Intercompany Agreements

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An Intercompany Agreement ("***ICA***") is usually a commercial agreement for services, the sale of goods, financing or intangible property made between companies related through ownership, under common control or part of the same group of companies. Companies have many reasons, including operational, strategical IP, tax and legal, to enter into ICAs.

For example, a holding company may hold shares in subsidiaries but not conduct active business operations or have active employees. The holding company may therefore enter into an ICA with another company in the same group for administrative services.

Do ICAs differ from other commercial agreements?

ICAs are similar to commercial agreements between unrelated parties, although the companies within a group will try to keep the ICA much shorter and lighter to ensure that the stakeholders in both inbound and outbound companies spend little time on compliance or interpreting terms.

But ICAs differ from other commercial agreements because ICAs usually are set up intending to maximize a group's overall profits, reduce its costs, increase its earnings or achieve the above. Because the agreement is between related companies, they can make the agreement as they see fit. Given their discretionary nature, ICAs are often audited and scrutinized for compliance with tax transfer pricing and other regulations.

How are ICAs regulated?

Related companies must follow specific rules and regulations, which will vary by jurisdiction, for their intercompany transactions.

Unlike transactional agreements between unrelated parties, most countries' taxing authorities will scrutinize ICAs to make sure that all transaction terms under the ICA are similar to those between unrelated parties acting at arm's length. In the U.S., this principle is enshrined in law under Section 482 of the Internal Revenue Code of 1986, as amended (the "Code"). Some form of the arm's length standard (or other transfer pricing method) is used in jurisdictions around the world (with very few exceptions) and will also apply to international ICAs.

ICAs are regulated in each jurisdiction differently. In certain jurisdictions, these agreements must be in writing, lest governmental and taxing authorities will not recognize them and the companies will lose any benefits those jurisdictions provide to the related parties. In many jurisdictions, those authorities will scrutinize a related party relationship or transactions between related parties (such as, for instance, in the U.S.). ICAs are often regulated by a jurisdiction's treasury or fiscal authorities but are also regulated by other agencies (consider the Federal Acquisition Regulations ("***FAR***") and Defense FAR Supplement ("***DFARS***") rules in the United States).

Most often, if the parties' conduct differs from the written terms of their ICA, the regulatory authorities will rely on the parties' conduct, rather than the written document, to scrutinize the

parties' compliance with regulations or tax treatment.

Among the regulations applicable to ICAs are the transfer pricing regulations under Code section 482. Such regulations are aimed at ensuring that the companies' profits are taxed in the jurisdiction to which the profits are attributable (that companies do not use ICAs to shift profits to lower-taxed jurisdictions). However, companies are not precluded from entering into ICAs to minimize their tax liability; from a corporate perspective in some jurisdictions, they may even be compelled to do so. ICAs are often scrutinized and audited by governmental authorities.

OECD member countries apply specific OECD guidelines to ICAs between companies of certain multinational enterprises ("***MNEs***"). Usually member country authorities will determine the criteria that would make an MNE subject to such guidelines.

Practical steps to make compliance easy:

Most times, it is advisable to have a written ICA. You can achieve this by having recitals in your agreement providing context to the ICA transaction, having a clear and specific statement of the intended transaction and outcomes and by keeping your actions consistent with your ICA and the transfer pricing policies that may be in place in your group. Specifically, for U.S. companies, an ICA should have clear terms for payment, quantity, warranties, amendments and updates, term and termination. You should keep all your ICAs together, up to date and ready for a fiscal or other governmental inspection.

ICAs should reflect the actual conduct of the parties. If you require fewer units than you contracted for, if you no longer need contracted administrative services, if you ceased any performance under the contract or if there has been any other shift in the operational realities of your relationship with the related entity, promptly update the ICA to reflect those realities and even plan in advance where possible. As of the time of this article, many transactions have been affected by COVID-19 and companies are reorganizing or have reorganized various parts of their operations to adapt to the new realities of the market. ICAs therefore need to be adjusted to reflect those new operational realities.

Have your ICA drafted jointly by your legal and finance departments so they can inform each other's positions and educate each other on the issues related to transfer pricing on one side and legal requirements on the other. Depending on the industry you are in, you may have other than tax obligations related to ICAs. For instance, FAR and the DFARS contain many requirements applicable to ICAs. So, if you are dealing with the government as a customer, you should have your legal team review your ICAs, given FAR and DFARS.

Have clear transfer pricing policies within your group in line with market practices and have your ICAs comply with those policies.

If you have questions regarding intercompany agreements or other commercial agreements, please contact the attorneys below.