# Cleaning Up the IP Toxic Spill

*By*

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Times are hard. Margins are squeezed, resources cut to the bone. Everyone is working so hard they've hardly left the office in months and are starting to look like angry zombies. And still revenue growth is flat at best, after-tax profits are down, and the Board is breathing down your neck: It's your job to make things all better. Or else.

For that you need time, energy, and resources. But this morning you came to work and there was yet another foreign tax authority's demand on your desk, a memo from Legal marked "Urgent" clipped to it. The demands have been coming faster and getting more aggressive ever since the 2008 crash, wanting information you don't have, threatening to adjust income, past, present, and future, into their jurisdictions. You throw this latest one onto a pile with the others and can almost hear a sound like water swirling down a drain.

You know that even if you gave them everything they wanted, saved all the fight and heartache, it could be years, if ever, before the U.S. reduced the corresponding domestic income it claimed the right to tax. These days, taxes are like the three laws of thermodynamics: You can't win, you can't break even, and you can't get out of the game.

It started all those years ago with that first patent, developed right here in the U.S. It had been a big hit and the company had plowed the money back into the business, forming a domestic research and development subsidiary, which in turn generated more hits. To exploit it all the company had formed a new marketing sub, which in turn acquired its own Malaysian manufacturing facility and later another one in Singapore. At acquisition the Singapore facility had owned an Indian R&D lab and, for some reason lost in time, a Serbian software company. After that the company bought an accounting firm, itself a partnership of LLC's located around the world, which kept track of it all. And for a period of time the company had simply bought anything it could afford that promised either more efficient operations or a return greater than the hurdle rate, including an Australian pharmaceutical developer and a French food distributer with customer lists a mile long and a whole lot of trucks roaming all over Europe.

And it worked, too. The company made good profits right up until the music nearly stopped, back in 2008.

But now, with government deficits rising around the world, tax authorities everywhere were clamoring for attention and money. Why is the Serbian unit selling the same software to the U.S. marketing company, the French food distributor, and the London piece of the accounting firm for three different transfer prices? The Indian and U.S. research and development facilities just delivered work product to the Australian pharmaceutical developer that resulted in a new drug patent. Who owned that work product, and how do you justify the prices charged? Is the U.S. parent providing expertise to help the Australian sub obtain FDA approval of the new drug, and if so, why was no royalty assessed for use of that intangible?

And on and on it goes, an ever rising torrent of demands, all carrying the threat of a greater tax burden. The other day you had actually been told the company didn't even have a complete listing of all its intangible assets. It's finally clear. In all that growth the company never fully appreciated the tax consequences of its acquisitions. Now the intellectual property is in all the wrong places, the intragroup transfer prices are impossible to defend, and the resulting turmoil is an anchor slowing growth.

You grab the latest demand off the stack and exit your office, heading toward the legal department. It's time to centralize the management of all this IP, move it to a friendlier tax jurisdiction, and eliminate this drain on resources and threat to financial stability. It's time to clean up this toxic IP spill.

## A. Down the Rabbit Hole

### 1. What Are Intangibles?

It's ridiculous. Businesses always know their assets. These buildings, those machines, somewhere there's an inventory of every last paper clip. You barge into the chief counsel's office. "How come we don't know what intellectual property we own?"

He corrects you. "Intangible property. Intellectual property is old-speak for hard assets like patents, trademarks, and copyrights. The stuff you can sell and I can sue people over."

"What's the difference?"

"Intangible property, translated directly from the original Latin, means 'we get to tax you anyway'. It includes things like going concern value, workforce in place, methods and systems, expertise. Oh, and don't forget the granddaddy of them all, goodwill. Plus all the hard stuff, too."

And then he tells you a story. Once upon a time there was a company comprised of two domestic units that made highly customized doodads. One unit consisted of a handful of very well paid experts who sat at their desks performing complex calculations and using shrink-wrapped software to sift through reams of data until they had figured out exactly how each customer's doodad should be made. The second unit consisted of the poorly paid and they spent their days setting up fancy, nearly automatic machines according to the first unit's direction. The machines made the doodads.

Every year the company made $10,000,000 of profit and ninety percent of it came from fees charged for work done by the expert unit. One day, with snow falling, the wind howling, and a tax bill due for thirty-five percent of those profits, the company spun off the expert unit into a subsidiary, which it located on a lovely Caribbean island: warm, sunny, and tax free. Nothing moved there but the employees. Even the desks and chairs were left behind. The next year, and every year after, the company only paid tax on 35% of the one million of manufacturing profits and nothing at all on the other nine million. And they all lived happily ever after.[1]

"They didn't transfer any hard assets, no machines or patents or software," the lawyer says. "All they really did was file some paperwork and relocate a few employees."

"But something went to that sandy beach, something worth nine million bucks a year. The company wouldn't have just given away a business worth that kind of money."

