Agenda

• Introduction: intragroup contracts
• Intragroup contract drafting
• Distribution and sales transaction
• Production settings
• Dealing with intangibles & IP
• Management of intragroup contracts
• Conclusion
• Questions and answers
Introduction:

Relevance of intragroup contracts
**Introduction: intragroup contracts and BEPS**

Relevance of intragroup contracts

Intragroup contracts have increased in relevance due to the OECD articles regarding BEPS action items 7 (Permanent Establishment), 8-10 (adaption of transfer prices to added value) and 13 (transfer pricing documentation and Country-by-Country Reporting)

**BEPS action items 7, 8-10, 13**

Starting points when assessing the appropriateness of a transaction are the contractual relations between affiliated companies and the related assignment of functions and risks

The newly introduced Country File has to comprise all relevant intragroup contracts

The contractual allocation of risks to a party that doesn’t control these risks or doesn’t have the financial resources for this purpose, is not allowed. In these cases, the allocation must be made to the party that does actually control the risks and is financially able to do so

The parties’ actual conduct supplements or replaces the contracts in case the agreements are incomplete or the parties do not comply to them

<table>
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<th>Relevance for companies</th>
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<tbody>
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<td>Contracts as a starting point</td>
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<td>Actual conduct</td>
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<td>Function and risk profile</td>
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<td>Arm’s length prices</td>
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Written intragroup contracts should be entered into regularly reviewed and adjusted for all intragroup transactions

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Intragroup contracts and BEPS
Relevance of intragroup contracts

Written legal agreements as starting point when a revenue authority considers transfer pricing under new OECD Guidelines:

Areas of impact include:
- Recharacterisation
- Risk allocation
- Restructuring
- Intellectual property
Intragroup contract drafting
Intragroup contract drafting
Example: Master Distributor Model and its agreements

Global HQ

Master Distributor (Tax Efficient Location)

- License/Cost-Sharing Agreement
- LRD Agreement
- License Agreement
- Service Agreement
- Tolling Agreement

Sales Companies

IP Companies

Service Companies

Production Companies (Tollers)

Third-Party Customers

Raw Material and Packaging Material Suppliers

Contractual arrangements
Physical flows
Legal title

3rd Party Warehouse

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### Intragroup contract drafting

**Substantial provisions**

<table>
<thead>
<tr>
<th>Essentialia negotii</th>
<th>Standard provisions</th>
<th>Contract conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Definition of contracting parties</td>
<td>• Term / termination</td>
<td>• Authorization to sign? Policies?</td>
</tr>
<tr>
<td>• Definition of subject matter</td>
<td>• Confidentiality (post contractual)</td>
<td>• Hand written signature vs. electronical signature</td>
</tr>
<tr>
<td>• Description of main rights / obligations</td>
<td>• Liability / Limitation of liability</td>
<td>• Dates of signature and entry into force</td>
</tr>
<tr>
<td>• Agreement on price / remuneration</td>
<td>• Change of control</td>
<td>• Retroactive effect for tax purposes?</td>
</tr>
<tr>
<td></td>
<td>• Choice of law</td>
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<td></td>
<td>• Choice of jurisdiction</td>
<td></td>
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<tr>
<td></td>
<td>• Arbitration clause</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Force majeure</td>
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<tr>
<td></td>
<td>• Written form requirements (simple or advanced written form clause? Changes via e-mail?)</td>
<td></td>
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<tr>
<td></td>
<td>• Severability clause</td>
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</tr>
</tbody>
</table>
Distribution and sales transaction
Intragroup contract drafting
Contract types distribution and sales

**Authorized dealer / distributor**

- Acting **on own behalf** for **own account**
  - Dealer agreement serves as framework; sale / delivery of goods under separate sales contracts
  - Analogy to agency law needs to be considered; compensation claims

**“Low Risk Distributor”**

- Similar to dealer / distributor, but **strongly limited risk profile**
  - Arm’s length questionnable
  - In third party scenarios distributors e.g., take price risk, have to keep stock, have to handle warranty claims etc.

