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Taxation of Intellectual Property: IRC 1235, FDII and GILTI, Taxation of Moving IP Offshore

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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FENWICK

Taxation of Intellectual Property

Presenter: Daphny Lazarus

Overview

Ownership

- Legal ownership of intellectual property rights generally derives from legal title: the person holding the legal title to the patent
- Tax ownership is based on an economic concept, and not legal title.
- IP rights sometimes referred to as “bundle of sticks” in which each stick represents an individual right – the person holding all or most of the sticks is the tax owner.
  - Tax ownership can be transferred by means of a license agreement.
- As a result, if all economic rights to IP 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” the IP.

Sale or License: Patents

- Patent owner's interest consists primarily of the exclusive rights to exclude others from making, using, selling, offering to sell, or importing the patented item.
- To "sell" an interest in a patent, the sale must consist of the transfer of all these rights (or an undivided interest therein). If patent owner does not part with all these exclusive rights, the transaction will generally be treated as a license.
- The owner may still be able to sell the right to a patent in a particular geographic area or with respect to a product line. However, transferee must have the exclusive rights to make, use, sell, offer to sell and import the patented item within this restriction.
- Transfer is considered the sale or exchange of a capital asset held for more than 1 year, regardless of whether consideration is fixed or contingent or payable in one lump sum or over a period of time.

Sale or License: Copyrights

- To receive capital gains tax treatment on the transfer of a copyright, the seller must part with all substantial rights in a given medium of expression.
- An exclusive right in a medium of publication for the life of the copyright is generally treated as a “sale” for federal income tax purposes.
- A non-exclusive license will generally be taxed and treated as a license.

Sale or License: Trademarks and Trade Names

A trademark or trade name can generally be “sold” if the transferor does not retain any “significant power, right, or continuing interests” with respect to subject matter of the trademark or trade name.

Treatment of Self-Created IP

- Certain self-created IP is excluded from capital gains tax treatment:
  - A patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer whose personal efforts created such property, is not treated as a capital asset.
- Limited to where the taxpayer's personal efforts created the property.
- "Personal efforts" of the taxpayer do not create intangibles where the taxpayer is a business entity, and the property is created by its employees.
  - All of the costs and expenses should be paid for by the corporation at the current going rate for the services rendered.

IP Migration

Overview: IP Migration

- Transfer of IP rights can be accomplished via:
  - Sale
  - License
  - Contribution
  - Cost Sharing Agreement

Sale of IP

- For U.S. 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 of tax purposes.
  - The IRS can recharacterize a transfer to comport with the correct tax view.
- In a sale, the seller recognizes capital gain or loss, recovering tax basis (gain = proceeds –basis).
- Purchaser amortizes cost over 15 years.
- Transfer pricing rules must be applied to related party sales.

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License of IP

- If tax ownership is retained, the transfer is a license.
- If a license, the licensor is taxed on royalty payments as ordinary income. No tax basis offset.
- Licensee usually can deduct royalty payments as business expense.
- Transfer pricing rules apply to determine royalty rates between related parties.

Contribution

- Generally, the IRC provides for the tax-free transfer of “property,” including IP, to a subsidiary corporation or to a partnership.
- Section 351 provides that the contribution of property to a corporation in exchange solely for the corporation’s stock is tax-free if the transferors together own at least 80% of the corporation after the exchange.
- Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Cost Sharing Agreement

- Cost-sharing agreements are intercompany cooperation contracts, established to provide the correct allocation of costs between different legal entities but which belong to the same economic group, to determine the apportionment of expenses and costs resulting from the exercise of shared activities, such as internal accounting, communication, legal and administrative services.
- The parties agree to share the costs of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement.

Trends in IP Alignment and Planning

Building a better working world

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Speaker

- Zak Perryman Managing Director
- EY LLP

Topics

- Defining IP
- Transfers of IP generally
- Outbound transfers of IP
- Inbound transfers of IP
- Trends

1

Intangible Property (IP) defined

IP defined - section 367(d)(4) (Previously in Section 936(h)(3)(B))

- **INTANGIBLE PROPERTY** - 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,
  - goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment), or
  - other item the value or potential value of which is not attributable to tangible property or the services of any individual.

- "Nothing in the amendment made by subsection (a) shall be construed to create any inference with respect to the application of Section 936(h)(3) of the Internal Revenue Code of 1986, or the authority of the Secretary of the Treasury to provide regulations for such application, with respect to taxable years beginning before 1January 2018."

