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Patent Asset Transfers:
Tax Implications of Patent Sale, License, Cost Share Arrangement, Contribution

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Patent Asset Transfers

Tax Implications of Patent Sale, License, Cost Share Arrangement, Contribution

April 4, 2019

FACULTY:

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1. Ownership - Legal vs. Tax

When Do Tax Considerations Impact Patents?

- Creation and Acquisition of Patents
- Valuation of Patents
- Licensing or Sale of Patents
- Mergers, Acquisitions, Reorganizations involving Patents
- Intercompany/Affiliate Transactions involving Patents
- Management of Patents and Patent Portfolios
- Litigation over Patents

Tax Ownership vs. Legal Ownership

- Legal ownership generally derives from legal title: the person holding the legal title to the patent, *i.e.,* the registered owner, is the legal owner of the patent
- Tax ownership is based on an economic concept, and <u>not</u> on legal title
- Tax ownership rests with the person possessing the "*benefits and burdens*" of ownership
- The "*benefits and burdens*" are a bundle of economic rights and risks – the person holding all or most of that bundle is the tax owner
- Historically, courts have cited multiple factors as indicative of tax ownership, but key factors are agreed to be:
  - Rights to profits from operations, sale, or license, and
  - Bearing the risk of loss or damage
- As a result, if all the economic rights to a patent have been transferred to Party B, but Party A still holds the legal title, then Party B is the tax owner and Party A is the legal owner. Party B will bear the tax consequences of "owning" that patent.

See generally on tax ownership Grodt & McKay Realty, Inc. v. Comm'r, 77 TC 1221 (1981)

Tax Ownership Is Divisible

- Tax ownership of a patent can be divided in various ways

- Division is often based on geography
  - For example, the U.S. economic rights and risks may be held by one party, and the foreign economic rights and risks may be held by another party

    See generally on division of tax ownership Waterman v. Mackenzie, 138 U.S. 252 (1891)

  - U.S. economic rights relates to the right to exploit the patent in the United States i.e., to license or sell into the United States
  - Foreign economic rights relates to the right to exploit the patent outside the United States

Tax Ownership: Location Considerations

- Non-tax IP professionals often seek U.S. legal ownership of a patent to benefit from U.S. legal protections and enforcement avenues for the patent, which generally are tied to legal ownership and not tax ownership

- By contrast, tax advisors historically have tended to seek non-U.S. tax ownership of a patent's foreign rights to benefit from foreign patent box tax regimes and other tax incentives meant to achieve tax efficiency
  - Notably, U.S. Tax Reform has changed this equation

Tax Ownership: Legal Enforcement Considerations

- Tax/corporate structuring could have a negative impact on patent legal enforcement and damages
  - Example:
    - ✓ Patent holder enters into non-exclusive license with affiliate
      - Tax considerations likely resulted in a license and not a sale
    - ✓ Patent holder sues a third party for patent infringement
    - ✓ Court finds patent holder is not entitled to lost profits because it is not selling the items covered by the patent, its affiliate is
    - ✓ Court finds that the affiliate also is not entitled to lost profits because it has a non-exclusive license
    - ✓ Damages are limited to reasonable royalties and not lost profits

See Poly America v. GSE Lining Technology, 383 F.3d 1303, 1311 (Fed. Cir. 2004)

2. Patent Boxes, IP Holding Companies, and FDII

Tax Planning Tools

- ❑ What is a Patent Box?

- ❑ Shifting Landscapes - Tax Rates Drive IP Tax Planning
  - ❑ U.S. TAX REFORM
  - ❑ BEPS

