Basic U.S. Multinational Tax Planning Strategies for Intellectual Property

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Paul W. Oosterhuis
Moshe Spinowitz

BASIC U.S. TAXATION OF INTELLECTUAL PROPERTY

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- Deduction for R&D expenditures connected to a trade or business.
- Credit for R&D Expenditures equal to either
  - 20% of expenditures in excess of ratio of R&D expenditures to revenues during historical base years; or
  - 14% of expenditures exceeding 50% of average expenditures over the prior 3 years.
- Income from exploitation of IP is generally subject to tax as ordinary income.
- Reduced capital gains rates apply to individuals that sell IP.

- Royalties paid by CFCs to U.S. taxpayers eligible for foreign tax credit in general limitation basket.

- Royalties earned by CFCs are Subpart F income unless
  - » are paid by related party CFCs;
  - » are paid by third parties and CFC engages in active product development or marketing activities related to the royalty income.

- Income from the sale of manufactured products is not Subpart F income even if valuable IP is imbedded in product where
  - » CFC manufactured the product itself;
  - » CFC supervised manufacturing by related or unrelated contract manufacturers; or
  - » CFC purchased product manufactured in same country as CFC incorporation.

TRANSFER OF IP TO EX-US NEWCO

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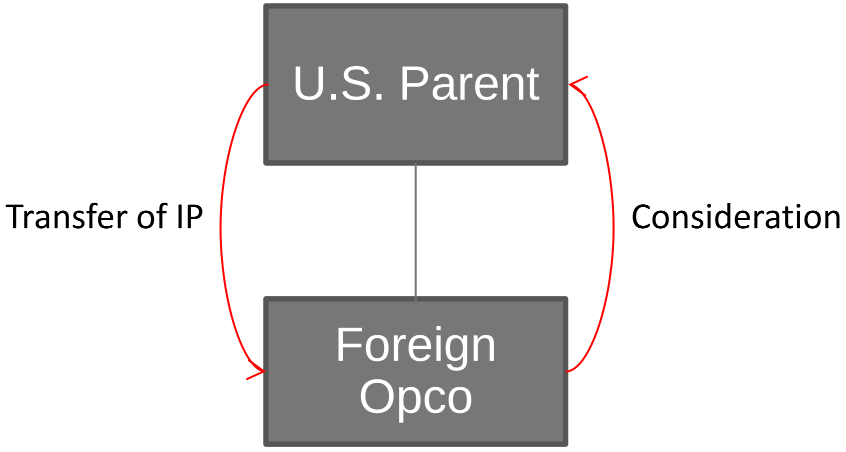
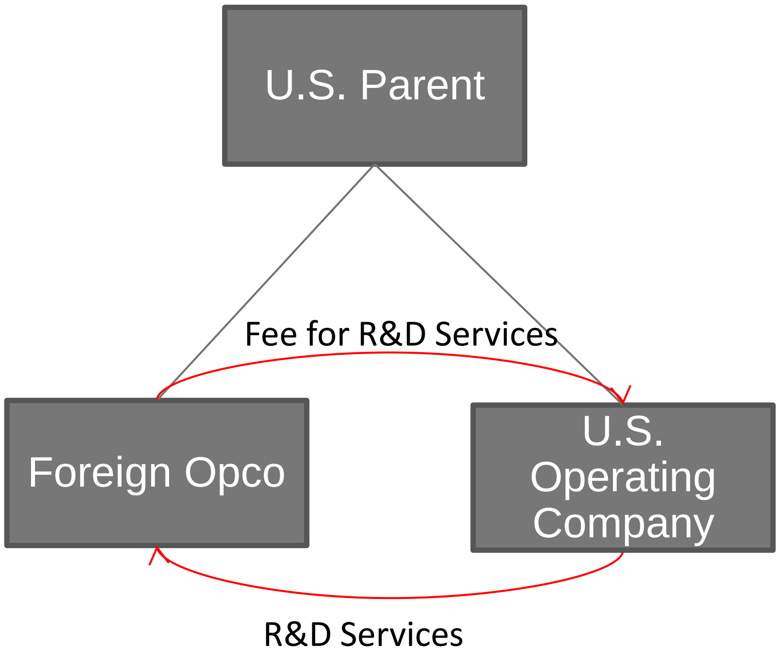


