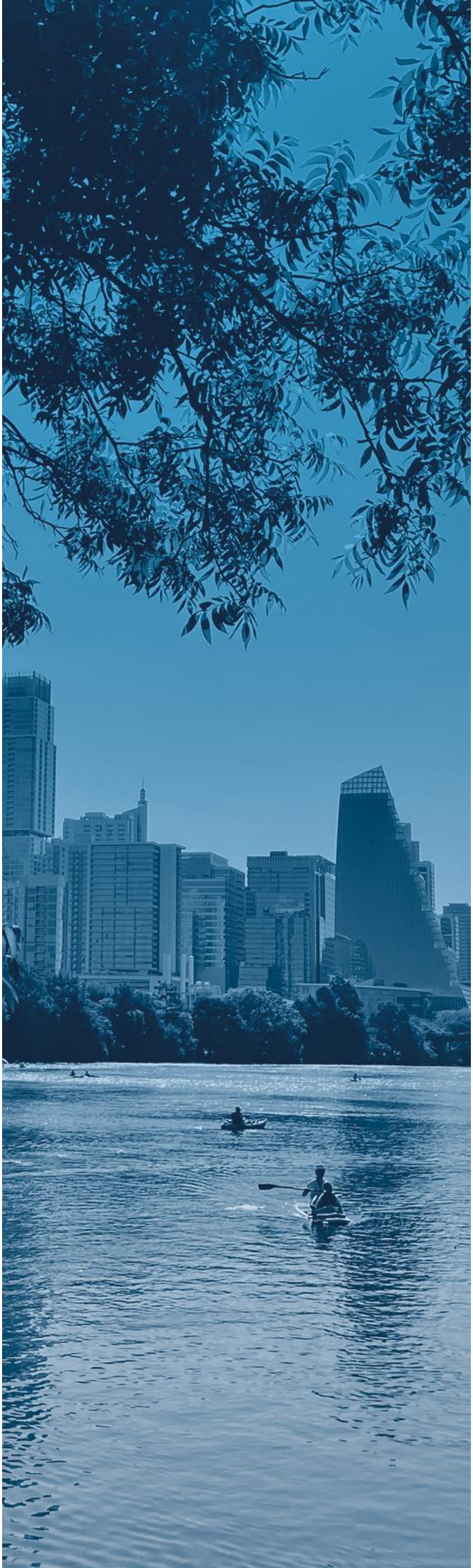

Effective Intercompany Agreements for Transfer Pricing Compliance

A practical briefing for multinational groups and transfer pricing professionals

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01 **Who is this briefing for?**

This briefing note is for tax, transfer pricing, legal and compliance professionals within multinational groups, as well as their transfer pricing advisers.

It is based on the experience of our team at LCN Legal, a law firm which specialises in the legal implementation of transfer pricing (TP) compliance. We work alongside tax and TP professionals around the world, helping to ensure that multinational groups have intercompany agreements which support their transfer pricing policies and which are audit-ready.

We have found that a number of groups fail to maintain intercompany agreements which are aligned with their TP policies. On page 8, we give some examples of common problems that we come across. These issues are not confined to smaller multinational groups. They also affect large corporates with well-resourced tax and legal teams, including those which are advised by large tax and TP advisory firms.

We believe these issues arise due to a skill gap. Tax professionals are often unfamiliar with the drafting of commercial contracts and the impact of individual clauses in intercompany agreements. Whereas commercial lawyers are often unfamiliar with the principles of TP and the OECD Transfer Pricing Guidelines. As a result, many groups are exposed to unnecessary tax risks, and to the burden of protracted tax enquiries, audits and even disputes which could have been resolved earlier or avoided completely.

We have created this guide so that multinational groups can avoid these pitfalls. Our lawyers are recognised as world leaders in intercompany agreements and we have been featured in many respected journals, including Tax Notes, International Tax Review, Tax Journal, Finance Director Magazine, Accountancy Magazine and Thomson Reuters Practical Law. In addition, our co-founder, Paul Sutton, is the author of 'Intercompany Agreements for Transfer Pricing Compliance: A Practical Guide' – available **here**.

As we do not advise on tax, TP, economic analysis or comparables, we do not disrupt your existing tax and TP relationships, and the services we offer are designed to integrate seamlessly with those provided by your other advisers.

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02 **What are intercompany agreements (ICAs)?**

Intercompany agreements (often referred to as ICAs) are legal agreements between related parties. They define the legal terms on which services, products, intangible assets and financial support are provided within a group. These transactions can take many forms.

Typical transaction types covered by ICAs include:

- Management services
- Administrative and other back office services (e.g. finance, tax, legal and HR services)
- Marketing services
- R&D services
- Sales agency and commissionaire arrangements
- Appointment of limited risk distributors (e.g. on a target margin basis)
- Appointment of full risk distributors
- Contract manufacturing and toll manufacturing
- Intellectual property licences and intra-group franchises
- Transactional profit splits
- Cost sharing / cost contribution arrangements
- Shared services arrangements
- Loan facilities (e.g. term loans, revolving credit and overdraft facilities)
- Intercompany debt in security form (e.g. loan notes)
- Guarantees and other forms of security or financial support
- Cash pooling
- Secondment of staff and other mobility arrangements.

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03 **Why are ICAs essential for transfer pricing compliance?**

Transfer pricing (or TP) is one of the most challenging and highest risk areas of tax compliance for multinational groups. Significant resources are invested in preparing appropriate TP policies and models, and producing TP documentation. Such resources may be wasted unless the group's TP policies are legally implemented correctly.

It is self-evident that policies for regulatory compliance have no value if they are not followed in practice. In the same way, TP policies provide little protection from tax risks if they are not actually implemented – both legally and operationally.

The key role of ICAs in TP is reflected in the following foundational points:

- ICAs are the starting point for delineating transactions as part of TP analysis by tax administrations, as contemplated by the OECD's Transfer Pricing Guidelines (the same principles apply under the rules in many countries, including the USA)
- From a formal perspective in terms of base erosion and profit shifting (BEPS) compliance, the OECD's Transfer Pricing Guidelines require that master files contain 'a list of important agreements relating to intangibles', and that local files include copies of 'all intercompany agreements entered into with the relevant local entities'
- As shown in a number of recent cases (such as those involving Coca-Cola, SingTel and BlackRock), the presence or absence of legal terms in ICAs can completely change the economic characteristics of intercompany transactions; they are therefore fundamental to pricing under the arm's length principle.

Intercompany agreements therefore perform a critical function in defining controlled transactions, documenting the allocation of risk, evidencing the ownership of intangibles and specifying the pricing (including any post year-end true-up or true-down arrangements).

From a practical perspective, ICAs are often one of the first documents which tax inspectors ask for in a transfer pricing enquiry or audit. Gaps in intercompany agreements – or discrepancies between intercompany agreements and TP documentation – are easy for tax administrations to identify and will often become the focus of their investigations.

