

Intellectual property in transfer pricing planning

Danny Beeton, Murray Clayson and Christopher Forsyth
Freshfields Bruckhaus Deringer LLP, London

The authors examine the legal, tax and economic considerations

This article provides a general overview of the issues which are relevant to tax-efficient Intellectual Property (IP) structuring. Because of the complexity of these structures, differing commercial considerations between companies and multiple jurisdictions involved, there is no standard solution. However, we have suggested some checklists and frameworks to help in that process.

First we should define our key terms, as follows:

- we will use the term “IP” as shorthand to refer to the wider set of intangible assets. In principle, all IP rights that are identifiable and have a market value can be included in IP restructuring schemes. These can include trade mark rights (including brands), copyrights, patents, designs, database rights, domain names, know-how rights, semi-conductor topography rights and plant breeders’ rights, for example. Whether the IP rights are registered and/or otherwise formally legally protected is generally not highly relevant from a tax perspective, although for certain classes of IP if they are not, tax authorities may question whether there is economic substance, and therefore value, attached to these rights. On the other hand, it will often be relevant to consider whether IP rights are legally enforceable (that is, use by others can be prevented), since in the absence of legal rights it may be said that a putative independent buyer would not be prepared to pay a price. Tax authorities may also assume that know-how has already been shared across a group, so that the onus will be on the company to explain why this is not the case. Where rights are not registered (e.g. copyright, database rights, rights in know-how) it may not be simple to establish current legal ownership;
- by Transfer Pricing we will refer to the provision of goods, services, funding or rights to use intangible assets between related parties. There is an international requirement to set internal charges in a group at “arm’s length” levels, or face tax penalties.

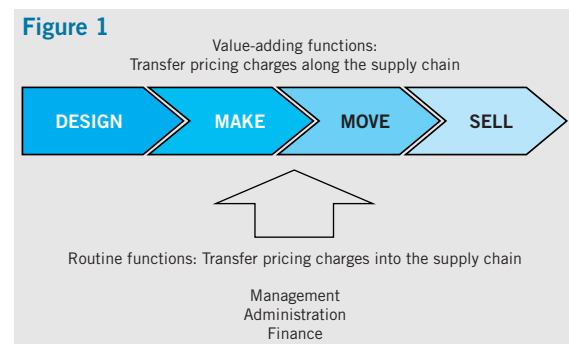
This is related to the fact that transfer pricing is a major tax planning tool, especially where intangible assets are involved. We will refer to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (TPG);

- we will use the terms Parentco, IP Holdco and Opco to describe, respectively, the parent company in a multinational group, the company in that group in which the group’s IP may be centralised, and an operating subsidiary.

We have kept our discussion at the conceptual level with some real world examples, rather than discussing the relevant legislation of any particular jurisdiction.

I. Analytical frameworks

Three analytical frameworks can help to understand the techniques and issues involved in transfer pricing planning using IP: the supply chain, the IP decision process and the economic objective. These are discussed in turn below.



The supply chain for any company involves transfers of goods, services, finance or rights to use intangible assets along the “value chain” of activities which create the non-routine profit of the company, and into the value chain from the supporting functions.

Danny Beeton,
Christopher
Forsyth and Murray
Clayson are
respectively Head
of Transfer Pricing
Economics, IP
Partner and Tax
Partner

The intangible nature of IP rights renders them easily movable and creates the potential for valuable tax planning (tax planning with intangibles is more popular than tax planning with risks, the other major tool of transfer pricing planning, anecdotally because it is easier to understand). This often involves the migration of IP into favourable tax jurisdictions and the creation of licensing structures and resulting royalty streams. Devising and implementing these structures requires detailed thought from and collaboration between tax, IP and transfer pricing economics experts and close collaboration between them. This expertise must be applied internationally. Without it, there is a risk that a scheme can prejudice the underlying IP rights, rendering them worthless in the process.

For IP rights to be capable of being transferred and licensed, the relevant rights need to be identifiable and capable, under domestic law, of being transferred. Some restructuring arrangements involve a transfer of legal title; others will only require the transfer of “economic ownership”, which will not necessarily amount to a transfer at all from an IP legal perspective, but rather a licence, in which the licensee is given the right to exploit the IP in question for its own gain. In certain cases this kind of “transfer” of economic ownership may be sufficient to obtain tax benefits since, typically, the tax structuring focuses on economic value.

While IP restructuring can be tax-driven, it can also be driven by a wish to centralise the management and control of IP rights so as to maximise their (marketing) value for the group, or to find a “home” for acquired brands in the context of a merger or acquisition (M&A) transaction in which substantial IP rights are involved.