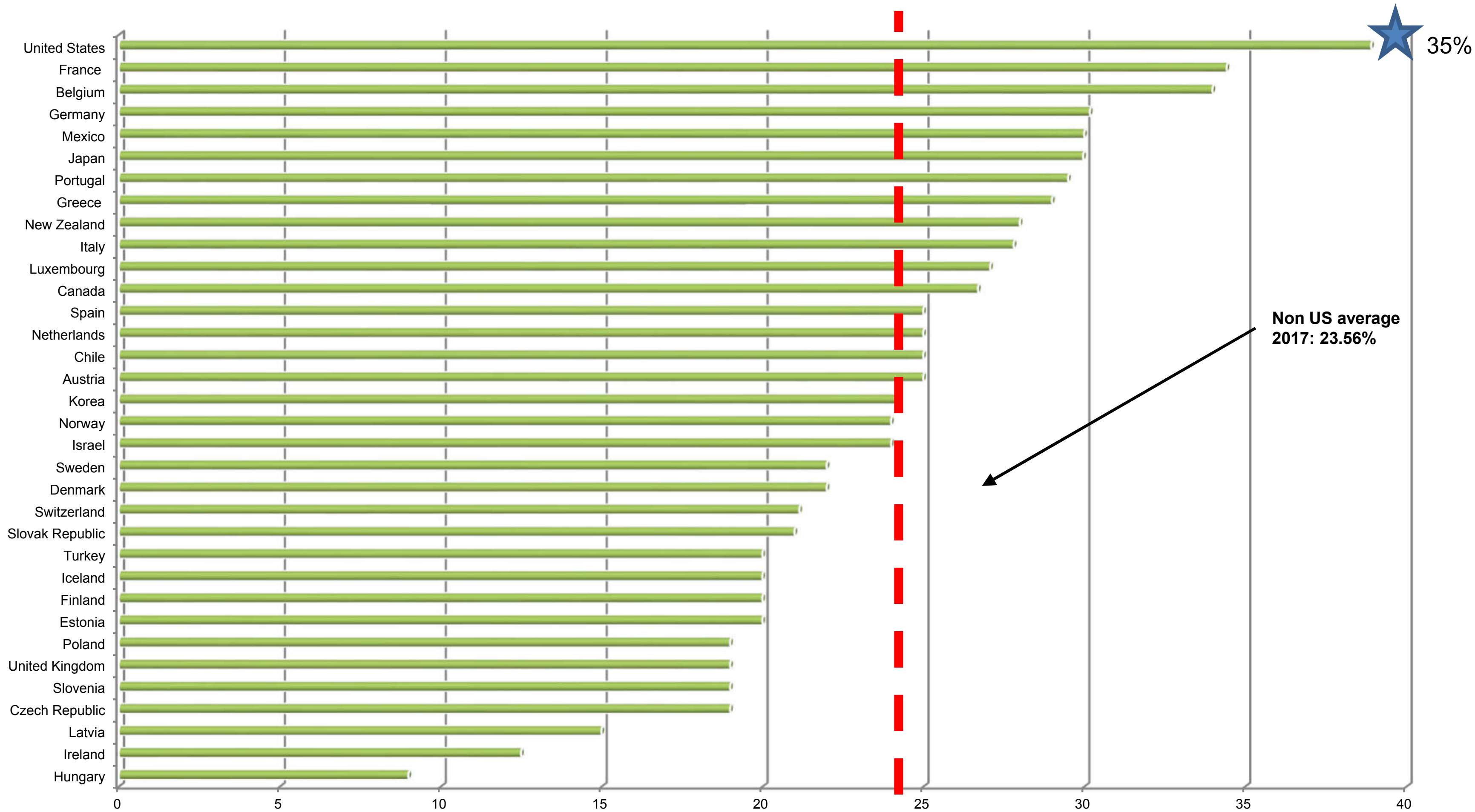
- ❑ What is Foreign Derived Intangible Income (FDII)??

What is a Patent Box?

- A "patent box" is a tax incentive program for income generated from patents and other qualifying IP assets.
  - A patent box provides tax relief once an invention has become profitable, while R&D tax credits (the "usual" IP related tax incentive), provide tax benefits only at the front end of the innovation life cycle.
- Many European countries have established patent box regimes including, *inter alia*, the U.K., Ireland, Luxembourg, France, the Netherlands, Italy, Spain, Belgium, Switzerland, Turkey.
- Patent boxes provide a reduced rate, generally in the 5% to 15% range, either via:
  - a directly reduced tax rate on patent box income (such as France, Netherlands, Turkey, and the UK), or
  - a deduction leading indirectly to a reduced tax rate (such as Belgium, Italy, Spain, and Switzerland).
- Until 2018, the high U.S. corporate tax rate, and absence of any U.S. patent box regime, drove U.S. companies toward patent box countries as part of their global tax planning

Tax Rates Drives IP/Tax Planning

Corporate tax rates in 34 OECD countries, 2017



IP Holding Companies

- Why create an IP HoldCo? USCo transfers the foreign rights to the patent to a HoldCo in a country with a patent box regime or a low corporate tax rate (e.g., Ireland at 12.5%)

  - USCo transfers the patent to an IP HoldCo (contribution/sale/license/cost-share)
  - IP HoldCo owns the patent for tax purposes, earning royalty/fee income taxed at the special lower IP rates in the HoldCo country
  - Transfer pricing requirements apply arm's length rules to setting royalties
  - USCo generally can deduct the royalties/fees as costs/expenses of its business
    - Large companies now subject to U.S. tax reform's BEAT regime (a minimum tax)
  - Profits distributed to USCo by a subsidiary IP HoldCo as dividends may be subject to withholding tax
    - Tax treaty eligibility to access reduction or exemption
  - No shell companies: substance is <u>critical</u> for any IP HoldCo to qualify for patent box rates

IP Holding Companies: Substance

- Sufficient business substance needed to maintain and exploit IP in the HoldCo country to benefit from any patent box regime
  - Transfer of IP to an IP HoldCo cannot be a paper transaction only
  - Corporate formalities must be observed
  - A threshold level of commercial substance required including e.g., employees, business functions, decision-making, etc.)

