Taxation of Intellectual Property

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The tax rules surrounding intellectual property (“IP”) are indeed a tangled web that even experienced tax practitioners have trouble navigating. This circumstance is in part because the concepts are antiquated and have not kept up with innovations in technology and intellectual property law.

This paper provides an overview of some of the principal concepts in the taxation of IP. Section II, III and IV summarize some of the basic principles of acquiring and disposing of IP. Sections V and VI discuss some of the basic tax planning involved in multi-jurisdictional business operations, both multi-state businesses and multi-national businesses.

II. Characterizing Transfers of IP

One of the critical issues in taxing IP is characterizing the transaction between the IP owner and the user. In general, if the IP owner relinquishes legal title and all substantial rights to the IP for a fixed payment, tax law characterizes the transaction as a sale of the underlying IP. Most transfers of the use of IP, however, do not fall neatly into the bucket described above. For example, the IP owner might retain title and transfer some or all of the economic rights. The characterization of the IP often is contingent on the productivity of the IP to the user. These transactions can lead to fine distinctions in characterizing the transaction for Federal income tax purposes.

The tax law does not rely on the transfer of legal title to characterize the transaction between a sale and a license. Nor does it rely on the characterization of the transaction under applicable IP law. For example, the tax law characterizes many “licenses” of IP as sales for tax purposes.

If the tax law classifies the transaction as a sale or exchange, the transferor offsets the amount realized against its adjusted basis (its tax “cost” in the asset), and the difference can be capital gain or loss if the property is a capital asset or qualifies for special treatment under Internal Revenue Code (“IRC”) § 1231. On the other hand, if the tax law classifies the transaction as a license or lease, the transferor must report the amounts received as ordinary income, subject to depreciation or amortization of the adjusted basis of the property if the property qualifies for such deductions.

For many years, the characterization of IP transfers was solely the purview of the common law and the subject of numerous judicial battles between taxpayers and the Internal Revenue Service (“IRS”). More recently, Congress has enacted provisions stipulating the tax characterization of many transactions. As discussed below, however, the legislation is not comprehensive, and case law continues to prescribe the rules to characterize many transactions.

A. Case Law

The principal litigated issues regarding IP transaction characterization revolve around three features of IP transactions, although the facts of many cases address multiple issues.
1. Contingent Payments

Initially, the IRS took the position that payments contingent on the transferee’s sales or profits were like royalties, because they were spread out over a period of years and gave the transferor an continuing interest in the property, and thus should not be given capital gains treatment. Had the courts agreed with this theory, virtually no transfers of IP would have qualified as a sale of the IP for tax purposes, because the difficulty of valuing IP usually dictates the parties to employ a royalty arrangement. Largely for this reason, the courts regularly rejected the IRS position and the IRS has long since conceded this issue.

2. Geographical and Field-of-Use Restrictions

Owners of patents, copyrights, and other intangibles often limit licensees’ exploitation of the IP to specified geographical areas or fields of use. The IRS’s original position was that the IP was indivisible, so that geographical and functional divisions were indicative of a license even if the user obtained exclusive rights within the specified domain. The IRS’s indivisibility theory of IP was also rejected by the courts, which held that the transfer of exclusive rights to a patent, copyright, or trademark could be a sale for tax purposes even if restricted to a geographical area or a prescribed field of use. The IRS surrendered on this issue in 1954.

3. Reservations of Control

An owner of IP typically retains some control over geographical and field-of-use restrictions by requiring the assignee to adhere to quality and other standards prescribed by the assignor. Drawing the line between “the reservation of sufficient rights and restrictions merely to protect [the taxpayer’s] continuing financial interest and the reservation of rights to continuing participation in the business on such a scale that it cannot properly be said that there was a sale” has proven problematic for courts. Moreover, because the court analyzes both the conduct of the parties and their formal contract rights in determining whether the arrangement is a sale license, the outcome of these particular cases is of limited predictive value.

4. Summary of Case Law

In sum, the case law looks to whether the taxpayer disposes of all substantial rights in the underlying IP to distinguish between sales or exchanges of the IP and licenses of the IP. The more control that the owner places on the user’s use of the IP, the greater the likelihood of a characterization of the IP as a license.