The lawyer shrugs. "It was an intangible. Call it 'expertise', maybe 'workforce in place'. How about 'going concern value' or 'systems and methods'? Whatever it was, you do something like that today and the homeland will tax you anyway."

"Europe, too?"

"More and more."

### 2. Who Owns the Intangibles?

Ownership, it turns out, is a term of art and depends on the laws of each "relevant jurisdiction".[2] In the U.S., the first test is legal ownership, which works well for "hard" IP like patents, trademarks, and copyrights, all of which can be registered or for which there is usually a written contract. For the rest, though, the "soft" stuff, ownership is a facts and circumstances question, with words like "economic substance" and "control" guiding the analysis.[3] And for tax purposes even hard IP can be attributed an owner different than its legal owner if that is more consistent with the underlying economic reality.[4]

Foreign jurisdictions have their own standards and rules. It's easy to imagine that each jurisdiction will tend to see the intangible located where it produces the most tax revenue for that taxing authority. Where there is conflict between jurisdictions, or between them and the company, more of your resources get swept into resolving it, going through the competent authority process (if there is one) or, worst of all, paying tax on greater than a hundred percent of the income actually in dispute. And prior to resolution capital has to be placed in reserve for "uncertain tax positions" rather than invested in profit-making activities.[5]

Between the snow-covered doodad maker and its sandy island subsidiary, who owned the "going concern" intangible asset? If the sandy island subsidiary did then it must have been transferred in the reorganization. In the U.S. and just about everywhere else that triggers a host of statutory provisions intended to inhibit the outbound transfer of intangibles and to impose exit taxes on those that go.[6] In this case, at the very least the sandy island sub would owe a payment back to its parent more or less equal to the present value of all those future profits and which, of course, the homeland would get to tax.[7] On the other hand if the parent company retained the intangible then the sandy island sub would have to pay its parent ongoing royalties for the right to use it.

These two possibilities follow invoke very different statutory paths and the tax results are not economically equivalent. In the absence of an explicit evidentiary trail establishing which path the doodad company took the taxing authorities will reach their own conclusions and impose any penalties they find warranted.

You start thinking about your own company, about how it grew. This all just looks like people doing their jobs and there are no documents settling the ownership question for something like that. No one has ever given a thought to these invisible intangibles. Now you see them lurking out there like landmines set to go off anytime a business function crosses a border. You're going to have to dig up and disarm every single one of them. It's beginning to look like an ounce of prevention would have been a heck of a good idea.

**3. Where Are the Intangibles?**

Figuring out which jurisdiction your intangibles currently live in will be tricky. First you have to learn to recognize them and then you can figure out who is using them. Low hanging fruit consists of the patents, trademarks, and copyrights and will go quickly enough. But your company doesn't even have a master list yet of all those currently held around the world. So put that on the to-do list.

To find the soft IP you have to view each business unit with an economist's eye. Look for whatever is driving efficiency and profitability. Profits are usually a function of risk so a good place to start is by identifying the techniques used to manage that risk. Software written in-house or custom written by outside vendors, reporting systems, the way groups communicate to make things happen, it all counts. The magic words are expertise, workforce in place, and going concern value. They may be hard to define but you certainly know it when you see it.

Look, too, for formulas and methods that arose out of research conducted subsequent to (or perhaps related to) the issuance of patents, whether or not in actual use. Include any client lists, as well as special expertise developed in-house to deal with governmental regulatory authorities, and any software (down to the lowest spreadsheet macro) cobbled together to perform the special functions required by your particular business.[8] Identify all synergies, that ephemeral but real value generated by a system in excess of the sum of its parts.[9] In short, identifying intangibles is a top down analysis of how your company generates value. With a bit of luck, a lot of this work has been done recently enough for the purpose of actually running an efficient operation and can be reviewed now with an eye to identifying intangibles for tax purposes.

Once they are identified you can determine in which taxing jurisdiction they reside. Go one by one and start by noting who is using each one. If a single unit is using a particular intangible then its location is likely just where that unit is. Next determine who created the intangible and if it's not the unit currently using it then the transfer was probably a taxable event that might haunt you one day. Put those on a special list.

If an intangible's use is shared among different units residing in multiple jurisdictions then the domicile question is more difficult. One way to sort this situation out is to imagine that the intangible's home jurisdiction is where it was created and the other units are using it pursuant to a license or sale. In this model, of course, either royalties or a payment commensurate with income is due back to the creating unit that eventually will be taxed. You'll have to set defensible values for those fees and account for them, past, present, and future.

