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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

October 14, 2021

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1. Ownership - Legal vs. Tax

Tax Impact of Patent “Ownership”

- 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 not 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
  - Tax ownership can be transferred by means of a license agreement
- 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 sought 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

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. International Tax Aspects of Patent Asset Transfers: Patent Boxes, IP Holding Companies, and Evolving U.S. Tax Rates and Rules

International Tax Planning Tools

- Patent Box
- Foreign IP Holding Companies
- Shifting U.S. Tax Landscape
  - Volatile U.S. Corporate Tax Rate
  - The FDII Regime
  - Super Royalty Provision

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 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).
- Patent box regimes generally require a threshold level of substantive activity be carried out in the country in order to qualify for the patent box rate benefits.
- The United States has never implemented a formal patent box regime and, before 2018, the U.S. also offered the highest corporate income tax rate at 35%. As a result, U.S. companies have looked to patent box countries as part of their global IP tax planning. Access to the patent box country is often accomplished via an IP Holding Company.

Foreign IP Holding Companies

- Why create a foreign IP HoldCo? To take advantage of the foreign country patent box regime.
  - USCo transfers the foreign rights to its patent to a subsidiary IP HoldCo established in a foreign country with an advantageous patent box regime or a low corporate tax rate (e.g., Ireland at 12.5%)
  - The transfer of the patent to the IP HoldCo is accomplished by contribution, sale, license, or a cost-share arrangement
  - IP HoldCo owns the patent for all 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 it pays to IP HoldCo as costs/expenses of its business
    - Large multinationals must also navigate the "Base Erosion Anti-Abuse Tax" introduced under the Tax Cuts and Jobs Act of 2017 ("**TCJA**") meant to prevent U.S. tax avoidance through profit shifting.
  - Profits distributed by IP HoldCo to USCo as dividends may be subject to foreign withholding tax
    - USCo should be evaluated for tax treaty eligibility in order to access reduction or exemption of withholding tax;
    - Foreign tax credits can otherwise apply to offset any double taxation of dividend

Foreign IP Holding Companies: Substance

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

- The OECD formalized these substance requirements in its anti "Base Erosion and Profit Shifting" (**BEPS**) initiatives
  - 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
  - *The increased substance requirements arguably led to a migration of activity/substance away from the United States and to the patent box countries….*

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 non-tax legal framework of the patent box country beneficial?

IP Holding Companies: Summary

Key Tax Considerations

- Effective Tax Rate
- Substance Requirements
- 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

IP Tax Planning - It's All About the Tax Rate

- U.S. Tax Rate volatility

2018 - Corporate Tax Rate Reduction

"Permanent" Reduction from 35% to 21%

2021 - Corporate Tax Rate Increase?

Proposed Increase from 21% to 26.5%

“Foreign Derived Intangible Income” (FDII) Regime

- The FDII regime is meant to compete with patent box regimes by providing a lower U.S. tax rate of **13.125%** on FDII, achieved through a 37.5% deduction of “FDII”.

- FDII includes a U.S. company’s income from the sale, license, or lease of “property” (such as a patent), or from the provision of services, to or for unrelated persons in foreign market.

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

- The FDII rate will rise after 2025 to **16.4%** via reduced deduction to 21.875%

- To benefit from the FDII regime the U.S. company must retain ownership of the patent and the income – a strike against the use of IP HoldCos

Will FDII be Repealed or Modified?