The differing terms used in a tax context, as opposed to an IP context, can result in statements being made to tax authorities about the proposed structure that are not desirable from an IP perspective. For example, in IP terminology, “transfers” of IP are transfers of ownership of the intangible asset, whereas in tax terminology the “transfer” may be a licence – a right to do or use something which would otherwise be preventable by the right owner through the enforcement of an IP right.

While an IP transfer might involve an outright transfer of legal and beneficial title, it may also involve a licence from the Parentco to the IP Holdco on terms that enable the IP Holdco to exploit the IP in question by sub-licensing it to Opcos for royalties that IP Holdco will retain, rather than passing them back to Parentco. That licence from the Parentco to the IP Holdco may be characterised as having brought about a transfer of “economic ownership” from a tax perspective, while remaining a “licence” from a legal IP perspective. References to “transfer” in this article should be read in both ways – the comments made apply equally to both methods.

It is important for the IP experts to liaise with the tax experts to ensure that the communications with tax authorities work to achieve the desired aim without prejudicing the subject IP.

Any company that wishes to maximise the after-tax return from IP will consider some variant of the decision process in Figure 2, i.e. a series of questions about where to own the IP and how to transfer it to

Figure 2

	Techniques – tax and IP	Constraints and Pitfalls – tax and IP
Step 1: Where to own it		
Step 2: How to get it there		
Step 3: How to charge for it		
Step 4: How to manage it		

But to complete this framework we need another analytical framework...

that location, for example, and in each case the relevant technique for achieving this outcome and how to avoid the potential pitfalls. We will return to this framework at the end of this article.

Figure 3

Maximise the Net Present Value (NPV) of the intangible asset where:

$$NPV = -C + \sum_{i=1}^n CF (1-t) / (1+r)^i$$

where:

- C= upfront costs
- CF= each cash flow from the intangible asset
- i= time period
- n= number of periods for which the CF will be generated
- t= effective tax rate
- r= discount rate

and: $r = rf + rp + ln$

where:

- rf= risk free rate
- rp= risk premium
- ln= rate of inflation

and: $rp = rin + rc$

where:

- rin= risk associated with the intangible asset
- rc= risk associated with the country

The after-tax return from any IP will be the outcome of the underlying commercial potential of the IP and the tax rate and risk of the jurisdiction in which it is owned, which we can decompose in the manner of Figure 3.

II. Implied objectives of transfer pricing planning involving IP

If we accept the overarching economic objective of Figure 3, then the following sub-objectives follow:

- minimise the after-tax development cost;
- maximise the cash flow;
- maximise the number of periods for which the cash flow will be generated;
- minimise the effective tax rate;
- minimise the risk associated with the intangible asset;
- minimise the country risk;
- trading-off these objectives where necessary; and
- using transfer pricing and IP planning techniques.

We will discuss the techniques and constraints/pitfalls for each of these sub-objectives in turn in the next section.

III. Techniques, constraints and pitfalls

A. Minimise the after-tax development cost

1. Techniques

In practice, minimising the after-tax development cost of IP could involve cost plus development in a low cost

jurisdiction, or jurisdictions with favourable tax frameworks for IP development.

2. Constraints/pitfalls

The key issues in choosing a location which can minimise the after-tax cost of IP development is to identify a low cost location for development taking into account any existing Research and Development (R&D) tax credits which may be foregone if development is located in or transferred to another jurisdiction, and the availability of similar benefits in the prospective new location.

B. Maximise cash flow

1. Techniques

Commercially-driven IP planning is often designed to centralise IP management and control so as to maximise the marketing value for the group – if IP is centralised in a low tax jurisdiction, all the better.

2. Constraints/pitfalls

Given the commercial benefits of centralising IP management, a key concern in IP planning is whether any partial migration of IP could reduce the overall value of a company's IP.

It is important to understand whether any third parties may have rights – where patents are concerned, the inventor may have certain rights and, in some countries, including the US, will have been named as the patent applicant.

In certain jurisdictions, certain IP rights cannot be transferred, for example in Germany there are peculiarities concerning the assignment of employee copyright. In certain other jurisdictions it is not possible to transfer part of an IP right. In all cases, the national laws regulating the relevant IP right (or at least those in the major markets covered by the restructuring) will need to be taken into account.

It is possible that IP restructuring could create a threat to the wider cash flow of a company, for example if there were to be an impact on the credit rating, interest rate and maximum funding of the company that has transferred its IP, or if there were to be an impact on perceptions of its creditworthiness with suppliers and customers, who may then change their prices and terms as a result.

In practice many technology-driven companies find it difficult to identify where their intangibles are owned – for example when their engineers meet and exchange ideas in both official forums and in the regular course of their work; in such a situation those companies can find little alternative to allowing all of their employees and subsidiaries to have free access to the intangibles that result.