- **Transactions**
  - U.S. Parent (or other IP-owning U.S. affiliate) transfers IP to a foreign subsidiary in a favorable jurisdiction.
- **Considerations**
  - Transferred IP can either constitute product-specific worldwide IP rights or only ex-U.S. rights.
  - Following the transfer, Foreign Opco funds the ongoing R&D related to the transferred IP.
  - IP can be transferred via an exclusive license that is a transfer of beneficial ownership, with the U.S. retaining legal title, or a license that retains some rights to U.S. licensor.
  - The U.S. transferor will be compensated based on the fair market value of the transferred IP.
  - Consideration can be paid either in an upfront lump sum, in the form of a royalty payable if and when the product is commercialized, or a combination of both.
    - IP can also be transferred to Foreign Opco as a capital contribution, in which case U.S. Parent would be required to include a "deemed royalty" in income if and when the product is commercialized.

INTERCOMPANY ARRANGEMENTS – LICENSED IP



- **Transactions**
  - In conjunction with the license of IP, U.S. Parent and Foreign Opco enter into a series of intercompany services agreements governing the ongoing development of the IP.
  - U.S. Parent and Foreign Opco enter into an R&D services agreement with a U.S. affiliate.
  - Foreign Opco pays the U.S. affiliate a fee for the R&D services and retains ownership of any resulting IP.

- **Considerations**
  - Deductions associated with the R&D costs cannot be claimed in the U.S., and are "trapped" at the Foreign Opco level; R&D credit still available.
  - U.S. operating company makes services profit typically on a cost-plus basis (unless under qualified cost-sharing agreement).
  - Foreign Opco should have personnel based outside the United States who are responsible for its business operations. Overall this generally includes personnel with overall responsibility for (i) finance functions, (ii) R&D activities, and (iii) business development.