B. IRC § 1235

IRC § 1235 characterizes a transfer by a “holder” of a patent of all substantial rights to that patent as a sale or exchange of a capital asset held for more than one year. This characterization applies even if the amounts received are payable periodically during the transferee’s use of the patent or are contingent on the productivity, use, or disposition of the transferred property. Since its enactment in 1954, § 1235 has proven useful to provide inventors and other eligible holders a capital gain safe harbor without having to rely on the sometimes confusing case law discussed above.
1. **Holder Defined**

For purposes of § 1235, a holder must be an individual. Primarily, the holder is the individual whose efforts created the invention. The term also includes an individual who (1) acquired an interest in the invention for money or money’s worth, paid to the creator before the invention’s reduction to practice, and (2) is neither the creator’s employer nor a related person when the rights acquired are determined and the amount to be paid is fixed.

2. **Transfer of All Substantial Rights**

To qualify for preferential treatment under § 1235, the holder must transfer “all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights.” The language of the instrument of transfer is not controlling, so that a transfer of the requisite rights can satisfy § 1235 whether it is called a sale, license, or assignment.

The regulations provide that “all substantial rights to a patent” means all rights (whether or not then held by the transferor) that are of value at the time of the transfer. Accordingly, the holder may retain a security interest to ensure performance or payment without destroying sale or exchange treatment. Moreover, the regulations require an analysis of all the circumstances to determine whether retention of a right to prohibit sublicenses or sub-assignments or a failure to convey the right to use or sell the patent is substantial.

An assignment of an exclusive right to exploit a patent in a single field of use or geographical area does not satisfy the “all substantial rights” requirement of § 1235. In other respects, however, the principles determining whether all substantial rights have been transferred follow those used to ascertain the existence of a sale or exchange, as opposed to a license, in situations not subject to § 1235.

For example, while a transferor’s retention of a right to terminate for nonperformance is not inconsistent with a completed transfer, a right to terminate at will before the patent’s expiration renders § 1235 inapplicable and negates sale or exchange status. On the other hand, the failure to make an express grant of the right to use a patented product is consistent with a transfer of all substantial rights if the right is either insubstantial or granted by implication.

3. **Transfers Outside of § 1235**

While § 1235 guarantees capital gain treatment to any holder meeting its conditions, other taxpayers can qualify for capital gain treatment under the case law discussed above without adverse inference from their exclusion from § 1235.

C. **IRC § 1253**

Section 1253 characterizes “transfers” of trademarks, trade names, and franchises. For this purpose, a transfer includes a renewal of the rights. Any “transfer” of a trademark, trade name, or franchise is not a sale or exchange if the transferor retains “any significant power, right, or continuing interest” with respect to the subject matter of the franchise, trademark, or trade name. Moreover, amounts paid on account of the transfer of a trademark, trade name, or copyright that are contingent on the
productivity, use, or disposition of the IP are taxable as ordinary income. A transfer that runs afoul of § 1253 cannot be recharacterized as a sale or exchange under the common law principles discussed above.

Section 1253 specifies the significant powers, rights, and significant interests that would cause the transfer not to be a sale or exchange, as follows:

1. A right to disapprove any assignment of such interest, or any part thereof;
2. A right to terminate at will;
3. A right to set standards for products sold, services furnished, or promotional equipment and facilities;
4. A right to require that transferee sell or advertise only transferor’s products;
5. A right to require that transferee buy substantially all supplies and equipment from transferor; or
6. A right to payments contingent on productivity, use, or disposition.

Unlike § 1235, § 1253 also provides specific rules characterizing payments by the user of the IP. Amounts paid on account of the transfer of a trademark, trade name, or copyright that are contingent on the productivity, use, or disposition of the IP are deductible by the payor, if such payments are (1) one of a series of payments payable at least annually and (2) such payments are relatively equal in amount or payable in accordance with a fixed formula. This treatment is similar to the treatment of royalties. All other payments are capitalized in the tax basis of the IP, similar to purchase price.

III. Recovering the Cost of Acquiring IP

Generally, the cost of purchasing IP is not currently deductible but is instead “capitalized” in the cost of the IP and recovered through ratable amortization over a period of years. The method and term of amortization depends on the circumstances under which the taxpayer acquired the IP.

A. IRC § 197

If § 197 applies to an asset, the taxpayer amortizes the cost of the asset equally over the 180-month period beginning with the month of acquisition. Section 197 applies to the following acquisitions of IP.