C. Maximise the number of periods for which the CF will be generated

1. Techniques

Clearly it is important to register IP effectively wherever possible in all sales locations and arrange for

maintenance and development of the IP on a “contract” basis (if the IP Holdco will not carry on this function itself) in order to keep it up-to-date. A business must continue to manage its trademark and patent portfolio to cover key sales jurisdictions.

There are marked variations in the life of different types of IP and they are not always what we would assume – for example, patents generally last for twenty years but in certain sectors the technology normally expires first (for example, in the recent US *Veritas Software Corp. et al v Commissioner*, 133 T.C. No. 14 case software was determined to lose its value after only two to four years); copyright lasts for 75 years after the death of the author; design rights are much shorter. Arguable, know-how cannot be a form of “property” (for example, it disappears if the secret gets out), but it can still be licensed as an exclusive contractual right. One major company assumes that its know-how has a lifetime of ten years.

2. Constraints/pitfalls

The holder of an IP right must be sure that the selected IP holding structure does not compromise enforcement of the rights or recovery of damages at a local level. In any jurisdiction, there will be the standard IP risks of invalidation of the IP by a third party, or of the IP becoming redundant, or of changes in the interpretation of the IP law. In any review of the likely legal position on IP it is important to bear in mind that the ability to enforce IP rights may be determined by the rules of the jurisdiction in which the rights are used, as well as how they are held.

D. Minimise the effective tax rate

1. Techniques

Tax-effective IP planning may well be simpler where it involves the purchase or creation of IP offshore (and the related location there of the IP maintenance/protection functions, or at least the strategic direction of those functions). More usually, it will involve the migration of existing IP, in which case it is necessary to consider the tax exit charge consequences.

First, the exit charge will depend on the value of the IP which is being migrated. This must reflect the licence terms, exclusivity and geography involved (cf. OECD TPG 6.20 ff).

There is something of a debate over the extent to which IP can be transferred at cost. Thus it may be reasonable to value one early stage creation at cost on the basis that it is work in progress, but if a company expects from experience that at least one of its creations will be a “blockbuster” each year (for instance in the pharmaceutical or video games industries), a tax authority may contend that it is not realistic to value them all at cost. There may be a parallel with the US concept of “workforce-in-place” being an intangible asset and the debate arising of how far that concept can be extended (if one employee moves, there has been no transfer of an intangible, and if they all move, an intangible has been transferred, but what is the cut-off point?).

Where valuations are highly uncertain, they can generally be based on forecasts of revenue and costs,

without the expectation that a tax authority would be able to use hindsight to revalue the asset on the basis of outturn figures (see OECD TPG Annex to Chapter VI and the UK *DSG Retail Limited v R&CC* [2009] UKFTT 31 (TC) (*DSG*) case, for example). However, in some jurisdictions the transfer pricing rules, or the interpretation of them by local tax authorities, do not allow a transfer of IP rights at a fixed price, especially if it is difficult to establish such a price because of uncertainties in the future royalty streams. This assumes that unrelated parties would have agreed to a pricing mechanism, taking into account not only the estimated value on the transfer date, but also actual revenues generated over a number of years thereafter. This may lead to an earn-out arrangement (also referred to as a price commensurate-with-income standard, or “super royalty”). If such an arrangement is required, this may negatively affect the tax benefits of the structure. Similar valuation issues will apply in an M&A situation where a part of the overall purchase price of a business may have to be allocated to the IP rights.

The decision in the *Veritas* case was that intangible assets should be valued individually and not in the aggregate – an IP transfer is not a transfer of a business, and cannot be valued by reference to the profits of the business as a whole.

The actual tax impact of a migration of IP would also be influenced by the ability to use tax losses to shelter capital gains.

The migration itself can take several forms, as follows:

- the outright sale of IP at an early development stage when the certainty of successful development (and hence the valuation) are low. Anecdotally, it is the experience of some companies that it may be best to pay an exit charge up-front because the seller’s state tax authorities then tend not to contend that the subsequent royalty rate charged by the IP Holdco to the operating companies is too high;
- formalising know-how into IP offshore;
- sharing the development costs, ownership and exploitation (i.e. partial migration – see Case Study 1 for an example);
- a “with on the vine” royalty payment for the old IP, with its subsequent maintenance and development being paid for by a low tax company, which would then have sole rights to exploit it. For example, in *Veritas* it was determined that software

would only have a lifetime of two to four years, and that the appropriate royalty rate for it should decline by a constant factor each year (e.g. by one third), before falling to zero in the last year); and

- the transfer of the IP to a branch of the same company in a low tax jurisdiction followed by the tax-free, or tax-deferred incorporation of that branch, where the tax law of the original jurisdiction permits this.

