Select U.S. International Tax Considerations in IP Related Transactions

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Key U.S. Tax considerations
Agenda

☐ Introduction

☐ General & Structuring Issues
- Source of payments from IP
- Royalties paid to or from a foreign person
- Cross licensing
- Valuation, useful life and the use of economists

☐ Transfers of IP – General Considerations
- Sale v. License & the all substantial rights standard
- Section 482 transfer pricing, the arm’s length standard and the definition of “Intangible Property”
- Outbound Transfers of IP under § 367(d)

☐ Developing/Acquiring IP
- General
- Cost Sharing Agreements
Key U.S. Tax considerations

Introduction

- Use of IP in Multi-National Enterprises and the importance of tax planning.

The purposes of this presentation are:

- To provide background information and knowledge relating to the issues discussed herein
- To familiarize with relevant terms and concepts
- To equip with basic tools to allow issue spotting
Structuring Issues:
Source of payments from IP

- Royalties for the use of IP are sourced under “place of use” rule.
- Payments made as a consideration for the “sale or exchange” of IP are sourced under general “residence of the seller” rule.
- As a result, royalties paid from the U.S. for the use of IP in the U.S. as well as consideration paid as a sale or exchange of IP by a U.S. seller, is U.S. source income.
- A quick word about the U.S. tax system.
Structuring Issues: Royalties paid to a foreign licensor

- U.S. source royalty paid to a foreign licensor from a U.S. licensee, is generally subject to U.S. withholding tax of 30%.

- The Withholding rate could be reduced or eliminated if the licensor is a resident of a country with which the U.S. has an income tax treaty.

  - To qualify for treaty benefits, foreign person generally need to (i) be resident of treaty jurisdiction, (ii) satisfy a limitation on benefits (LOB) provision, if any, and (iii) qualify for treaty benefits under § 894, if applicable.
Structuring Issues:
Royalties paid to a foreign licensor

- **Luxembourg**: 0% withholding; low corporate tax rate on royalties; LOB provision less restrictive than newer treaties.
- **Netherlands**: Same.
- **Ireland**: Same.
- **Switzerland**: 0% withholding; low corporate tax rate for royalties; LOB provision requires Swiss company generally to be owned by Swiss residents.
- **Belgium**: Same as Switzerland, but presumably the chocolate is better (but not the ski).

- Beware of conduit financing arrangements.  
  (see next slide)
Structuring Issues:
Royalties paid to a foreign licensor

- Beware of conduit financing arrangements – Example:
  - Conduit financing regulations would deny treaty benefits.

Diagram:
- Cayman Company
- Dutch Company
- US Company
  - Royalty payments from US Company to Dutch Company
  - License from Dutch Company to US Company
  - Sub license from US Company to Royalty Company
  - Income from use of IP in the U.S.
Structuring Issues:
Royalties received from a foreign licensee

☐ If the royalty is being received from a foreign licensee by a U.S. licensor, foreign withholding tax considerations must be taken into account.

☐ Most income tax treaties lower the withholding rate, and some exempt royalties from withholding altogether.

☐ U.S. taxpayer that is required to bear the burden of any foreign withholding tax should attempt to obtain a foreign tax credit in the United States for such amounts.
Structuring Issues: Cross licensing

- Instead of paying license fees for patent rights, a licensee may convey a license under its own patents to the licensor in a cross-license arrangement.

- The potential income likely to be received by any one party in a cross-licensing arrangement is offset by the business expenditure for license fees that such party would pay to the other party, provided a number of factors are favorably satisfied by each party to the transaction.

- Beware of IRS scrutiny.
Valuation, Useful life and the Use of Economists

- Valuation of IP assets.
  - May be required for transfer pricing purposes.

- Useful life and declining royalties.

- Manage your economists (and lawyers).
Transfers of IP – General considerations: Sale v. License & all substantial rights standard

- Common methods to transfer IP, include:
  - a lump-sum transfer;
  - a transfer for payments contingent on the IP's productivity or use; and a
  - fixed payments over a period of time

- The proper characterization of an IP transaction for tax purposes (as bona fide licenses or as a sale or exchange) is critical.

- It is crucial for parties to a license agreement of any significant size to have a tax counsel review and comment upon the proposed arrangement at the early stages.
Transfers of IP – General considerations: Sale v. License & all substantial rights standard

☐ For a transfer of IP (especially a patent or know-how) to qualify as a “sale or exchange,” “all substantial rights” to the IP must be transferred to the buyer.