- Biden Administration initially proposed eliminating the FDII regime, contending the regime has lead to increased offshoring
- Multiple proposals floated in Congress including:
  - discard FDII in favor of a new front end R&D tax benefit
  - modify FDII by changing its calculation formula to benefit companies investing in innovation activity within the United States
  - Complement FDII with an enhanced innovation focused R&D benefit
- Global pressure against FDII since its inception has included:
  - WTO had contended that FDII is U.S. protectionism manifesting as an unfair export subsidy .
  - The OECD has asserted that the FDII regime is a "harmful tax practice"' violating BEPS Action 5 recommendations for IP incentive regimes to require nexus and substance
- Critics contend the regime is overly complex as a planning tool, involving complex calculations and too many data inputs to determine ultimate effective benefit to a U.S. company, and may inadvertently encourage U.S. companies to locate depreciable assets abroad; others contend the FDII rate is not low enough to be competitive
- Under the current Senate Finance Committee's draft legislation, FDII would be re-designated as "Foreign-Derived Innovation Income" while a new category of domestic income would be designated as DII or "Domestic Innovation Income" – a new methodology for calculating the deduction would tie in domestic research and experimentation, and training, expenses to anchor the tax benefit to U.S. activity
- The proposals on FDII have evolved from elimination to modification; final outcome remains to be seen…

The Super Royalty

To discourage offshoring of IP assets:

- The “Super Royalty” provision of the U.S. tax code provides that any contribution by a U.S. person of a patent or other IP asset to a foreign company may be treated as a taxable sale in exchange for a stream of deemed payments contingent on the productivity, use, or disposition of the IP asset.
- The deemed payments effectively are a deemed royalty and therefore referred to as a “Super Royalty”.
- The deemed Super Royalty is taxable to the U.S. person as ordinary income for the life of the transferred IP asset.
- The Super Royalty provision is a red flag to watch out for in any international IP tax planning endeavor

3. State and Local Tax Considerations

Overview of State and Local Tax Considerations

- IP Holding Companies
- State Corporate Income Tax Consequences
  - Licensing Fees and Patent Sales
  - Patent Litigation Proceeds
- Personal Income Tax Consequences
  - Nonresidents and Sourcing Patent Streams
  - Characterization Issues
- Sales and Use Tax Consequences

IP Holding Companies – Introduction and History

- IP Holding Companies
  - Common Structure
  - Deduction Generator
  - Spawned lots of litigation
  - “Geoffrey the Giraffe” Cases
- What happened since?
  - Addback statutes
  - States adopt combined reporting
  - Generally IP Holding Companies produce less benefit for state tax purposes now

IP Holding Companies –Current Issues

- Impact of Addback Statutes
  - Double Taxation Problem: IP holding company has economic nexus, addback statute applies to in-state company.
- IP Holding Companies 2.0 – Structures
  - Use of captive insurance companies.
- This framework should be considered for current related company licensing transactions.
- Common recent analogue: shared computer code across related companies.

Patent Licensing and Sales of Patents – State Corporate Income Tax Issues

- Tax Base Issue
  - Income apportionable or allocable?
  - Case law and statutes generally hold that income from patent licensing and sales of patents is apportionable (so include in the tax base).
  - BUT – cessation of a business case law goes the other way.
  - Could be fact specific and state specific.
- Sourcing
  - If business income, UDITPA and most state statutes say to source based on state(s) of use.

Patent Infringement Lawsuits

- Similar tax base and sourcing issues.
- Different results across states
- 1998 NC Polaroid Case
  - Polaroid received $925M in patent litigation proceeds from Eastman Kodak.
  - Took the position that the proceeds were non-business income, not taxable in NC.
  - Polaroid: nonbusiness income, BC we are not in business of licensing patents, so our recovery for patent infringement was not in the regular course of our business.
- Cases very fact specific (facts and state case law matter)

Personal Income Tax Issues

- Only an issue for nonresidents
- Residents taxed on all their income, nonresidents taxed only on income sourced to the state.
- So sourcing issue exists for nonresidents.
- Example: 2010 NY Advisory Opinion TSB-A-10(3)(I).
  - Professor's research at a NY-based university resulted in discovery of a treatment for glaucoma, which he patented.
  - Assigned his rights to the patent to the university in exchange for a portion of the royalties that the university would collect.
  - Professor a nonresident. Royalties NY source income? Compensation for services?
  - Ruling: income not from a NY source (intangible asset that does not have a NY source).

