



The Crucial Role of ICA Contractual Terms in License and Service Agreements

Licensing agreements and service contracts between related entities are among the most complex—and most highly scrutinized—transfer pricing transactions. Given the high degree of risk involved, you'd think that the contractual terms of these intercompany agreements (ICAs) would scrupulously reflect the obligations, functional realities, and economic substance that undergird the arrangements.

Unfortunately, you'd be wrong. In our experience, ICAs too often fall short of that bar, exposing compliance gaps that leave companies unnecessarily vulnerable to audits, adjustments, and disputes. It's worth remembering that to many tax authorities, the ICA is the starting point—the low-hanging fruit—of the audit. Any inconsistencies between the agreement and the actual circumstances underlying the transaction would likely lead to more scrutiny.

Tax professionals aren't typically versed in the language of commercial contracts, so it's understandable why wading into the terms of an intercompany agreement might give some pause. Fear not. In this white paper, we demystify the process, uncover some of the pitfalls, and help you gain the confidence you need to benchmark and defend your intercompany licensing or service pricing.

Substance Over Words

Transfer pricing can be devilishly complex. It touches on so many moving parts of an enterprise—tax and strategy to legal, finance and operations. But in essence, the arm’s length principle that undergirds it boils down to two simple, interrelated questions:

If, magically, the related entity were to leave your corporate solution and become independent, could you still live with this agreement? And can you prove that to a tax authority in an audit?

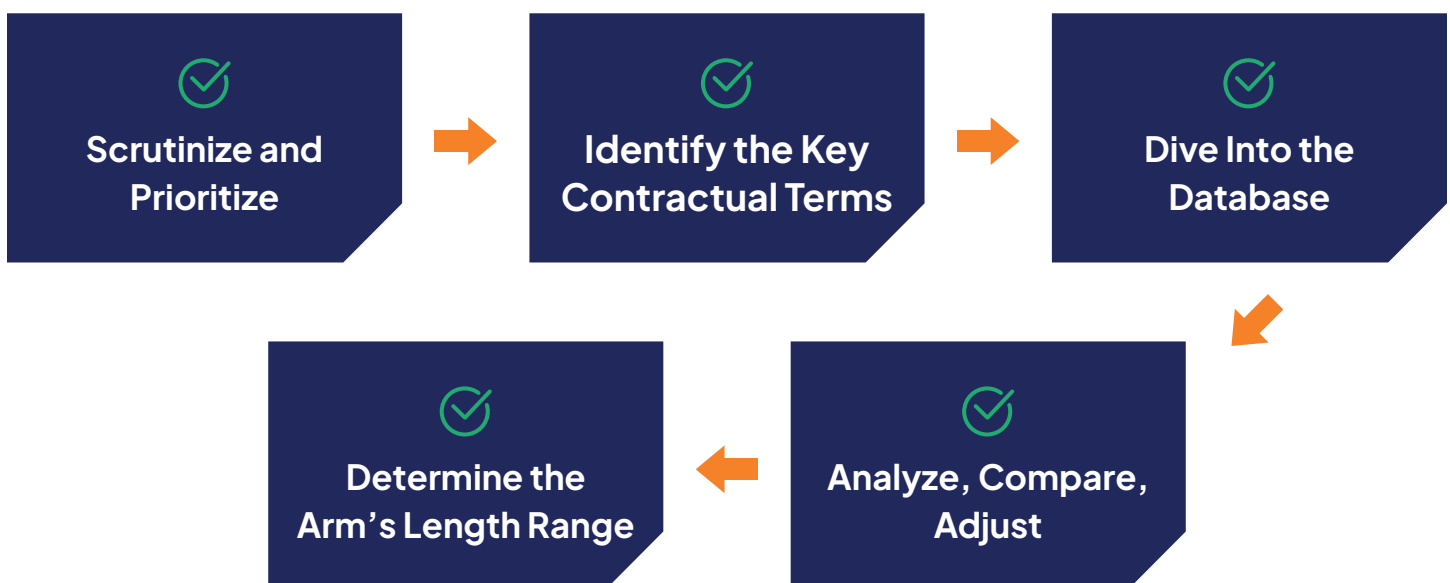
You want to say yes. You need to say yes. But how do you get there with confidence? How do you reverse-engineer that yes?

Hewing closely to OECD guidance is always a safe place to start. In its latest transfer pricing guidelines, the organization stresses that it is the economic substance of the intercompany transaction—the actual conduct of the parties in the covered transaction—that matters in your analysis, regardless of the words in the agreement, and that the two should be in sync. (Although local rules may vary, many jurisdictions have changed their transfer pricing laws in recent years to align with the OECD’s increasingly sharp focus on the practice.)