## 4. Valuation of Intangibles

Once the universe of intangibles is known you need to figure out what everything is worth. It's true enough that in general a valuation isn't needed until a transfer between related parties occurs. But such transfers can occur every routine day of the year. For example, your accounting firm might obtain confidential information from the French food distributor in order to prepare financial reports. The Australian pharmaceutical sub may request guidance from the parent company regarding a particular U.S. regulatory procedure. The R&D subs might exchange information and even personnel in furtherance of their various projects. All these and more, whether considered individually or aggregated, have potential tax impacts.[10]

Technically, these are all transfer pricing questions and traditionally each would be valued as the amount an unrelated party would have paid in a similar, arm's length transaction.[11] For tangible products one way this value can be determined (known as the comparable uncontrolled transaction, or "CUP") is by comparing the item sold in a related party transaction to similar ones transferred between unrelated parties.[12] Where the comparison is reliable, the price to the related party should be close to that charged in the unrelated transaction.[13] Getting to comparability, however, often requires that the observed prices be adjusted to compensate for differences such as the location of manufacture, transportation costs, risks shifted or borne, any additional services provided, and market penetration strategies employed, among many others.[14] And where too many adjustments are required, or they are too large or too unreliable, the proffered comparability may be lost entirely.[15]

Ultimately, the point of transfer pricing is to allocate related party profits between taxing jurisdictions. The inherent difficulty, however, of doing so one transaction at a time, even allowing for some aggregation,[16] has moved the United States away from arm's length price determination and toward a focus on the end goal, known euphemistically as the "arm's length result".[17] Thus, modern transfer pricing includes valuation methods that compare the profit margins claimed by related parties to those earned by "comparable companies".[18] And in the absence of even that basis courts have simply exercised their own judgment as to what the appropriate splitting percentages should be.[19] That said, however, the fact remains that when these matters are litigated those taxpayers who present in court a well-established CUP, all around the world, prevail.[20]

Transfers of intangible property between related parties can be valued for tax purposes by using the comparable uncontrolled transaction ("CUT") method, an approach similar to the tangible property's CUP but, as a rule, inherently unworkable.[21] Finding comparable transactions between unrelated parties is hard enough when dealing with toasters or medical devices and for intangibles is nigh onto impossible. What, for example, is the arm's length price for a unique patent or your workforce in place?[22]

The inability to price intangibles according to principles developed in the 1930's for tangible property[23] has led to the current rule that their tax value be calculated "commensurate with the income attributable to the intangible".[24] In the case of the experts and the sandy beach tax haven discussed above, the commensurate income is the $9,000,000 profit per year, for however many years might reasonably be expected.[25] If the intangible is transferred for a lump sum then the commensurate income is just the present value of that income stream. [26]

Note that if that business unit had been sold to an unrelated party, the price would have been fixed,[27] taxes paid on the gain,[28] and the matter swept into the past. That is the essence of the arm's length transaction, until recently the gold standard of transfer pricing. However, where an intangible is sold to a related party these days the "commensurate with income" rule is invoked. Now each year the "price" for the sale would be re-determined based on the current year's income attributable to the intangible.[29] The bottom line? For intangibles the question of an arm's length price is gone forever and the taxing authority is your new partner in an income stream that technically you no longer own.

Note also that when it comes time to move an intangible across a border (for instance, when transferring a business function from one subsidiary to another) in addition to potential U.S. transfer pricing issues there will be local jurisdiction ones as well (involving both the country the intangible leaves and the one to which it goes).[30] To defend the move before local taxing authorities you are going to need local counsel and local valuation experts in all of the affected jurisdictions. Let's face it, flying in foreign experts to tell the local tax authorities what the valuations should be is simply not going to play well anywhere in the world.[31]

"The thing to recognize about creating an intangible asset inventory," your legal counsel tells you, "is that it's just the beginning of cleaning up this mess. The entire process is going to be long and cost you money and resources. There will be setbacks and hard knocks along the way."

You start imagining making a pitch like that to the powers that be and squirm in your chair. "And?"

"And," he says, "in the end it will be worth it," but you're beginning to wonder.

**B. Start From Right Where You Are**

Your lawyer may be right about the long road ahead but there are a number of things that can be done right now to create a better future for your company and ease current troubles. They won't cost a lot more than you have to spend anyway and entail little or no risk. Here's the most important one: Stop doing what got you into this mess. Going forward you need to stop ignoring the tax aspects of your intangible assets. In other words, now that you can see you're in a hole for the love of God stop digging.

Do go ahead and put in the work to identify, locate, and value all the currently held IP. Even if you don't see the clean-up project through to its ultimate end you will need that inventory in the current and inevitable future tax proceedings. And by knowing exactly how things are now you can likely make that future better. Your inventory is an evidentiary trail that establishes who owns what, when and how they acquired it, and what it is worth.

Make it everyone's job to be aware of the role intangible assets play in the modern commercial enterprise. Every day your employees are making the business better and more efficient, creating value through the application of their expertise. Develop a system for reporting those improvements up the chain, right around the world, so they can be added to the inventory.

From now on do not, under any circumstances, enter into a new acquisition, formation, transfer, or reorganization without first deciding with whom and where ownership of all the associated intangibles should reside.