Sales Tax Issues

- Sales tax
  - Only applies to sales of TPP and certain service.
  - Should not apply to patent licensing or sales of patents.
- Caveat Emptor:
  - There are states like HI and NM that impose a broader-based gross receipts-type tax in lieu of a sales tax.
  - So should check before assuming no transfer tax applies to the sale.

4. 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)

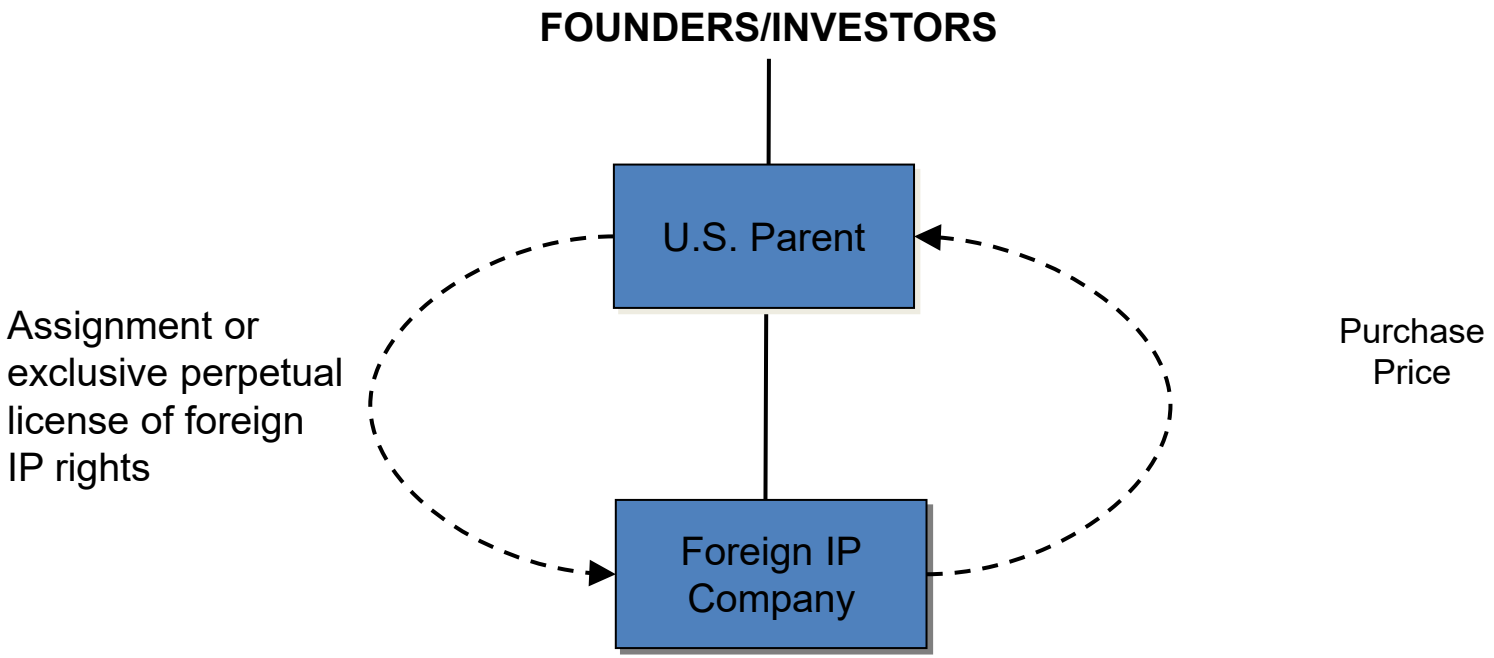
Sale vs. License

- 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

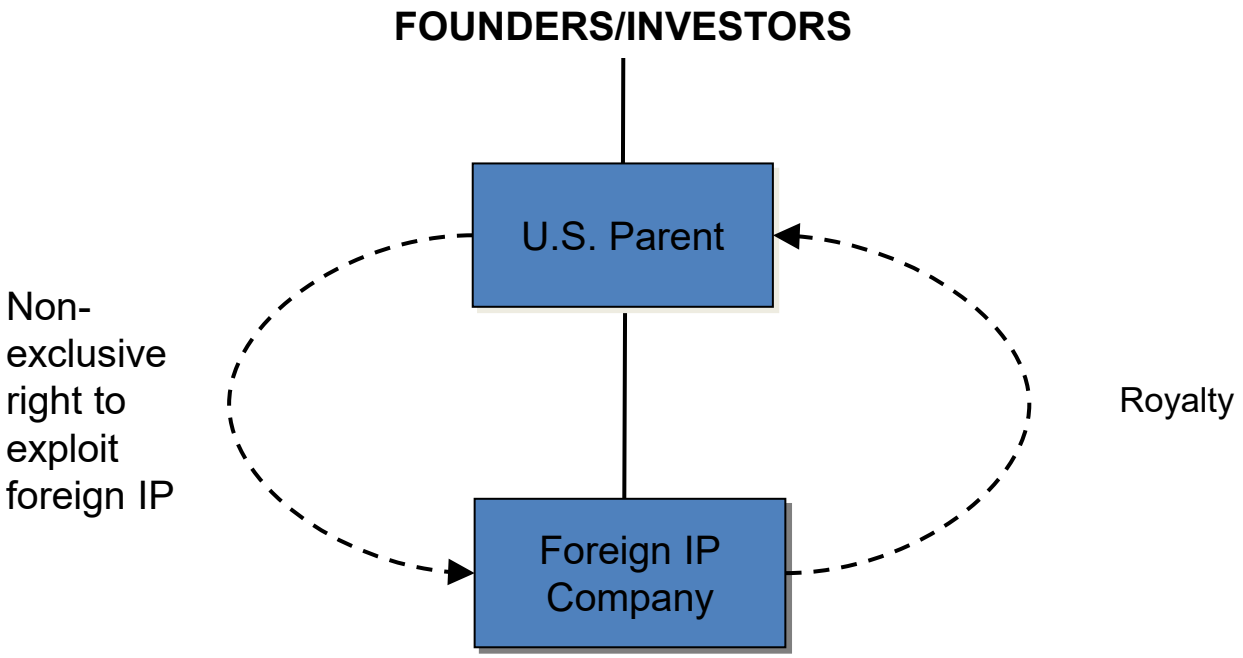
Sale of Foreign Patent Rights



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)