1. Patents and Copyrights

Section 197 applies to patents and copyrights, with two important exceptions. First, § 197 does not apply to the costs of developing a patent or copyright by the taxpayer. Second, § 197 does not apply to the purchase of a patent or copyright in a transaction (or series of transactions) pursuant to which the taxpayer does not acquire the assets of a trade or business. As a result, § 197 applies only to patents or copyrights acquired by a taxpayer in connection with the purchase of a trade or business.

2. Franchises, Trademarks, and Trade Names

Section 197 applies to acquisitions of franchises, trademarks, and trade names, irrespective of whether the taxpayer acquires the asset in connection with the purchase of a trade or business.
Accordingly, the cost of acquiring a franchise are amortizable over a 15-year period regardless of
the length of the franchise right. Moreover, the cost of renewing a franchise is treated as a separate
asset subject to a separate 15-year amortization period beginning with the month of renewal. The
new 15-year period does not apply to any unamortized cost of acquiring the original franchise (or
prior renewals).

B. IRC § 167

If § 197 does not apply to the costs of acquiring IP, § 167 determines the method of amortizing the
cost. These rules would apply to the cost of developing patents and copyrights as well as the cost of
purchased patents or copyrights not acquired in connection with the purchase of a trade or business.

1. Cost of Self-Developed Patents and Copyrights

A taxpayer may amortize the cost of a patent or copyright using one of two approved methods. First,
the taxpayer may depreciate the cost ratably over the legal life of the patent, under the so-called
straight-line method. If a patent or copyright becomes valueless in any year before its expiration the
taxpayer may deduct the unrecovered cost or other basis in that year.

Alternatively, the taxpayer may recover costs of the patent or copyright under the “income forecast
method.” Pursuant to that method, the depreciation deduction for any year is computed by
multiplying the property’s original basis by a fraction, the numerator of which is the income from the
property earned in that year and the denominator is the anticipated total income from the property.
The income estimate used in applying the method can only include income for the period consisting
of the year that the property is placed in service and the succeeding ten years. The taxpayer must
adjust the estimated revenues periodically to reflect changes in circumstances.

2. Separately Purchased Patents and Copyrights

A special rule applies to purchased patents or copyrights with purchase price payable on at least an
annual basis as either a fixed amount per use or a fixed percentage of the revenue derived from the
use of the patent or copyright. In that case, the amortization expense is equal to the amount of that
purchase price paid or incurred during the year. Otherwise, the taxpayer amortizes the patent or
copyright over the remaining useful life of the IP using one of the methods described above.

C. IRC § 174

Tax law permits a current deduction of certain “research and experimental expenditures.” The
taxpayer may elect to defer the expenditures and amortize them for a period of not less than 60
months. The taxpayer may adopt the current deduction method without the IRS’s consent only for
the first tax year that it incurs qualifying expenditures. Once adopted, the current expense method
must be used for all qualifying expenditures in that year and in later years, unless the taxpayer gets
the IRS’s consent to capitalize and amortize the expenditures.

For this purpose, “research and experimental expenditures” are research and development costs
in the experimental or laboratory sense. Whether expenditures qualify as research or experimental
expenditures depends on the nature of the activity to which the expenditures relate, not the nature of
the product being developed or the level of technological advancement the product or improvement represents. A product for this purpose includes any pilot model, process, formula, invention, technique, patent, or similar property, including products to be used by the taxpayer in its trade or business and products to be held for sale, lease, or license. It also includes the cost of obtaining a patent, such as attorneys’ fees incurred in making or perfecting a patent application.

IV. Disposing of Intellectual Property

Under tax principles, a disposition of IP characterized as a sale or exchange under the principles described in Section II above can be a taxable transaction pursuant to which the taxpayer recognizes gain or loss equal to the excess of the sales price over the adjusted tax basis of the IP. In certain circumstances, however, the transaction will qualify for “nonrecognition” treatment, meaning the taxpayer defers the gain or loss until it later disposes of the property received in exchange for the IP.

