Tax Insights & Commentary
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How Intercompany Agreements Can Mitigate Transfer Pricing Risk

- *Mayer Brown partners analyze intercompany agreements*
- *Getting outside advice, deciding on amount of detail are key*

Multinational groups constantly evolve, grow, and consolidate, and operational facts and circumstances always change. Say a growing company decides to expand internationally. It may choose to incorporate new foreign subsidiaries that will operate a manufacturing facility in one country and a limited-risk distributor in another.

The tax department will probably pay a lot of attention to the proper transfer pricing for transactions between these related parties of the growing multinational group. When it does so, it should ensure that the intercompany transactions, including the arm's-length pricing, are memorialized in written intercompany agreements. We'll address the most common questions you might have about these agreements.

Are they even important? The short answer is yes. If you don't have intercompany agreements in place, the IRS has the authority to impute contractual terms consistent with the economic substance of the underlying transaction.

That might not sound like a big deal because, in transfer pricing, the substance generally controls anyway. But failing to document your transfer pricing in intercompany agreements exposes you to unnecessary risk and unpredictability. This is because the multinational gave up the opportunity to proactively set the terms of the intercompany transactions and risks, allowing the IRS to identify the parties, characterize the transaction, and set the arm's-length price.

Agreements allow the company to memorialize a transaction as intended, and if the contractual terms have substance and reflect arm's-length principles, the IRS should respect them.

Who drafts them? Some companies rely on outside advisers. Others do the drafting in-house. Tax department personnel may draft them in the first instance, while other companies might prefer their in-house lawyers hold the pen or at least review them before they are executed.

There are a couple of best practices here. First, it's helpful to centralize the drafting and maintenance of intercompany agreements. Centralization ensures that a specific department or person has a bird's-eye view of all the intercompany agreements who can ensure they are consistent with one another, modified when necessary, and updated on a regular basis.

Second, it's helpful to consult with tax attorneys experienced in this area, as intercompany agreements can implicate a variety of tax issues. Transfer pricing, withholding, and deductibility are prime examples, and rules on these issues may vary by jurisdiction.

Rules and regulations and reporting obligations constantly change. Transactions involving intellectual property may raise even more issues. Unless in-house personnel feel confident they can identify and address all these issues for relevant jurisdictions, it's wise to get outside assistance.

How much detail should we include? Detail is a double-edged sword. The more detail you include, the more predictability you potentially buy with the agreement. But detail also makes it more difficult to change the terms of a transaction in response to new events or business needs.

Generally, all intercompany agreements include terms covering the parties involved, the nature of the transaction, pricing, payment, and duration of the arrangement. Many agreements also include risk-allocation provisions, dispute-resolution mechanisms, compliance clauses, and terms related to confidentiality or data protection. Which terms to include—and how much detail to lay out for each term—is a judgment call.

For example, some intercompany agreements will simply refer to annual transfer pricing documentation or state that the price is set in accordance with Section 482 of the tax code or OECD principles, while others will provide detailed and precise pricing terms. While all these options are valid, flexibility should be balanced with clarity, and the right balance can differ among companies.

When do we execute them? The Section 482 regulations contemplate greater deference for intercompany arrangements that are "agreed to in writing before the transactions are entered into." It's therefore best to execute agreements as early as possible—preferably before the transaction or arrangement begins.

In practice, it's often necessary to document a transaction that is already ongoing or underway. In those situations, companies must ensure that the agreement's terms are consistent with the terms of the ongoing business arrangement.

It's also important to check local-country rules that might contain their own nuances concerning written agreements that are executed after a transaction is underway.

What do we do with them? Centrally maintain them, comply with them, and update them. Section 482 regulations allow the IRS to disregard an intercompany agreement if "the contractual terms are inconsistent with the economic substance of the underlying transaction." Accordingly, the company must abide by the written terms of its own intercompany agreements.

For companies with many intercompany agreements, this may require significant organizational effort and recordkeeping, but the time and effort is well worth it. Companies also should revisit and update intercompany agreements regularly to stay compliant. Failing to update old intercompany agreements can risk a tax authority view that the agreement is stale and no longer applicable.

How do we terminate them? Very carefully. Terminating an existing intercompany agreement is sometimes necessary to protect the business, but it may lead to other tax and transfer pricing consequences. The most common option for termination is through a general termination clause that specifies a notice period. Another option is through a force majeure clause (also referred to as a hardship clause).

Parties should make sure they comply with the terms and consider how third parties justify these types of terminations. It's important to document the circumstances triggering this clause, including whether the terminating party owes arm's-length compensation. Absent such termination clauses, parties should assess the impact of non-performance claims and liquidated damages provisions.

Although parties can simply agree to contract rescission, they should be careful to document their intention to unwind a transaction and be prepared to defend the change in a potential audit by a tax authority.

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