The LCN Legal Guide: How to put in place effective Intercompany Agreements for Transfer Pricing

An introduction for large corporates and their tax advisers

Dear Reader

Welcome to our introduction to putting in place effective intercompany agreements for transfer pricing.

This guide is written for tax and transfer pricing professionals. It is based on our experience of working with large multinationals and their tax advisers for over 10 years.

What this guide covers

Most transfer pricing professionals agree that putting in place consistent intercompany agreements can support a group's transfer pricing policies.

In the following pages you will find practical information including:

- The benefits of intercompany agreements
- The basic requirements of intercompany agreements
- Choosing the best format for intercompany agreements
- Checklist for reviewing intercompany agreements
- A case study showing how this works. This is based on anonymised information from one of our client engagements.

Who we are

LCN Legal is a law firm, which is authorised by the Solicitors Regulation Authority. We don't advise on tax, and we don't carry out comparables research. We are specialists in the legal implementation of group structures, and this includes intercompany agreements.

Our team has advised FTSE100 and Fortune 500 companies on projects involving over £12.8 billion of assets. We contribute to the LexisNexis online resources on transfer pricing, as well was various other publications such as Financial Director Magazine, Practical Law Magazine, Practical European Tax Strategies, International Accountant, Tax Journal, Estates Review, Butterworths Journal of International Banking & Financial Law. We regularly present training sessions to major accounting firms, large corporates and banks on a range of corporate law issues.

In addition, we regularly publish free resources on our website, including interviews with senior tax professionals from organisations such as

Walmart, Reed Elsevier and South West Water. You can subscribe for free updates on our website www.lcnlegal.com.

Act on this guide and create firm legal foundations for your transfer pricing

If you are reading this guide, then it is likely that your organization either:

(a) does not, yet, have consistent intercompany agreements in place; or

(b) is updating its transfer pricing policies and supplies, and it therefore needs to update its legal arrangements.

Either way, you need to take action to benefit from the information in this guide.

This does not have to be a painful process. We can help you in one of two ways:

- If you have the authority to engage legal support, and you want to work with lawyers who are experienced in drafting intercompany agreements, you can ask us to prepare them for you. You can use the form on pages 20 to 22, to tell us what you need. We will give you a fixed fee quote within two business days.

- If you do not have the authority to engage lawyers, or your group can only instruct lawyers on a pre-approved panel, you can speed up their work by providing them with our suite of template intercompany agreements. These templates cover many of the most common intra group supplies such as:
    - HQ services
    - R&D services
    - IP licences
    - Term loan facilities
    - Sale of goods

"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."
Director, International Tax and Transfer Pricing, Fortune 500 Company

- Limited risk distribution
- Agency agreements

The suite of templates is available for immediate download here: http://lcnlegal.com/template-intercompany-agreements/

We hope you find this guide useful, and we look forward to being of service.

With best wishes

Paul Sutton

Paul Sutton

Partner, for and on behalf of LCN Legal

1. The background: the benefits of intercompany agreements

Most transfer pricing professionals agree that intercompany agreements can play an important role in supporting a multinational group's transfer pricing policies.

From a tax perspective, they enable a group's tax function to set the starting point for discussions with local tax authorities as regards what supplies are made within the group, and on what terms. In many cases, this is the main motivation.

This is particularly important for arrangements relating to intangibles – where, a given set of activities and payments may be consistent with a number of different scenarios as regards ownership and risks.

In some jurisdictions, post-year end "true-up" type adjustments are only permitted if they are made in accordance with a legal agreement in force at the beginning of the relevant year.

> "Intercompany agreements allow a group's tax function to set the starting point for discussions with local tax authorities."

From a legal perspective, intercompany agreements also provide a focus for the directors of each legal entity involved, when considering whether proposed arrangements are in the interests of that particular company. This may sound like a 'soft' benefit. But in an environment where directors are being called to account in the media and at law, it is arguably fundamental. And it happens to reflect their actual, statutory obligations under the Companies Act and equivalent legislation.

Despite this, many groups do not have a consistent approach for creating and maintaining intercompany agreements. In some cases, no intercompany agreements at all are put in place. In other cases, the agreements used are heavily influenced by commercial contracts used with unconnected third parties – with the result that they are overly long, difficult to review quickly and contain contractual procedures which at best unused, and at worst directly in conflict with the way the arrangements are administered in practice.