A. Status of IP as Capital Asset

One of the major stakes in disposing of IP is whether any gain or loss from the disposition is subject to the special rules for capital assets. Under current law, an individual’s gains with respect to capital assets held for more than one year are treated as long-term capital gains and taxed at a maximum rate of 15%. Capital assets held for not more than one year are treated as short-term capital gains and are taxed at the individual’s ordinary income tax rate. An individual may only deduct $3,000 of capital losses in excess of capital gains in any tax year. Capital gains recognized by corporations are taxed at the same rate as ordinary income, and corporations may deduct capital losses only against capital gains.

1. Assets Held by Creator

One major issue is whether the creator of IP can treat the IP as a capital asset. The answer depends on the type of IP.

A holder of a patent treats the taxable disposition of a patent as the sale of a capital asset held for greater than one year, irrespective of the actual period that the holder actually held the patent. A holder includes the individual whose efforts created the patent. Accordingly, an individual inventor may treat gain from the disposition of a patent as long-term capital gain.

A copyright held by the person whose efforts created the work is not a capital asset.

Transfers of franchises, trademarks, and trade names are not treated as sales of capital assets if the transferor retains any significant rights, as discussed above. Moreover, payments contingent on the productivity, income, or use of the IP are taxable as gain that is not long-term capital gain.

2. Assets Used in a Trade or Business

If a taxpayer develops or acquires IP that it uses in its trade or business and which is depreciable, special rules under § 1231 apply to the gain. In that case, any gain from the sale of such IP held for greater than one year is treated as long-term capital gain. A copyright cannot qualify for the special treatment under § 1231, however.
B. **Taxation of Contingent Payments**

Payments based on the productivity, use, or income of the IP are generally reported under the “installment method.” Under the installment method, the taxpayer recognizes for any taxable year from a disposition as it receives payments in the proportion that the payments received in that year bears to the total contract price.

With respect to contingent payment sales, special rules allocate the taxpayer’s basis to payments received and to be received in the sale. The rules distinguish between contingent payment sales depending upon sale price and payment term:

1. If the contingent payments have a maximum selling price, the basis is recovered in the same proportion as the payments in the year bears to the maximum selling price.
2. If the contingent payments do not have a maximum selling price, but the time over which the payments will be made is determinable, the taxpayer will recover its basis ratably over such period.
3. If the contingent payments have neither a maximum sales price or a fixed period over which payments are to be made, the taxpayer recovers its basis ratably over a period of 15 years commencing with the date of sale.

A taxpayer may elect not to have the installment method apply to deferred payment sales, in which case the taxpayer would be taxable in the year of disposition based on the fair market value of the stream of contingent payments (plus the amount of any fixed payments). This valuation exercise of the contingent payments can be extremely complex, due to the uncertainty around the payments themselves.

C. **Tax Deferred Dispositions**

The IRC permits a taxpayer who exchanges property for certain other property not to recognize gain or loss at the time of the exchange, effectively deferring the taxable event until a subsequent realization event. For example, pursuant to § 351, a taxpayer does not recognize gain or loss on an exchange of IP for stock of a corporation that the transferor (together with other transferors of property) controls immediately after the transfer. Similarly, pursuant to § 721, a taxpayer does not recognize gain or loss on the exchange of IP for an interest in a partnership (or limited liability company taxable as a partnership).

A key issue in determining the applicability of these sections in an exchange is whether the taxpayer’s transfer of IP to the entity constitutes property for tax purposes. Under the case law discussed in Section I.A. above, the tax law will recognize a transaction as a transfer of property if the taxpayer transfers all substantial rights to the IP, including transfers subject to geographic or field of use limitations.
V. Use of IP in Multi-State Enterprises (the IP Holding Company)

A. Background

Many states, primarily in the eastern United States, permit or require affiliate entities to file separate tax returns for each entity in the affiliated group, even when the entities file a single consolidated federal income tax return. This filing system leads to a tax planning structure to shift income attributable to IP from operating companies operating in separate return states to a state that does not tax the income attributable to IP.

Delaware, for example, exempts the income of a corporation domiciled in Delaware if its sole activity in Delaware is the maintenance and management of intangible investments. Other states, such as Nevada, have no corporate income tax.

The tax planning strategy involves setting up an affiliated entity (“IP Holdco”) in a state like Delaware or Nevada. The sole purpose of IP Holdco is to acquire the IP used within the business and license the use of the IP to the operating companies throughout the affiliated group.

The anticipated tax benefit from this strategy is that the operating companies could deduct the payment of royalties to IP Holdco, reducing the taxable income in states where the corporations file separate returns. IP Holdco reports the income in its state of domicile, but under the rules of that state, the royalty income is not subject to tax.

