparables.
8. Governing law and formal requirements: Check that the agreement contains a clear choice of law provision, and that legal advice has been obtained on any areas of uncertainty as to formal requirements.
9. Administrative and reporting provisions: Check that any administrative provisions, such as change control clauses or pre-approval of budgets, matches what actually happens in practice.
10. Corporate benefit: Check that the arrangements as a whole make commercial sense from the individual perspectives of each of the participating entities.

Conclusion

The OECD's Transfer Pricing Guidelines are primarily intended to help tax administrations and multinational enterprises resolve transfer pricing 'cases', and to provide a common framework for tax administrations to adopt.

The task facing multinational enterprises is different: it is to design, implement and maintain appropriate corporate structures, effective ICA terms and ongoing systems to facilitate continuing transfer pricing compliance. It is also important that those structures and systems should support not only the group's transfer pricing compliance objectives, but should also meet its commercial, regulatory and corporate governance needs. This means that a holistic, cross-functional approach is essential.

Putting in place and regularly updating intercompany agreements can seem like a complex and costly process. Failing to do so, however, is usually a false economy. Intercompany agreements do not have to be complicated – in fact they need to be simple so that stakeholders fully understand them – but, like anything else, they need to be properly planned and implemented, and supported by appropriate ongoing systems.

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ACTION POINTS

Key action points for transfer pricing functions within multinational groups and their advisers:

- Establish what template intercompany agreements are currently used within the group, and whether they need to be updated
- Consider which intra-group supplies would most benefit from intercompany agreements to support the group's transfer pricing objectives and should therefore be prioritised
- Identify all relevant stakeholders who need to be involved in the design and implementation of intercompany agreements
- Establish clear accountabilities for creating and maintaining appropriate templates, arranging signatures and archiving signed intercompany agreements.
- Choose the appropriate contracting model (e.g. global agreements, bilateral agreements, hybrid, contract schedule / standard terms)
- Exercise caution as regards proposals to 'backdate' arrangements. As is highlighted in the OECD's 2017 Transfer Pricing Guidelines, risk cannot be allocated after the event