Managing trademarks in the BEPS environment – the shifting tax landscape

The international tax regime for IP rights is shifting. Multinational companies should revisit their internal ownership and licensing structures to ensure that they meet guidance forthcoming from the Organisation for Economic Cooperation and Development

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The structuring of intellectual property and other intangible property rights is a critical business consideration for any multinational group, particularly with respect to popular global brands. A global brand can be a crucial factor driving profitability for any product and the underlying intellectual property associated with such brands can thus account for a high percentage of corporate value. Multinational groups typically exercise great care in deciding how to protect the intellectual property associated with any global brand, considering factors such as maximising legal IP protection (including the availability of benefits through international treaties), planning IP litigation strategy (including the availability of remedies) and matching the approach to business objectives. All of these factor into the decision of where to legally hold title to such rights and how to structure licensing of IP rights to related and unrelated parties. Although business and IP considerations affect the ownership and licensing of IP rights within a multinational group, tax issues – such as transfer pricing and withholding tax – are ever present and frequently constitute material exposures for any multinational group.

Due to current international tax law changes, multinational companies should reconsider current IP holding structures to confirm alignment of key functions associated with the ownership and licensing of IP rights within their corporate group. On September 16 2014 the Organisation for Economic Cooperation and Development (OECD) released seven deliverables in connection with its ongoing base erosion and profit shifting (BEPS) project. The Action Eight deliverable, entitled "Guidance on Transfer Pricing Aspects of Intangibles", outlines a number of fundamental proposed changes to the OECD Transfer Pricing Guidelines. The guidance set forth in the Action 8 report, although potentially subject to change in the next few months, is aimed at limiting the amount of profit that can be claimed by rights holders. This article provides a brief overview of the BEPS project, discusses the relevance of that project to multinational groups and analyses select aspects of the Action Eight report.

What is BEPS and why does it matter?

In July 2013 the OECD and G20 countries adopted a 15-point action plan to address BEPS. The term is used to identify the perceived problem that multinational enterprises take affirmative steps to shift profits to low or no-tax jurisdictions. Various OECD members believe that the risk of profit shifting is particularly high with respect to IP rights, including trademarks, which can be moved between jurisdictions through various intercompany agreements such as licensing, cost-sharing and sale transactions.

The core goal of the OECD's action plan is to develop guidance and consensus-based rules that address alleged flaws and gaps in the international tax rules as applied to multinational enterprises. As described by the action plan, the OECD is of the opinion that the international tax rules require a fundamental restructuring to account for the modernisation of the economy and to ensure that business profits are taxed in the jurisdiction where the economic activities generating the profits are performed and where value is created. According to the action plan, economic globalisation and the increased sophistication of multinational enterprises have facilitated the current global tax environment, where profits are frequently subject to no or low taxation as a result of "practices that artificially segregate taxable income from the activities that generate it".

The OECD's BEPS project is important to all multinational companies and cannot be ignored. The consensus guidance from it will effectively become the default standard international tax rules. While the OECD's guidance is not law *per se*, a significant number of the 34 OECD member countries, as well as non-member countries, will treat the guidance as relevant, to some extent, to their internal transfer pricing laws upon finalisation by the OECD (expected later this year). The guidance is expected to result in new tax legislation and administrative guidance in both member and non-member countries, and will likely lead to changes to standard tax treaty provisions, which could affect future treaty negotiations and amendments. Ultimately, it will lead to profound changes in the international tax landscape for multinational enterprises. Several countries have already taken steps to implement various aspects of the BEPS guidelines even before they are finalised.

First wave of BEPS guidance

On September 16 2014 the OECD released the first seven deliverables, in the form of fairly lengthy and detailed reports. A number of the deliverables contain draft or interim guidance, which the OECD explained was necessary to account for likely modifications and changes that will result from the ongoing work in 2015. The OECD is scheduled to release the remaining eight deliverables in the latter half of 2015.

The Action Eight report provides guidance on the transfer pricing of intangible property, which will be finalised as revisions to Chapters I, II and VI of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The proposed modifications introduced in the Action Eight report include clarifications and guidance relating to the definition of IP rights, guidance on identifying transactions involving intangibles and supplemental guidance for determining arm's-length conditions for transactions involving intangibles.

