



DRAFTING INTRA-COMPANY AGREEMENTS

COMMON PROBLEMS AND BEST PRACTICES FOR A MORE EFFICIENT SUPPLY CHAIN

For multinational companies, having a complex web of intra-company transactions and supporting agreements is commonplace. It has often been the case that in-house legal departments view the drafting of such intra-company agreements as perhaps less substantial than some of their other tasks, which is understandable. Such agreements are simply viewed as documenting transactions with affiliates, they would be expected to carry negligible litigation risk, there may also not be any negotiations of specific provisions, there may be no need for extensive representations and warranties, these agreements are often simply viewed as “something for the file”. Perhaps less understood is the risk such agreements could pose to the tax, customs duty, and even legal liability positions of the company. For these reasons, this article will highlight some of the important considerations and possible pitfalls to be avoided in drafting such agreements. We conclude with a short bullet point list of key best-practice take-aways.

PURPOSE OF INTRA-COMPANY AGREEMENTS

No different from an ordinary commercial agreement, the first consideration in properly drafting intra-company agreements is to understand the underlying purpose of the transaction. For example, if the agreement is necessary to support the company’s tax and transfer pricing positions then, in order to be properly useful, the agreement should clearly provide for the functional, legal and economic considerations that will be necessary to support those positions.

Intra-company agreements may also be required in order to facilitate transactions that may require government approvals, such as the clearance of goods through customs or to facilitate the remittance of funds that may be restricted under foreign exchange controls. Poorly drafted or insufficiently specific agreements may make it more difficult to explain the “real” or substantive nature of these transactions. This may also give rise to unnecessary controversy and possible imposition of penalties by tax authorities. If the agreement is insufficient to serve its intended purpose then it will be poor evidential proof and is more likely to result in unintended tax or customs consequences.

BIGGEST RISK: INTRA-COMPANY ROYALTY AGREEMENTS

Royalty payments between related entities is one of the most common types of intra-company transactions that requires such agreements and typically leads to the largest potential

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exposures. These royalty agreements also are the most likely to impact the company's tax, customs duty, and legal liability positions if not properly drafted and adhered to. As such, an overview of how royalties are treated from a customs and tax perspective will be instructive as to how best to craft and draft such agreements for in-house counsel.

As a practical matter, nearly every jurisdiction into which multinational companies will be importing and selling are members of the World Trade Organisation ("**WTO**"). These countries have implemented the various WTO technical agreements through national legislation, which includes the Agreement on Customs Valuation ("**ACV**"). Whilst there remain local interpretation and practices that may differ, we will structure this discussion around the basic provisions of the WTO agreements as being broadly applicable to our example on royalty agreements.

Amounts paid in royalties may be subject to import duties and VAT. According to Article 8(1)(c) of the ACV, in order to determine the customs value, there must be added to the price actually paid or payable for the imported goods, an amount for royalties and license fees that are related to the imported goods and which are paid by the buyer either directly or indirectly, and such royalties and license fees are paid as a condition of sale of the goods, to the extent that such royalties and fees are not included in the price actually paid or payable. Thus, as we can see here, this is a conjunctive test. The royalties must be both related to the imported goods and paid as a condition of the sale for import. In other words, but for the payment of the royalty, the buyer could not purchase and import the imported merchandise.

So what is "related to" the imported merchandise? For this question, we can look to the customs valuation regulations of China as an example. China's regulations provide some concrete definitions and are broadly compliant with the WTO agreement. In China, customs valuation is provided for under the Measures of China Customs for the Determination of Value of Imports and Exports [General Administration of Customs Order 2013, Effective January 2014] ("**Order 2013**").

Article 13 of Order 213, lays out the conditions under which the China customs authorities will consider a royalty or license fee to be "related to" imported merchandise. According to China Customs, if imported goods contain patents or know-how, are produced using patents or licensed know-how; or are specially designed or manufactured to implement the patent or know-how, then royalties and license fees paid for such patents or know-how would be considered to be related to the imported merchandise.

With respect to trademarks, if imported merchandise bears the licensed trademark for which a royalty is paid and may be sold directly after importation with trademark affixed or after some

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minor additional processing to affix the trademark, then the trademark for which a royalty is paid will be considered by China customs to be related to the imported merchandise.

Finally, with respect to copyright material, which includes imported goods that contain words¹, music, pictures, images and other content, and the royalty and license fees are paid but and re-sell the imports goods as imported or after some minor processing, then Chin

Processing, then China Customs will consider the copyright royalty to be related to the imported merchandise.

There have been several complex interpretations of what types of payments are made as a condition of the sale for export. We have even seen many complex interpretations as to what is a “sale for export” within the meaning of the customs valuation principals. We will not delve deeply into these topics here. Other than to discuss them in connection with drafting

Now that we have seen some of the major considerations for the possible dutiability and taxability of import transactions subject to royalty and license fees, we can more clearly see the common problems that may arise with most typical intra-company royalty agreements. These intra-company agreements are often quite broadly worded and non-specific, which could result in the customs and tax authorities taking a conclusion contrary to the company’s own position on dutiability and leaving the company without adequate defences.

