

The Importance of intercompany contracts in transfer pricing



CONTEXT

In today's globalized economy, multinational corporations engage in a myriad of complex intercompany transactions, which often involve the transfer of goods, services, intellectual property, etc., across international borders. These intercompany transactions are subject to scrutiny by tax authorities worldwide, particularly in the context of transfer pricing.

To ensure fair and compliant intercompany business dealings, the importance of well-structured and documented legal contracts in transfer pricing cannot be overstated.

Brief

IN BRIEF

Transfer pricing regulations aim to ensure that related-party transactions are conducted on an arm's-length basis, meaning that the prices charged in intercompany dealings are comparable to those that would be charged between unrelated parties under similar circumstances.

As per the OECD¹'s guidance for applying the arm's length principle², the identification of the commercial or financial relations depends on various factors amongst which are the contractual terms of the transaction.

One of the primary functions of a contract in the transfer pricing context is to delineate the respective rights and obligations of the related parties involved. By clearly defining these terms, contracts can help establish the economic substance of the transaction and support the allocation of risks and functions among the entities within the multinational group. This delineation is vital in justifying the transfer pricing method chosen, the remuneration, and the resulting allocation of profits among the group entities concerned.

Moreover, legal contracts play a pivotal role in establishing, expressing the financial, commercial terms and conditions of the intercompany transactions.

Similarly, independent parties generally formalise transactions through written contracts which reflect the intention of the parties at the time that the contract was concluded.

Further, intercompany contracts are essential in demonstrating the business rationale behind the pricing arrangements and in providing a basis for comparability analyses to assess the arm's-length nature of the prices charged.

- (1) *OECD stands for the Organization of Economic and Commercial Development, OECD transfer pricing guidelines Version of July 2022.*
- (2) *Section D.1. Identifying the commercial or financial relations under subsection D.1.1. The contractual terms of the transaction.*

Brief

Accordingly, well-drafted contracts can help mitigate transfer pricing disputes by providing a clear record of the intentions and expectations of the parties at the time of entering the transaction. Should a transfer pricing audit or examination occur, having comprehensive and contemporaneous contracts can significantly strengthen a multinational corporation's position and reduce the risk of adjustments by tax authorities.

OPTIMIZING THE INTERCOMPANY CONTRACTS MANAGEMENT CYCLE

To ensure the effectiveness of contracts in transfer pricing, multinational corporations should adopt best practices in their contract management processes. This includes implementing robust controls to ensure that contracts accurately reflect the economic and legal substance of the intercompany transactions and are consistently adhered to in practice.

Common pitfalls in managing the intercompany contracts portfolio within organizations include - but are not limited to - the following:

- **Contradictions between the intercompany contracts and the actual conduct of the related parties:** where differences exist between the contract and the actual conduct, the contracts should be adjusted to express the effective conduct of the related parties accordingly. Under the substance over form approach, certain tax authorities may overlook the intercompany contracts - as an element of evidence - if found to be misaligned with the actual conduct of the parties.

- **Outdated intercompany contracts:** as per the OECD applicable transfer pricing guidelines³: 'where there is doubt as to what transaction was agreed between the associated enterprises, it is necessary to take into account all the relevant evidence from the economically relevant characteristics of the transaction. In doing so one must bear in mind that the terms of the transaction between the enterprises may change over time.'

(3) OECD Transfer Pricing Guidelines January 2022, Chapter 1, Paragraph 1.47

Brief

Where there has been a change in the terms of a transaction, the circumstances surrounding the change should be examined to determine whether the change indicates that the original transaction has been replaced through a new transaction with effect from the date of the change, or whether the change reflects the intentions of the parties in the original transaction'. It is hence advisable to regularly review the intercompany contracts in place and update them as part of the annual transfer pricing compliance exercise.

- **Absence of intercompany contracts:** where there are no intercompany contracts in place, organizations are urged to prepare adequate intercompany contracts to support their intercompany transactions accordingly. Other elements of evidence (e.g. invoices, ledgers, emails, meeting notes, etc.) may help in the absence of such contracts but are not enough to substantiate the rights and obligations of the parties involved nor to delineate or recognize the underlying intercompany transactions.

- **Unsigned intercompany contracts:** written contracts must be signed in general to be valid between the parties. Certain tax authorities may reject intercompany contracts as a piece of evidence if found to be unsigned. In such a case, there would be no legal record of the terms and conditions agreed between the parties. This may lead to misunderstanding and lack of evidence in the event of a legal dispute or litigation. Although in an intercompany context it is unlikely that related parties enter litigation, it is however advisable to have signed contracts in place for them to be valid in front of the tax authorities.

- **Backdated intercompany contracts:** Although this may be acceptable in certain jurisdictions from a legal perspective it is not recommended to use such an approach from a tax / transfer pricing perspective as it may create rejection and further scrutiny from the tax authorities in the event of a tax audit which may question the effective entry into date of the contract versus its signature.

CONCLUSION

In conclusion, the significance of contracts in transfer pricing cannot be underestimated. Well-structured and documented contracts not only provide a clear framework for related-party transactions but also serve as critical evidence to substantiate the arm's-length nature of intercompany pricing to tax authorities.

Taken on standalone basis, intercompany legal contracts are crucial but not sufficient as a sole transfer pricing documentation, in case of challenge by the tax authorities. It is hence important to ensure other transfer pricing compliance and reporting elements are well prepared and maintained and that all elements are aligned and consistent with each other.

By emphasizing the importance of contracts in transfer pricing, multinational corporations can enhance compliance, mitigate tax and legal risks as well as contribute to a more transparent and efficient global tax environment.



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