

Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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1. To what extent are a multinational enterprise's intra-group contracts respected for transfer pricing purposes?

The mere fact that a multinational group has intra-group contracts can be meaningless, and poorly conceived contracts are worse than no contracts at all. However, when a multinational taxpayer has a well-designed transfer pricing program, supported by good contracts, the taxpayer is reasonably positioned for tax audits.

Intra-group contracts serve two important purposes:

- Good contracts are evidence to tax examiners that the taxpayer takes seriously its responsibility to develop and administer a high-quality transfer pricing program; and
- The contracts provide a roadmap for the examiners to analyze the functions, assets and risks of the relevant parties.

The contracts must reflect the taxpayer's intended allocation of risks and responsibilities. When the contracts do so, the contracts generally are respected by transfer pricing examiners in the United States.

However, taxpayers should beware of unintended consequences. A new contract that purports merely to document, but actually changes, the allocation of functions, assets, or risks can constitute a taxable event. History matters in transfer pricing.

2. How much emphasis is placed on related party agreements as part of a taxpayer's transfer pricing documentation, or as an important source of functional analysis information?

The absence of extensive intra-company agreements is not fatal, but the lack of agreements raises doubts in the examiner's mind whether the taxpayer has reasonably considered the allocation of functions, assets and risks. For instance, if there is no contract explaining which party bears warranty risks, or foreign exchange risks, or inventory risks, then the examiner's only option is to look at the conduct of the parties and try to determine whether each party is properly compensated for the risks it actually has assumed. That is hard work for the examiner – and dangerous ground for the taxpayer.

What is worse, however, is for a taxpayer to prepare intra-company agreements and then fail to follow

their terms. In our experience, for example, it is not uncommon to find that a “risk-free” distributor does, in fact, bear some warranty risks, or risks of non-collection from customers. When it is clear that a taxpayer is ignoring the allocation of risks set out in the contracts, the taxpayer's credibility is seriously damaged.

3. What content is expected to be found in related party agreements?

It is a cliché to say it, but the cliché is true: related party agreements should mirror the agreements that would be adopted between unrelated parties.

Here is a specific example. Many multinational companies have captive service providers that operate as R&D labs, call centers, accounting centers, or provide other services. Such a service provider has only one customer, its related parties. An unrelated service center, dependent entirely on a single customer, would insist on strong notice provisions and significant compensation in the event the customer decided to exit the agreement. But many related party taxpayers in this situation write agreements that simply say, “I will pay you cost-plus markup,” with no provision for notice and no compensation in the event of a shut-down.

That's simply wrong, and tax examiners may properly insist that the service center earn a profit to protect itself if and when the customer exits the arrangement.

4. To what extent can taxpayers be held to their related party agreements, even if they are not in line with normal commercial arrangements or economic reality?

U.S. courts generally hold taxpayers to the form of their transactions, as reflected in related-party contracts. However, in the United States – and in other countries where the examiners are acting professionally – inter-company pricing agreements are not treated as a tool in a game of “Gotcha!” Rather, they are useful evidence of the degree to which the taxpayer has considered and assigned risks and responsibilities. But if the agreement is unusual and does not reflect normal business practices, then the examiner will – properly – question the agreement and likely give it less weight, unless the taxpayer can provide

convincing evidence why the risks and functions are shared in the particular manner at issue.

5. Is the situation different for certain transactions? For example, financial ones?

Practices do differ among industries and types of transactions. For instance, there has long been a common format for documenting loans (even before the U.S. Department of Treasury proposed regulations under section 385 of the Internal Revenue Code), both in determining the interest rate and explaining the rights of the lender and borrower. Low-risk distributors have standardized agreements that highlight the kinds of risks these parties are likely to incur. For R&D transactions, there are standard approaches for allocating the rights to any research and the compensation to the party undertaking the work.

Taxpayers do not need to invent new documentation for related party contracts; there are lots of models. But, the taxpayer absolutely must consider the specific facts for its business. Using off-the-shelf contracts for related party contracts, and then ignoring the terms in daily practice, leads to disasters – and well it should. Tax examiners have a right to expect taxpayers to take the creation of intra-company contracts seriously and to follow the terms carefully.

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