INTERCOMPANY ARRANGEMENTS – QUALIFIED COST SHARING ARRANGEMENT

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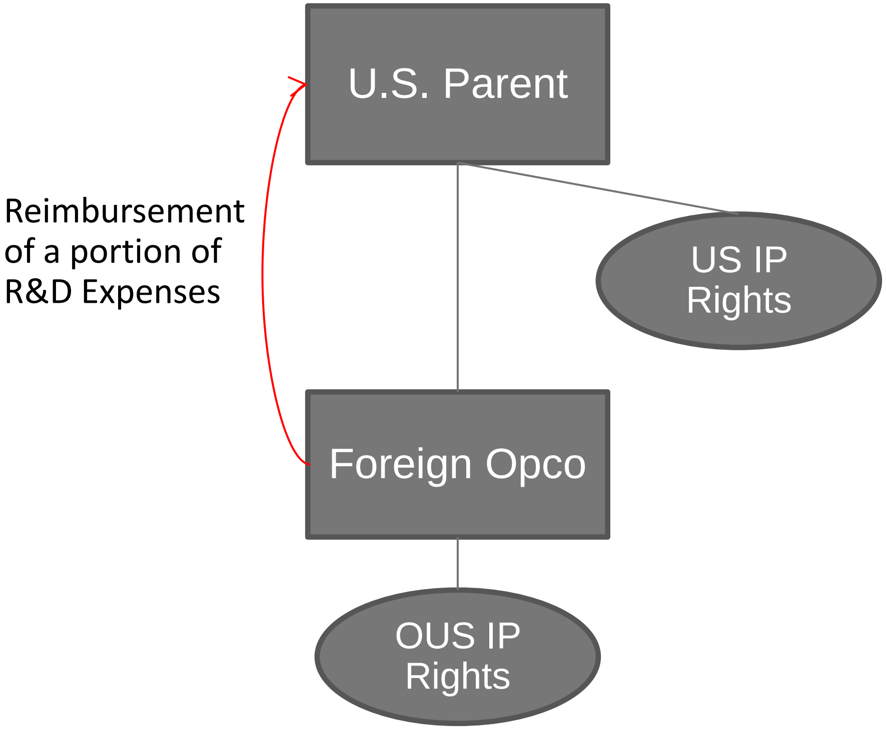
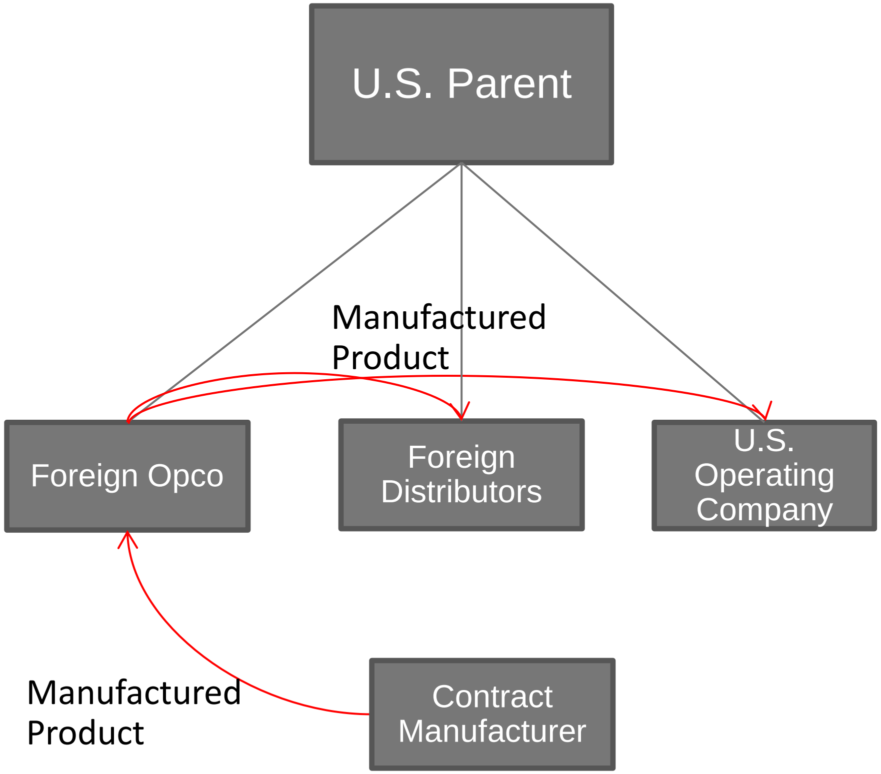


- **Transactions**
  - U.S. Parent and Foreign Opco enter into a qualified cost sharing arrangement pursuant to which the parties share the ongoing expenses associated with the development of the IP, and each party has the right to earn the income resulting from its exploitation of the IP in its respective territory.
    - Division of IP need not be done on a territorial basis; but that is most common basis for division.
  - U.S. Parent conducts ongoing R&D activities and Foreign Opco reimburses U.S. Parent for Foreign Opco's appropriate share of those expenses.

- **Considerations**
  - Deductions associated with the R&D costs ultimately borne by Foreign Opco (i.e., after reimbursement of U.S. Parent) cannot be claimed in the U.S., and are "trapped" at the Foreign Opco level; R&D credit still available.
  - U.S. operating company is reimbursed at-cost for the R&D expenses allocated to Foreign Opco (no cost-plus profit margin).
    - Per Tax Court's decision in *Altera*, under current law, stock-based compensation paid by U.S. Parent does not need to be included in the cost-base for the cost-sharing reimbursement calculation.
  - Arguably personnel not necessary at Foreign Opco.