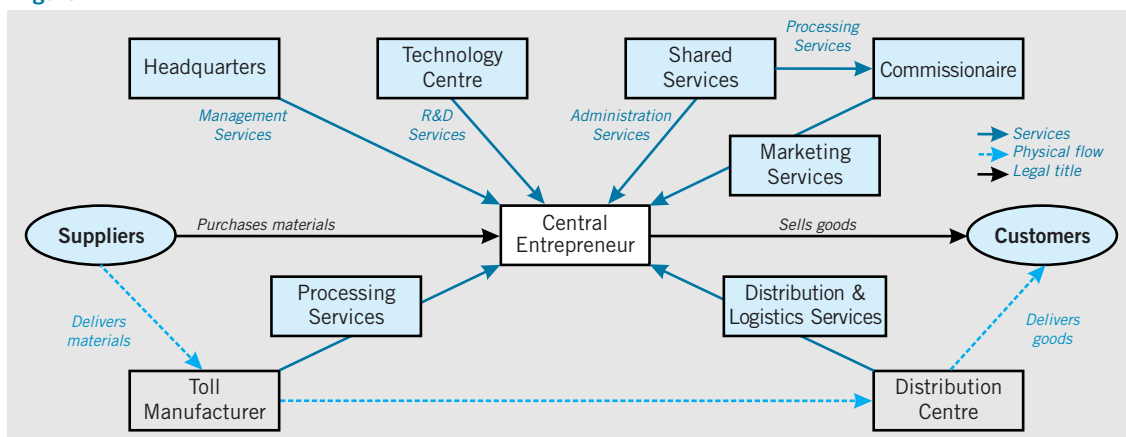
Having transferred the IP, there is a choice of options for how it will be charged for to the Opcos. These include lump sums up-front and/or at milestones, fees per unit, percentages of revenue and mixtures of these three. Where the potential revenue from IP is uncertain, it is common for independent licensors to require a lump sum payment and a royalty.

Where a percentage royalty on sales is chosen, this could be securitised in order to raise finance. However the intangible is charged for from the options above, it may, depending on its nature, be possible to bundle it up with access to centralised services as a franchise fee (see Case Study 2 for an example). This could have various benefits including that it may be worth more than the sum of the parts, so that a higher overall charge could be made, and also that it could mitigate withholding tax (WHT) (consider OECD TPG 6.17-19). Alternatively it could be rolled up in a charge for products, if the IP Holdco is inserted into the supply chain as a manufacturer, so potentially eliminating WHT altogether.

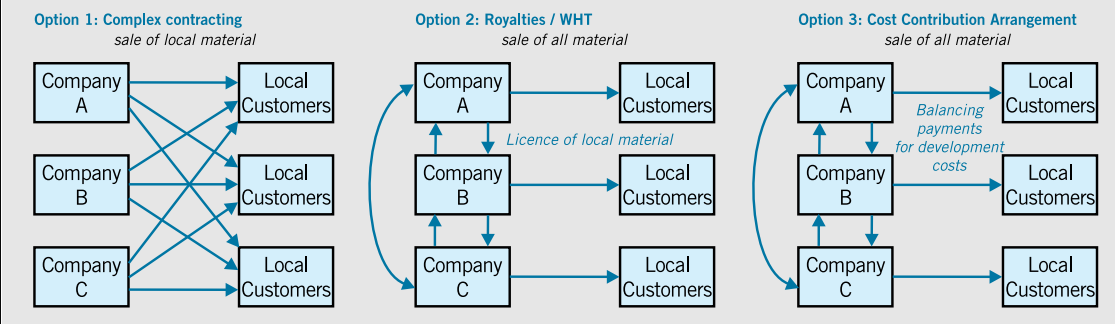
More radically, the IP Holdco could become the central entrepreneur for the group, booking all third party revenue and paying the Opcos a service fee (see Figure 4). This could produce the largest longer term tax benefits but at the expense of the largest up-front capital gains tax payments as the Opcos would give up not just their IP but also their informal intangible assets such as their supplier and customer relationships.

A further critical tax planning issue may be the possible application of controlled foreign company (CFC) rules. These typically require an attribution of the income of controlled companies located in low tax territories back to the parent company jurisdiction. That of course could at a stroke undo the tax planning which might otherwise be achievable by the use of a low tax zone IP Holdco. The UK is currently reviewing its CFC regime with a specific focus on IP holding companies.

Figure 4



Case Study 1



Shared material

Context:

- intangible material generated in several locations
- ideally to all be sold in each location.