Because the issues addressed in Action Eight affect the work on the 2015 projects addressing risk, recharacterisation of transactions and hard-to-value intangibles, various sections of the 2014 report are shaded in grey to signal the fact that they are subject to further refinement and revision as part of the OECD's work in 2015. The Action Eight report states that such information should be viewed as an interim draft of guidance, which will be finalised in connection with the 2015 BEPS deliverables.

Impact on trademark portfolios

The Action Eight report contains a number of critical modifications to the OECD Transfer Pricing Guidelines, which will affect trademark and other rights holders. In particular, the report provides guidance used to determine which entities in a multinational enterprise group should be entitled to realise profits attributable to the commercialisation of trademarks and other IP rights.

Most notably, the Action Eight report does not rely on legal rights to define the owner of IP rights when attributing profits to various members within a multinational enterprise group. Rather, it provides that a more substantive evaluation must be applied to determine how profits attributable to intellectual property should be allocated between members based on the respective functions performed, assets used and risk assumed in connection with the development, enhancement, maintenance, protection and exploitation of the relevant intellectual property. The Action Eight report indicates that Chapter VI of the OECD Transfer Pricing Guidelines will be replaced in its entirety by the redrafted section set out in the Action Eight report.

The Action Eight report retains the current international tax principle that the legal owner of IP rights is generally considered the owner of the intangible for transfer pricing purposes. If no legal owner can be identified under applicable local law or the governing contracts, ownership for tax purposes is determined based on a facts and circumstances analysis, which focuses on which member of the multinational group has the practical capacity to restrict others from using the intangible.

The Action Eight report emphasises that for transfer pricing purposes, the legal owner and a licensee of intangible property are considered to hold separate and different intangibles. The report provides the following example to highlight the separate ownership concept in the context of a licensor and licensee: "For example, Company A, the legal owner of a trademark, may provide an exclusive license to Company B to manufacture, market, and sell goods using the trademark. One intangible, the trademark, is legally owned by Company A. Another intangible, the license to use the trademark in connection with manufacturing, marketing and distribution of trademark products, is legally owned by Company B."

As emphasised by this simple example, licences and other intercompany agreements can create separate intangible rights which must be considered in allocating the returns from any intangible property right. Written intercompany agreements remain critical aspects of any intangible property structuring efforts within a multinational enterprise. Where no written contracts exist, the contractual terms are ambiguous or incomplete or the conduct of the parties is inconsistent with the

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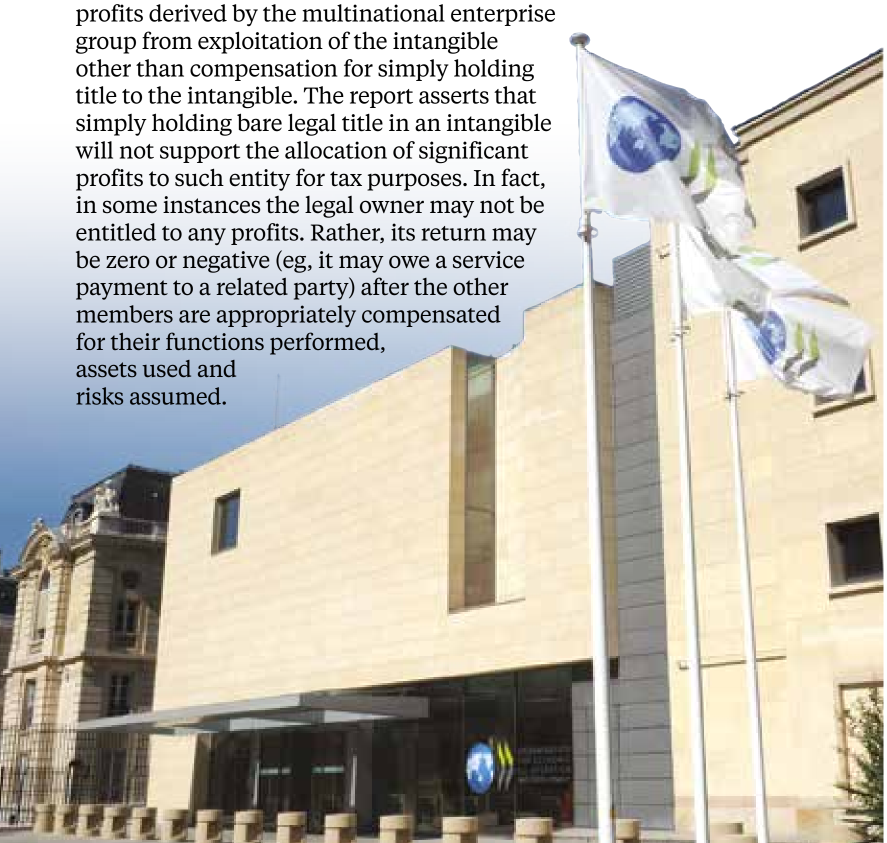
written contracts, the terms of the transactions involving the transfer of intangible property rights will be inferred from the conduct of the parties. Thus, the absence of written agreements could provide taxing authorities with considerable flexibility in defining (or redefining) the relationships between members of a multinational enterprise.