**Commercial agent**

- Acting **on behalf of another** for **account of another**
  - EU Agency Directive grants very similar rights and obligations to agents acting within the EU / EEA
  - Mandatory rules do not apply to agents outside the EU / EEA

**Agents’ compensation claim – analogous application for distributors**

- Choice of law
- Customs / duties
- VAT
- Warranty / guarantee
- Right of return regarding inventory
- Termination period
- Etc.
Case study 1
Year-end adjustments

Example distribution agreement

• Distribution agreement for a limited risk distributor
• The agreement contains a year-end adjustment clause
  – The limited risk distributor shall receive an arm’s length routine return according to Art. 9 of the OECD Model Tax Convention
  – Reference is made to arm’s length range of returns (without specifying range)
  – Year-end adjustments (credit / debit notes) are made to median of range

• Year-end adjustment mechanism has to be detailed in order to duly consider standards of contractual drafting such as the principal of certainty!
• Careful drafting of year-end adjustment clause is strongly recommended!
• Duly consider potential director’s liability and insolvency risks!
Production settings
Intragroup contract drafting
Contract types production

**Manufacturer**
- Production *on own behalf*, on *own account* and *own risk*
- Owned / licensed intangible assets
- Own warehouse

**Contract manufacturer**
- **Guaranteed purchase**
- Own procurement of raw materials
- In part own warehouse
- Laws governing contracts of sale applicable

**Toll manufacturer**
- **Guaranteed purchase**
- Providing of raw materials
- **No / very limited risks and responsibilities**

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Case study 2
Agreement vs. actual conduct

Example contract manufacturing

• According to the intercompany agreement the principal is responsible for production planning

• Actual conduct
  – Contract manufacturer contacts sales entities for sales budgets / planned sales volumes
  – Contract manufacturer develops a production plan and implements it
  – Contract manufacturer factually decides upon operational planning

• Regular review and adjustment of agreements to the parties’ actual conduct is essential to ensure consistency of contractual agreements, functional and risk profile as well as arm’s length prices
Dealing with intangibles & IP
Intragroup contract drafting

Identify the intangible

Identifying from a legal perspective – the different intangibles involved (trade secrets, intellectual property rights, licenses, etc.) and distinguish them from other issues, such as provision of services

Identify legal owner

Identifying the legal owner of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership

Identify parties re functions, risks, assets

Identifying the parties performing functions (including specifically the important functions), using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting (“DEMPE”) the intangibles. Use of the “DEMPE tool”

Drafting agreements

Drafting / modifying existing agreements on arm’s length basis, consistent with the conduct of the parties including their relevant contributions of functions, assets, risks, and other factors contributing to the creation of value

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An intangible is something which
• Is not a physical asset or a financial asset
• Is capable of being owned or controlled for use in commercial activities, and
• Whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances

In a transfer pricing analysis involving intangibles it is important to identify the relevant intangibles with specificity

- Patent
- Know how
- Government licenses
- Trademark
- Copyright
- Combination
  - Other intangibles
  - Services / goods
- Others

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Intragroup contract drafting
Substantial provisions regarding intangible assets

<table>
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<tr>
<th>General provisions</th>
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<tr>
<td>• Detailed description of DEMPE functions</td>
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<tr>
<td>- Development</td>
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<tr>
<td>- Enhancement</td>
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<tr>
<td>- Maintenance</td>
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<tr>
<td>- Protection</td>
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<tr>
<td>- Exploitation</td>
</tr>
<tr>
<td>• Description of intangible assets</td>
</tr>
<tr>
<td>• Remuneration – interest for delay</td>
</tr>
<tr>
<td>• (If necessary) adjustment of license rate</td>
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<tr>
<td>• Termination clause</td>
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<td>• Audit clause</td>
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</tbody>
</table>