Decisions:

- where to own the IP – everywhere that it will be used
- how to get it there – through the sharing of development costs in proportion to sales value
- how to charge for the IP – no charges
- how to manage the IP – adherence to a Cost Contribution Agreement (CCA) monitored by the head office.

Constraints/pitfalls:

- much lower development unit costs in one territory, implies controversial balancing payment to other companies or tweak the formula?
- one company would not start selling the material for some time after it started developing it – to join the cost share later or receive controversial reimbursement with no profit mark-up in early periods?
- legal enforcement – does it require all the parties to be involved in any action? Or the legal and beneficial owner, if separate? Should the CCA assign ownership of the material to each of the other companies? Should this be done by a licence clause or a non-assert clause?

In practice, many companies already use the central entrepreneur (IP owner and risk-taker) model, but site it in the home jurisdiction in order to gain greater control over the business, rather than in a favourable tax jurisdiction. Other companies in industries where major investments are made in physical assets worry that an Opco tax authority will view a central entrepreneur as only the “infrastructure owner” in the group and argue that it should just make the normal return on these assets for its industry.

In general, it is advisable to run the proposed IP structuring transaction by the statutory auditor of the group in order to avoid unexpected accounting issues (specifically related to International Accounting Standard 38 and Special Purpose Vehicle consolidation rules) that may directly or indirectly impact on the transfer pricing structure that will be chosen for tax purposes.

Transfer pricing compliance must then be addressed, and this will include the following tasks:

- documenting the commercial rationale for the IP migration;
- defining the IP in question;
- valuing the IP, using the market price method (most likely when the IP was originally acquired from a third party), the cost method (if the IP is still at an early stage of development), or the income method (the present value of the forecast royalty stream);
- benchmarking the level of the new charges to the Opcos;
- preparing new charging agreements;
- meeting the extensive requirements for Cost Contribution Agreements (CCAs) (OECD TPG 8.40-43), if that route has been chosen; and
- perhaps seeking to enter an Advance Pricing Agreement (APA) with one or more of the tax authorities involved.

2. Constraints/pitfalls

As noted above, there is a link between the valuation of the IP at the point of transfer and the expected subsequent revenue stream accruing to that IP. The subsequent level of charges could be challenged if the assumptions on which the forecasts were based were not robust, or if there is reason for a tax authority to believe that independent parties would not have agreed to a fixed payment or royalty rate, or if there is a mismatch between the original valuation and the level of the subsequent charges.

A major area for challenge (substance/transfer pricing/CFC) is whether the managers of the IP have moved to the low tax jurisdiction.

IP Holdco structures are intended for sheltering future group *profits*. If the group as a whole were to be loss-making, an IP scheme may inefficiently cause it to pay tax, since the IP Holdco will typically derive net royalty income, albeit at a low rate, and any internal contract R&D company would be expected to report a steady profit. In such a situation, compared to a structure without an IP scheme in place, Opco losses could be larger (due to the royalty charges, other things being equal) and generally these losses cannot be compensated with the profits realised by the IP Holdco (tax loss lock-in). Also, a retransfer out of the IP Holdco could result in a loss realised in the IP Holdco that may not be usable for the group.

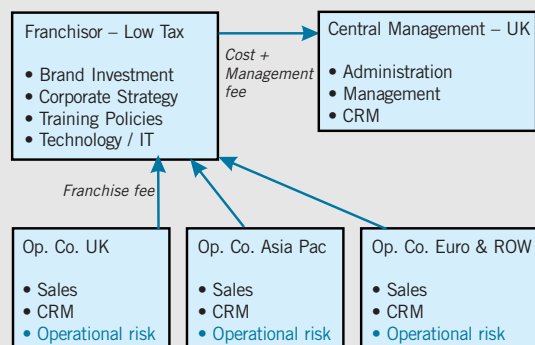
In some jurisdictions, the transfer of IP rights is subject to specific taxes or stamp duties. (However, under European Union (EU) Value Added Tax (VAT) rules, the transfer of IP rights is generally not subject to VAT in the country of the transferor. Any VAT on the acquisition of the IP rights in the IP Holdco jurisdiction is often recoverable.

Care needs to be given to the details of the IP migration and subsequent licence agreement in order to avoid further challenges, including the following aspects:

Case Study 2

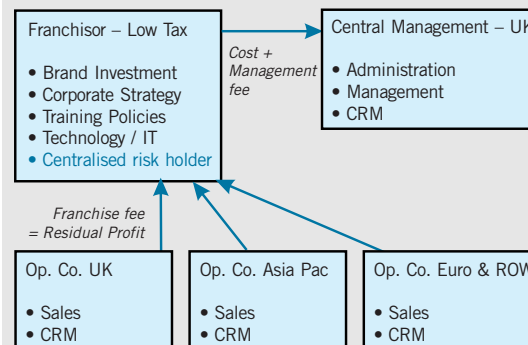
The franchise model – 1

Centralised IP, decentralised risk, franchisor outsources service provision



The franchise model – 2

Centralised IP, centralised risk, franchisor outsources service provision



New image

Context:

- new image to take the company up-market, increase revenue per transaction
- linked to better quality, more consistent and expert service
- hence new marketing and trade intangibles.