Section 367(d) and Section 482

- Section 367(d)(2) is amended by adding at the end the following new subparagraph:
  - "(D) Regulatory authority –For purposes of the last sentence of subparagraph (A), the Secretary shall require –(i) the valuation of transfers of intangible property, including intangible property transferred with other property or services, on an aggregate basis, or (ii) the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."

- Section 482 is amended by adding an additional third sentence:
  - "For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."

2

Transfers of IP

Key tax considerations

Treatment of IP-related income

- Sale versus License of IP
  - “All substantial rights” standard
  - Contrast with transfer of tangible goods or provision of services
- Capital versus Ordinary (individuals)
- Source of Gain versus Royalties
- Amortization/Depreciation Deductions

Consideration for related party transactions

- Section 482
- Section 367(d)
- Outbound transfers of IP

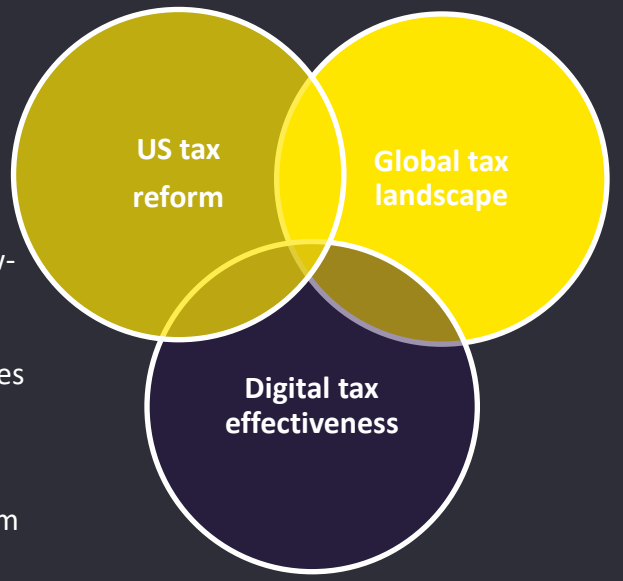
3

How These Changes May be Addressed: Options for Strengthening IP Structures

Interplay of issues - Shifting and highly integrated global tax landscape

US tax reform:

- Lower existing rates and/or future rates to increase
- Corporate tax rate reduced to 21%
- Expanded current US tax on controlled foreign corporations (CFCs) under Global Intangible Low-Taxed Income (GILTI) at 13.125%
- Lower current 13.125% rate on intangible income from foreign sales foreign-derived intangible income (FDII)
- Base Erosion and Anti-Abuse Tax (BEAT) results in potential minimum tax
- Interest expense limited



Global tax landscape:

- Increased focus on employee substance to attribute profits from intangibles development, enhancement, maintenance, protection and exploitation (DEMPE)
- Lower tax nexus (PE) standards
- Increasing array of local anti-abuse measures attacking a variety of operating models
- Aggressive Anti-Tax Avoidance Directive (ATAD) and BEPS-oriented agenda in countries of revenue source
- Local incentives are still possible (e.g., Ireland committed to 12.5% rate)

Digital tax effectiveness:

- EU, OECD and unilateral country interim actions driving toward turnover taxes on various digital business models
- Longer-term drive to create separate digital permanent establishments and profit attributions to user bases, etc.

