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seminar

# Critical Tax Issues for IP Managers

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# Basic Tax Concepts

- Taxable Income
  - Ordinary income rates
  - Capital gains rates
- Capital Asset Concept
  - Amortization
  - Concept of basis
- Tax Ownership Concepts
- Transfers Across International or State Borders
- Tax Law Approach to IP
- Use of Tax Valuations of IP

# Sources of IP- Related Tax Law

- Federal Tax Law - Internal Revenue Service
  - Statutes
  - IRS Regulations
  - Administrative Rulings and Determinations
- Caselaw
- State and Local Taxing Authorities (“SALT”)
- Foreign Country Laws
- International Tax Treaties

# IRS Audit Basics

- Position on Tax Return
- IRS Audit Commences
- Audit Must Finish Before Statute of Limitations Expires
- Notice of Deficiency
- IRS Appeals
- Tax Litigation
- Civil Audit v. Criminal Investigation
- APAs
- Competent Authority

# When Do IP-Tax Issues Arise?

- Creation of IP
- Acquisition of IP
- Licensing
- Sale of IP
- Mergers, Acquisitions, and Reorganizations
- Intercompany/Related Party Use of IP
- Management of IP and IP Portfolios
- Litigation
  - Settlements
  - Discovery

# Creation and Acquisition of IP

- Which company should create/acquire?
- Choice of type of entity issues
- Transferring fruits of R&D to related entities
- Cost sharing arrangements
- Deductions, credits, amortization and capitalization
- Allocations of purchase price in acquisitions
  - Statements of consideration in assignments
- Section 338 elections and amortization limitations

# License v. Sale of IP

- Section 1253 – Transfers of Franchises, Trademarks, and Trade Names
  - Not a taxable sale if the transferor retains “any significant power, right, or continuing interest”
- Section 1235 – Sale or Exchange of a Patent
  - Applies to transfer (other than gift, inheritance, or devise) consisting of all substantial rights to patent
  - Applies to transfer of undivided interest which includes all or part of such rights
  - Treated as sale with long term capital gains – can cover royalties
- Section 1249 – Ordinary Gain for US-Foreign Related Party Sales
  - Applies to sale of patent, invention, model, design, copyright, a secret formula or process, or any other similar property.

# Royalties and International Withholding Rules

- The 30% withholding rate (Secs. 1441 and 1442)
- Tax treaties and reduced withholding rates
  - Can be 0% withholding in some cases (following Art. 12, U.S. Model Treaty)
  - Different types of royalties might be treated differently (e.g. Industrial royalties vs. copyright royalties for motion pictures)
  - May not qualify for reduced withholding where carrying on business through a Permanent Establishment
- Limitation of benefits clauses may require higher rates

# Related Company Transfer Pricing Basics

- Concept of Tax Parity
- Arm's Length Standard
- Comparability of prices, transactions, profits, risks, etc.
- Commensurate with income standard
- IRS powers to impute structure (e.g., transfer of an intangible)
- IRS valuation approaches
- Services, intangibles, and tangible goods
- Transfer Pricing Documentation will refer to IP

# Tax Transfer Pricing Definition of IP

**(b) Definition of intangible.** --For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual --

- (1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
- (2) Copyrights and literary, musical, or artistic compositions;
- (3) Trademarks, trade names, or brand names;
- (4) Franchises, licenses, or contracts;
- (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- (6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

# Transfer Pricing IP Enhancement Rule

## **(4) Contribution to the value of an intangible owned by another**

**(i) In general.** --The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of an intangible owned by another controlled taxpayer will be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to §1.482-1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

Consider the case of goodwill and “inure to” clauses

# Transfer Pricing Economic Substance Rules

- “The Commissioner will evaluate the results of a transaction as actually structured by the taxpayer unless the structure lacks economic substance.”
- “However, the Commissioner may consider the alternatives available to the taxpayer in determining whether the terms of a controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances.”
- “In such cases, the Commissioner may adjust the consideration charged in the controlled transaction based on the cost or profit of an alternative as adjusted to account for material differences between the alternative and the controlled transaction, but will not restructure the transaction as if the alternative had been adopted by the taxpayer.”
- Treas. Reg. 1.482-1T(f)(2)(ii).

# Trademark Examples in Transfer Pricing Regulations

- Wristwatch Examples
  - Contractual terms imputed from economic substance
  - Intangible property examples
- Athletic Apparel Examples
  - Contractual terms imputed from economic substance
  - Non-arm's length compensation
  - Intangible property examples

## Section 367(d) – Imputed Royalties

- Special rules for transfers of intangibles
- Only applies to certain corporate reorganizations (non-taxable)
- Transfers of intangibles from U.S. taxpayers to foreign corporation
- Treated as having sold property (gain taxed)
- Treated as ordinary income
- IRS can impute royalty stream for useful life of property

# IP Holding Companies

- International Tax Issues
- Concept of Active Trade or Business
- State Tax Issues
  - Nexus
  - Out of state license of trademarks for use in state
  - Other types of IP?