Implementing and maintaining a comprehensive suite of intercompany agreements is therefore a pre-requisite for any corporate group to be tax audit-ready.

"Risk analysis should be consistent with intercompany agreements."

IRS Guidance on Transfer Pricing Best Practices, January 2023

"The transfer pricing documentation should address ... allocations of risk, how the risk allocations compare to the comparable companies used, and why the resulting pricing is consistent with the agreement."

IRS Guidance on Transfer Pricing Best Practices, January 2023

"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."

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 edition, p57

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04 **What practical impact do ICA clauses have on arm's length pricing for TP purposes?**

A single clause in an intercompany agreement can make a significant difference to the pricing of the relevant transaction under the arm's length principle.

The OECD's Transfer Pricing Guidelines contain a good example of this. It relates to the impact of a 'buy-back' clause, whereby a related party distributor of goods may benefit from a contractual undertaking from the supplier to repurchase any unsold stock. The default legal position is typically that the distributor bears the inventory risk when it holds stock, but this clause has the effect of transferring that risk to the supplier. In that particular example, the presence or absence of such a clause in the ICA accounted for a 20% difference in the calculation of an arm's length return for the distributor in question.

Illustration of the impact of a single clause in ICA appointing an intragroup distributor performing routine functions
(Source: OECD Transfer Pricing Guidelines 2022, p463.)

	Case 1: The distributor does not assume the risk of obsolescence of products because **it benefits from a 'buy-back' clause** whereby all unsold inventory is purchased back by the manufacturer	**Case 2:** The distributor assumes the risk of obsolescence of products. **It does not benefit from a 'buy-back' clause** in its contractual relationship with the manufacturer
Sales of products (for illustration purposes, assume both sell the same volume of the same product on the same market at the same price)	1000	1000
Purchase price from the manufacturer taking account of the obsolescence risk in accordance with the functional analysis	700	640
Gross margin	300 (30%)	360 (36%)
Loss on obsolete inventory	0	50
Other expenses	250	250
Net profit margin	**50 (5%)**	**60 (6%)**

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Case study: HMRC v BlackRock Holdco 5 LLC

The case of *HMRC v BlackRock Holdco 5 LLC* (2022) provides another example of the link between the legal terms of the transaction and the economic analysis. This case concerned a structure used by the BlackRock group of companies to acquire the North American investment management business of Barclays Global Investors. As part of this structure, an intermediate holding company issued loan notes totalling $4 billion in return for a loan received from its parent company.

A central question in the transfer pricing issue concerned covenants to support the $4 billion loan. The parties agreed that an independent arm's length lender would have required covenants from various third parties, including the target company of the acquisition. Crucially, no such covenants had been put in place.

The Upper Tribunal considered that the absence of those covenants 'materially alter[ed] the economically relevant characteristics of the transaction'. There was no comparable transaction under which the loan would have been made at all; and therefore no interest deduction could be allowed on transfer pricing grounds.

You can find our analysis of this case, as published in the Tax Journal, **here**.

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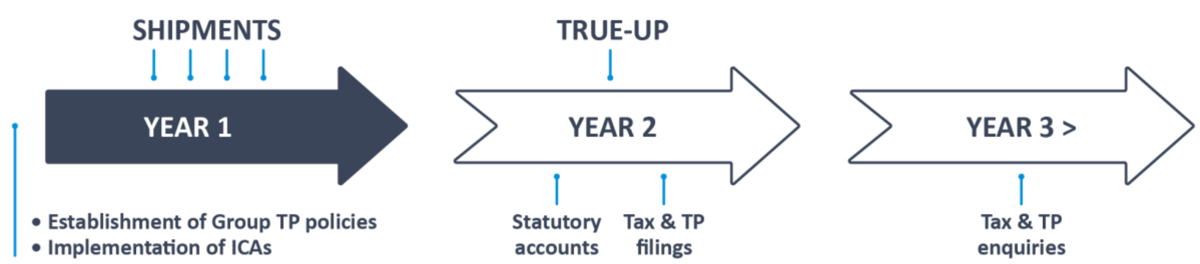
05 **At what point in the TP lifecycle do ICAs need to be put in place?**

There is a common misconception that intercompany agreements should be implemented as part of the year-end process, when assembling the formal transfer pricing documentation for the historic period in question. This is incorrect: in order to support a taxpayer's position, ICAs need to be put in place in advance, not after the event. This is important for two reasons: transfer pricing, and tax-deductibility of payments, as explained below.

The first reason is that the OECD's Transfer Pricing Guidelines set a clear expectation that ICAs are entered into *ex ante*, or in advance. This is particularly important for intercompany transactions in which the allocation or assumption of risk is economically significant (as illustrated by the example on page 5 relating to buy-back clauses and inventory risk). The Guidelines are very clear that retrospective contractual allocation of risk after the event does not work as the relevant economic outcomes are already known, and the concept of 'risk' is only meaningful when there is uncertainty about the future.

The second reason – tax deductibility of payments – relates to the local rules in certain countries. Examples include Austria, whose 2021 transfer pricing guidelines state at para 58 that, *"In general, a tax deduction can only be allowed on the basis of clear and unambiguous agreements concluded in advance."* (Emphasis added.)

The diagram below illustrates the appropriate timing for the implementation of ICAs in the context of controlled transactions during a particular financial period (shown as 'Year 1' in the diagram) between a regional entrepreneur and one of the local sales entities (distributors) within the entrepreneur's group.



Since shipments of goods and customs compliance processes happen in real time, appropriate ICAs need to be implemented in advance in order to provide a legal framework for the transactions and supplies involved.

"The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk."

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022, p57

"The relevant point in time for applying the arm's length principle is the conclusion of the [intercompany] agreement, not the date on which the relevant transaction is performed."

German Administrative Principles on Transfer Pricing, June 2023

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06 **Typical defects in the legal implementation of TP models found in multinational groups**

Many multinational groups fail to maintain a portfolio of agreements that is ready for a tax audit.

In some cases, this is because they lack a clear understanding of the impact of individual contractual clauses on risk allocation for TP purposes, and on the VAT/GST treatment of intercompany supplies.

Many tax administrations, including the USA's Internal Revenue Service, have noted deficiencies in the transfer pricing documentation filed by multinational groups, including a lack of alignment between the TP analysis and the terms of intercompany agreements.

This creates unnecessary risks, because tax administrations can easily identify any deficiencies. They merely need to ask for copies of the ICAs, and carry out a desktop review against master files and local files.