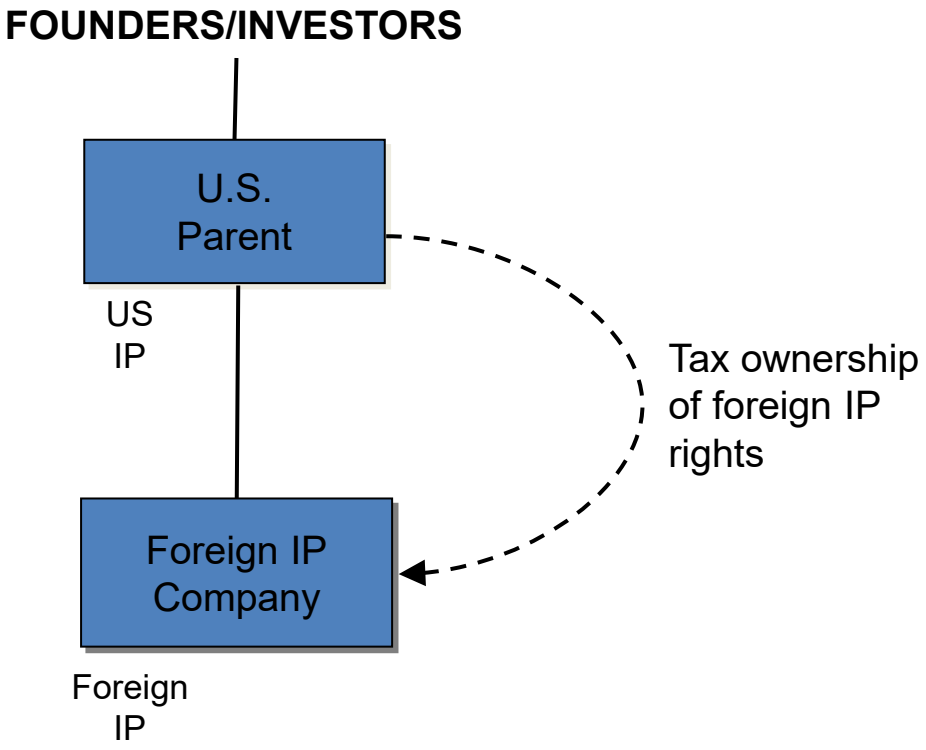
License of Foreign Patent Rights



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



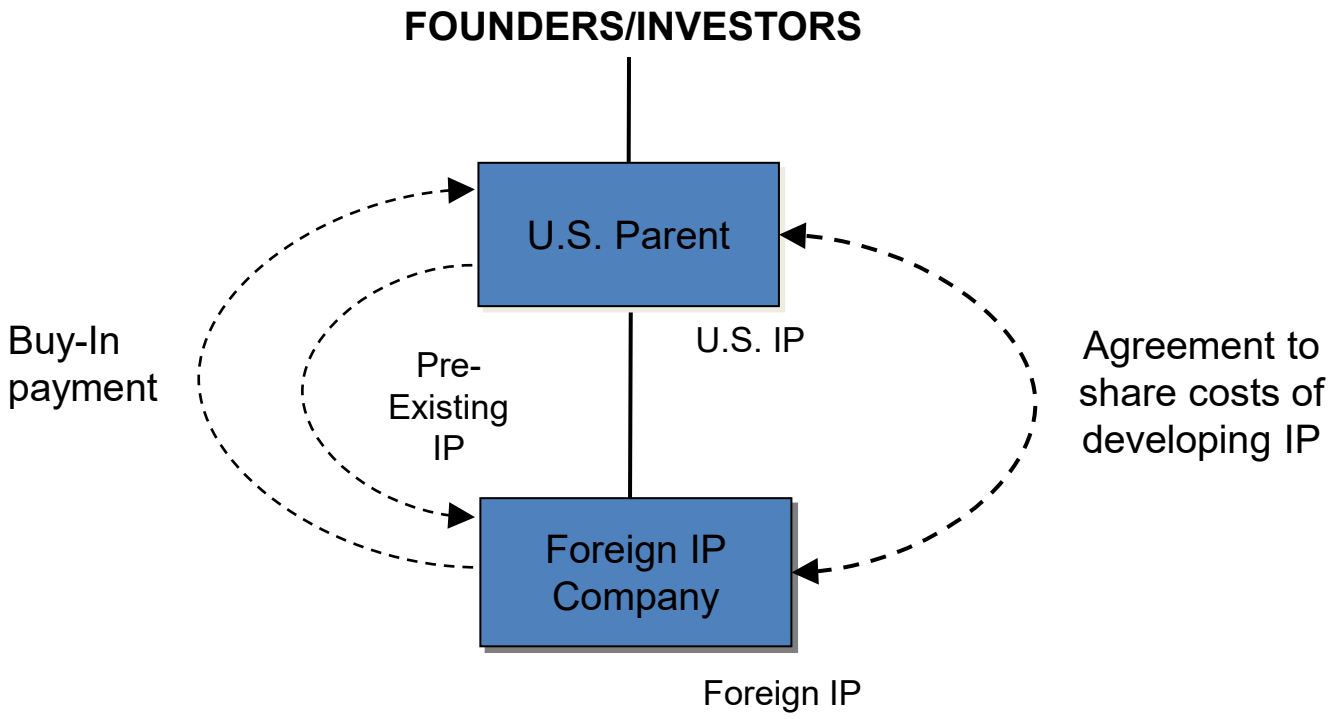
Contribution of Foreign Patent Rights

- 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.

5. 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
WHEN PLANNING
TRANSACTIONS INVOLVING PATENTS

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