2. The key requirements of intercompany agreements

It is worthwhile being clear about the basic requirements of intercompany agreements.

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.

The agreements also need to appropriately differentiate the terms of the supply from other reference points, especially other intra group supplies of similar goods, services or finance which use different pricing. 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 actually followed.

> "Complicated reporting provisions will not enhance a group's transfer pricing position if they are not actually followed."

The terms of the intercompany agreements must be consistent with the legal and beneficial ownership of any relevant assets. For example, an intra-group agreement where a company purports to grant a licence over intellectual property which it does not actual own, may be likely to create confusion rather than promoting the group's transfer pricing 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. For example, 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)
- 'giving away' assets or value, especially if it is to a parent undertaking

Finally, the intercompany agreements must be capable of being legally binding. From an English law perspective, this is not difficult to achieve, since there are few formal requirements. (Exceptions include land conveyances, leases, guarantees and documents granting powers of attorney.)

However, 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.

3. Choosing the best format for your intercompany agreements

Where different legal entities are under common control, there is no need for the legal agreements between them to apply the same level as detail as is commonly used with unconnected third parties. The objective should be to document the key terms as simply as possible, so as to provide an appropriate record both for corporate governance and for tax purposes. In general, it is therefore not helpful to use the content of commercially negotiated agreements in an intragroup context.

In essence, intercompany agreements can be structured in three main ways:

- Global agreements – where a single document is entered into between multiple entities. For example, a parent company (P) may provide similar head office services to a number of subsidiaries (S1, S2, S3 etc). The arrangements may be reflected in a single agreement which is signed by P as well as S1, S2 and S3. That agreement may set out the types of service provided, the legal terms of supply, the methodology for determining the fees payable to P, and the method of allocating fees as between S1, S2 and S3.

"The objective should be to document the key terms as simply as possible."

- Bilateral agreements – where a series of two-way agreements is entered into. Using the example of head office services mentioned above, separate agreements would be entered into between P and S1, P and S2 and so on.

- Hybrid arrangements – reflecting a combination of the above approaches.

Although global agreements may be simpler to implement, they have the disadvantage that it is more difficult to accommodate the specific requirements of local jurisdictions without disclosing the 'special arrangement' to all the relevant tax authorities.

Very often, the best approach will be a hybrid arrangement known as the "standard terms / contract schedule" approach. For example, in the head office services example given above the contractual relationship would be reflected in two documents:

- A set of "standard terms", being the standard conditions on which P provides those services generally. This would include standard terms such as any agreed service levels, ownership of IP rights in any deliverables, limitation of liability, general principles regarding allocation of costs between multiple recipients and so on.

- A series of short "contract schedules" which are signed between P and S1, P and S2 etc. These contract schedules would set out the particular pricing and other terms which apply for each individual subsidiary, and any special terms which override the standard terms. Each contract schedule would refer to the standard terms and incorporate them into the agreement by reference, so that it is not necessary to set out the standard terms themselves in full each time.

This approach has a number of advantages. The actual document which needs to be signed is kept short, usually two to three pages. The standard terms do not change. The arrangements as a whole are easier to manage and update, because the commercial variables are set out up front in the contract schedule, rather than buried in an appendix to a long agreement. And because the actual contracts created are bilateral, it is easier to accommodate variations for subsidiaries in particular jurisdictions, and to manage the confidentiality of those arrangements.

This following link allows you to download our suite of templates intercompany agreements for arrangements such as R&D services, term loans, head office services, IP licences.

[ ]

4. Checklist for reviewing intercompany agreements

The following is a checklist which 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:
    a. Subject matter: the nature of the goods, services or finance to be provided
    b. Warranties and indemnities: including service levels, warranties as to standard of care or specification of goods etc
    c. Limitations on liability: the presence or absence of any limitations on the recourse of one party against the other

> "Pay particular attention to any attempt to 'backdate' arrangements."

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 – see further below. 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 is 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 trade marks), ascertain where 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 new intellectual property** – 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 or 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 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.

> "Make sure that the arrangements make commercial sense for each of the participating companies."

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.