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<tr>
<th>In particular – research &amp; development (contract of service)</th>
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</thead>
<tbody>
<tr>
<td>• Decisions</td>
</tr>
<tr>
<td>• Control</td>
</tr>
<tr>
<td>• Providing intangible assets</td>
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<tr>
<td>• Risk assumption</td>
</tr>
<tr>
<td>• Allocation of rights regarding research results / enhancements</td>
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<tr>
<td>• Protection / maintenance</td>
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<tr>
<td>• Exploitation</td>
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<tr>
<td>• Etc.</td>
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</table>

<table>
<thead>
<tr>
<th>In particular – brands &amp; patent licenses (license agreements)</th>
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</thead>
<tbody>
<tr>
<td>• Description of affected rights</td>
</tr>
<tr>
<td>• Exclusive / non-exclusive use</td>
</tr>
<tr>
<td>• Right to sublicense</td>
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<tr>
<td>• Territorial limitation</td>
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<tr>
<td>• Price</td>
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<tr>
<td>• Owed services</td>
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<td>• Consequences of termination</td>
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<td>• Etc.</td>
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</tbody>
</table>
Intragroup contract drafting

To be entitled to IP return:

• Must control **operational** risks
  
  − Operation means: development, enhancement, maintenance, protection, exploitation (aka **DEMPE** functions)
  
  − **Thus IP return has shifted from financial capital to people functions (!)**
    
    ▪ Financial capital gets a projected risk-free return or a risk-adjusted return
    
    ▪ The OECD has not agreed on what to do with actual returns (who gets the unanticipated upsides)

Controlling operational risks requires **for each** operational risk:

• In-location people that:
  
  − are qualified, have decision-making authority, demonstrate in-location exercise of decision-making authority as it relates to risk mitigate
  
  − No in-location white lab coat requirement or headcount requirement

• Board meetings are no longer sufficient

• Setting procedures and policies no longer sufficient
Neither legal ownership nor liability for costs will alone entitle an entity to intangible related return ("IRR").

Consider the functions, assets and risks associated with the development enhancement, maintenance protection and exploitation of intangibles.

## Indicators of entitlement to intangible related return

### Functions
- Design and control of research and marketing programmes
- Management and control of budgets
- Control over strategic decisions on development
- Decision making on defence and protection
- Ongoing quality control over outsourced functions

### Assets
- Intangibles used in research, development or marketing (e.g. know-how, customer relationships)
- Physical assets
- Funding (bearing costs is important, but not in itself sufficient to attribute IRR)

### Risks
- Costly development of intangibles
- Product obsolescence, or loss of competitiveness
- Infringement/cost of defence
- Product liability

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Management of intragroup contracts
Contract management

Challenges

- Drafting of a considerable number of contracts, for example regarding globally present sales companies
- Management and storage of contracts
- Content-related review of coexistence between actual conduct and contractual agreement
- Review regarding contract term
- Adjustment of contracts to current legal developments
Automation – “serial letter 2.0”

- Automation significantly helps reducing the efforts in connection with drafting frequently required documents. We guide the way to “big” and “small” solutions

Information Extraction Tools – efficiency gains by the use of “Machine Learning”

- Information Extraction Tools can be programmed to automatically summarize the content of contracts (e.g., parties, term, provisions governing termination) or to detect particular provisions (e.g., change-of-control-clauses). Here again: The correct tool for your job
Conclusion
# Intragroup contracts

## Conclusion

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<tr>
<td>Intercompany agreements are crucial for tax purposes</td>
<td>Intercompany agreements are not only about pricing but about the allocation of functions, responsibilities and risks between the parties</td>
</tr>
<tr>
<td>Drafting intercompany agreements is complicated and requires tax and legal expertise</td>
<td>Intercompany agreements have to be renewed, amended, terminated and finally stored to be find years later</td>
</tr>
</tbody>
</table>

→ Ensure to have them!  
→ Team-up between Tax and Legal!  
→ Do not underestimate the complexity  
→ Have a clear process in place!
Questions and answers
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