Do not create any new intangibles without having in place a plan for them to be held in the favorable tax jurisdiction where you now realize all the rest of the IP should have been. Your research and development facilities are working hard to create the technologies of the future. You want their work product to wind up in a tax favorable jurisdiction. Here is how to make that happen.

First, go ahead and create a special subsidiary, an IP company, to own, manage, and hold all your future intellectual property. The classic choice of domicile is the sandy island tax haven where the snow covered doodad makers went but there are other possibilities. Ireland, Singapore, the Netherlands, and Switzerland all offer extensive access to developed markets with the potential for effective tax rates in the single digits. Second, all research and development should be conducted on a cost-plus basis on behalf of your new IP company. The last thing you want is to continue the uncontrolled development of IP in scattered locations around the globe. There will be a future. Begin preparing for it now.

## C. Know Where You Want to Go

### 1. The Beginning

Here is the dream. A single company owns all your intangible assets, of which it has complete and perfect knowledge. It is domiciled where income taxes are nonexistent. It licenses the IP out to your subsidiaries, and perhaps third parties, around the world. Because of favorable treaty provisions, those royalties come back to your haven free of withholding tax. Those same royalties reduce the profits of the licensees paying them, and thereby minimize all local jurisdiction taxes.

With a lot of work, you can realize much of this dream but there are going to be obstacles to overcome. First, those zero income tax rate havens have no treaty networks to speak of and that means business done abroad is going to be subject to withholding taxes. In the United States and elsewhere withholding taxes are deducted from the amount received so not even ordinary business deductions are available to reduce the bite.[32]

Second, in the ideal vision the lion's share of all your worldwide profits are moved from the production and distribution occurring in the local jurisdictions to royalties paid directly into your tax haven. If achieved that would leave little for the local jurisdictions to tax and it's unlikely they would overlook the decline in public revenue or quietly acquiesce to it. There will be transfer pricing issues surrounding the amount of those royalty payments. You will need to be prepared with pricing studies, expert testimony, and a battery of lawyers familiar with the laws and procedures of all the jurisdictions where you do business.

Third, as lovely as beach huts can be on vacation, running a business from there, attracting and retaining the expertise needed to conduct operations year round on an isolated island, can be quite difficult. And the less actual work done at the sandy beach office the more it lacks economic substance and the more open to attack as a sham it becomes. Nonetheless, certain arrangements have withstood the test of time.

One option is to establish a licensing subsidiary in a country that has a rich treaty network with the rest of the world. Luxembourg will do, as will the cantons of Switzerland. In Switzerland, for example, royalties paid by a resident of a treaty country on intangibles licensed by a Swiss company are not subjected to a withholding tax by the treaty country.[33] And after some negotiation, the Swiss themselves will impose a combined federal and canton tax of around ten percent. Better still, the Swiss impose no withholding taxes on IP royalties paid by your licensing sub to its island domiciled parent. Finally, once the money is sunning itself nicely in a beachside bank the local income tax rate, of course, equals zero. Your effective worldwide tax rate on the royalty? About a third of what it would have been in the United States.[34]

Luxembourg offers similar arrangements. It is common, in fact, to combine these opportunities by locating the IP licensing company in Luxembourg and then opening a Swiss branch. Doing this can enable you to utilize various technical rules involving foreign managed companies and further lower the effective tax rate.[35]

Depending on where you are doing business, consider Singapore as well. Look to the treaties available and the tax rate which can be negotiated, and compare these benefits to the costs required to attain that rate. In Singapore, as elsewhere, the favorable tax rates may be received only in exchange for local employment commitments, or siting manufacturing facilities there. Remember also that you don't have to choose just one. A single IP company could have one, two, or more licensing subsidiaries, each serving a particular geographic region.

Another option commonly employed is the so-called Double Irish structure, which takes advantage of two key factors. First, Ireland does not impose a withholding tax on paid royalties. Second, the United States and Ireland fundamentally disagree about where a corporation is domiciled. The U.S. says a corporation is domiciled where it was formed while the Irish believe it resides where it is managed. When combined with the U.S.-Ireland tax treaty, these factors allow for a powerful reduction in the effective tax rate. Here is how it works.

To begin, the U.S. parent ("USP") establishes a wholly owned Irish subsidiary ("S1"), which in turn creates its own, wholly owned second tier Irish subsidiary ("S2"). The first tier subsidiary then establishes its management in a tax haven country which means, from the Irish point of view, that S1 is domiciled in the offshore tax haven. For U.S. purposes, however, S1 remains an Irish corporation. Finally, S2 "checks the box" to be deemed for U.S. tax purposes a pass-through entity.[36]