The Action Eight report emphasises the importance of contemporaneous written agreements used to define intangible property ownership rights and contributions from related parties. As stated in the report, written agreements should be in place at or before the time that related entities enter into transactions leading to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intellectual property.

While legal ownership is considered a gating item for determining ownership for tax purposes, the Action Eight guidance quickly moves past legal ownership as the fundamental basis of determining the allocation of profits between related parties for tax purposes. As described by the report, legal ownership is merely a first step in the tax analysis and for "transfer pricing purposes, the legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the [multinational enterprise] group from exploiting the intangible". According to the report, "[l]egal ownership and contractual relationships simply serve as reference points for identifying and analysing controlled transactions relating to the intangible".

The Action Eight report provides the basic example of an internally developed intangible, legal ownership of which is held by an entity that performs no relevant functions associated with the management of the intangible, assumes no relevant risks and acts solely as the legal owner. In such case the report concludes that the legal owner will not be entitled to any portion of the profits derived by the multinational enterprise group from exploitation of the intangible other than compensation for simply holding title to the intangible. The report asserts that simply holding bare legal title in an intangible will not support the allocation of significant profits to such entity for tax purposes. In fact, in some instances the legal owner may not be entitled to any profits. Rather, its return may be zero or negative (eg, it may owe a service payment to a related party) after the other members are appropriately compensated for their functions performed, assets used and risks assumed.



On September 16 2014 the Organisation for Economic Cooperation and Development released seven deliverables in connection with its ongoing base erosion and profit shifting project

For an owner of intellectual property to be entitled to all returns generated from it, the Action Eight report proposes requiring the owner to:

- perform and control all functions related to the DEMPE of the intellectual property;
- assume and control all risks related to the DEMPE of the intellectual property; and
- provide all assets, including funding, necessary to the DEMPE of the intellectual property.

For self-developed trademarks, more important DEMPE functions may include design and control of marketing programmes, and management and control of marketing budgets. For either self-developed or acquired trademarks, other important functions may include key decisions regarding defence and protection of trademarks, and ongoing quality control over functions performed by related or unrelated enterprises, which may have a material effect on the trademarks' value. The contractual allocation of rights, functions and risk alone will be insufficient to support the allocation of profits for tax purposes under the guidance set out in Action Eight. Rather, an IP owner within a multinational enterprise group must have the substantive capability of assuming such rights and risks, and also controlling them, in order to support the allocation of substantial profits to the IP owner.

The Action Eight report recognises that outsourcing certain functions within a multinational enterprise group is necessary and consistent with standard business practices between unrelated parties. However, it imposes a number of key limitations on such outsourcing arrangements in the context of transfer pricing within a multinational enterprise group. The report acknowledges that independent entities outsource aspects of the development or maintenance of IP rights (eg, through a contract R&D agreement). However, it states that in such outsourcing relationships between unrelated parties, the contractor will operate under the direction or control of the IP owner. The control and direction standard for outsourced functions therefore requires the IP owner to employ the personnel necessary to execute the control and direction over outsourcing relationships within the multinational enterprise group if the products of such services are to be attributed to it.

The upshot of this is that a brand-owning company seeking to obtain all returns generated from its intellectual property will likely have to be able to demonstrate substantially greater activity than previously, particularly with respect to the DEMPE functions. If other entities in the group are controlling DEMPE functions, then under the guidance they are entitled to share in the IP returns, allowing the countries in which those affiliates are located to tax a portion of the profits that the group would like to see attributed to the brand-owning company. If ownership within any multinational enterprise group does not currently meet the substantive test of IP ownership for tax purposes reflected in the Action Eight report, satisfying the test may require the restructuring of functions within the group to avoid tax surprises in the future. Aligning capabilities and functions within the group to track legal ownership of IP rights could require the movement and restructuring of job functions and human capital.