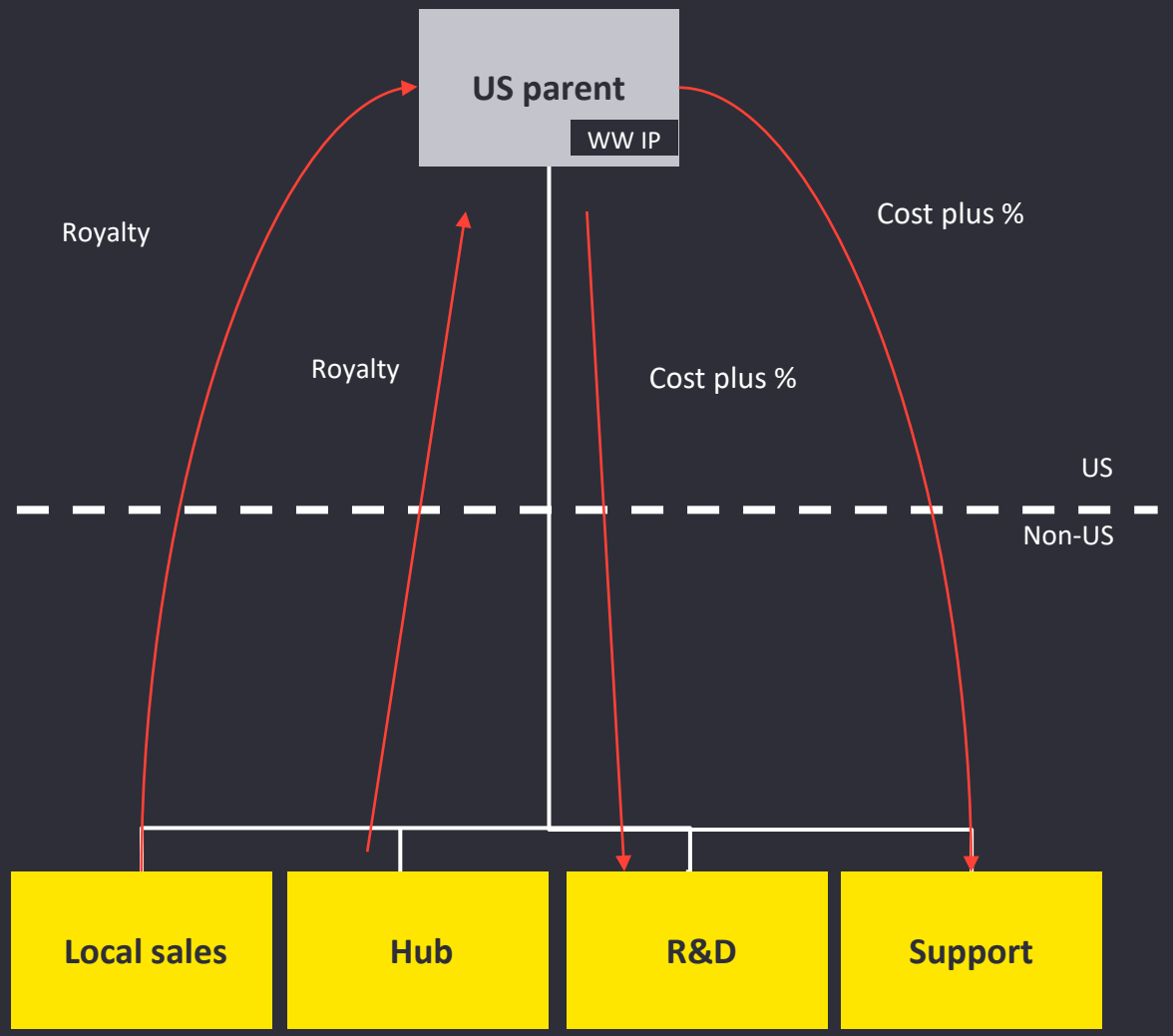
Given these global changes, taxpayers generally have two leading options to align its D&T IP with their business.

1. Centralize IP in the US

2. Cost Share IP with Foreign Principal

IP owned outside the US

Option 1: onshore IP to the US



Possible options

- Generate a step-up in basis or not?
- Lower US rate and FDII
- Potentially mitigate BEAT impact (depends on specific facts)
- Evaluate viability of non-US supply chain hub

Considerations

- Consider changes to payment flows and possible BEAT impacts
- Bring BEAT payment entities back as branches of a partnership?
- What needs to move to stay under safe harbor?
- Stability of US tax regime
  - Stability of US tax rates
  - Statutory rate and FDII rate
  - GILTI FTC profile and future guidance

Why are companies inbounding to US?