5. How to managing the process of executing intercompany agreements

As for any intra-group arrangement, the process of putting in place intercompany agreements should respect the obligations owed by the directors (or equivalent officers) of each individual entity participating in the arrangements.

In a UK context, this includes the obligation of a director to “exercise independent discretion” when considering issues affecting the company of which that person is a director. A paper trail which indicates that directors or signatories simply signed documents without question, is clearly unhelpful.

> “A paper trail which indicates that directors simply signed documents without question, is clearly unhelpful.”

From the perspective of a group company in the UK which is proposing to enter into an intercompany agreement, that agreement may well be material in the context of the company’s business. The articles of association of such a company would typically provide that the company is to be managed by its directors, meaning the directors collectively acting by board resolution. In that case, it would be appropriate to consider the terms of the agreement arrangement at a board meeting, unless the board has already granted delegated authority to an individual director or a committee of directors, and scope of the authority granted covers this type of arrangement.

For groups with very large numbers of companies participating in intercompany agreements, it may be beneficial to arrange for the actual execution of the intercompany agreements to take place by electronic signature. A number of proprietory solutions for this are available at relatively low cost, and which do not require software to be installed on the signatories’ computers. Those solutions often involve circulating a link by email to the relevant signatories, who can then either authenticate the signature online, or can sign and fax a hard copy. The main advantage of using this type of system is that it provides a means of tracking which documents have been signed, and PDF copies of the signed documents are produced automatically.

6. Backdating intercompany agreements

One of the most common legal issues which arises in the context of intercompany agreements is whether a particular agreement can be backdated. The short answer is 'no'. Giving a document a date which is earlier than the date when it was actually signed, would almost certainly constitute fraud. Clearly, the ideal position is to put in place the relevant intercompany agreement in advance, as with any commercial arrangement.

The range of options available in this situation depends on the proposed terms of the agreement, and whether it can be said that the relevant arrangements are already in operation.

- *Documenting arrangements which are already in operation*

  One possible scenario is that the relevant supply arrangements are already in operation, but they just have not been documented yet. For example, head office services may have been supplied from a particular historic date, as reflected in the functional analysis. In this situation, it may be possible to create a document after the event which recites what actually happened, and which records the key terms of the supply. The document should be dated when it is actually signed, but it can refer to the historic effective date of the transaction.

  This approach may be harder to justify where the arrangements are unusual or where a particular contractual risk profile is intended, which is not clearly evidenced by the conduct of the parties – such as limited risk distribution arrangements.

- *Documenting a transaction which has not yet happened*

  In other cases, it may not be possible to say that the relevant arrangement have already been in operation – but it may still be desirable to achieve a 'backdated' effect. In this situation, it may be possible to put in place an agreement now, with a historic 'effective date'. For example, a group may want to move from a distribution model for the sale of goods (where local subsidiaries hold acquire legal title to the relevant products and sell them on to customers, bearing commercial risk) to an agency model (where local subsidiaries act only as introduction agents, and take no credit risk or other commercial risks in the sale of the products). The seller/

principal may agree with the local sales companies to treat the arrangements as they had been in place as from the previous year end. This could involve putting in place agency agreements now, which are dated when they are actually signed. The agreements could specify, amongst other things, that revenue and risk would be apportioned by reference to the historic effective date, with adjusting payments being made accordingly. This type of arrangement would not bind third parties, but it may be effective from an accounting and tax perspective depending on the length of time which has elapsed since the intended historic effective date.

Whenever any form of backdating is proposed, it is important to review the facts carefully. Additional due diligence should be considered in order to manage the risk of any unintended liabilities being triggered, and to make sure that the legal effect of the relevant arrangements is as intended.

7. How to deal with supplies between a parent company and a permanent establishment

From a legal perspective, a permanent establishment is not a separate entity from its 'parent' or head office. It may be subject to local registration requirements (for example with Companies House), but it is still the same entity. A person cannot enter into a contract with itself, and therefore a legal agreement between a "parent" and its own branch has no legal effect.

> "An agreement between a parent company and its own branch has no legal effect."

From a tax perspective, it may nevertheless be useful to allocate supplies and profits between the head office and the establishment. In order to document that, an appropriate approach would be to refer to the key terms in a memorandum (which may be signed), rather than attempting to support a fiction that a contract has been created.