With these preparations in place, USP then transfers its non-U.S. rights in software, copyrights, or trade secrets to S1, which in turn licenses those rights to S2.[37] It is S2 that does the manufacturing and distribution of the end product to unrelated parties in Europe and the Middle East. From those earnings S2 pays royalties to S1, thereby reducing its Irish profits, with whatever is left being taxed at just twelve and a half percent.[38] In the meantime, pursuant to the current treaty between Ireland and S1's island domicile, S1 is not subjected to withholding taxes on the royalties received.[39] Better still, having checked the box on S2, the United States sees only a single Irish corporation (S1-S2), actively engaged in the manufacture and distribution, and so ignores the exchange of royalties between them. As a result the constructive dividend rules of subpart F are avoided and those profits represented by the royalty payments avoid current U.S. taxation.[40]

Not surprisingly, these benefits do come at a price. Like Singapore, Ireland requires that the local subsidiary have economic substance. Irish citizens will have to be hired to do real and meaningful work. And from time to time there are discussions of upsetting the entire apple cart by repealing or suspending the favorable tax treatment of royalties, most recently as a consequence of the 2008 crash. Note also that although the money earned by the S1-S2 group is taxed at a very favorable local jurisdiction effective rate it will be taxed again should it ever be repatriated to the United States.[41]

## 2. The Middle

### a. Migrating Currently Held IP Offshore

Once you have settled on a structure all your future-created IP can reside in it. The next question is which of the currently held intangibles should also be moved into the IP company.

Moving intangibles across a border can be difficult, litigious, and expensive. In the United States, for example, any transfer of an intangible asset to a foreign corporation is deemed to be a contingent-on-profits sale. This means that the income later earned by the foreign corporation on the intangible will continue to be taxed in the United States in spite of any fixed price paid at the time of sale, and your U.S. taxes will be based on the foreign earnings just as though you had never migrated it.[42]

When it comes to foreign held IP, the good news is that you may not have to move it all. First, royalties earned on the IP may already be free at least of withholding tax pursuant to an applicable tax treaty. Second, if the IP is presently in a territorial tax jurisdiction (and not one, such as the United States, that taxes worldwide income) then income earned on it outside that territory will not be taxed by the jurisdiction (although it may be subject to tax at the site of payment). While there may be advantages to centralizing the management of all your IP or removing it from an especially troublesome tax jurisdiction, as a practical matter in cases such as these the costs of movement will likely outweigh the attendant benefits.

Where those managerial advantages are desired they may be achieved to a great extent by rearranging your corporate structure while leaving the intangible assets in their respective jurisdictions. Often such rearrangements can be accomplished free of U.S. taxes.[43] Because much of the foreign earnings and profits may not yet have been taxed in the United States, to receive that favorable tax treatment on reorganization you must ensure that each moved foreign subsidiary's not previously taxed earnings and profits are added to those of its new parent.[44]

As an alternative to reorganization consider an outright purchase by the new IP company of a foreign subsidiary's stock from its parent. The cash received by the U.S. parent of the target subsidiary will be taxed as a dividend to the extent of the IP company's, and then the target subsidiary's, earnings and profits.[45] That purchase qualifies as foreign income repatriation, though, and so the U.S. parent would be able to make use of the indirect foreign tax credit to offset any domestic taxes imposed.[46]

In the case of U.S. sited intangibles the risk of future tax surprises can be reduced by entering into an advance pricing agreement ("APA") with the Internal Revenue Service.[47] This voluntary process in theory allows taxpayers to resolve their transfer pricing issues before the transaction occurs, provided they disclose fully all the relevant details.[48] The process is often bilateral (potentially multilateral) and so includes an agreement with the foreign taxing jurisdiction as well.[49] It can, however, take many years to complete and so its preemptive effect is severely limited. In addition there are upfront costs and demands for information that require significant resource allocation and not every intangible is eligible for an advance pricing agreement.[50]

Consider also that some IP simply has no value outside its country of domicile. Don't cling to trademarks valuable in one country but unknown in others when it would be cheaper to develop new trademarks abroad geared to those cultural norms. Don't seek to transfer software whose functionality can be recreated on-site in new, cross-border locales. And don't cling to copyrighted material that can be recreated less expensively in the new jurisdiction using images and language more compelling there.

Some of your IP, inevitably, is completely lacking in value, or at the very least is not worth more than the cost of maintaining and defending it: patents so old they protect nothing anymore, copyrighted manuals and brochures for processes and products that no longer exist, trademarks in desperate need of updating. If they aren't earning their keep stop paying to own them. Consider abandoning such IP by opening it to the public domain or donating it to an educational or charitable institution. You will certainly reduce your tax exposure going forward and there might even be a bit of public relations benefit to boot.

Remember that where you intend to use the IP within the United States, moving it to a non-treaty jurisdiction (which includes most of the sandy island tax havens) means paying a withholding tax on the royalties received on it by the IP company, which obviates the reason for moving it in the first place. Better planning is to retain in the U.S. company the rights to use the IP in the United States, while migrating offshore all rights to the IP for the rest of the world.