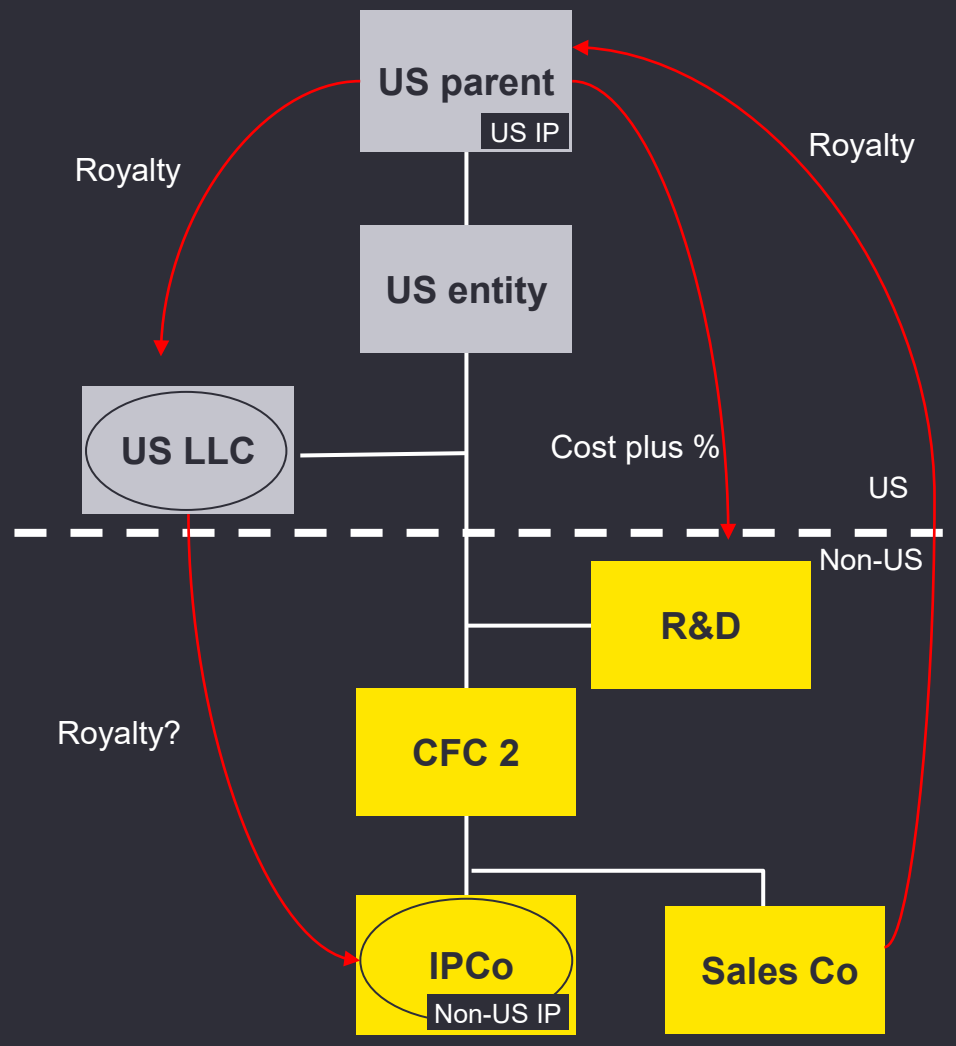
- DEMPE Alignment
- Tax Attributes – e.g., excess credits in general basket
- Public Relations, especially consumer products
- GILTI basket limitations due to expense allocation

Key considerations

- BEAT
- Imported basis
- Inbound liquidation or reorganization
- Distribution
- Contract R&D or other intercompany services
- Disregarded foreign branch transactions
- Foreign tax credits – branch basket considerations
- FDII qualification