SET UP POST-COMMERCIALIZATION STRUCTURE FOR SALES & DISTRIBUTION



- **Transactions**
  - Foreign Opco manufactures itself or employs a contract manufacturer to manufacture the products embodying the IP.
  - Foreign Opco on-sells the products to related-party distributors both inside and outside the United States.
  - Sales price reflects value of embedded IP except with cost-sharing where sales to U.S. do not reflect IP value.
  - Often related party distribution agreements are structured to limit local-country distributors' risk with respect to marketing and related activities; result is less profit allocable to market country.

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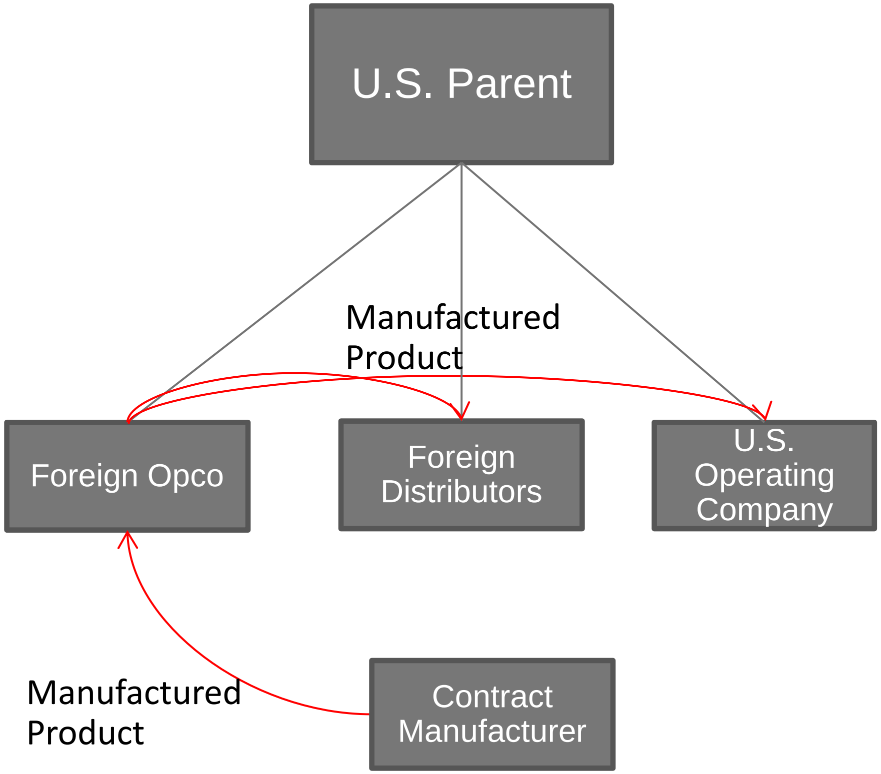

- **Considerations**
  - Manufacturing should be conducted outside the U.S.
  - If contract manufacturer is used, and its activities are conducted outside the country of Foreign Opco's incorporation, Foreign Opco must supervise the manufacturing activities. Supervision includes:
    - oversight and direction of the activities or processes pursuant to which the property is manufactured;
    - activities "considered in" but insufficient to satisfy the substantial transformation test;
    - material selection, vendor selection, control of raw materials, work-in-progress, or finished goods;
    - management of manufacturing costs or capacities (such as managing the risk of loss, cost reduction, or efficiency initiatives, etc.);
    - control of manufacturing-related logistics;
    - quality control (such as sample testing or establishing quality control standards); and
    - developing, or directing the use or development of, product design and design specifications, and manufacturing-related IP.
  - If Foreign Opco meets this test, then its profits are only subject to local tax, and not current U.S. taxation.
  - However, Foreign Opco cash must be held outside the U.S.
  - Foreign Opco cannot exploit the IP by licensing it to a third-party, as the resulting royalty income would likely be taxable in the U.S.
  - Foreign Opco can in many circumstances sell the IP to a third-party, but the consideration received must be held outside the U.S.
  - Repatriating IP will trigger U.S. tax on value of IP.

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