One way to accomplish this is simply to sell the offshore rights to the intangible to the IP company. An alternative is the "long-term" license accompanied by a declining royalty payment that eventually equals zero or a small, nominal amount. As discussed previously, however, the outright sale option invokes the transfer pricing requirement that the sale be commensurate with income.[51] As such, no final price can be set between related parties and instead the IRS will continue to assert its jurisdiction over the transaction for years to come. The latter option also has transfer pricing issues so that the final result may not differ significantly from the former option. In any case long-term licensing arrangements are often deemed sales. And sales come with tax consequences on the gains implied.

For these reasons, the principal technique for achieving this migration in a tax efficient manner is the Cost Sharing Arrangement. The CSA works best to migrate patents, trade secrets, and complex software, although it could in principle be used with soft IP such as management techniques, processes and methods, and expertise. Similar to a joint venture, participants in the

CSA pool their various resources, i.e., intangibles and cash, and then use them to develop new technologies, sharing the costs incurred and the new technologies developed.[52] Older intangibles of diminished value (for example, an aging software system) typically form the "platform" on which future technologies are developed. In return, the participants receive interests (i.e., licenses) in the CSA's work product, equal in proportion to their contributions and non-overlapping either by geography or field of use.[53] To achieve this favorable result, all participants must have committed to and actually borne their share of the costs of the venture, and received in return interests based on the reasonably anticipated benefits.[54]

For example, imagine a U.S. parent ("USP") company has a patent with fifteen years left before expiration but which, due to rapidly advancing technology, is already in danger of being surpassed in the market place. USP then enters into a cost-sharing arrangement with its wholly owned subsidiary, say, a tax haven IP company, and contributes to the CSA all rights to the patent. Both parties agree to share the costs of developing the new technology based on it.

The key to the migration is that USP will receive from the CSA not its original patent but instead the right to exploit the newly developed technology within the geographic confines of the United States. The wholly-owned, tax haven IP company receives the right to exploit that technology throughout the rest of the world.[55] Although the original patent remains (with, no doubt, minimal effect) the new technology has been "migrated" offshore absent any onerous exit taxes and restrictions. Most importantly, royalties received by the foreign IP company for licenses granted outside the United States are not subject to U.S. taxes.

As expected, there are some downsides to this strategy. First, because of their ability to migrate IP offshore CSA's are subject to strict scrutiny by the affected taxing jurisdictions.

Second, the benefits received by the parties must be proportional to the value of the intangibles contributed (i.e., the platform contributions, or "PCT") and the share of the research and development costs borne by them. As a result, there will be battles to establish and defend the values claimed by the CSA. Finally, the domestic company will be able to take R&D expense deductions only for its own share of CSA expenses paid. R&D expenses attributed to the wholly owned tax haven IP company will have no tax effect and be lost forever.

**b. Migrating the U.S. Company Offshore**

While the Double Irish, CSA, and other structures are tried and true, they do not offer certainty over the long haul. Transfer pricing and the commensurate with income standard can be used to shift profits from your overseas structure into the U.S. jurisdiction. Treaties can be amended and regulations updated or created, wiping out withholding tax exemptions at the stroke of a pen. New cost sharing arrangement regulations were finalized just this year, imposing even more burdensome requirements, and last year saw implementation of both the anti-hopscotch and anti-splitter rules that limit the ability of U.S. companies to use certain organizational structures to achieve foreign tax credit benefits.[56] The now proposed U.S. "alternative minimum tax" for foreign source income,[57] if enacted, could undo everyone's careful planning. The simple fact is that in these hard times U.S. companies are taxed ever more aggressively on their world-wide income.[58]

The principal solution is simple enough to state but difficult to achieve: a company domiciled in the United States should have no foreign source income. But any U.S. parent company with foreign subsidiaries will inevitably be in line to receive foreign source income. The solution? Transform the U.S. parent of a foreign subsidiary into a domestic subsidiary of a foreign parent. Known as “inversions”, in 2005 Congress enacted I.R.C. §7874 to limit their use. If achieved, it can provide a measure of certainty, at least as regards U.S. taxation, that is today so hard to attain.

To start, you will want to separate your assets, intangible and otherwise, and isolate those needed to function in the domestic market in a separate U.S. corporation. As discussed previously, there is no point in moving assets out of the United States just so you can license them back and incur withholding taxes on the royalties paid. Once this isolation is complete, what remains of your company is its ownership of the IP company and the other foreign subsidiaries along with the rest of world rights in all the domestic IP.

Now you are ready to invert your company with the IP subsidiary, which can be accomplished either by exchanging your stock or your assets for a controlling share of the IP company’s stock. Typically, a stock inversion uses a reverse triangular merger while an asset inversion is a direct exchange of foreign stock for domestic assets. Depending on the choice there can be gain or loss recognized by shareholders (but not the company) on these transactions.[59] Either way, once the U.S. parent company becomes the subsidiary of a foreign corporation the §7874 anti-inversion rules will come into play.