IP owned outside the US

Option 2: onshore income to US but maintain IP offshore



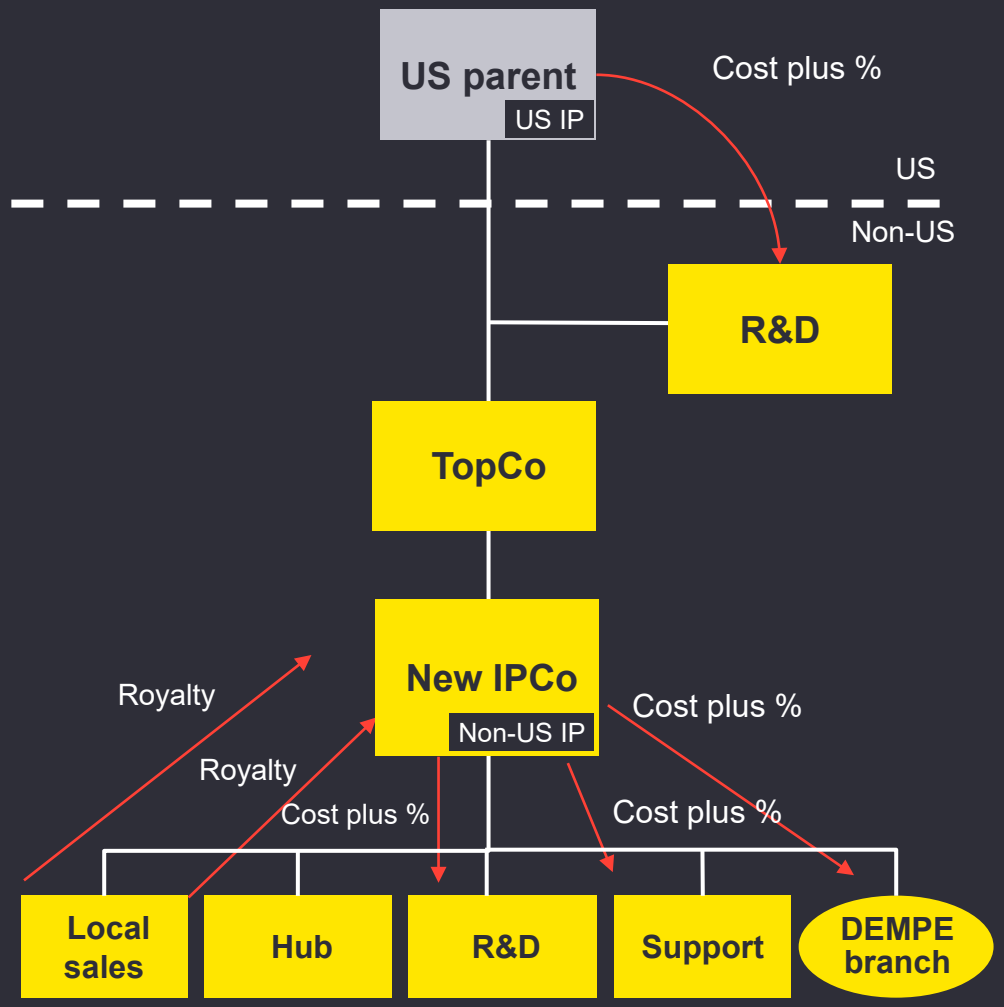
Possible options

- US Parent charges DEMPE fee
- US Parent right to income for defined term
  - Usufruct
  - Capital license
- US Parent acts as licensee and global principal
  - Royalty free license
  - Prepaid license

Considerations

- Willing to use a temporary solution while US and global tax policy environment stabilize
- Exploitation of IP by US LLC and associated state tax considerations
- Increased complexity as US LLC pays for ROW costs during usufruct period
- Non-US cost-sharing expenses have no related income. Can expense be benefited?
- Willing to have all or almost all of IP returns be taxed in the US
- Desire to not commit IP asset to any particular jurisdiction at this time

IP owned inside the US
Option 3: outbound transfer of IP to foreign location (with appropriate substance)



Possible options

- Potentially create step-up in basis for US purposes
- Functionality elsewhere?
- Onshore to an EU jurisdiction (Ireland, Netherlands)
- Onshore to a non-EU jurisdiction (UK, Switzerland, Singapore)
- Single local entity vs. double local entity?
- Augment local substance with branch planning on a temporary or long-term basis?

Considerations

- Level of DEMPE substance outside of US (or via US branch)
- Stability of US/FDII rates
- GILTI FTC profile

US Outbound IP Transfers

Valuation

- Useful life
- Definition of IP – goodwill

Method of transfer

- Rights
- Sale
- License
- Consideration
- Contingent
- Fixed (lump sum or installment)
- Matching of income (FDII?) and deductions (GILTI)
- Section 367(d) contributions

Other considerations: how should taxpayers respond?

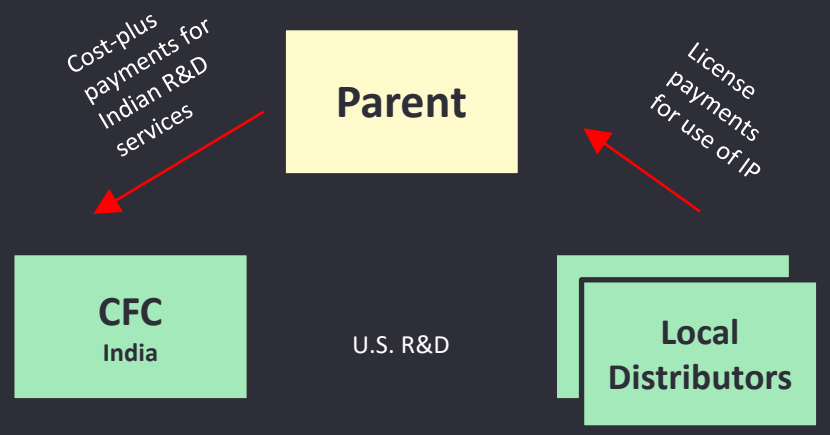
- **Post-TCJA considerations relevant to CSAs fundamentally the same as offshoring IP in general.**
  - 367(d) amendments, expanded definition of intangible property
  - 482
  - Expanded Definition of “intangible property”
    - GW, GCV, workforce in place
    - Any other item if value not attributable to tangible property/individual services