- Meaning, all rights that are of value at the time of the transfer

☐ The fact that a contract is called a “license,” or that the payments are called “royalties,” is not important in determining whether the transfer is a sale.

☐ The issue is what rights are “substantial.”
Transfers of IP – General considerations: Sale v. License & all substantial rights standard

- Generally, the following factors are considered indicative of substantial rights:
  - exclusivity;
  - duration for the remaining useful life;
  - right to prevent unauthorized disclosure;
  - restrictions on disclosure;
  - right to use the property produced by the know-how; and
  - sublicense rights.

- Also consider:
  - title ownership;
  - field of use limitations;
  - geographical limitations;
  - restrictions on assignment and on quality standards.
Transfers of IP – General considerations: Sale v. License & all substantial rights standard

□ The following rights have generally been determined not to be “substantial” rights:

- certain rights to reacquire following events over which the transferor has no control;
- termination on default; termination upon insolvency or bankruptcy;
- payments contingent upon use of the know-how;
- indemnification for infringements;
- termination for failure to make minimum sales; and
- transferee’s rights to terminate.

□ Due consideration should be given to foreign country characterization. Countries such as Japan, Korea and Israel have become quite sensitive to these issues.
Transfers of IP – General considerations: § 482 transfer pricing & *arm’s length* standard

- Section 482 sets forth certain requirements on transfers of intangible property between affiliated entities.

- It requires, that any consideration paid by the non-US affiliate to the U.S. company for the transfer or license of the IP be for *an arm’s-length* amount that is *commensurate with the income* attributable to the intangible property.

- What is the concern?
Transfers of IP – General considerations:
§ 482 transfer pricing & arm’s length standard

- **The Concern**: absent transfer pricing rules, taxpayers could reduce effective tax rate by placing profits in lower tax jurisdictions.

- Transfer pricing is the pricing (and laws governing such pricing) of transactions between related parties.

- Not just relevant to tax havens. Relevant for transactions between two related parties in two developed, high-tax jurisdictions.
**Transfers of IP – General considerations: Effect of Transfer Pricing**

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<th>AS reported by the group</th>
<th>U.S.</th>
<th>Ireland</th>
<th>Total</th>
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<td>60</td>
<td>100</td>
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<tr>
<td>Tax Rate</td>
<td>40%</td>
<td>12.5%</td>
<td>23.5% (Global ETR)</td>
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<th>Ireland</th>
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<td>100</td>
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<tr>
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<th>Post-IRS adjustment</th>
<th>U.S.</th>
<th>Ireland</th>
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• 20 of income reported as Ireland income is allocate from Ireland to the U.S.
Transfers of IP – General considerations: 
The arm’s length Standard

- Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. Treas. Reg. § 1.482-1(a)(1).

- The arm’s length standard is the foundation of both U.S. and international transfer pricing law.

- Ad-hoc approach (vs. “pre-established” method such as formulary apportionment).

- Requires a “functional analysis.”

- Separate entity treatment.
Transfers of IP – General considerations: The arm’s length Standard

- Worldwide Application of the Arm’s Length Standard:

>Over 50 bilateral U.S. income tax treaties incorporate the arm’s length standard. Article 9 of the U.S. Model Treaty provides that when commonly controlled entities make or impose conditions that “differ from those that would be made between independent enterprises,” the Contracting States can make appropriate adjustments.

>Treasury’s Commentary on Article 9 further binds U.S. treaty law to § 482 and the arm’s length standard. It states that Article 9 incorporates the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly § 482.

>The OECD’s Model Treaty contains a virtually identical Article 9 as the U.S. Model Treaty, and its commentary incorporates the arm’s length standard, stating, “This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises... on other than arm’s length terms.”
Transfers of IP – General considerations:
The arm’s length Standard

“Commensurate with income” (CWI) standard enacted in 1986, applicable specifically to transfers of IP.

Section 482 (second sentence): “In the case of any transfer (or license) of intangible property..., the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.”
Transfers of IP – General considerations: The arm’s length Standard

- **Periodic adjustments.** The CWI standard allows the IRS to impose periodic adjustments to the arm’s length price for arrangements that cover more than one year. Treas. Reg. § 1.482-4(f)(2).