That means, first of all, that you must conduct a thorough functional analysis to lay out the assets involved, contributions made, risks assumed, and functions performed by each related party in the transaction. And second, you must ensure that the contractual terms in your ICA reflect the essence of that analysis. Under the OECD’s BEPS (Base Erosion and Profit Shifting) Action 13 guidance, these legally binding documents must be integrated into the company’s “local file” and “master file.”

So, look at those clearly illuminated contractual terms as a lighthouse, guiding you through the dark night of benchmarking, to the safe harbor of arm’s length confidence.

Let’s get started on the journey.





✓ Scrutinize and Prioritize

All intercompany transactions are important, but some are critical. Pay special attention to your ICA's contractual terms when the controlled transaction:

- has a material financial impact
- is inherently complex or unique (often the case with intangibles)
- involves a high degree of risk or uncertainty
- has a history of compliance issues
- is strategically important to the company

These kinds of transactions are more likely to attract scrutiny from tax authorities, so you want to be proactive and vigilant in zeroing in on these risks.

✓ Identify the Key Contractual Terms

While licensing agreements and service contracts differ in many ways, when it comes to the contractual terms that are salient for a benchmarking analysis, they're surprisingly similar. Here are some of the key areas that will form the basis for your functional analysis. They should be detailed, in financial terms, in your ICA:

- **Pricing structure.** Assess the pricing mechanism, such as royalty rates, fixed fees, cost-plus arrangements, or other pricing methodologies.
- **Scope of services or licensed rights.** Understand the scope of the services provided or the rights granted under the licensing agreement—for example: permitted uses, geographic scope, duration, exclusivity, change-of-control clauses, and any restrictions.
- **Payment terms.** Evaluate the payment terms—including frequency, currency, upfront or milestone payments, as well as any discounts or penalties for late payment.
- **Duration, renewal, and termination provisions.** Review the specified duration of the agreement and any provisions for renewal, renegotiation, termination, and notification.
- **Performance standards.** Identify any performance standards, service levels, or quality requirements specified in the contract.
- **Allocation of risks and responsibilities.** Analyze how risks and responsibilities are allocated between the parties, including indemnification clauses.
- **Intellectual property rights.** Review the ownership, use, and protection of intellectual property rights, including any restrictions or licensing conditions.
- **Compliance with legal and regulatory requirements.** It goes without saying, so we'll say it: Ensure that the contract complies with all relevant laws, regulations, and industry standards.

Now, a real-world reality check. In addition to these baseline areas, there are a few special issues to watch out for as you examine these ICAs—all of which come from decades of real-world experience.

Licensing agreements are often too casual in defining the parameters of the intangible, and/or too vague in specifying rights and expectations. Factors such as exclusivity, brand dilution, and quality control—whose impact can be material—are also often unaddressed or under-defined in ICAs. Another consideration: should a licensee be exposed for violating overseas laws, the legal and reputational risks involved could significantly affect the agreement or price; that should be accounted for, as well.



In service contracts we frequently find soft spots, such as a lack of clear definition of the services being provided, and of apportionment metrics for recipients. For example: sales are often used as the apportionment factor—yet they don't generally correlate well with back-office services such as HR, payroll, or insurance.

As these examples illustrate, it is exceedingly easy for material details to slip through the cracks of a contract—so it's worth going the extra mile to make the terms in your controlled transaction's ICA as comprehensive, clear, and airtight as possible. You won't be able to conduct a credible benchmarking analysis without them.

✓ Dive Into the Database

Once you've selected your transactions and determined their key functional characteristics, you're ready to start looking for comparable transactions, typically using the Comparable Uncontrolled Price (CUP) method—the “gold standard” for many tax authorities (and the OECD), as it directly compares prices charged in controlled transactions with prices charged in similar transactions between unrelated parties.

That said, since you're comparing functions rather than financials, finding reliable comparable data can pose challenges: it's not an apples-to-apples process. The information you seek isn't published daily in the Wall Street Journal, or found on a Form 10K.

Products, services, geographic locations, market conditions, volume, timing, currency exchanges, and contractual terms are as unique and individual as transactions. There can also be discrepancies or inconsistencies in the data, making meaningful comparisons difficult. Those issues are amplified when it comes to specialized transactions or niche industries.

Fortunately, there are powerful data analytical tools available today that can make the task much easier. Purpose-built search engines can analyze large volumes of potentially comparable ICAs through a sophisticated transfer pricing lens. They function as a multilayered data extraction engine that can uncover and zero in on key payment structures and salient contractual terms, supporting the credibility of your benchmarking, and bolstering your documentation.