Typical problem areas for multinational groups in the legal implementation of their TP include:

- ICAs which contradict the allocation of risk described in TP documentation, meaning that historic tax filings may be incorrect
- Gaps in the intercompany transaction types covered by ICAs, so that certain transactions are not legally documented at all, leaving risk allocation and price open to the interpretation of tax administrations, which is unlikely to be favourable
- ICAs that are too long, use unnecessarily complex language, contain administrative provisions that are not followed in practice, and/or are poorly structured, leading to the agreements not being reviewed by the relevant persons. This can result in agreements which do not reflect how the group actually works, or do not take into account the needs of important stakeholders
- Out-of-date ICAs which no longer reflect the group's structure, its contracting structure, or the operations of the relevant business units
- ICAs that are unsigned, undated, incomplete, or not centrally archived
- Failure to integrate newly acquired or incorporated legal entities into the ICAs
- ICAs which have not been updated to reflect revised benchmarking or revised TP policies and models
- Over-reliance on local tax managers to maintain files of signed intercompany agreements, with no assurance that they are complete, and no contingency plans in place if those managers are unavailable or have left the group.

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07 **The consequences of not having appropriate ICAs in place**

Multinational groups which do not have appropriate and signed ICAs in place are unable to present a clear statement to tax authorities of what intragroup supplies are being made, and how risks are allocated between group companies.

They are therefore exposed to the risk of unnecessary TP adjustments, fines and penalties. As has been seen in several judgments, such as The Coca-Cola Company v Commissioner (USA, 2020), Aspro v Commissioner (USA, 2022) and the 2022 decision by Spain's National Court, inadequate ICAs can have significant consequences for tax and TP.

For example:

- In certain jurisdictions, corporate groups are routinely subject to fines and penalties, simply for failing to produce signed ICAs when requested
- Expenses may be disallowed
- Post year-end 'true up' or 'true down' adjustments may be rejected
- Local tax authorities may be more likely to attempt to recharacterise a transaction as something other than that claimed by the taxpayer
- Groups may be subject to adverse TP adjustments and associated fines and penalties.

You can read our detailed analysis of the Coca-Cola case **here**.

> **"Not having a written agreement may be like giving the tax authority the right to access your bank account so it can withdraw what it considers to be fair. This is so even if you provide transfer pricing documentation."**
>
> *Mayer Brown*

> **"It is [a] recurring principle of tax law that setting aside contract terms is not a two-way street. In a related-party setting such as this, the taxpayer has complete control over how contracts with its affiliates are drafted. There is thus rarely any justification for letting the taxpayer disavow contract terms it has freely chosen."**
>
> *US Tax Court in The Coca-Cola Company & Subsidiaries v IRC (2020)*

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08 **What other functions do ICAs perform?**

ICAs are not only required for transfer pricing compliance. They are also instrumental in managing several other areas of risk and compliance.

By way of example, intercompany agreements play a key role in areas such as:

- The analysis of VAT / GST charges
- Customs compliance
- Regulatory compliance (e.g. in the financial services and insurance sectors)
- Enforcement of intellectual property rights against third parties
- Managing personal liability risks for directors
- Supporting the external and internal audit of group entities
- Exchange control and cross-border funds flows (for some countries such as China, ICAs are part of the mandatory documentation required for any transfer of funds out of the country)
- Demonstrating ‘substance’, especially as regards control functions exercised in offshore jurisdictions such as the Cayman Islands, Mauritius, Jersey, Guernsey and the Isle of Man
- Ringfencing assets from legal risks
- Preparing the group for sale, IPO or fundraising (since TP is often regarded as one of the most significant tax risks facing cross-border businesses, and ICAs are a key means of managing those risks).

More fundamentally, if appropriate ICAs are missing, the directors and officers of the group companies participating in an intragroup transaction have no point of reference when considering whether or not to approve the arrangements. They will therefore be exposed to potential personal liability for failure to act in accordance with their legal and fiduciary duties to each individual company of which they are a director or officer.

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09 **What does an effective system of ICAs look like?**

An audit-ready suite of ICAs has several key attributes.

In order to be ‘effective’ for transfer pricing purposes, ICAs must be all of the following things:

- Aligned with the allocation of functions, risks and rewards described in the TP policies
- Legally binding
- Correctly signed and dated on behalf of all the participating entities
- Kept updated on a regular basis, so that they continue to provide an appropriate legal framework for the group’s TP policies, corporate structure and operations as they evolve
- Appropriately archived, so that they can be accessed quickly when required.

The requirement is therefore to have a set of ‘audit-ready’ signed agreements, which can be produced at short notice, when needed to respond to tax enquiries, audits and investigations.

As mentioned in the previous section, these agreements should not merely be consistent with the group’s TP policies, but should also be consistent with its regulatory objectives and the practicalities of its day-to-day operations, intragroup supplies and recharges.

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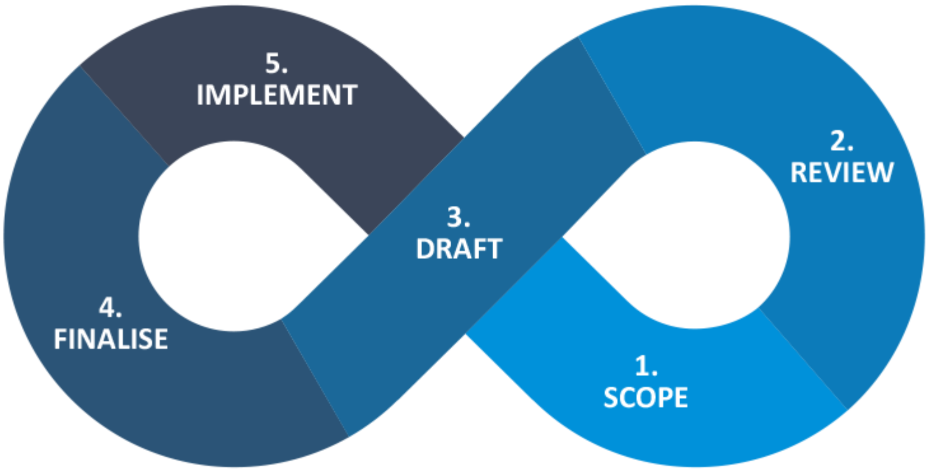
10 **What process should multinational groups follow to maintain effective audit-ready ICAs?**

Implementing appropriate ICAs is not a one-off project. This is because, over time, the group's composition will change (for example due to acquisition, organic growth or reorganisation). Also, the group will need to update its TP compliance strategies from time to time, due to changes in tax legislation and in the group's business models, functions, ranges of products and services, value drivers and market conditions.

New transactions, or changes in the nature of intragroup transactions, may mean that new ICAs are needed or that existing ones need to be revised. This must be monitored on a regular basis. A typical process for maintaining intercompany agreements often follows five key stages or steps, as shown in the diagram below.



Step 1: Scoping

The first step is to carry out a high-level review of the group's draft transfer pricing policies and group structure chart to identify the key intercompany transaction types for the group (or subgroup) concerned. Those transaction types may, for example, include central support services, appointment of limited risk or full risk distributors, R&D services, intellectual property licences, transactional profit splits and intercompany loans.

Each of those transaction types will require a corresponding agreement. For groups with more complex arrangements, the various transaction types may need to be prioritised by reference to the associated risks from a commercial, regulatory and tax perspective.

