Importance of contractual provisions in transfer pricing evaluations 1/26/21

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The legal form, meaning the contract between related parties and its provisions, has always been among the factors that come into play when assessing whether prices applied in controlled transactions are arm's length. This article discusses why the legal form of a transaction is important, looks at a common approach to preparing intragroup contracts, and explores some rules that should be followed when drafting those contracts to mitigate transfer pricing risks.

The importance of the contract for your controlled transaction

Under amendments to 15.2 section of the Taxes and Duties Act, which recast the transfer pricing documentation requirements and apply to transactions made starting from the financial period that begins in 2018, a taxpayer preparing a local file and a master file is required to not only give information about substantial contracts for intragroup transactions but also attach their copies.

An assessment of contractual provisions is recommended by the OECD Transfer Pricing Guidelines, and case-law summaries also indicate the importance of the legal form of a transaction, where in the event of a taxpayer's dispute with the tax authority, the legal form of the transaction had a decisive role.

An approach to preparing the contract for a controlled transaction

The contract determines a legally binding relationship between the parties and is a document that sets out the overall understanding of the activities, obligations and responsibilities of the parties to the transaction, and how they split the risks and rewards.

Thus an intragroup contract is a strong tool for showing that the transaction is compliant and the fee is arm's length, as well as serving as a starting point for the tax authority to understand and evaluate the transaction.

We have noticed that entering into intragroup contracts is often seen as an irrelevant and unnecessary formality because companies in the same group usually share a common global goal to maximise the group's profitability, and it is unlikely that a dispute might arise between related companies. Contracts are often carelessly drafted and out of date, and they fail to reflect the economic reality of the controlled transactions (being inconsistent with their economic substance and actual performance).

Rules to follow in creating the legal form of a transaction

The legal form of intragroup transactions can exist either orally or in writing.

If the parties' agreement is oral, it will not lose its legally binding character only because there are no written provisions. In that case the contractual relationship between the parties will be inferred from their

actual behaviour and from economic principles that usually govern relationships between independent companies, and this can also be found in the correspondence and communication (emails, letters, recorded conversations etc) between the parties.

When a transaction is documented in writing, it is important to ensure that the contractual provisions are consistent with the actual behaviour of the parties and with the economic substance and performance of the transaction described in the transfer pricing documentation – the facts and circumstances of the transaction. The written clauses of the transaction have to make express and implied provisions for how the functions, liability, risks and rewards are split between the parties, as well as making sure that those provisions are consistent with how independent companies would behave, including fee determinations.

It is also important to ensure that your intragroup contract contains at least key elements, i.e. information that is necessary for a transaction as such and without which the intended transaction is not possible. This mainly applies to a description of the subject matter of the contract (clear identification of goods, services, intangibles or any other item) and a description of the fee (how it is determined and calculated).

To show that the fee applied to the controlled transaction is arm's length, your intragroup contract should describe how and when the arm's length nature of the fee was or will be verified:

- *The ex-ante* approach involves arriving at an arm's length price when completing the transaction;
- *The ex-post* approach involves testing the (actual) result of unrelated parties' circumstances.

The contract should additionally define the following:

- The parties' obligations and liability, which can help identify and later validate the assumed risks by additionally stating how the parties assume the risks in force majeure circumstances, which is especially relevant during the period of Covid-19 restrictions because in that case a clause can be inserted to describe how the parties undertake to split the relevant risk;
- The contract period and how it can be terminated.

The contract should avoid imposing any extra administrative burden, such as an obligation to prepare delivery and acceptance statements, the lack of which may later cause difficulties.

A lack of high-quality intragroup contracts may increase the probability of additional information requests and due diligence reviews during the tax authority's control measures. On the other hand, carefully drafted intragroup contracts with a comparatively small investment of time and cost will create security and can mitigate potential non-compliance risks inherent in your transactions.

If you need assistance in reviewing or preparing contracts for your controlled transaction or in discussing your contractual provisions, please feel free to reach out to PwC's transfer pricing team.