Decisions:

- where to own the IP – existing Opco in Switzerland

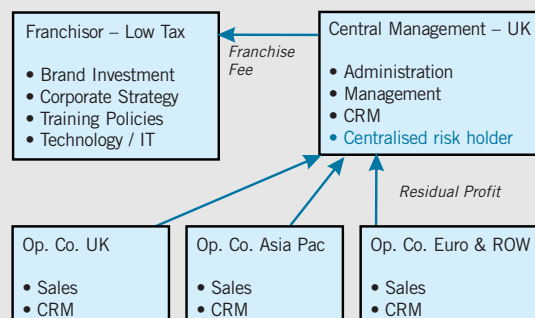
- how to get it there – finance the development from Switzerland
- how to charge for the IP – franchise fee, packaged with services
- how to manage the IP – out of Switzerland through franchise agreements.

Constraints/pitfalls:

- continued UK role in providing central services – need to design an option to fit.

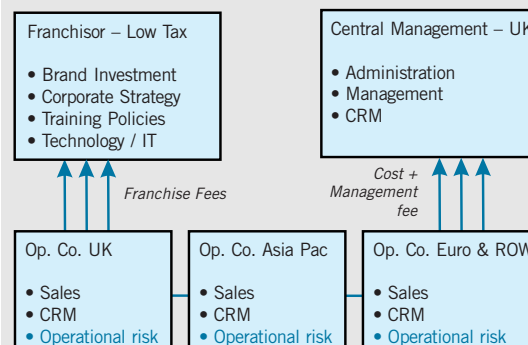
The franchise model – 3

Centralised IP, separate centralised risk, risk-taker as entrepreneur



The franchise model – 4

Centralised IP, decentralised risk, independent service provider



- has the IP been properly defined – has some been left behind to be taxed at the old rate?
- will some development of the IP continue in a high tax production or marketing jurisdiction, leaving part of the profit to be taxed at the old rate (witness the US *Glaxo* case)?
- has all of the IP been captured in the new licence agreement so that the charge can be maximised?
- could the terms of the new licence agreement have been changed so as to increase the royalty rate? But conversely:
- are the terms so long term/exclusive/global that a tax authority could argue that open market royalty rates (“Comparable Uncontrolled Prices”) would not be sufficiently comparable to be used as a reference point, and adopt a less tax favourable method for establishing the royalty rate (see the UK *DSG* case for an example of the comprehensive rejection of comparables)?

Another area of risk relates to transfer pricing re-characterisation. We may note the recognition that “For wholly legitimate business reasons due to the relationship between them, associated enterprises might sometimes structure a transfer in a manner that

independent enterprises would not contemplate” (OECD TPG 1.10; 6.13) and that “A tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by them” (TPG 1.36). However, in exceptional circumstances tax administrations may disregard actual structure where:

- the economic substance of a transaction differs from the form; or where
- the arrangements in their totality differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner *and* the actual structure practically impedes the tax administration from determining an appropriate transfer price (TPG 1.37).

TPG 8.29-30 also provides for the disregard of all or part of a cost contribution agreement and TPG 1.27 discusses situations in which a taxpayer’s allocation of risk can be disregarded. The OECD Business Restructurings paper: Issues Note 4 also provides for transactions to be recharacterised on the grounds of “commercial irrationality”. In the UK, there are grounds for recharacterisation in Income and Corporation Taxes Act 1988 Schedule 28AA paragraph 1(2)

although this point was ultimately not pursued by the tax authorities in *DSG*. However, in *Veritas*, it was ruled that the licence of pre-existing IP by the new central IP Holdco cannot be characterised as the sale of that IP to the IP Holdco unless the licence arrangement lacks economic substance.

If IP rights are licensed in relation to physical goods that are imported by the licensee and are subject to import customs duties, then there may be an issue that the royalty payments are considered to form part of the value of the imported physical goods, increasing the duties.

In cases where physical goods with a high “IP value” are shipped within the group to overseas subsidiaries, separately charging the sales companies for the use of the IP rights could be considered, rather than including the IP rights in the transfer price. This may allow for additional tax savings on import and customs duties. However, both the World Customs Organisation and the EU have agreed that trade mark royalties can in certain circumstances be dutiable.