This initial scoping phase may often include an initial assessment of which legal entities are likely to be involved in the relevant transactions, whether as supplier or recipient, licensor or licensee, lender or borrower, and so on.

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Step 2: Review
The next step is to carry out a detailed review of the draft transfer pricing documentation, existing ICAs, the group structure chart, the legal entities involved, the ownership of intellectual property and other intangible assets, and the group's contracting model with third parties.

This review focuses on understanding the commercial and legal nature of each transaction type, the intended (or implied) allocation of economically significant risks, the ownership and control of intangible assets and the intended pricing models. This is because a key aim of the exercise is to achieve clearly demonstrable alignment between the TP policies and the terms of the agreements.

A key output of this stage is a comprehensive list of the legal documents and actions required to give effect to the intended TP policies. In some cases, this may include corrective action to address defects in the legal implementation of TP policies for prior periods.

Step 3: Drafting ICAs covering each of the relevant transaction types
This step involves the preparation of discussion drafts of 'master' agreements covering each of the relevant transaction types. Our recommended approach is to ensure that the draft ICAs are clear and unambiguous, legally binding, written in plain language, kept as short as possible, and of course aligned with the intended tax and TP treatment.

Step 4: Finalising the draft ICAs
This involves taking on board the needs of the key stakeholders before the draft ICAs can be finalised. Relevant considerations do not just include tax and TP issues, but also regulatory compliance, customs, sales taxes, IP protection, HR compliance and asset protection.

We generally recommend standardising ICAs on a global basis as much as possible. However, localisation may be required to address local regulatory or tax sensitivities. In some cases, this may involve arranging translations or bilingual agreements. Again, we advocate taking a risk-based approach to apply an appropriate level of time and budget to the localisation of ICAs.

Step 5: Implementation
This involves preparing individual ICAs for signature, together with the ancillary documents and filings as detailed in the relevant implementation plan. As part of this step, it is important to follow an appropriate process for obtaining the necessary corporate approvals at the level of the relevant legal entities. This usually involves preparing briefing notes for directors, so that the commercial rationale for the arrangements is set out appropriately.

Once the relevant documents have been signed and dated, it is of course important to collate the signed copies and archive them in a central repository with appropriate access rights.

Regular monitoring is essential: a group's portfolio of ICAs must be kept up to date, to reflect its intercompany transactions as they evolve. This monitoring and review should be carried out at least annually, and in many cases more frequently. Where relevant changes are identified, Steps 1 to 5 as described above will need to be repeated.

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11 **About LCN Legal**

LCN Legal works alongside leading tax and TP professionals around the globe, helping multinational groups and financial institutions to put in place the ICAs they need to support their TP policies, and to avoid costly mistakes.

We do not provide tax advice, functional analysis, value chain analysis or benchmarking reports. This means that we do not compete with our clients' existing tax and TP advisors. On the contrary, we support and complement them.

We help groups to manage the entire process of reviewing, updating, implementing and maintaining their ICAs, as well as the corporate, debt and supply chain structures that these agreements are based on.

Three things that make LCN Legal unique:

1. **We are the leading experts in ICAs.**
   Our book 'Intercompany Agreements for Transfer Pricing Compliance – A Practical Guide' is the definitive work on the subject.
2. **We bring a global and cross-functional perspective.**
   Around the world, large corporates and leading TP professionals choose us because we offer a unique skill set: we are corporate and commercial lawyers with an understanding of TP. This allows us to take a cross-functional approach to designing and implementing ICAs. We liaise with all the stakeholders involved (not just in tax) to ensure that the ICAs support all of the group's objectives.
3. **We provide ongoing support to maintain audit-readiness**.
   We focus on the end result that corporates need: a comprehensive central archive of signed ICAs, which is aligned with TP policies and kept up-to-date. This enables our clients to respond quickly and effectively to tax audits, and reduces the risks of protracted investigations, adverse TP adjustments and double taxation.

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12 **How LCN Legal helps multinational groups to maintain their ICAs**

Since its establishment in 2013, LCN Legal has advised multinational groups with combined annual revenues of over USD 140 billion on their ICAs and group, equity and debt structures.

We help groups to manage the entire process of reviewing, updating, implementing and maintaining their ICAs and to optimise their group, functional and supply chain structures.

The benefits of engaging LCN Legal to manage your ICAs:

- ICAs reviewed and aligned with your group's structure, operations and TP policies
- ICAs properly signed and dated by all relevant group entities
- Local translations and notarisation/legalisation arranged for you, wherever required
- A comprehensive, central repository of electronic copies of signed agreements maintained in a secure cloud-based archive
- ICAs updated as required to reflect changes in the group, its operations and its TP policies as they evolve over time
- Telephone support available when required to access copy agreements or to obtain advice on specific issues as they arise.

Here are some examples of how we help multinational groups, working alongside tax and TP professionals worldwide.

Healthcheck review of existing ICAs
We review samples of your existing ICAs for the key transaction types that present the highest risk of TP challenge for your group. We present our findings in the form of a healthcheck report. This not a dense legal document that is hard to follow. On the contrary, it looks at each of the key relationships in a group, and what the TP documentation says about that relationship. We highlight any gaps or discrepancies using a 'traffic light' system: red for a definite problem, amber for a potential problem, and green where no material issues have been identified. This gives the group a clear and easily accessible picture of what action it needs to take.

We also offer a free automated tool that allows you to conduct a basic healthcheck yourself. It is available **here**.

Workshops on ICAs for in-house tax and legal teams
Our workshops help multinational groups to revise and update their ICAs for TP compliance. This is a cost-effective way to enhance the capabilities of in-house legal teams that have the capacity and resource to manage the work, but not the specialist understanding of this particular area.

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Design of ICAs, tailored for each transaction type
Different types of transaction require different ICAs. We review the group's TP policies and documentation, and then create appropriate ICAs for each key transaction type. These will include the functionality required to meet OECD standards. We can also help with the implementation of ICAs, by creating all the necessary individual ICAs and arranging and managing signatures (including electronically).

Ongoing hosting, monitoring and maintenance of ICAs
Maintenance of ICAs is vital. We can maintain a comprehensive, secure, cloud-hosted archive of signed copy ICAs. As part of this service, we carry out regular checks: we contact the relevant people within the group, and find out whether circumstances have changed which may require changes or additions. This can be done annually, or more frequently if required. We also provide telephone support when required, for example to access copy agreements or to obtain advice on specific issues as they arise.

Full-service design and implementation of corporate structuring projects
For multinational groups that want the reassurance of knowing that their cross-border restructuring projects have been designed and implemented by specialists, and comply with relevant OECD guidance and all applicable local laws, we offer full-service legal support. This includes working as part of a multi-disciplinary team to plan the project and co-ordinate local legal support as needed.