- Exceptions (generally apply if actual profits earned fall between 80-120% of expected profits)
  - Internal CUTs
  - External CUTs
  - Other method used
  - Extraordinary Events
  - Five-year safe harbor
Transfers of IP – General considerations:

Why are the transfer pricing rules and principles so important in IP related transactions?
Definition of “Intangible Property”

- Generally, any asset that derives its value from its intellectual content, not its physical attributes.
- Under § 482 → § 936(h)(3)(B).
- Under § 936(h)(3)(B) IP means any:
  - patent, invention, formula, process, design, pattern, or know-how;
  - copyright, literary, musical, or artistic composition;
  - trademark, trade name, or brand name;
  - franchise, license, or contract;
  - method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
  - **any similar item,**
  - **which has substantial value independent of the services of any individual.**
Definition of “Intangible Property”

The OECD has a good understanding of this interrelationship, commenting that the creation of intangibles that do not exist in transactions between unrelated parties undermines the arm’s length standard:

- If too broad a definition [of the term intangible] is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.
Definition of “Intangible Property”

- The § 482 regulations define an intangible by reference to a list of specifically enumerated items (and other similar items) that have substantial value independent of the services of any individual. Treas. Reg. § 1.482-4(b).

- These items are typically the types of intangibles that are the subject of arm’s length license agreements.

- However, in spite of its own regulations, the Service has been all too ready to invent, and then require compensation for, intangibles that are not licensed between unrelated parties.
Definition of “Intangible Property”

- Goodwill & Workforce in Place.
  - From a tax valuation perspective, goodwill and going concern value is the residual value of a company that remains after all of the individual tangible and intellectual property is evaluated and subtracted from the total value of the company.
  - One area of current dispute is whether workforce in place, or access to a group of employees, is an intangible for which compensation is owing.
  - Have you ever seen a stand-alone license of “workforce in place” between unrelated parties?

- Beware of changing legislation.
Transfers of IP – General considerations: Transfer Pricing Methods for Intangibles

<table>
<thead>
<tr>
<th>Methods</th>
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<tbody>
<tr>
<td>Comparable Uncontrolled Transaction Method</td>
<td>Evaluates whether the amount charged is arm’s length by reference to the amount charged in a comparable uncontrolled transaction. § 1.482-4(c).</td>
</tr>
<tr>
<td>(“CUT”)</td>
<td></td>
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<tr>
<td>Comparable Profits Method</td>
<td>Evaluates whether the amount charged is arm’s length, based on profit level indicators derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. § 1.482-5.</td>
</tr>
<tr>
<td>Profit Split Method</td>
<td>Evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. § 1.482-6.</td>
</tr>
<tr>
<td>Unspecified Methods</td>
<td>Permitted if the taxpayer can show that the method gives the most reliable measure of an arm’s length result. § 1.482-4(d).</td>
</tr>
</tbody>
</table>
If a US entity transfers IP to a non-US corporation pursuant to certain transactions that do not trigger immediate taxation from a US federal income tax perspective, then § 367(d) would apply to treat the transfer of the IP as a sale from the US entity to its non-US affiliate for payments which are contingent upon the productivity, use or disposition of the intangible property.

- The US entity is treated as receiving payments annually over the useful life of the IP and the amount of those payments must be commensurate with the income attributable to the intangible property.
Developing/Acquiring IP

General

□ Developing IP.

– The ability to deduct the costs of developing IP to be licensed is a significant tax issue.

□ Acquiring IP.

– Generally, the cost of purchasing IP is not currently deductible but is instead “capitalized” in the cost of the IP and recovered through ratable amortization over a period of years.

– A licensee acquiring rights to use IP usually wants the fastest cost recovery possible. If a transaction is considered a license for tax purposes, the licensee should be able to claim royalty deductions in accordance with its method of accounting (cash or more likely, accrual) for such expenses.
Developing/Acquiring IP
Cost Sharing Agreements

For IP that have not yet been developed, a US company may wish to enter into a cost-sharing arrangement with its non-US affiliate.

Pursuant to the cost-sharing arrangement, a US company and its non-US affiliate would share the costs of developing certain IP and would receive certain rights to the benefits arising with respect to any IP developed pursuant to the cost-sharing arrangement.
Developing/Acquiring IP
Cost Sharing Agreements

US company and its non-US affiliate would be required to share future R&D costs and expenses relating to the IP being developed.

-The U.S. Treasury regulations relating to cost-sharing arrangements are extremely complicated and require the non-US affiliate to compensate the US company for the platform value of the property contributed by the US company to the cost-sharing arrangement and further require that value be adjusted to the extent future facts show that the US company did not receive sufficient compensation.
Questions?

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