In the statutory scheme the domestic corporation (now holding only the foreign-related assets) is called the “expatriated entity”.[60] The IP company (now the new foreign parent) is potentially a “surrogate foreign corporation” and if so will be treated for tax purposes exactly as if it were a domestic corporation.[61] That re-characterization would completely defeat the inversion process since the tax haven IP company would be no different for U.S. tax purposes than one located in Indiana.

This highly unfavorable result arises only if the new foreign parent "does not have substantial business activities in the foreign country…when compared to the total business activities of such expanded affiliate group".[62] The object here, plainly, is to prevent U.S. business from inverting to a post office box in a sandy island tax haven. But where the new foreign parent has sufficiently substantial economic substance the §7874 anti-inversion rules will not apply. The key question is, therefore, what constitutes "substantial business activities"?

Once upon a time this was a "fact and circumstances" issue, in which activities of the group as a whole are considered. Criteria included factors such as historical presence, operational activities, and management activities.[63] Adding a bit of certainty, inverting companies could seek to qualify for a safe harbor, where new foreign parent assets, employees, and sales in excess of ten percent of the group total would assure the avoidance of surrogate foreign corporation status.[64] By 2009, however, both the safe harbor and the examples illustrating it had been removed from the §7874 regulations.[65]

Recently, the IRS changed course yet again, this time expressly deleting the facts and circumstances test for substantial business activities and substituting in its place a new "bright-line rule describing the threshold of activities required" to avoid surrogate foreign corporation status.[66] This time the "safe harbor" requires that the foreign parent's share of group employees, assets, and income be at least twenty-five percent, a marked increase from the prior ten percent level.[67] In addition, group assets are defined to include only "tangible personal property or real property",[68] which serves to exclude the real value of almost every modern company, the intellectual property.

Thus, while it remains at least theoretically possible that a sandy island headquarters, actively engaged in the worldwide licensing of valuable IP and holding substantial tangible assets, could avoid characterization as a foreign surrogate corporation the more likely scenario of a sleepier tax haven IP company almost certainly would not. Nonetheless, a successful company migration might still be achieved by inverting to the top tier Irish corporation of a double Irish structure.[69] But given §7874's clear and ever evolving bias against inversions, the removal of the "facts and circumstances" standard, and a safe harbor that excludes consideration of a company's real value, the risks of this path cannot be denied.

**3. The End**

You sit for a bit, digesting it all. Completely cleaning up this mess really would be a long, hard slog, not to mention expensive, litigious, and risky. Tax planning is a gambler's game where halfway through the house gets to change the rules. And unlike investing, success here wouldn't mean earning new profit, growing revenues, or adding to company value by developing new markets or products. It would mean only paying out something less than you would have otherwise and there isn't much glory in that. Mathematically they may be the same but psychologically not so much. Stock prices don't generally rise on news that tax liabilities have waned. No executive in his right mind would take on this project.

You're still holding this morning's memorandum from legal, the yellow sticky note marked urgent bright on the front. You think of the pile of memos just like it waiting back in your office. There isn't any choice really. In a time of crushing deficits and ever more aggressive taxing authorities around the world, tax planning could be the difference between those who thrive and those who don't. You try again to imagine pitching this idea to the Board and sigh.

Your lawyer nods like he's reading your mind and says, "At least you can blame it all on the guy you replaced."

"And what if we can't fix it? What if it takes too long or costs too much and the Board loses patience?" In the back of your mind you're remembering that all too often reorganizations fail to produce their expected synergies.[70]

The lawyer shrugs. "Then the next guy can blame it all on you."