Corporate, debt and equity restructuring and value chain optimisation projects
We help multinational groups to create, update and maintain the corporate, debt, equity and value chain structures they need to achieve their growth and business objectives while also supporting their tax and TP compliance obligations. We typically take the legal project management role on cross-border restructuring projects, co-ordinating advice needed from local counsel, our clients' in-house legal teams, and their internal and external tax teams.

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13 **Where to find out more information about ICAs**

LCN Legal provides a range of free and paid-for resources about ICAs, the legal implementation of TP, and the legal design, planning and implementation of cross-border group structuring projects.

Our free resources can be found at **www.lcnlegal.com**. They include:

- Webinars, interviews and articles
- Our podcast, available **on our website** or via your podcast provider (search for 'The LCN Legal Podcast')
- Our **email newsletter** and **blog posts** on corporate structures for multinational groups and the legal implementation of transfer pricing.

You can also **order our book** 'Intercompany Agreements for Transfer Pricing Compliance – A Practical Guide' from our website.

To arrange a free, no obligation consultation with one of our senior lawyers about your group or a client you look after, call us on +1 747 212 0206 (USA), +44 20 3286 8868 (UK) or +86 21 2052 0623 (mainland China) or email us at **info@lcnlegal.com**.

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Appendix 1: **Frequently asked questions about ICAs**

Q: Can we put off implementing ICAs until we need to deal with a tax challenge?

There are three main problems with this strategy.

First, there may not be enough time to put in place new ICAs within the applicable time periods to respond to TP enquiries. 30 days is typical, and 10 days is not unheard of.

Second, the 'backdating' of agreements may well be ineffective. (The next answer gives more detail on this.)

Third, as mentioned earlier in this document, TP is not the only reason to put ICAs in place. Other common purposes include data protection or other regulatory compliance, or to protect and enforce intellectual property rights. Unless a group addresses the issue proactively, its tax function may be saddled with ICAs which have been prepared without addressing the tax or TP implications, and which may be unhelpful for TP compliance purposes.

Not being able to produce appropriate documentation can also significantly weaken a taxpayer's position during litigation, as seen in cases involving Coca-Cola, BlackRock, Singtel and Aspro, among others.

"The purported assumption of risk by associated enterprises when risk outcomes are certain is by definition not an assumption of risk, since there is no longer any risk."

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022, p57

Q: Can we backdate ICAs?

This is one of the most common questions which comes up in the context of the legal implementation of TP compliance.

The short answer is 'no'. Creating the appearance that an ICA was signed earlier than it actually was would almost certainly constitute fraud.

However, it may be appropriate for a corporate group to put in place ICAs with an historic 'effective date', in order to correct gaps or defects in its existing ICAs. In other words, the participating entities may agree between themselves to treat the arrangements as if they had been put in place on the earlier effective date, and make adjusting payments accordingly.

In such a case, it is clearly important that the new ICAs do not misrepresent the reality of the situation. The new ICAs should therefore show the actual date of signature. If it can be truthfully said that the new ICAs reflect the actual conduct of the parties and/or their original intentions, then this can be reflected in the recitals to the ICAs (and appropriate evidence retained).

Such an approach may not be effective for TP or tax purposes. As previously noted, risk cannot be contractually allocated retrospectively, and an attempt to re-write legal history will naturally carry less weight than contemporaneous documentation providing for clear pricing and allocation of risks which can then be said to 'play out', as envisaged by the OECD Transfer Pricing Guidelines.

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Irrespective of whether the approach of specifying a historic effective date is chosen, one thing is clear: if gaps or errors in ICAs are identified, they should be corrected as soon as possible. The longer such defects remain unaddressed, the greater the 'window' of exposure for the multinational group concerned.

Q: Are ICAs real agreements?

Some people believe that ICAs are 'artificial' – since they are between group entities, and would never be legally enforced or litigated, they therefore do not need to be legally binding. This is incorrect.

The OECD's Transfer Pricing Guidelines contain numerous references to contractual allocation of risk. And, clearly, 'contractual allocation' cannot take place without a legally binding contract.

The terms of ICAs can also make a significant difference to the position of creditors in corporate insolvency situations, since ICAs determine the rights and liabilities of individual legal entities. The claims of creditors relate to individual legal entities, not to the group as a whole, and therefore in cross-border insolvency proceedings, the terms of ICAs are closely scrutinised: they may be the subject of disputes between groups of creditors with conflicting interests. This shows how important it is that directors of specific group entities understand the legal and economic risks affecting the entities they represent, and do not solely rely on a consolidated, group-wide view.

There is one situation in which a controlled transaction for TP purposes cannot be implemented in a legally binding ICA: an arrangement between a company and its own branch or permanent establishment. Since there is only one legal entity involved in the arrangement, there cannot be a contract in the strict legal sense. However, best practice is to document the proposed allocation of functions, risk and reward between the 'parent' and its own branch. To make this consistent with other similar transactions across the group, one approach is to create a document which follows the format of an ICA between the parent and the management team of the branch, but with an acknowledgment that the document does not constitute a legally binding contract as such.

Q: Can we leave pricing clauses vague in ICAs?

This used to be a common approach, but it is now globally recognised as being ineffective.

The thinking was that leaving pricing clauses vague or open would give corporates more flexibility when filing tax returns. However, the reality is that there can be no contractual allocation of risk without a legally binding contract. And the economic consequences of a controlled transaction cannot be said to 'play out' (as contemplated by the OECD Transfer Pricing Guidelines), unless the terms of the transaction have actually been defined with specificity, and implemented in reality.

Under many legal systems, a contract may be invalid if it does not specify a price with legal certainty. Clauses which state that an intercompany price will be "such amount as the parties may agree from time to time," or "an arm's length price determined in accordance with the group's transfer pricing policies," clearly do not meet the required standard.

Similarly, if a group's TP policies state that particular entities are 'guaranteed' a minimum return (for example to reflect routine activities), this 'guarantee' needs to exist as a legal reality. The corresponding ICAs therefore need to specify how that return is calculated, in a form which is legally binding.

One example of this is seen in the Austrian TP guidelines, updated in 2021. They emphasise that the actual economic substance of a transaction must be delineated contractually, taking into account both an economic approach and the general principles of income allocation. This must be done to the standard that "a prudent and conscientious business

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manager" would apply. A key part of this is that written contracts must be in place. These must be clear, unambiguous, and have the same conditions that apply in similar contracts with third parties.

More fundamentally, if the pricing of an intercompany transaction is not clearly specified in an ICA, the directors of the legal entities involved are unlikely to have properly considered the arrangements. They are therefore exposed to liability for failing to comply with their legal duties.

Q: What impact do the terms of ICAs have on the VAT/GST analysis of intragroup supplies?

As with many areas of compliance, ICAs define and delineate intragroup transactions. This includes the characterisation and terms of the supplies from a VAT/GST perspective.

This table shows four ways that a contract can define the treatment of transfer pricing adjustments, and the VAT implications of each.