- BEPS has formalized substance requirements
  - Substance is evaluated for eligibility for patent box regimes, for tax rulings, etc.
    - New rules for allocating intangible-related income to “DEMPE” functions — development, enhancement, maintenance, protection and exploitation of intangible assets.
  - Withholding tax reduced rates and treaty benefits also depend on local substance
  - U..S. and foreign tax authorities increasingly focused on tax avoidance abuse

IP Holding Companies: BEPS

- BASE EROSION AND PROFIT SHIFTING
  - The practice of a multinational operating in at least two different countries taking profits and moving them to where they are taxed at a lower rate, and taking expenses and moving them to where income is taxed at a higher rate
  - Essentially exploiting differences in multiple different tax regimes

- The OECD (Organization for Economic Co-operation and Development) published a report *Addressing Base Erosion and Profit Shifting* in February 2013, followed by an Action Plan on BEPS identifying 15 specific actions countries should take to combat BEPS activities, many focused on IP
  - IP assets lend themselves easily to BEPS transactions for multinationals operating across many different tax regimes because transferring IP is a matter of legal paperwork

- BEPS Final Report approved October 2015

- Participating countries and have been actively implementing IP action items primarily via local legislation, with the U.S. on a parallel course – closing loopholes (e.g., Double Irish, Dutch Sandwich, etc.)

BEPS

"BEPS relates to a loss of substantial corporate tax revenue because of planning aimed at eroding the taxable base and/or shifting profits to locations where they are subject to a more favourable tax treatment."

-OECD report "Addressing Base Erosion and Profit Shifting" February 2013

IP Holding Companies: Non-Tax Concerns

- Tax Driven – but be mindful of non-tax legal concerns around Validity, Protection, and Enforcement of IP ownership
  - Is IP HoldCo country a signatory to key international IP treaties? Example: an IP HoldCo country may offer great IP tax regime, but not the trademark protection of the Madrid Protocol
  - Is the transfer, especially sublicense, of IP valid and effective for all legal and tax purposes?
    - ✓ Tricky where multiple transfers are made in the overall structuring
  - Does the HoldCo country recognize the validity of the IP?
  - Is goodwill assigned with a transferred trademark?
    - ✓ Example: under U.S. law transfers of a trademark without goodwill are invalid
  - Are creator's rights accounted for in the structuring?
    - ✓ France copyright law gives creators the right to be paid a percentage of gross revenues of films
  - Does IP HoldCo have the right to defend and enforce its IP and is the legal framework beneficial?

IP Holding Companies: Summary

Key Tax Considerations

- Effective Tax Rate
- Substance
- Withholding Tax
- Tax Treaty Network
- Exit Strategy

Key IP/Business Considerations

- Business Environment
- Legal Protection/Enforcement
- Registration of IP
- IP Treaty Network
- Operating Costs