For the IP Holdco strategy to be successful, IP Holdco must have activities in Delaware sufficient to establish nexus there, and must avoid any activity outside Delaware that might establish nexus with another state. In addition, IP Holdco must not be a member of a unitary business that has to file a consolidated or combined return with other members of the affiliated group.¹

B. Nexus

Nexus refers to the Constitutional requirements for the minimum contacts necessary to establish a state’s right to impose an income tax obligation on an out-of-state corporation. The nexus concept derives from the Commerce Clause. According to the Supreme Court in Complete Auto Transit, Inc. v. Brady,² the Commerce Clause precludes a state from taxing a corporation unless “substantial nexus” exists. Moreover, according to the Court in Quill Corp. v. North Dakota,³ substantial nexus requires a physical presence in the state attempting to tax the corporation.

Accordingly, businesses that implemented IP Holdco strategies took great care to create a physical presence in the domicile of IP Holdco, and to limit the activities of IP Holdco in other states. For example, officers of IP Holdco would travel to its domicile to sign checks and agreements, even if they had other duties within the organization.

¹ Several states, such as California, Michigan, and Illinois, require all entities engaged in a unitary business to file a single return for the entire group. This rule eliminates the benefits for taxes paid to those states.
C. Georgia Attack on IP Holdcos

Georgia imposes its corporate income tax on the portion of a corporation’s net income that it derives from and is reasonably attributable to property owned and business done in Georgia. Georgia does not have any laws specifically addressing IP Holdco.

In an early test of the IP Holdco strategy, the Georgia Department of Revenue (the “GDOR”) unsuccessfully attempted, in *Aaron Rents, Inc. v. Collins*,\(^4\) to reallocate the income of an IP Holdco to a Georgia based corporation by arguing that the IP Holdco was a sham corporation. In *Aaron Rents*, the Georgia corporation assigned a trademark to the IP Holdco (domiciled in Delaware), and the IP Holdco licensed the trademark back to the Georgia corporation.

The GDOR argued that the IP Holdco was a sham created for the sole purpose of tax avoidance, and that the financial transactions between the Georgia corporation and the IP Holdco were arbitrary shifts of income that should be disregarded in determining the taxable income of the Georgia corporation, effectively denying the deduction for the royalties paid to IP Holdco. The superior court held that there were adequate and valid non-tax reasons for establishing the IP Holdco:

1. To protect and enhance the value of the trademarks;
2. To segregate the trademarks from other company assets to enable quantification of profit from the trademarks;
3. To protect the intangibles against claims of creditors; and
4. To give the in-state corporation greater flexibility to pursue other business strategies.

The court also found the following factors persuasive in determining that the IP Holdco had engaged in sufficient business activity to be a separate and distinct corporate entity:

1. It maintained a separate corporate office in Delaware;
2. It maintained separate bank accounts;
3. It incurred operating costs;
4. It contracted in its own name;
5. It collected income and incurred expenses;
6. It filed its own Delaware franchise tax returns; and
7. It had its own corporate officers and board of directors who held regular meetings.

D. Attacks on the IP Holdco Strategy

The *Aaron Rents* case stands as a rare taxpayer victory in a war by separate states on the IP Holdco strategy. States have focused on one of three main lines of attack to eliminate the tax savings of the IP Holdco strategy.

1. Addbacks

One line of attack on the IP Holdco strategy is for a state to legislatively deny the royalty deduction to the operating company by “adding back” that deduction. States that have employed addback

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legislation include Alabama, Connecticut, Indiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, North Carolina, Ohio, New York, Rhode Island and Virginia.

2. **Forced Combined Reporting**

Other states have used existing statutes or have enacted statutes to require IP Holdco to file a combined return with the operating company in that state. The combined return effectively eliminates the deduction by the operating company by including the corresponding income of the IP Holdco in the combined return. Prior to implementing its addback statute, New York attempted, with mixed results, forcing a combination of IP Holdcos with their corresponding operating companies. In addition, Virginia has implemented this attack in the past.

3. **Taxing the IP Holdco**

The final line of attack is for the state in which the operating company operates to attempt to tax the IP Holdco. The major hurdle in this attack is for the state to assert that the IP Holdco has sufficient nexus in that state.