8. Action points

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

- Establish what template intercompany agreements are currently used within your 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
- Choose the appropriate contracting model (e.g. global agreements, bilateral agreements, hybrid, contract schedule / standard terms)
- Establish clear accountabilities for creating and maintaining appropriate templates, arranging signatures and archiving signed intercompany agreements
- Exercise caution as regards proposals to 'backdate' arrangements

Case Study: ABC group

Background

ABC group provides hardware and software solutions to enable the tracking of road vehicles. Its major customers include governmental authorities and security agencies, as well as carriers and other operators of fleets of vehicles. The group is headquartered in the UK and has local subsidiaries in Europe, the Americas and the Asia Pacific region. The top company in the group is ABC Limited, which is incorporated in the UK.

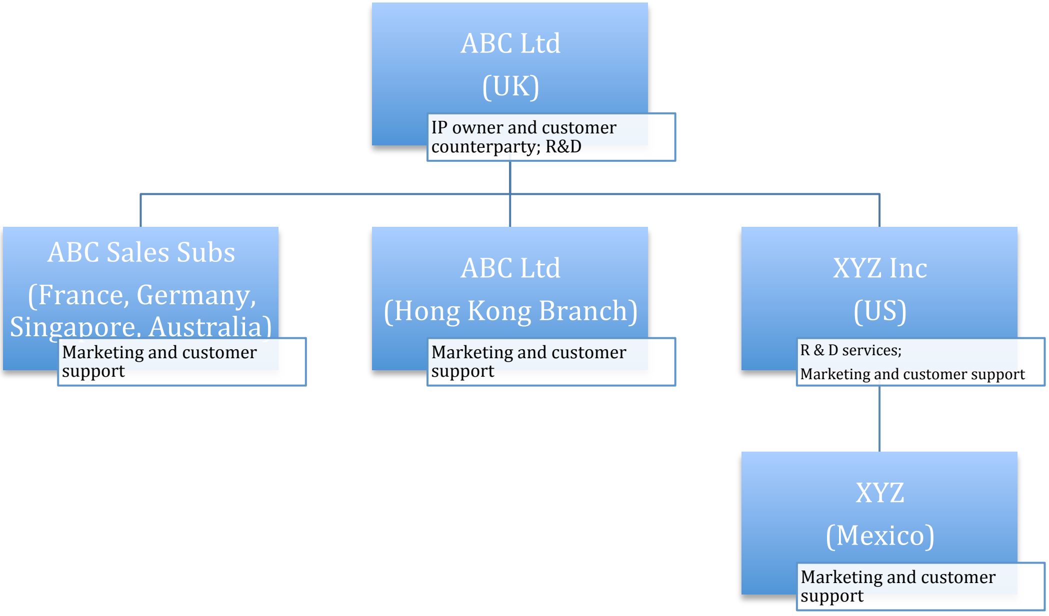
In 2010 ABC Limited acquired a US company XYZ Inc which had developed similar products. XYZ group's solutions included range of software developed between 1998 and 2002 which was designed to be installed on desktop PCs (the XYZ software).

The ongoing development of the group's technology is carried out by two main teams: one in the UK (originating from ABC group), and one in the US (acquired with the XYZ group). The current range of products comprises a composite of software originating from ABC Limited, XYZ Inc and third party providers. Going forward, it is intended that the software will be revised substantially. The core platform will be retained, but most features will be new, and it will be internet-based.

The intellectual property in the ongoing suite of products is to be held by ABC Limited.

ABC Limited uses its local subsidiaries within the group to promote and market its products. The customer contracts are currently held by the local subsidiaries, with revenue derived from those contracts being recognised in the subsidiaries. It is intended to move to an agency model, with the customer contracts held by ABC Limited, and the subsidiaries remunerated by way of commission for their marketing services and ongoing customer support.

Diagram: Group structure



Transfer pricing approach

Given the evolving nature of the software comprised in the group's products, it has been determined that a declining royalty arrangement is the most appropriate method of dealing with the relationship between XYZ Inc and ABC Limited as regards the historic XYZ software. This royalty is to be paid over a period of 5 years. The reducing amount of the royalty is intended to match the declining portion that the software originating from XYZ Inc represents, when compared to the overall software comprised in the products offered to customers.