Trademark law considerations

Although the required level of control over the DEMPE functions is an open question which will be better defined over time, the Action Eight report reflects that the control is expected to be high-level strategic control over the functions, whether directly or through controlling outsourced services. By controlling the DEMPE functions, a brand-owning company is ultimately viewed as directing the way in which the returns on the assets are optimised. One example set out by the OECD in the trademark context makes clear that the required control involves assessing, monitoring and directing both the use and exploitation of a trademark.

This is consistent with general trademark best practices and the trademark laws of many countries, which also tend to distinguish between strategic and more tactical control and decision making in connection with assessments of whether a brand-owning company is exercising adequate quality control to maintain the validity of its trademarks. The question of what level of brand owner control is satisfactory under trademark law typically arises in the context of an infringement action in which the defendant attempts to challenge the validity of trademarks as a defence to the infringement claim. The following court cases from the United States are illustrative.

In one recent case, The Freecycle Network (TFN) was prevented from stopping someone else from using the mark FREECYCLE because TFN had failed to oversee the use of its mark by its member groups. TFN wanted to stop FreecycleSunnyvale from using the FREECYCLE mark. TFN had permitted its member groups to use FREECYCLE and FreecycleSunnyvale argued that TFN had lost rights in its mark because it was not exercising control over its use by these member groups. The court agreed, citing the lack of an express contractual right to oversee the use of the mark by the member groups, as well as the lack of any actual oversight. In effect, TFN could not stop FreecycleSunnyvale from continuing to use the mark (see *FreecycleSunnyvale v The Freecycle Network*, 2010 WL 4749044 (9th Cir 2010)).

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In another recent case, Barcamerica was prevented from stopping someone else from infringing its rights in LEONARDO DA VINCI for wine. Barcamerica granted Renaissance Vineyards the exclusive right to use its LEONARDO DA VINCI mark in connection with wine products and alcoholic beverages. Barcamerica subsequently sued a competitor (Cantine Leonardo Da Vinci Soc Coop arl) for trademark infringement when that competitor began importing wine products under the identical LEONARDO DA VINCI mark into the United States for sale by a distributor. The competitor argued in defence that Barcamerica had forfeited its trademark rights because it was not overseeing the licensed products made by Renaissance. The court agreed and Barcamerica's trademark rights were cancelled. The court concluded that the favourable quality of the wine sold under Barcamerica's brand did not relieve it from overseeing quality and it was insufficient in that case to rely on the experience of Barcamerica's licensee (see *Barcamerica Int'l USA Trust v Tyfield Importers, Inc*, 289 F 3d 589 (9th Cir 2002)).

There is also a similar US case involving abandonment of a trademark in a parent/subsidiary relationship. In that case, the court found that the parent holding corporation had failed to control the use of its marks by several subsidiary insurance companies. It was determined that actual control over the nature and quality of the insurance services was exercised by the licensees. Because the parent company failed to control the nature and quality of the services provided by the licensees, the mark was abandoned and could not be enforced against a defendant infringer (see *CNA Financial Corp v Brown*, 922 F Supp 567 (MD Fla 1996), affirmed in part, reversed in part on other grounds, 162 F 3d 1334 (11th Cir 1998)).

As reflected by the cases above, a US court analysing a challenge to trademark validity will likely examine certain benchmarks of control, including whether the owner has ultimate decision-making authority concerning matters relating to the use of the trademark and the quality of the goods and services commercialised under the mark.

The international tax landscape surrounding the ownership and exploitation of IP rights is shifting. Now is the time for multinational companies with valuable IP rights to revisit their internal ownership and licensing structures to confirm that they satisfy the new OECD guidance, which is likely to be instituted imminently in many countries. **WTR**

CHECKLIST

Any global brand ownership and licensing structure should adhere to the following general principles:

- The company should have an intercompany trademark agreement structure, which should reflect economic substance.
- Intercompany trademark licences and transfers should comply with both trademark law and tax law. Licences and transfer agreements should be executed contemporaneously with any IP transfer.
- The intercompany agreements should be explicit about ownership of the trademark and marketing intangibles.
- The royalty or other payment amount should be based on or supported by sound transfer pricing economic analysis.
- The structure should ensure the exercise of ongoing brand management and control by the brand-owning company. Personnel, functions and risks should be aligned consistently with both the group's trademark and tax strategies.

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