In most of the reported cases, the state does not assert that the IP Holdco has a physical presence in the state. However, in *Geoffrey, Inc. v. South Carolina Tax Commission*,\(^5\) the South Carolina Supreme Court held that the state had sufficient nexus to tax an IP Holdco even without a physical presence in the state.

In *Geoffrey*, Toys “R” Us established an IP Holdco—Geoffrey, Inc. (“Geoffrey”)—for the purpose of holding and managing the Toys “R” Us trademarks. Geoffrey then licensed to each operating affiliate the right to use the trademarks, and each affiliate agreed to pay a royalty to Geoffrey based on a specified percentage of net sales.

South Carolina assessed Geoffrey for the tax that the operating company would have paid on this income on the theory that Geoffrey had “economic nexus” with the state. The South Carolina Supreme Court subsequently determined that Geoffrey had to file income tax returns and pay income tax in South Carolina even without any physical presence in the state. The court found it sufficient to establish nexus that Geoffrey owned intangible property used by an in-state affiliate—in this instance, the Toys “R” Us affiliate in South Carolina.

The *Geoffrey* decision has been much discussed in tax circles, but the Supreme Court denied certiorari in this case and has refused similar appeals from other states. Emboldened by the silence of the Supreme Court on the nexus issue, other states, including Arkansas, Florida, Missouri, New Mexico, and Ohio, have adopted rules subjecting the IP Holdco to tax in their states.

E. **The Future of IP Holdcos**

The aggressive attacks on the tax benefits by states has certainly chilled the implementation of IP Holdcos as a tax planning strategy. In our experience, companies would not consider establishing an IP Holdco in the current environment. Moreover, many companies have either already implemented

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or are considering implementing alternative structures due to the diminished state tax benefits of the IP Holdco structure.

VI. Use of IP in Multi-National Enterprises

Because IP is typically a major contributor to the profitability of most multinational companies, U.S. tax planning involving the offshore ownership and exploitation of IP has become more common. Moreover, as multinational companies continue their global expansion and also strive to improve business efficiencies through operational restructurings (often involving the centralization of certain business functions), the opportunities for reducing tax costs through effective IP tax planning have increased.

At its core, IP tax planning for a U.S.-based multinational involves determining which affiliate (or affiliates) within its worldwide group should derive income from the exploitation of that IP outside the U.S. Once this determination is made, the multinational company must address a number of complex U.S. (as well as foreign) tax rules and considerations in order to achieve the desired tax savings resulting from the IP tax planning. In addition, any IP tax planning within an affiliated group must satisfy the arm’s length requirements of the U.S. and applicable foreign transfer pricing regulations and guidelines. Some of these tax and transfer pricing considerations are highlighted below.

A. Methods and Tax Consequences of Transferring Intellectual Property Offshore

In general, a U.S. multinational can transfer IP (or economic rights with respect to that IP) to a foreign affiliate for exploitation outside the U.S. through one of the following four methods.

1. Sale

A U.S. multinational corporation can sell the IP to a foreign affiliate either for a fixed lump sum price or for payments that are contingent upon the use of that IP by the affiliate (i.e., effectively, royalty payments). Under U.S. transfer pricing rules prescribed by § 482, more fully discussed in Section D below, the purchase price paid by the foreign affiliate must represent an arm’s length consideration for the IP purchased in the transaction. On a sale of the IP, the U.S. seller of the IP would recognize gain to the extent the arm’s length consideration received exceeds its tax basis (generally cost) in the IP. In addition, if the foreign affiliate pays the purchase price in installments rather than in a lump sum amount, interest would generally be required (or imputed) to the seller for U.S. tax purposes.

Because a sale of IP is a taxable event, the immediate U.S. tax cost associated with a sale to a foreign affiliate will generally be substantial and will often be prohibitive. This alternative method for transferring IP offshore, however, may be worth considering in circumstances where the upfront tax cost can be minimized either through the use of existing tax losses to offset all or part of the gain on the transfer, or where there is little or no gain inherent in the IP either due to its high tax basis or low value (which may apply, for example, to a transfer of early stage, unproven technology). As noted below, determining the “right” value of IP for U.S. tax purposes is a difficult and challenging exercise and the ability of the IRS and other taxing authorities to make retroactive purchase price
adjustments in the case of transfers to offshore affiliates often creates uncertainty with respect to valuation issues.