(Source: European Commission VAT Expert Group Paper taxud.c.1(2018)2326098, April 2018)

Definition of Transfer Pricing Adjustment as per the contract	**VAT treatment**
Contract defines adjustments to reach guaranteed profit margin	Adjustment relates to a “profit adjustment”. This is not a Taxable Transaction: no debit or credit note or any other document for VAT purposes to be issued
Contract defines adjustment for previous supplies. Reference is made to a period during which transactions happened; list of invoice numbers attached, breakdown of the adjustment to each supply	Taxable transaction – supply of goods (or services). Debit or credit note to be issued; same VAT treatment as initial transaction
Contract defines the adjustment as billing of variances between actual and budgeted cost of marketing or administrative expenses	Taxable amount is adjusted, i.e. further (less) consideration for a “Supply of Services”. Debit or credit note to be issued
Contract defines the adjustment as a profit split (e.g. in case of a joint venture)	Adjustment relates to a “profit adjustment”. This is not a Taxable Transaction: no debit or credit note to be issued

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Q: How can we minimise the administrative burden of maintaining and updating ICAs?

There are several practical ways to achieve this, while also ensuring that the ICAs remain effective from both a legal and a TP perspective.

Here are some examples:

- As far as possible, standardise the format and content of ICAs across the group. For example, use standard terms across all ICAs, or categories of intercompany transactions and ICAs
- Use the same applicable law across all the portfolio of ICAs, unless there is a genuine need to do otherwise
- Streamline the agreements and remove unnecessary and inappropriate provisions, making them as easy to read, understand and review as possible (including for non-lawyers)
- Avoid unnecessary termination or expiry dates, so that the ICAs are as 'evergreen' as possible (unless specific circumstances exist which require a fixed termination date)
- Think of ICAs as being framework agreements, and avoid being overly prescriptive about terms which may change, such as product names and service levels
- Incorporate central policy documents by reference, such as policies for allocation keys
- Consider using multilateral agreements, rather than entity-by-entity bilateral ICAs. Used appropriately, the former can significantly reduce the administrative burden, and the risk of errors, over the long-term. (Read a short article on this **here**)
- Use electronic signatures where possible (see below for more on this)
- Consider adopting a governance-type approach, whereby one party to the agreement (usually the parent or regional entrepreneur) can unilaterally notify the other parties of changes to the agreement, allowing the other parties an appropriate period within which to object to changes Review ICAs regularly and update them as needed – this is far easier to manage and reduces the risks of errors in documents which are implemented under time pressure.

Q: Is functional analysis more important than intercompany agreements?

No. It is true that ICAs may be disregarded for TP purposes if they do not match the reality of how the group operates. Such documents would probably be ineffective for legal purposes too, since they would not reflect the 'true' agreement between the parties. Legal agreements are the starting point for 'delineating the transaction' between related parties, as well as assessing the allocation of risk, which inevitably affects an arm's length price.

In many cases, an analysis of the functions performed by a particular entity within a group may be consistent with a number of different contractual structures, each with a very different risk profile. Imagine, for example, an entity which acts as a procurement hub. One scenario could be that it merely provides facilitation services to other group entities. Another possibility would be that it acts as principal in purchasing goods or services from third parties, and sells them on to other members of the group. A functional analysis of the 'procurement hub' activity would therefore be incomplete without a clear understanding of the third party contracts involved, and the nature of the contractual relationship between the group entities, as implemented through appropriate ICAs.

> **"Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them and how the responsibilities, risks, and anticipated outcomes arising from their interaction were intended to be divided at the time of entering into the contract."**
>
> *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 edition, p42*

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Q: How should groups decide which ICAs to implement first?

For less complex group structures, and for groups with less complex supply chains, it may be possible to implement ICAs covering all its material intragroup supplies in a single project, often completed within two months. For more complex scenarios, the prioritisation of ICAs for particular supplies is typically a matter of risk assessment and comparables analysis.

The following factors are often important:

- Known and expected tax audits or investigations (including high-risk jurisdictions)
- Supplies which are fundamental to the group's value drivers
- Transaction types that are high-risk, high-volume and/or high-value
- Supplies to and from companies in low-tax and tax-free jurisdictions
- Supplies relating to other arrangements which are likely to be closely scrutinised by tax inspectors.

Q: What are the main areas of legal input which are required for transfer pricing compliance?

There are four main areas in which legal support will be needed.

1. Legal input into functional analysis (for master file and local files, as applicable):

- Legal aspects of the description of the group's business and functional model
- Legal ownership of assets (including intangibles)
- Identification of intangibles, including legal/beneficial ownership and extent of legal protection and ring-fencing of intellectual property
- Impact of regulatory issues
- Flow of contractual relationships, licensing and risk allocation, both internally within the group and externally, with third party customers, suppliers and lenders.

2. Identification of all 'constituent entities':

- For local files and, if applicable, country-by-country reporting.

3. Intercompany agreements (to be included in local files and referred to in master files, where applicable):

- Design of master ICAs for each intercompany transaction type
- Review of consistency with the group's intellectual property ownership, protection and enforcement strategy
- Review of impact of regulatory issues
- Implementation of ICAs, including briefing notes for parent and subsidiary boards as well as board minutes and other corporate approvals for corporate governance purposes
- Documented policies for, among other things: (i) the creation of further ICAs, as and when they are required; (ii) the maintenance of current ICAs; (iii) the avoidance of duplication and inconsistency as between ICAs; and (iv) ensuring that all relevant stakeholders are consulted in the ICA drafting process
- Documented policies and systems for the archiving and retrieval of signed ICAs, including access permissions, to enable immediate recovery of ICAs in the event of tax enquiries or audits.

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4. Business restructurings, acquisitions and sales (including any intragroup functions, business or asset transfers, to align the group's internal supply chain, assets and functions with its transfer pricing objectives):

- Legal, intellectual property, asset ownership and commercial contract due diligence
- Legal input into design and planning of restructuring projects
- Drafting and implementation of legal documents and corporate approvals to implement restructuring projects.

Q: What general principles should be followed when preparing and implementing ICAs?

The following general principles should apply whenever intercompany agreements are created or updated, whether for transfer pricing, regulatory or other commercial or strategic purposes.

1. Brevity – Each ICA should be as short as reasonably possible. Long and overly complex agreements are unlikely to be read and understood by all the relevant stakeholders, increasing the risk that they do not match the way the group actually operates or is capable of operating in connection with intragroup supplies. This is often the result of groups using third party commercial contracts as the starting point for intercompany agreements.

2. Simple language – As far as possible, ICAs should be expressed in simple language. This makes them easier to read, understand and translate. Quoting statutes and regulations should be avoided if at all possible.

3. Grouping of commercial terms – The key commercial terms should be grouped in one place, rather than being distributed across definitions, schedules and appendices. Again, this allows readers to understand the effect of the agreement more quickly. Standard terms are useful to apply when preparing several (but not all) types of intercompany agreements. Standard terms can often be used across the full suite of a group's ICAs.