As regards the sales role of subsidiaries, the group maintains a network of around 50 independent distributors globally, who act as resellers of the group's products on a non-exclusive basis in specific territories. The scope of those distributors' obligations includes various functions which are not intended to be carried out by ABC Limited's subsidiaries, such as the negotiation and conclusion of contracts with customers, invoicing and debt recovery, and obtaining approvals, permits and licences for trading. The proposed rate of commission to be paid to the subsidiaries for their marketing and introduction agency services is therefore lower than the typical margins achieved by the independent distributors.

Intercompany agreement approach

Taken at face value, a 'declining royalty' would imply that XYZ Inc would continue to own residual rights in the relevant intellectual property. This would not be desirable from a legal or a commercial perspective, since it would be unclear which entity is the owner of the intellectual property rights relating to any particular piece of code.

In order to create ABC as the outright owner of all intellectual property rights comprised in the software, various contractual approaches are possible. They include the following:

- An outright assignment of rights by XYZ Inc to ABC Limited, with the consideration for the assignment paid by ABC over a period of 5 years; or
- An exclusive licence granted by XYZ to ABC on a declining royalty basis, followed by an option to acquire the relevant rights for a nominal price.

The ongoing R&D role of XYZ Inc is documented in an R&D services agreement which provides for the intellectual property in all work products to belong to ABC Limited. This is in the form of a bilateral agreement.

The current distribution arrangements between ABC Limited and its subsidiaries are not reflected in written intercompany agreements. If they had been, they would probably have been in the form of distribution agreements incorporating master software licences granted to the subsidiaries, enabling them to grant sublicences in turn to customers. Notwithstanding the lack of written agreements, the existence of contracts from a legal perspective is evidenced by the conduct of the group companies.

In order to put in place the new arrangements, standard conditions are prepared which set out the generic terms on which marketing and introduction agency services are provided by the subsidiaries to ABC Limited. Those standard terms provide, inter alia, for the payment of commission and for all intellectual property rights created in the course of the subsidiaries' activities to vest in the parent.

Separate contract schedules are signed up between ABC Limited and each of the respective subsidiaries, which incorporate the standard conditions by reference and specify the key commercial variables in each case, such as commission rate and territory.

The contract schedules also record the termination of the previous distribution arrangements. Sublicences already granted to customers under the previous distribution model remain in place, but with the parent company indemnifying the subsidiary for all liabilities.

This request for quote is without obligation and will be held in strict confidence.

1. Preliminary information

Name of top company in group:	
Name of the company we should treat as our client (if different):	
Deadline to put in place intercompany agreements:	
Effective date for intercompany agreements (if different):	
Contact name:	
Contact email:	
Contact telephone number:	

2. Current status of the group's Transfer Pricing Policies for the relevant supplies

(Tick whichever applies)

- ☐ Updated and complete
- ☐ Updating in progress
- ☐ Updating required but not yet started

3. Current status of the group's Intercompany Agreements for the relevant supplies

(Tick whichever applies)

- ☐ No intercompany agreements in place
- ☐ Some intercompany agreements in place
- ☐ All in place but require updating or consistency

4. Overview of new intercompany agreements required

	Tick if required	Approx. number of **suppliers** for that arrangement	Approx. number of **recipients** for that arrangement
Back office / administration services	☐		
R&D services	☐		
Contract manufacturing services	☐		
Sales agency services	☐		
IP licence (master licence)	☐		
IP licence (sublicence)	☐		
Sale of goods / distribution	☐		
Limited risk distribution	☐		
Loan facilties	☐		
Other:			
	☐		
	☐		
	☐		
	☐		
	☐		

5. Level of legal support required

(Tick whichever applies)

☐ **Bronze**: Generic, untailored templates (available for immediate download at [ ])

☐ **Silver**: Templates tailored for each generic supply within the group

☐ **Gold**: Agreements created and populated for each individual supply

☐ **Platinum**: Agreements created and populated for each individual supply, plus project management of actual signatures

Next steps:

1. Send this completed form to us at info@lcnlegal.com. We will call if anything is unclear.
2. We will send you a fixed fee quote within two business days.
3. We will send you first drafts of the intercompany agreements within 14 days of you accepting our quote and sending us any background documents required.