For example, many intra-company royalty and license agreements define the scope of their grant of rights in a way similar to the below:

- *Licensor hereby grants to Licensee a non-exclusive and non-transferable license to **Distribute, Assemble, Manufacture** and use in the Territory the **Licensed Products** and parts therefore covered by Licensor’s **Patents, Know-how** and **Other IP** as further defined in Appendix A and to sell the Licensed Products and Accessory Products both inside and outside the Territory.*
Or
- *Licensor hereby grants Licensee a non-exclusive and non-transferable right to use in the Territory all Licensed Rights on goods, stationery, signage, and for the purposes of conducting business in the Territory.*

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¹ The language of Art. 13 also includes “software” but in this regard we note the applicability of the Software Valuation Agreement in China, which provides for the unique treatment of imported software. Imported software pursuant to this multilateral agreement is to be declared at the value for the physical medium on which the copyrighted software is imported, notwithstanding the royalty consideration.

License fee:

- *In consideration of the license to use Licensed Rights as provided in this Contract, the Licensee shall pay to the Licensor License Fees of 8% of Net Sales.*
- *License Fees shall be calculated in respect of each calendar quarter and shall be paid by the Licensee to the Licensor within thirty (30) days of the end of each such period.*

As is clear from the above example, even where certain trademarks or patents have no relation to any imported merchandise, this particular royalty and license agreement would provide no defence to the company as it makes no distinction and offers no specificity. The authorities will simply construe the expansive grant of rights to all be related to imported merchandise. In addition, as you can see in how the fees are provided for under this sample language, the royalty here is calculated on the basis of net sales of the merchandise and is reportable and payable over a short time period—i.e., contemporaneous with the import transactions. Thus, the company would not likely have any defence in this instance that the royalty is indeed paid as a condition of the sale for export.

IMPLEMENTING THE REGULATORY CONSIDERATIONS IN YOUR DRAFTING

When drafting royalty and license agreements amongst affiliated entities, it is a best practice to more precisely define the licensed rights granted under the agreement. Try to avoid using a broad definition, e.g. *“Licensed Rights” means all trademarks, patents, copyrights, know-how and confidential information owned by the Licensor*, but to define each and every type of licensed right. E.g. *“Copyright” means all copyrights owned by the Licensor as set out in Appendix 1*, it will allow for a detailed analysis of whether royalties relate to imported goods and may enable the company to provide a response to enquiries as to which portions—if any—should properly be subject to import duty and taxes.

In addition, if it is possible, specify different licensable rights granted under the agreement, perhaps even different license fees or royalty rates for each specific type of right being granted, where appropriate. Where royalties and license fees have no relation to the imported merchandise but are subsumed with those that do, drafting separate agreements to deal with trade related payments and those that deal with non-trade related payments will also be a best practice.

With respect to specific rights and varying rates or even separate agreements, we should also bear in mind that our intra-company payments for these licensed rights as well as any other intra-company transaction should satisfy the “arm’s length” test. As such, the royalty fee may need to be supportable under the company’s transfer pricing policy and applicable

transfer pricing studies. If this is the case, the more specific we get and the more varied we get with licensed rights and applicable rates, the more difficult it may be to support the

payments of royalties for such specific rights under transfer pricing principals. Thus, coordination with your internal and external tax advisors is prudent.

Clarifying through the drafting of the agreements that the royalties are not a condition of the sale of the imported merchandise is also important. In doing so, separating the timing of the import transactions and the payment of the royalties may be helpful. For example, a quarterly retrospective payment of license fees rather than a more contemporaneous payment of license fees will go a long way in demonstrating that the payment of the royalty or license fee is not a condition of the sale. Further to this point, we note that many standard form agreements provide that the licensee cannot purchase the merchandise unless all license fees have been paid. The World Customs Organisation has issued an advisory opinion on this point that such provisions would be viewed by member customs authorities as prima facie evidence that the royalty and license fee is a condition of the sale for import.

Finally, we note that intra-company agreements are not simply for the file but need to reflect reality. We have seen situations where provisions of the royalty and license agreement provide the company with solid defences to the duty and tax positions taken by the authorities. In some circumstances the weight placed upon these otherwise helpful agreements was weakened or even nullified because the agreements made provision for sales reports, or procedures that were not being done or followed. As a result the authorities took the position that the agreement was not in fact governing the dealings between the parties with respect to the royalties in question and therefore irrelevant to the duty and tax analysis at issue.

It should also be obvious that, if the royalty is indeed related to the imported merchandise and it is payable as a condition for the sale for import, then those are the facts and planning efforts and careful drafting will not impact the company's position. However, where the company does indeed have a supportable position with respect to one or both of the prongs of the dutiability test then these best practices may be useful.

BEST PRACTICES IN DRAFTING INTRA-COMPANY ROYALTY AND LICENSE AGREEMENTS

- Where the bundle of rights being granted may not all relate to the physical merchandise, specify the different types of rights being granted within the agreement;
- Where different rights are being granted, explore whether different royalty rates may be applicable to various types of rights and if so, whether those rates for those specific rights can be supported under the company's transfer pricing practices;
- Where certain rights are unrelated to merchandise transactions, consider drafting an entirely separate agreement for such licenses;

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- In providing for the calculation of royalty fees and the mechanism for their payment, be as clear as possible where the payments are not actually a condition for the sale for import, by separating out the payments in time and calculating their quantum on a basis other than import merchandise value; and
- Ensure that the agreement does not provide for any procedure, communication, report, or other condition that is not actually being followed. If so, update your intra-company agreements to ensure they reflect current commercial realities and practices.



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