4. Consistency with transfer pricing policies – This includes the key functions or obligations performed by the relevant entities, the ownership of intangible assets, the allocation of risks and costs, the calculation, currency and payment terms for the relevant charges, and (where appropriate) the exclusion of charges for shareholder services and costs, which do not directly benefit the relevant recipient entity.

5. Consistency with legal relationships – Each ICA should be consistent with the legal relationships regarding the ownership and use of assets (including intangibles), the flow of supplies and related contractual relationships with third parties and the allocation of risk reflected in those relationships.

6. Corporate benefit – The arrangements documented in ICAs should be such that the directors of each participating group company can properly approve them as promoting the interests of that specific entity. This includes taking account of the relevant company's financial resources and its ability to assume risk and satisfy its liabilities, including all contingent liabilities, on an ongoing basis.

7. Legally binding – ICAs should contain the elements necessary for them to be legally binding under all applicable laws. An exception is an 'agreement' between a parent company and its own branch or permanent establishment. This will not be a legal agreement, since there is only one party. Rather, it is a memorandum of understanding of the applicable commercial terms, agreed to by the board of the parent and the managers of the branch.

8. Briefing notes for directors – Directors of participating entities should be briefed on the reasons for putting in place the agreements, and the likely implications of the proposed terms.

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9. Stakeholder review – The overriding principle is that the proposed intercompany agreements should be reviewed by all relevant stakeholders, so as to ensure that the agreements reflect the needs of the group as a whole, as well as the reality of intragroup transactions and recharges.

Q: How long should ICAs be?

This depends on the type of transaction involved, the complexity of the arrangements, the applicable pricing methods, and the payment mechanics. The aim should always be to document the key terms as simply as possible.

Usually, ICAs should be between five and fifteen pages in length. Longer agreements may look impressive, but they are usually less robust, because they are less likely to be read and understood by key stakeholders, and less likely to reflect the operations of the group and the relevant parties. They are therefore less likely to be fit for purpose.

Q: Why do we need briefing notes for local boards and signatories of ICAs?

The process of putting in place intercompany agreements should support good corporate governance. “Tax told us to sign,” is unlikely to be a helpful answer, either for subsidiary boards, individual signatories, or for the group as a whole.

The need to explain and document the commercial rationale for intercompany transactions is illustrated by the decision of the Wisconsin Tax Appeals Commission in the US-US transfer pricing case of Skechers USA, Inc filed in 2023. In brief, Skechers USA, Inc (“Skechers”) formed Skechers USA Inc II (“SKII”) as a 100% subsidiary. Skechers contributed to SKII all of its US domestic IP, plus a substantial sum in cash, in return for shares issued by SKII. SKII remained a 100% subsidiary throughout.

SKII immediately licensed the IP rights back to Skechers. As a royalty, Skechers was required to pay all of its operating margin in excess of 2% to SKII, with interest accruing on unpaid royalties. Skechers then claimed a Wisconsin franchise tax deduction for the royalties paid to SKII.

In the words of the Appeals Commission: “Every piece of documentary evidence that was contemporaneously produced to justify the creation of SKII and the subsequent transactions at issue stressed the reduction of state tax liability.” Furthermore, “Skechers did not engage its corporate law firm, or anyone else, to develop a corporate reorganization plan focused on any non-tax benefits.”

The commercial and legal rationale for proposed intercompany transactions should therefore be documented both at the inception of the structure and at the point of its implementation. The boards of parent and subsidiary companies should receive a high-level briefing on the reasons for the proposed approach, the issues which the directors are being asked to consider and the terms of the ICAs they are proposing to approve. This is something that we routinely cover as part of our work with multinational groups and transfer pricing advisers.

Q: Can we use electronic signatures to implement ICAs?

Multinational groups very often use electronic signatures as a tool for the execution of ICAs and other documents. The majority of jurisdictions worldwide recognise electronic signatures as a legitimate method of executing most legal agreements, including ICAs.

The EU regulation on electronic identification and trust services for electronic transactions in the internal market (known as the ‘eIDAS Regulation’) ensures that electronic signatures are recognised, provided certain conditions are met. An

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amended form of the eIDAS Regulation is in effect in the UK. In the US, the law permits the use of electronic signatures in many situations, and pre-empts many US state laws that would otherwise limit the use of electronic signatures.

LCN Legal works with local legal counsel around the world to ensure the effectiveness of execution clauses in ICAs, including the use of electronic signatures.

Q: How should a group's in-house legal function be involved?

Many of our clients have experienced in-house legal, compliance and company secretarial teams. All three of those teams should be fully consulted in the design, implementation and maintenance of ICAs. Whenever we run workshops for multinational groups on ICAs for TP compliance, we recommend that people from all three teams attend, along with people from tax, TP, finance and other relevant functions. This encourages a common understanding and appreciation of key aspects of TP compliance and effective implementation for tax audit readiness of the group.

Clearly, it is up to in-house legal teams to decide whether they want to deal with the detail themselves, or to prioritise other things (such as strategic advice, market-facing agreements and corporate and finance transactions). If those teams are not familiar with TP principles, OECD Guidelines and the particular requirements for TP compliance, they may want to outsource that role to specialists such as LCN Legal. They might also ask us to review their templates, systems and processes, to give assurance that they deal appropriately with the issues involved and ensure robust TP compliance for their group.

Q: Are ICAs required for low value-adding intra-group services?

Yes. The OECD Transfer Pricing Guidelines specify that in order for an MNE to take advantage of the simplified methodology for low value-adding services, it must elect to apply that approach and prepare appropriate documentation. That documentation includes "Written contracts or agreements for the provision of services and any modifications to those contracts and agreements reflecting the agreement of the various members of the group to be bound by the allocation rules of this section."

ICAs for low value-adding services should specify the scope of the relevant services, the allocation key selected for each category of services, as well as which any related third party costs which are to be recharged without a mark-up. Those ICAs should also include other commercial provisions such as currency for payments, frequency of invoicing and payment terms.