Popular Jurisdictions

- Ireland
- Netherlands
- Luxembourg
- United Kingdom

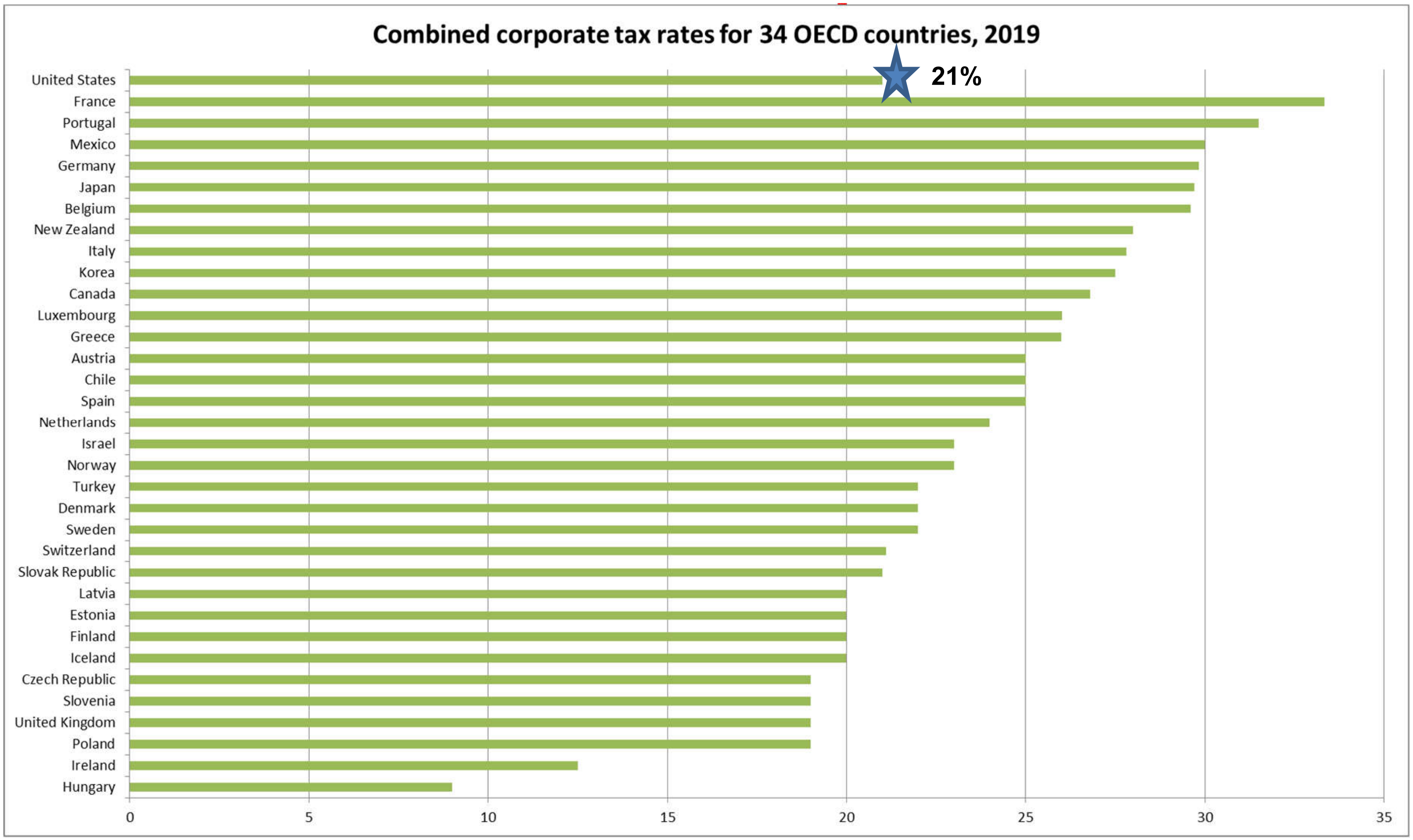
2018 – U.S. Tax Reform Tax Rate Change

Corporate Tax Rate Drops 14% in 2018

Permanent Reduction from 35% to 21%

When Tax Rates Change, Tax Planning Changes

Corporate tax rates in 34 OECD countries, 2019



U.S. Tax Reform: The New FDII Deduction

- The FDII regime is a new U.S. tax deduction for U.S. corporations tied to "Foreign Derived Intangible Income"

- What is FDII? Gross income earned by a USCo from the sale, license, or lease of "property", or the provision of services, to or for persons, and use, outside of the United States
  - IP sold or licensed to a foreign related party must be evaluated for FDII qualification, dependent on the property ultimately being licensed/ sold to an unrelated foreign person

- Royalties and fees from licensing patents to foreign users are in scope of FDII

- The FDII regime reduces the tax rate applied to royalties earned from exploiting patents outside the United States to **13.125%** (after 2025, the rate rises to **16.4%).**
  - No Foreign IP HoldCo – to benefit from FDII regime, the USCo must retain ownership of the patent and its income

U.S. Tax Reform: Is FDII a Patent Box?

- The FDII regime is designed to keep patents in the United States, functioning like a patent box
  - U.S. tech company patents new device – can sell or license overseas at 13.125% under FDII
- FDII aims to eliminate incentive to locate patents overseas when selling into foreign markets
- However, FDII is unlike other patent box regimes because it includes no explicit IP requirements – no nexus or substance thresholds, and there is no explicit tie to patents or IP assets generally
- Does the FDII Regime eliminate incentive for a USCo to use a foreign IP HoldCo in the future?

U.S. Tax Reform: Is FDII Permanent?

- Legitimate counter measures to Base Erosion or Unfair Protectionism?
  - Is FDII an unfair export subsidy that violates World Trade Organization rules? (Incentive to use IP in the United States in order to create an export…)
  - Will FDII be subject to legal challenges that impact its reliability in the long term?

- Contradicts BEPS principles?
  - Does FDII regime align with BEPS Action 5 recommendations for IP incentive regimes regarding nexus, substantial activity, and limiting benefit to patent/copyright income?