E. Minimise the risk associated with the intangible asset

1. Techniques

Clearly, the key requirement in this respect is to ensure that the IP Holdco has the capability to manage the development and exploitation of the IP effectively. Even know-how can be defended in a contract, or through the doctrine of equity with injunctions, or fiduciary relationships/duty. It can be protected through restrictive covenants and confidentiality obligations. In this way know-how ownership can come close to IP ownership in terms of certainty. The major difference is that once the secret is out, the value disappears.

2. Constraints/pitfalls

It is possible that the new ownership arrangements could make it harder to enforce legal ownership of the IP – for example, problems in this respect can arise in CCAs, in which legal IP ownership may be shared.

Schemes that involve a split in trade mark ownership (for instance, all the marks in one geographical region remain where they are – all the marks in another geographical region are transferred to a different owner) are generally viewed with disfavour by those in charge of trade mark portfolios within large companies, given the need to ensure that in dealings with those marks in courts around the world a consistent message is conveyed about the marks and what they stand for.

A transfer of registered IP rights will need to be recorded at all the relevant national IP registers where the rights are listed. These recorded requirements, while administrative in nature, are time-consuming and can be very expensive if the IP right portfolios that are subjected to the restructuring are extensive (it is not unusual for a company that relies on its IP rights to own thousands of registered rights all over the world). In some jurisdictions, such as the UK, those transfers must be recorded within six months of the transfer date, to avoid losing rights to claim costs/

damages in infringement proceedings relating to the IP rights transferred.

In most jurisdictions, it is possible to grant licences of IP on terms that permit the licensee to benefit from the further exploitation of that IP by sub-licensing. However, that is not the case for all IP rights everywhere. In India, for instance, a structure that involves sub-licensing of a trade mark may render that mark vulnerable to attack.

Licences (whether from the Parentco to the IP Holdco or from the IP Holdco to the Opco) will need careful consideration to ensure that, while meeting the desired tax objectives, they do not contain terms that undermine the value that the IP rights encapsulate. The duration of the licence, its financial terms, its provisions as to enforcement of the IP rights and its termination provisions are all potentially relevant to that issue.

Each type of IP right has its own legal regime, both at a national and regional level. In implementing an IP right’s restructuring, careful attention must be paid to the relevant IP right’s legal regime in order to ensure that any proposed transfer and/or licensing scheme can be implemented without prejudicing the underlying rights or the owner’s ability to enforce them, both in terms of obtaining injunctive relief and recovering damages. Certain issues may arise in the case of trade mark-based restructurings given the function that a trade mark (or brand) plays as a guarantee of origin in relation to the goods and services on which it is used.

Where the IP rights that are being restructured are registered, e.g. patents, trade marks and registered designs, one must also consider any changes to the relevant IP registers that are required by virtue of the proposed restructuring. If legal title is to be transferred, the new owner should be recorded as such on the various relevant IP registers – a potentially time-consuming and expensive exercise.

F. Minimise the country risk

As an example of country risk in IP planning, the US Treasury Department reported in 2004 that: “[Country X’s] existing legislation governing protection of intellectual property rights is insufficient, and enforcement efforts have been sporadic and largely ineffective . . . (T)he laws are largely not enforced and [foreign] firms have had little success in getting justice in this area from [country X] courts.”

1. Techniques

The techniques for minimising IP country risk include thorough prior review of the local IP protection and enforcement of property rights, formal registrations, APAs, and seeking to agree low tax risk status with the local tax authority.

2. Constraints/pitfalls:

In broad terms, there are three types of country IP risk over which a taxpayer can have little control, as follows:

- legal decisions/willingness to enforce the law;
- political risk, such as nationalisation, civil unrest and war; and

- regulatory risk – price constraints (e.g. in the pharmaceutical and utilities sectors), fines (where the IP has allegedly been used to abuse monopoly power), and windfall taxes (for example on banks).

In some jurisdictions, a licensing structure may limit the IP infringement remedies available to the IP Holdco and the Opc. For example, in a patent infringement case a licensor could not claim profits lost by its sister company to which it had granted a non-exclusive licence, because a non-exclusive licensee has no legal right to enforce ownership of IP and cannot be a party to an action to recover damages.

As a general point, the IP Holdco should be set up in a way that prevents the tax authorities of any other jurisdiction than the IP Holdco's jurisdiction – perhaps particularly Parentco's – from successfully arguing that the IP Holdco is resident in that other jurisdiction (or could be considered to have a permanent establishment there). This would generally require a certain minimum level of "substance" in the IP Holdco and requires careful thought about where the effective management of the IP Holdco is exercised.