- **Potential Downsides to FDII**

  - Complexity around “foreign use”
  - Durability
  - Potentially higher rate of tax

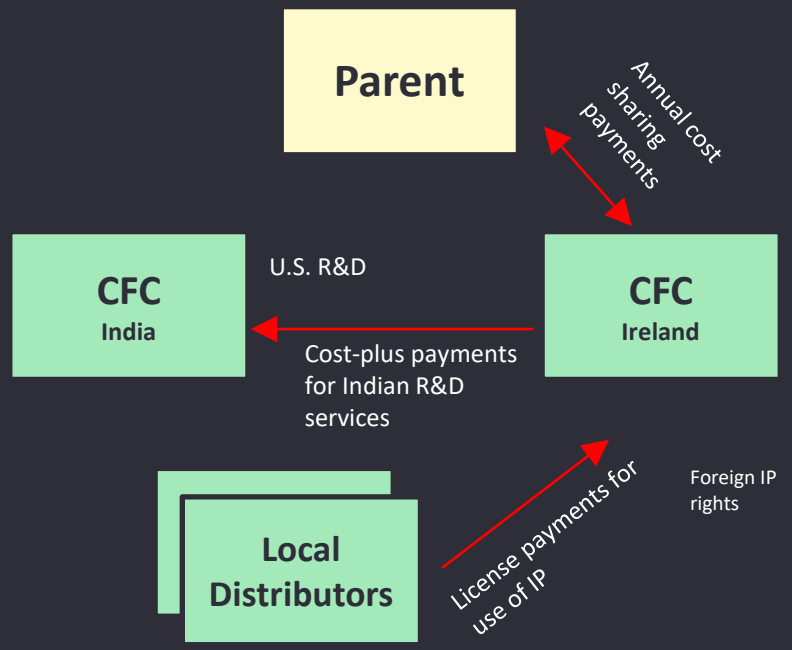
- **Foreign Considerations**

BEAT Impact of Intangible Development Costs



- Parent (a U.S. multinational) holds its domestic IP, which it licenses to various foreign affiliates
- Foreign affiliates deploy the IP via sales/services/licenses in their local markets, earning significant local profits not taxable under subpart F
- Substantially all of the local distributor profits would be GILTI income, but that FTCs would be available to significantly reduce the resulting U.S. tax
- Parent conducts a majority of its R&D in the U.S., but also contracts with its Indian CFC for substantial on a cost-plus basis
- Payments to Indian subsidiary viewed as “base erosion payments” under section 59A(d), and may cause Parent to become an “applicable taxpayer” for BEAT purposes
- BEAT liability may significantly exceed the tax deduction benefit of the Indian R&D payments (given the impact of recomputing tax liability without FTCs), Parent is incentivized to avoid this result
- Assuming Parent desires to continue Indian R&D as a business matter, consider the impact of adopting cost sharing to partially mitigate the BEAT consequences.

Cost Sharing- Mitigation of BEAT



- Parent transfers foreign IP rights to an existing or newly-formed CFC who will serve as foreign IP hub and as foreign cost sharing participant
- Intercompany R&D agreements modified so that Irish CFC now makes payments to Indian CFC; Parent continues to fund US R&D
- Assume a US-foreign RAB share of 60/40, with IDCs of 100x payable by Irish CFC to Indian CFC (or other foreign service providers) and IDCs of 100x incurred by Parent and US consolidated group members
- Under cost sharing regulations, Parent will owe foreign IP hub a cost sharing payment of only 20x (60% of 200x less 100x already funded by Parent), significantly reducing amount of base erosion payments (Parent may fall below threshold)
- If US IDCs exceed foreign IDCs, base erosion payments may be completely eliminated
- Note that reworking intercompany agreements in this manner may also be advisable for companies already using a cost sharing structure

Where to hold IP

Where to align IP

Common jurisdictions

1. US
2. Ireland
3. UK
4. The Netherlands
5. Singapore

Business Considerations

1. Proximity to/relationship with business footprint
2. Availability of skilled workforce
3. Accessibility/transportation links
4. Maturity and stability of physical, legal and financial infrastructure
5. Impact on existing corporate structure
6. Reputational risk/corporate image

Tax Considerations

1. Tax rates, incentives, tax treaty network
2. Ability to manage foreign effective tax rate
3. Ability to repatriate cash to the US
4. Substance requirements

Questions?

Thank you for your participation.

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Thank You

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