- Eventual political reversal?

- Overly complex as a planning tool? FDII involves complex calculations and many data inputs to determine ultimate effective benefit to a U.S. company

- Is FDII rate low enough? 13.125% is still higher the Ireland's corporate tax rate of 12.5% and, rising to 16.4% in just 5 years, will still be higher than patent box regimes

- Will there be a race to the bottom? Retaliatory measures by EU countries and to maintain ever lower IP tax rates….

U.S. Tax Reform: Other Developments

- The U.S. tax rules have long discouraged off-shoring of IP assets by way of a Super Royalty mechanism, among other provisions.

- Under the Super Royalty provision, the contribution by a U.S. person of an IP asset, including a patent, to a foreign company is treated as a taxable sale in exchange for payments that are contingent on the productivity, use, or disposition of the IP asset, i.e., a sale in exchange for a stream of payments.
  - The deemed stream of payments is akin to a royalty and referred to as a Super Royalty

- The Super Royalty is taxable as deemed ordinary income for the life of the IP asset

- Before U.S. tax reform, certain IP related value could be transferred outside the scope of the outbound penalty provisions; however, U.S. tax reform expanded the scope to include goodwill, going concern value, workforce in place, etc. as “intangibles” subject to the outbound penalty provisions…

BREXIT IMPACT

- Evaluate intercompany royalty payments flows to/from U.K. companies and EU companies for impact of losing reliance on EU Directives for withholding tax exemptions
  - EU Parent-Subsidiary Directive
  - EU Interest and Royalties Directive

- Evaluate eligibility for tax treaty benefits to mitigate loss of EU Directives
  - United Kingdom maintains extensive bilateral tax treaty network, including with the United States
  - Tax treaty references to European Union may impact treaty access, e.g., limitation on benefits provisions that depend on EU ownership

- Evaluate re-structuring intercompany payment flows to allow for access to withholding tax exemptions under EU Directives or applicable tax treaties

- Evaluate restructuring groups to mitigate tax related impact of a U.K. group company falling out of the EU (eg., impact on existing group tax consolidations, other group companies' access to U.S. tax treaty benefits etc.)

3. Transfer Structures and Tax Implications

IP Migration

- Transfer of IP rights to IP HoldCo can be accomplished via:
  - Contribution
  - Sale
  - License
  - Cost Sharing Arrangement

Tax Characterization of Patent Transfer: Sale or License?

- Tax characterization is not based merely on form or intent of the parties, or the legal characterization, but on the economic substance of the transaction

- In short, for US tax purposes:
  - If tax ownership of the asset is transferred, the transfer is a sale
    - ✓ e.g., an exclusive perpetual license of all economic rights and risks is a sale for tax purposes
  - If tax ownership is retained, the transfer is a license
    - ✓ e.g., a non-exclusive or a term limited license generally won't be a sale for tax purposes (unless the term extends for the known useful life of the patent)

- The IRS can recharacterize a transfer to comport with the correct tax view

See e.g., Kavanagh v. Evans, 188 F.2d 234 (6th Cir. 1951); Tomerlin Trust v. Comm'r, 87 T.C. 876 (1986); Comm'r v. Wodehouse, 337 U.S. 369 (1949)