✓ Analyze, Compare, Adjust

After narrowing down your choices, the next step is to conduct a detailed analysis of comparables, identify similarities and differences, and make necessary adjustments to align financial results with the controlled transaction.

Not all potentially comparable transactions will meet the economic-substance criteria for comparability. It can be helpful to weigh the various factors by breaking the analysis down into similarities and differences.

In evaluating similarities:

- Look for transactions involving similar types of intangible assets or provision of similar services.
- Consider market conditions such as industry dynamics, geographic location, regulatory environment, and economic conditions.
- Assess the functionality of the parties, including functions performed, risks assumed, and assets employed.
- Examine contractual terms such as pricing mechanisms, payment terms, scope of services or licenses, duration, warranties, indemnities, and intellectual property rights.

In evaluating differences:

- Evaluate the level of control, which can impact the allocation of risks and responsibilities between parties and the materiality of the comparison.
- Consider variations in geographic scope, which often affect pricing and market conditions.
- Analyze differences in the scope of service or license, as they may impact the value and pricing of transactions.
- Assess material differences in contractual terms such as pricing mechanisms, payment terms, warranties, indemnities, and intellectual property rights.

If there are material differences between the controlled agreement and the best comparables you can find, adjustments will be necessary to align the financial results. You may need to adjust for variations in product features, geographic markets, economic conditions, volume discounts, or other factors that could impact pricing.

Adjustments can be cost-based, income-based, market-based, involve regression analysis, or a combination thereof. They may take the form of percentage changes, dollar adjustments, or other relevant metrics. (For instance, if the comparables feature longer contract durations than your agreement, you might apply a positive adjustment to their prices to accommodate the increased risk associated with the longer term.)



✓ Determine the Arm's Length Range—Then Connect the Dots

To arrive at your safe harbor—the credible arm's length range of your controlled transaction—you need to synthesize the results of your analysis, calculate adjusted prices for selected comparables, derive a weighted average price, and, if there's a sufficient amount of data available, establish a statistically robust arm's length range of confidence that conforms with the expectations of tax authorities.

This range is based on upper and lower bounds of your tolerance level, typically expressed in quartiles. Advanced search engines can assist, by providing access to comprehensive datasets and analytical tools. (More detail on this process can be found in our article on benchmarking.)

Most important of all: documentation. There are as many permutations of this process as there are transactions, but the bottom line is this: your arm's length range, your adjustments, your calculations, your selections, your rationales, and your methodologies all must pass the acid test of rigor and economic substance. So do yourself a huge favor and meticulously document everything in your ICA. In a matter as subjective and high stakes as transfer pricing for license and service agreements, even a missing word can spell disaster.



Pitfalls to Avoid

For all their usefulness in supporting individual transactions, you can't look at your ICAs in a vacuum. Those contractual terms must be evaluated in the context of your broader transfer pricing policy. What is the procedure for enforcing that policy? Is it reflected in the agreement?

Almost as dire as not having an agreement in place at all, is having one that's 20 years old. Or one with an evergreen clause that automatically renews—despite any dispositions or acquisitions that may have taken place. Another obvious red flag: having multiple agreements signed by the same officer in the same title in each of the subsidiaries.

Keep in mind also that the risk of disconnection is ever-present. Your policy may change because you've acquired other companies along the way, or you've changed how the business is running. Your procedures may have had to be adapted because you made acquisitions or dispositions. Market conditions, industry trends, and economic factors are always in flux. All of these affect the comparability of transactions. You must be vigilant in keeping your ICAs up to date. Don't file them away and forget about them, assuming you are covered.

If your intercompany agreements aren't current or don't align with your actual transfer pricing policies, tax authorities are likely to just disregard the agreements completely—and recharacterize the transactions in whatever way suits them best.

The Road to Confidence

We began this paper with two simple questions: *If, magically, the related entity were to leave your corporate solution and become independent, could you still live with this agreement? And can you prove that to a tax authority in an audit?*

In this paper, we've strived to give you the tools to respond in the affirmative. From prioritizing critical transactions to diving deep into comparative analysis and adjustments, we've outlined a strategic framework to unlock confidence in benchmarking, find an appropriate arm's length range, and defend your intercompany license and service agreements.

Despite the powerful data analytic tools now available to companies (and regulators), there's no killer app or silver bullet for transfer pricing compliance. It will always be a tough slog and a high-wire act at the same time. Adhering closely to OECD guidance, conducting thorough functional analyses, and meticulously documenting every aspect of the process is the best and only way to fortify your license- and service-agreement pricing, and safeguard against audits, adjustments, and disputes.



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