2. License

Instead of selling the IP, a U.S. multinational can license the IP to a foreign affiliate in exchange for arm’s length royalty payments based on the use of that IP outside the U.S. The royalty payments received will be taxable to the U.S. multinational and will be treated as foreign source income to the extent the IP is used outside the U.S. Furthermore, under certain “look-through” rules, the foreign source royalties received by the U.S. multinational will be characterized as “general category income,” for foreign tax credit purposes, to the extent allocable to “general category income” of the foreign affiliate. Thus, if the foreign affiliate actively exploits the IP in its business, the royalties received should generally be treated as general category foreign source income (which is typically more beneficial).

Depending on the jurisdiction of the foreign affiliate, the royalties paid to the U.S. multinational may be subject to local country withholding taxes, which may be reduced or eliminated under an applicable income tax treaty with the U.S. Some countries also require recording royalty-bearing licenses with IP, fiscal, or other authorities and/or governmental approval of as a prerequisite to payment of royalties outside of the country.

3. Contribution

A U.S. multinational can also contribute the IP to a foreign affiliate in exchange for shares of common stock in that affiliate. Although a transfer of property to an 80% owned affiliate for stock is generally treated as a tax-free transaction, an exception exists with respect to the contribution of IP to a foreign corporation. Specifically, if a U.S. company transfers IP to a foreign affiliated corporation in a transaction that otherwise qualifies as a tax-free contribution or corporate reorganization, the U.S. transferor is treated as having sold the IP in return for annual payments contingent upon the productivity, use or disposition of such IP (i.e., royalties). Thus, even though no actual payments would be made by the foreign affiliate, the U.S. company is taxed annually on a deemed royalty over the life of the IP contributed. The deemed royalties received by the U.S. company are sourced and characterized, for foreign tax credit purposes, in the same manner as actual royalties (and hence will generally be foreign source “general category income” if the IP is used offshore in an active business).

4. Cost Sharing

Although not involving a legal transfer of existing IP, a U.S. multinational can enter into a qualified cost sharing arrangement (“CSA”) with a foreign affiliate under which the parties contractually agree to share the costs and risks of developing new IP resulting from such arrangement in proportion to their shares of “reasonably anticipated benefits” from their individual exploitation of that IP. Under a CSA, the foreign affiliate is treated as a having an economic (but not legal) ownership interest in

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6 Because the U.S. company does not actually license the IP to the foreign affiliate (and does not actually receive any royalty payments), the offshore jurisdiction will not allow a royalty expense deduction to the offshore affiliate for any such deemed payments (potentially resulting in double taxation).
the newly developed IP under such arrangement and the exclusive right to profits attributable to its respective interest in the cost shared IP. A U.S. company can therefore own and license existing IP to a foreign affiliate and also transfer “economic” ownership with respect to future IP to that affiliate under a CSA. However, under a CSA, the foreign affiliate must compensate the U.S. company for any existing IP (and certain other resources and capabilities) developed, maintained, or acquired by such U.S. company and which is reasonably anticipated to contribute to the development of the new IP. Determining the amount of compensation that must be paid by the foreign affiliate to the U.S. company for its “platform contribution” to a CSA is perhaps the most significant issue that must be addressed under this alternative.

B. Offshore Exploitation of Intellectual Property

A foreign affiliate that owns or licenses IP can exploit that IP by licensing the rights to either other foreign affiliates or unrelated third parties in exchange for royalty payments. Alternatively, the foreign affiliate can use the IP in connection with the manufacture of products for sale to related or unrelated parties, in which case the affiliate’s economic return on that IP is effectively embedded in the purchase price of the products sold. Although the foreign affiliate may be subject to a low rate of income tax on the royalty or sales income in its local country, such income could also be subject to U.S. taxation under the anti-deferral provisions contained in Subpart F of the IRC. If these provisions apply, the royalty or sales income earned by the foreign affiliate will be subject to current U.S. tax law even if the income is not actually repatriated to its U.S. shareholders through dividend distributions. As a result, a significant component of U.S. tax planning and structuring with respect to the offshore exploitation of IP involves navigating around these complex anti-deferral rules.