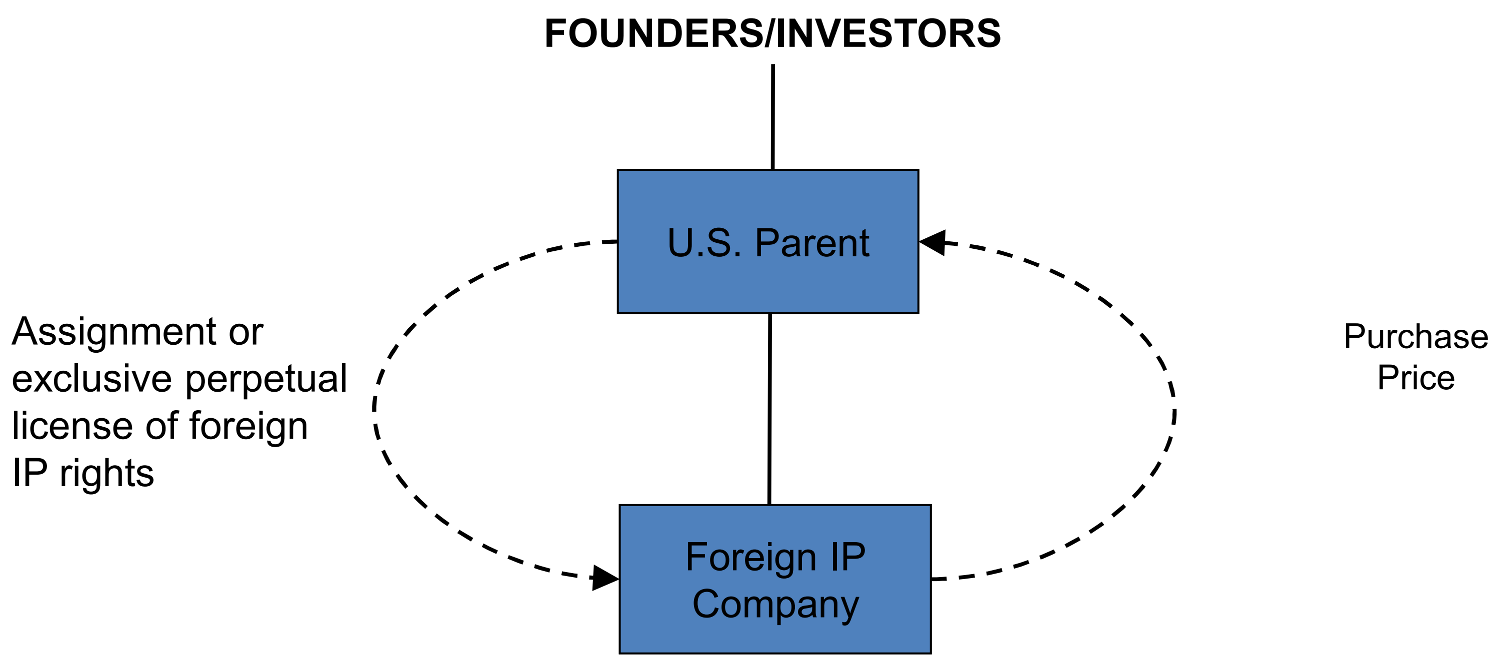
Sale vs. License

- Tax characterization of a transfer dictates the tax consequences:
  - Sale
    - Seller recognizes capital gain or loss, recovering tax basis (gain = proceeds - basis)
    - For individuals, long term cap gain if held over 1 year or certain section 1235 requirements are met
    - Purchaser amortizes cost over 15 years
    - U.S. source if seller is a U.S. taxpayer
    - No withholding tax issues for gain
    - FDII for U.S. corporations
    - NB: For owners and investors in self-created IP, U.S. tax reform has eliminated capital gains treatment.

	IP Sale	IP License
Type of Income	Gain Capital	Royalties Ordinary Income
Sourcing	Seller's Residence	Country of Use

  - License
    - Licensor taxed on royalty payments as ordinary income; No tax basis offset
    - Continued ability to amortize patent cost if applicable
    - Licensee usually can deduct royalty payments as a business expense
    - Royalties are foreign source if relate to rights used outside of the US
    - Withholding may apply on cross-border royalties unless tax treaty applies
    - FDII for U.S. corporations

Sale of Foreign Patent Rights



Sale of Foreign Patent Rights

- Sale of patent by USCo to Foreign IP HoldCo

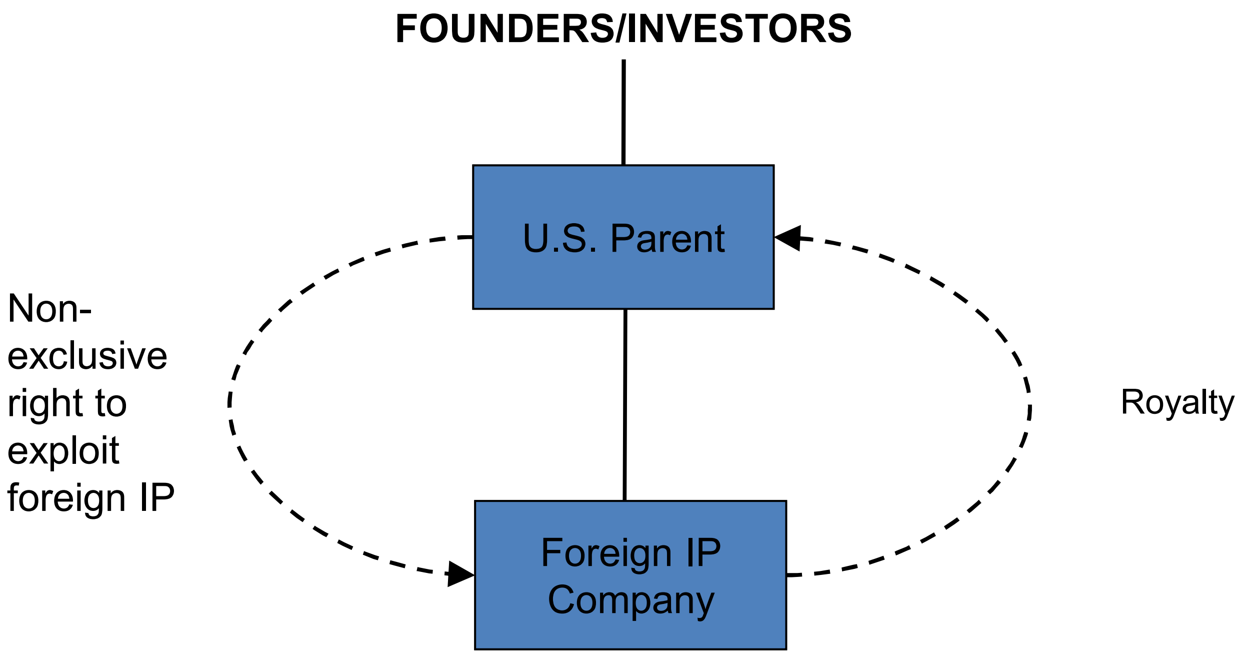
  - By assignment or exclusive perpetual license of foreign patent rights