Suitable tax jurisdictions for an IP Holdco include not only regimes with a low formal tax rate, but also "onshore" jurisdictions with a high tax rate, but with attractive features, including the following:

- attractive depreciation mechanisms for IP rights, so that accelerated amortisation can be used against other income. In this case, from an overall tax perspective generally only a tax deferral benefit is achieved
- attractive special regimes for IP rights. This may include structures using an IP Holdco that is incorporated and resident in a high tax jurisdiction, but with a permanent establishment (branch) in a low tax jurisdiction. An example is a Luxembourg company with a Swiss or Irish branch
- "royalty box" or "patent box" systems where, despite the usually high rate of tax, a special low rate is applied to qualifying royalty income (e.g. in the Netherlands).

If the profits realised at the IP Holdco's level are taxed at the Parentco's level, immediately when realised (e.g. under CFC rules) or upon distribution, at the Parentco's (high) tax rates, the tax saving for the group might evaporate. If instead the Parentco is resident in a jurisdiction applying an exemption system for distributions extracted from subsidiaries (participation exemption), and assuming that CFC rules are not in point, the issue is whether the conditions for this exemption can be met, given the specific activities in the IP Holdco and its (usual) beneficial tax position. Some jurisdictions require minimum (effective) tax rates or impose specific conditions, e.g. related to active management of the IP rights, on subsidiaries holding IP rights.

If the Parentco is resident in a jurisdiction that taxes dividends while applying a credit system for underlying tax upon distribution of dividends, then the IP Holdco's profits will ultimately become subject to Parentco tax. The tax benefit offered by the scheme will then, in most cases, consist of a deferral benefit.

In both types of jurisdiction, anti-deferral rules or anti-abuse rules may apply: we have already mentioned CFC legislation, and there are other forms of anti-tax haven legislation.

	Techniques – tax and IP	Constraints and Pitfalls – tax and IP
Step 1: Where to own it	<ul style="list-style-type: none"> IP management skills Existing IP location Low effective tax rate Available tax losses 	<ul style="list-style-type: none"> Poor IP protection regime Breaking up the portfolio Poor treaty coverage/AWHT CFC exposure
Step 2: How to get it there	<ul style="list-style-type: none"> Sale at early stage Wither on vine royalty Cost share buy-in 	<ul style="list-style-type: none"> Not identifying and moving it all Exit charge
Step 3: How to charge for it	<ul style="list-style-type: none"> IP company in the supply chain Royalty/franchise fee Cost Contribution Agreement 	<ul style="list-style-type: none"> Not including all IP in the licence Terms don't maximise the charge Enforced profit in bad years?
Step 4: How to manage it	<ul style="list-style-type: none"> Formal IP registrations Transfer pricing agreements APAs? 	<ul style="list-style-type: none"> Lack of substance Ongoing IP development in higher tax jurisdictions

Specific anti-tax haven rules may also apply from the Opc's perspective, making it impossible to deduct royalties based on the tax position of the IP Holdco or reversing the burden of proof regarding the IP Holdco's activities.

These types of rules (especially CFC legislation) will generally have a substantial impact on:

- the ability to achieve the intended tax benefits,
- the place where the IP Holdco is located within the group or
- the required level of substance in the IP Holdco location.

Therefore, careful attention at the early stage of the restructuring process is required.

In choosing the IP Holdco's location, consideration should be given to possible exit scenarios: would a re-transfer of the IP rights out of the IP Holdco lead to substantial tax costs (capital gains tax, transfer taxes, stamp duties, tax losses being trapped in the IP Holdco, etc)?

If the IP Holdco is to be financed through equity, capital taxes and stamp duties at IP Holdco level should be considered.

The need for treaty protection and/or the application of the EU Interest and Royalty Directive in order to reduce or avoid withholding tax at the payer level on royalty payments to the IP Holdco may necessitate the use of an intermediate company, though careful consideration should be given to the risk of conduit structures being challenged on the basis that the intermediate company is not the beneficial owner of the royalties (see the UK *Indofood International Finance Ltd. v JPMorgan Chase Bank NA* case on interest conduits and the impending *Velcro Canada Inc v The Queen* case on royalties in Canada).

IV. Conclusions

By way of example, on the basis of this high level review of the objectives and issues involved in IP planning, a company might complete the framework set out at the beginning of this article in the manner of Figure 5.

Danny Beeton, Christopher Forsyth and Murray Clayson are respectively Head of Transfer Pricing Economics, IP Partner and Tax Partner in the London office of Freshfields Bruckhaus Deringer. They can be contacted at: danny.beeton@freshfields.com christopher.forsyth@freshfields.com murray.clayson@freshfields.com