Under the Subpart F rules, if a foreign affiliate controlled by a U.S. company (i.e., a controlled foreign corporation or “CFC”), licenses the IP to a related affiliate, the royalties received by that foreign licensor are currently taxed to the U.S. company regardless of whether the royalties are remitted back to the U.S. By contrast, if the CFC licenses the IP to an unrelated party, the royalties are not currently taxed to the U.S. company if they are derived in the active conduct of a trade or business. A CFC can only satisfy this relatively narrow “active royalty” exception if (1) it has developed, created or produced the IP (or acquired the IP and added substantial value to such IP) and is regularly engaged in the development, creation or production of IP of such kind, or (2) it is regularly engaged in marketing the IP outside the U.S. through its own employees located in the foreign country and through an organization that is substantial in relation to the amount of royalties derived from the licensing of the IP.

If the foreign affiliate/CFC does not license the IP, but instead employs the IP in manufacturing and selling products, current U.S. taxation of the sales income under Subpart F can be avoided if the affiliate either physically manufactures the products or makes a “substantial contribution” through the activities of its own employees to the physical manufacture of the property by another party under a contract manufacturing or tolling arrangement. Thus, subject to the potential application of certain “branch rules,” sales income earned by a foreign affiliate/CFC that actually manufactures or substantially contributes to the manufacturing of products using the IP is not currently taxed in the U.S., even if the CFC sells the products to other affiliated entities in the corporate group.
C. Transfer Pricing Considerations

In order to prevent the inappropriate shifting of profits between controlled entities, the U.S. transfer pricing rules contained in § 482 and regulations require that a sale, license, contribution, or cost sharing arrangement with respect to IP between controlled parties must satisfy the arm’s length standard. This standard requires that the results of the IP transfer between the U.S. company and its foreign controlled affiliate must be consistent with the results that would have been realized if uncontrolled parties had engaged in a comparable transaction under comparable circumstances. A transaction involving uncontrolled parties need not be identical in order to be considered “comparable” to a transaction between controlled parties, but must be sufficiently similar such that it provides a reliable measure of an arm’s length result. In addition, the consideration for the transfer of IP must also be “commensurate with the income” produced by the use of the IP over time. Under this latter requirement, the IRS may periodically adjust the consideration for the transfer of the IP (e.g., by adjusting the sales price or the royalty rate to allocate more income to the U.S. company) to ensure that such consideration continues to be commensurate with the income currently produced by that IP.

The U.S. transfer pricing regulations provide that the arm’s length consideration with respect to the transfer of IP to a controlled entity under either a sale, license, or contribution transaction must be determined under one of the following four methods: (1) the comparable uncontrolled price method, (2) the comparable profits method, (3) the profit split method, or (4) any unspecified method. The regulations require, however, that this determination must be made by using the method that produces the most reliable measure of an arm’s length result for the controlled transaction, taking into account all the facts and circumstances. The primary factors in determining the “best” transfer pricing method are the degree of comparability between the controlled and uncontrolled transactions, the quality of the data, and the reliability of the assumptions used in the analysis. To the extent that the consideration for the transfer of IP between controlled entities falls within an “arm’s length range” of results derived from IP transfers between uncontrolled entities, the transfer would generally satisfy the arm’s length standard. Some foreign taxing authorities also apply transfer pricing rules that may result in a valuation that differs from that acceptable to the IRS.

With respect to a CSA, recently issued regulations set forth various methods for determining the arm’s length consideration required to compensate the cost sharing participants for any existing IP and other resources (referred to as “platform contributions”) made available under such arrangement and which is reasonably anticipated to contribute to developing new “cost-shared” IP. In situations where a foreign affiliate shares in the cost of future IP development, but does not contribute any existing IP to the CSA, these regulations significantly limit the economic returns that can be realized by the foreign affiliate from its economic ownership interest in the new IP.

VII. Conclusion

Historically, tax planning with respect to domestic and foreign transfers and licensing of IP has been a fruitful area to reduce taxation. However, as the U.S. federal and state and foreign governments have aggressively attempted to eliminate or reduce the opportunities for abuse and focus more upon
the true substance of these transactions in determining whether or not taxation is appropriate, the opportunities afforded by careful tax planning have been correspondingly reduced. However, active tax planning in this arena is still necessary, not only to assess whether there remain areas for tax reduction, but to make sure that planned activities do not inadvertently result in unexpected taxation.