  - IP HoldCo purchases the patent for its fair market value

  - Gain is taxable to USCo (FDII)
    - ✓ Downside of sale is that the upfront tax cost on gain can be prohibitive
      - generally need low valuation or losses available to offset gain

  - Transfer pricing rules must be applied to related party sales (arm's length pricing and documentation)

License of Foreign Patent Rights

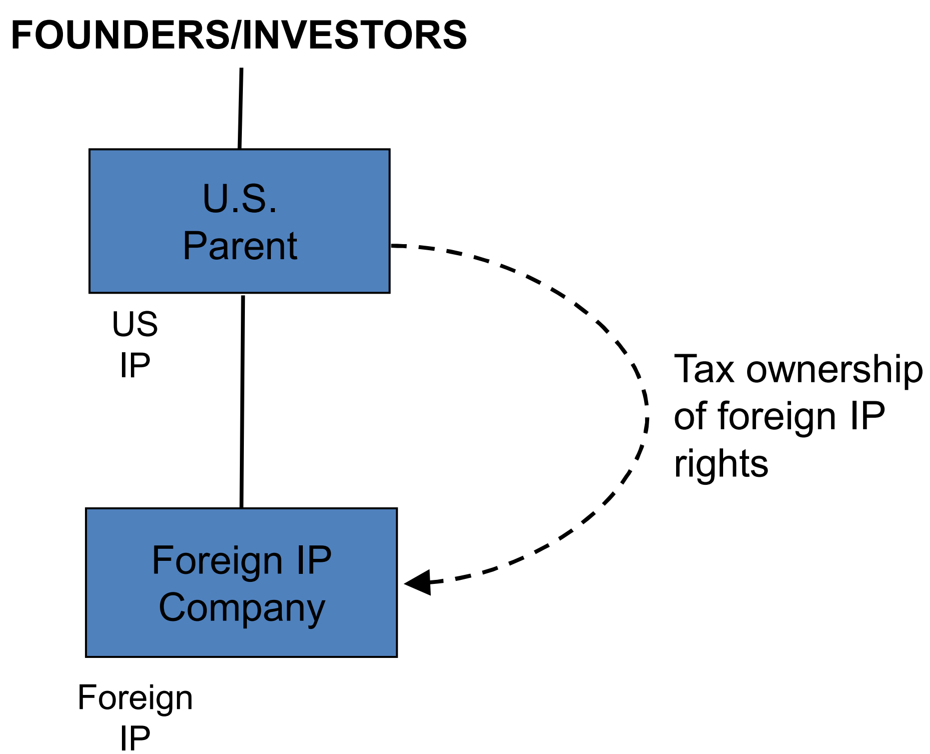


License of Foreign Patent Rights

- ❑ License by USCo to Foreign IP HoldCo

  - ➢ Effected by non-exclusive license to exploit foreign rights to the patent
  - ➢ IP HoldCo pays a royalty to USCo
  - ➢ Royalties are taxable to USCo (FDII)
  - ➢ Upside: tax efficient method for high value IP
  - ➢ Downside: royalty income is taxable and foreign withholding tax could apply to royalty payments unless a US double tax treaty is available
  - ➢ Be aware of transfer pricing rules applied to royalty pricing