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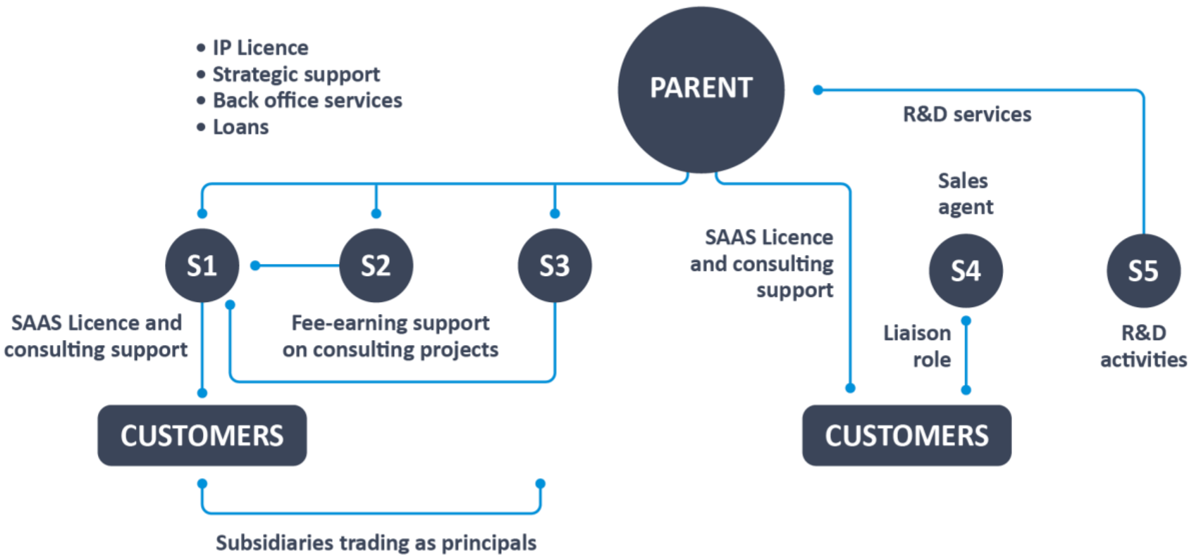
Appendix 2: **Simplified case study illustrating a typical flow of intra-group supplies and related ICAs**

The following is a simplified case study that shows a typical flow of intragroup supplies and related ICAs within a software as a service (SaaS) business.

Case study: SAAS and Consulting Services



In this example, the group's main business model is licensing software as a service. The group also provides consulting support to clients in order to implement the group's SaaS solutions. Intellectual property is held centrally by the parent company. Local subsidiaries S1, S2 and S3 act as principals in licensing the relevant software in the local markets, and also provide consulting services to help customers implement the group's SaaS solutions. Subsidiary S4 acts as a sales agent in its own country of operation, with subscription agreements being entered into directly between the parent and local customers. Subsidiary S5 provides research and development services to the parent for the benefit of the group.

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The main intercompany agreements are likely to comprise the following:

Back-office services agreements between the parent (as supplier) and each of the subsidiaries (as recipients). The relevant services may include matters such as finance and accounting, IT, tax, HR, commercial and legal support. Depending on the transfer pricing methodology used by the parent, these services may be charged for on a cost-plus basis. The relevant agreements may take the form of a series of bilateral agreements between the parent and each subsidiary and incorporating a set of standard terms. Each agreement will be on similar terms, and will include an ‘allocation key’ to allocate centrally incurred costs between the multiple service recipients. As an alternative, a single multilateral agreement may be used.

Strategic services agreements between the parent (as supplier) and each of S1, S2 and S3 (as recipients). Again, these may take the form of a series of bilateral agreements, or a single multilateral agreement. Each agreement may include an intellectual property licence. It may therefore be similar in commercial terms to a franchise agreement, since in effect the parent is providing a bundle of strategic services, know-how and intellectual property to enable each of S1, S2 and S3 to carry on their respective businesses. Depending on the transfer pricing methodology used, the fees payable to the parent by each of S1, S2 and S3 may be a function of the profits achieved by the respective subsidiaries. Other pricing methodologies may also be appropriate, depending on the circumstances.

A ‘global’ consulting services agreement entered into between the parent, S1, S2 and S3, as the group entities which employ fee-earning staff who provide consulting support to end customers. For any given customer project, staff from more than one of the relevant group companies may provide assistance. This global agreement, therefore, allocates risk and revenue between the relevant group companies with respect to each consulting client engagement.

A sales agency agreement between S4 (as supplier) and the parent (as recipient), dealing with the services, which S4 provides in facilitating the conclusion of subscription agreements between the parent and third party customers.

An R&D services agreement between S5 as service provider and the parent as recipient, relating to the R&D activities carried out by S5 and the ownership of intellectual property. This agreement will likely include an assignment to the parent of any intellectual property developed by S5 on an ongoing basis.

Intragroup loan agreements, as required.

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Testimonials and awards

Testimonials

"I really like the format! It is very clear and easy to follow. Can you teach our lawyers to write so clearly? I wonder sometimes if they are being paid by the word."

Brian Sturtz, Former Director of International Tax and Transfer Pricing at Walmart Stores, commenting on template Intercompany Agreements created by LCN Legal

"I worked with Paul Sutton for many years, in my role as Group Tax Manager of Sumitomo Electric Wiring Systems (Europe) Ltd (SEWS-E Ltd), and also for a period as SEWS-E Ltd Company Secretary. In this time I had extremely valuable assistance and advice from Paul, not only as regards general corporate law matters, but also particularly across a wide spectrum of legal aspects of SEWS-E Ltd group transfer pricing policies, implementation, inter-group agreements and legal compliance."

Martin L Kinsey, Former Group Tax Manager, Sumitomo Electric Wiring Systems (Europe)

"I found it refreshing to go through the technical challenges and best practice on unwinding entities, including project managing the process, with some highly skilled and experienced in-house tax and legal experts."

Lee Holloway, then Group Head of Tax, Next plc, commenting on a seminar presented by LCN Legal

"I have been working with Ivan Hanna over the past year on various corporate matters including a group share restructuring project and Intercompany Agreements for our transfer pricing compliance. Compared to other corporate law firms I have worked with, Ivan took the time to understand our business, our stakeholders and my needs. He was incredibly responsive and went above and beyond to manage our various stakeholders and turn around a big piece of work in a short amount of time. I have no hesitation in recommending Ivan or LCN Legal – they are what all solicitors should be!"

Becky Karver, CFO, Deallus Consulting

"LCN take a pragmatic approach to intercompany agreements: documents are written to include the necessary terms but are not overly complex or lengthy for no good reason. The team turn things round quickly and are priced competitively."

Alex Williams, Chief Financial Officer, Axis Spine Technologies Ltd

"At Caisson Investment Management, we have worked with Leiza across a number of areas including corporate restructuring and commercial agreements and we have always received a dedicated service that is second to none. Having legal agreements that are easily understood and effectively reflect the commercial terms is of great importance and Leiza delivers both effortlessly. It is an absolute pleasure working with Leiza as she guides you through the whole process with ease and professionalism."

Michael Newman, Finance Partner, Caisson Investment Management

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Testimonials (cont.)

"We have worked with LCN Legal over a couple of years with a focus on a material corporate reorganisation project, resultant transactions and the setup of new intercompany arrangements. We have found LCN to be able to assist across wide ranging issues apart from the core reorganisation work for which they have been excellent. Not only has their implementation work been professional with fast turnaround times, we have been particularly impressed with their understanding of the business, their advice, design work and guidance throughout. Above this, they are a pleasure to deal with, a valued partner and we would strongly recommend their services."

Group Managing Director and CFO of a multinational FinTech business

Awards

Winner – LexisNexis awards 2023, International Team of the Year

Winner – The Law Society Award 2020, International Team of the Year

Shortlisted – Legal Business Awards 2021, Boutique Firm of the Year

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