Contribution of Foreign Patent Rights



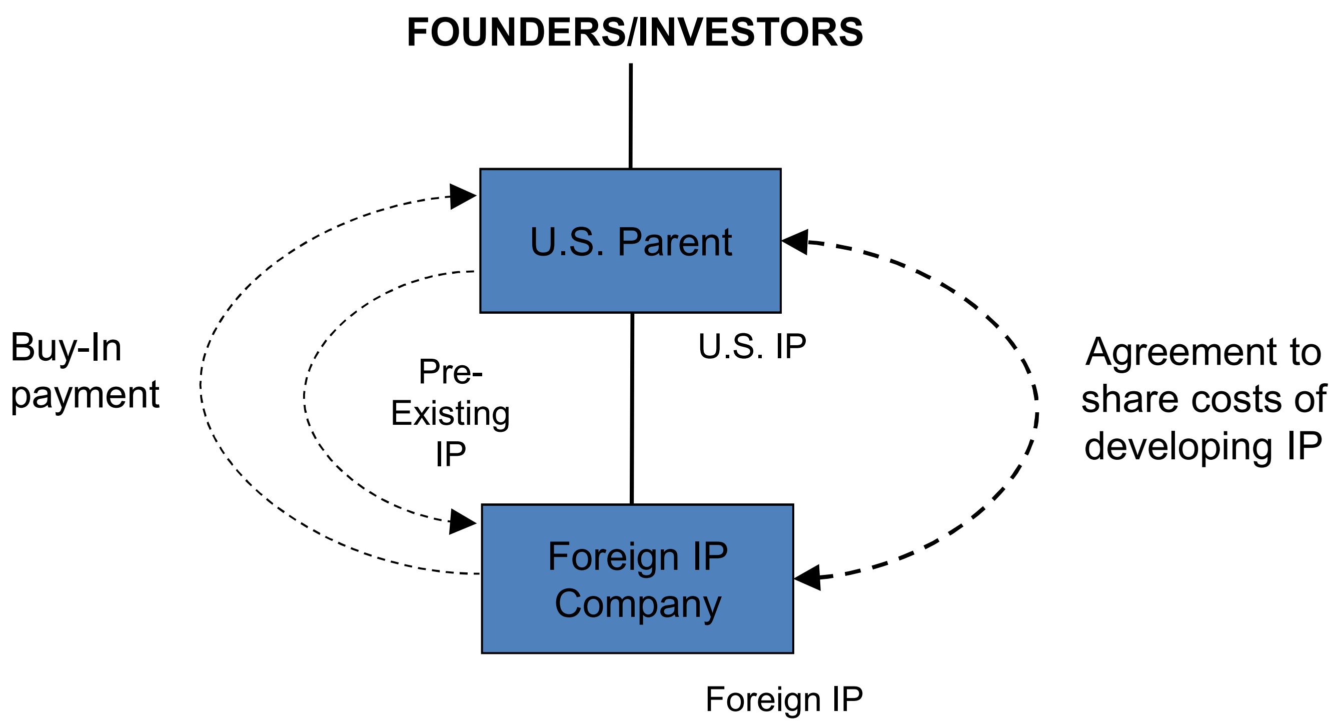
Contribution of Foreign Patent Rights

- Contribution of Patent by USCO parent to IP HoldCo subsidiary
  - Domestic to domestic – contribution of a patent by a USCo parent to a US subsidiary generally tax free under Code Section 351
  - Domestic to foreign – contribution of a patent by a USCo parent to a foreign subsidiary generally taxable under special outbound transfer rules that deem an ongoing and taxable royalty payment from the foreign subsidiary to the domestic parent, known as the SUPER ROYALTY PROVISION (Tax Code Section 367(d))

BEWARE

Never transfer IP from the United States to a foreign affiliate without first considering the US tax implications!!

IP Cost Sharing Arrangement



IP Cost Sharing Arrangement

- Effectively a joint venture where two parties agree to co-develop an IP asset using a cost sharing agreement (CSA) under US tax rules
- The parties share IP development costs in exchange for, and in proportion to, an ownership interest in any resulting future IP
  - Ownership may be divided e.g., based on geography
- The parties share profits/losses from the IP
- At least one party contributes/licenses/sells existing IP to the arrangement and the other party pays a "buy in" price to use that IP
- Issue – how to value contributed or exclusively licensed IP
- Benefit – each party owns co-developed IP
- Extensive ongoing documentation and planning required

See I.R.C. 482, Treas. Reg. 1.482-1, et. al.

3. Best Practices for Tax Efficiency

Coordinate Patent Legal and Tax Planning

- ❑ Goal – a patent that is both legally protected and held or transferred in a tax efficient manner

- ❑ Coordinating tax and patent professionals can avoid problems, including:
  - ➢ Compromising tax positions or inadvertently triggering taxable income
  - ➢ Undermining legal ownership, enforcement, and defense of patent rights

COLLABORATE WITH TAX ADVISORS
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