[1] *Cf. Alberta Printed Circuits Ltd. v. R.*, [2011], CarswellNat 1373, 2011 TCC 232.
[2] Treas. Reg. 1.482-4(f)(3)(i)(A).
[3] Treas. Reg. 1.482-4(f)(3), 1.482-1(d)(3)(ii)(B).
[4] Treas. Reg. 1.482-4(f)(3), 1.482-1(d)(3)(ii)(B). *See also DHL Corp. and Subs. v. Comm'r*, T.C. Memo. 1998-461, *rev'd in part*, 285 F.3d 1210 (9th Cir. 2002).
[5] FASB Interpretation Number 48 (also known as FIN 48).
[6] *See*, *e.g.*, I.R.C. §§367(d), 7874.
[7] I.R.C. §482 (commensurate with income standard applies to intangible property transfers).
[8] *See, e.g., Hospital Corp. of America v. Comm'r*, 81 T.C. 520 (1980); *G.D. Searle v. Comm'r,* 88 T.C. 252 (1987); *Sundstrand Corp. v. Comm'r,* 96 T.C. 226 (1991)..
[9] TAM 200907024 (IRS Feb. 13, 2009); Treas. Reg. 1.482-1(f)(2)(i)(aggregation of transactions), 1.482-7T(g)(2)(aggregation in a cost sharing arrangement context). *See also Veritas Software Corp. v. Comm'r*, 133 T.C. 297 (2009).
[10] Providing services such as these constitutes a transfer of value and the related payments have been used both to reduce local income and to allow outbound transfers of money that are not subject to withholding tax as dividends. Lowell, Burge & Briger, *U.S. International Transfer Pricing, §6.02* (2006); *Grenada Industries, Inc. v. Comm'r,* 17 T.C. 231 (1951), *aff'd,* 202 F.2d 873 (5th Cir. 1953). Current U.S. regulations state that certain expressly listed and not excluded services (generally, low margin services) are chargeable only at cost unless a different method yields a better arm's length result. *See* Treas. Reg. 1.482-9(b). Provision of other sorts of services may be valued by the comparable uncontrolled services method, a cost-plus method, or either the comparable profits or profit-split methods. *See* Treas. Reg. 1.482-9(a).
[11] *See* Treas. Reg. 1.482-1(b). *See also* I.T.A. §§69, 247 (Canada); OECD model treaty Article 9 (note that the OECD strongly opposes formulary apportionment).
[12] Treas. Reg. 1.482-1(b)(2)(i). *See, e.g., Woodward Governor Co. v. Comm'r,* 55 T.C. 56 (1970); *Bausch & Lomb, Inc. v. Comm'r,* 92 T.C. 525 (1988); *PPG Indus., Inc. v. Comm'r*, 55 T.C. 928 (1970).
[13] In addition to the CUP, other techniques used to calculate this value include cost-plus and resale price methods. *See* Treas. Reg. 1.482-3(a).
[14] Treas. Reg. 1.482-1(d).
[15] Treas. Reg. 1.482-1(c)(2)(i).

[16] Separate transactions of the same type may be combined when they are so interrelated that aggregation provides the most reliable basis on which to determine the arm's length consideration. *See*, *e.g.,* Treas. Reg. 1.482-1(f)(2)(i)(A).
[17] *See* Treas. Reg. 1.482-1(c)(1)(there is no preferred hierarchy of methods and the "best method" is that which produces a "more reliable measure of an arm's length result"). See also Treas. Reg. 1.482-3(a)(methods available include, *inter alia*, comparable profits and profit split).
[18] Treas. Reg. 1.482-4(c). *See also* Treas. Reg. 1.482-5(a)(comparable profits method is a comparison of operating profit for a particular "identifiable business activity" to that of uncontrolled comparables); *E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979)(adoption by the Court of "Berry ratios", i.e., an analysis of margin ratios for comparable companies, as set forth by government expert witness, Charles Berry).
[19] Treas. Reg. 1.482-6(a)(profit split method "evaluates whether the allocation of the combined operating profit" is an arm's length result). *See also Hospital Corp. of America v. Comm'r,* 81 T.C. 520 (1980); *Eli Lilly & Co. v. Comm'r*, 84 T.C. 996 (1985).
[20] *See* Richard Ainsworth & Andrew Schact, *Transfer Pricing: The CUP – Case Studies: Australia, US, UK, Norway and Canada,* Boston University School of Law Working Paper 12-12 (Feb. 28, 2012). In prior incarnations of I.R.S. regulations the CUP was first in a hierarchy of prescribed transfer pricing methods. The ability of companies to self-generate such comparables, however, caused the IRS to abandon hierarchies altogether in favor of a "best method" approach. *See U.S. Steel Corp v. Comm'r,* 617 F.2d 942 (2d Cir. 1980); Treas. Reg. 1.482-1(c).
[21] Treas. Reg. 1.482-4(c)(other authorized methods include comparable profits and profit split, and methods not listed but producing more reliable results may also be allowed).
[22] Where an intangible has been recently purchased from an unrelated party, however, it may be sold on to a controlled party at a similar price. As time passes between the uncontrolled and controlled transfers, however, the former's value as a CUT diminishes. *See* Treas. Reg. 1.482-4(f)(2).
[23] *See Asiatic Petroleum Co. v. Comm'r,* 79 F.2d 234 (2d Cir. 1935).
[24] I.R.C. §482.
[25] Treas. Reg. 1.482-4(f)(6)( a lump sum is commensurate with income if it represents an advance payment of royalties, taking into account the licensee's expected sales).
[26] Treas. Reg. 1.482-4(f)(6)(i)(the present value should be calculated using an "appropriate discount rate"). The manner of determining appropriateness, however, is not set forth. A discount rate, for example, might begin with the present risk-free rate and then be adjusted for cost-of-capital, own credit rating, and associated risks. A weighted average cost of capital could also be employed. A more sophisticated model might project a matrix of expected rates covering each of the expected future periods.
[27] That is, the buyer and seller would each have applied their own models of expected future revenues, risk factors, and discount rates and used the results to arrive at an agreed-upon price.
[28] I.R.C. §§1001, 1012.
[29] Treas. Reg. 1.482-4(f)(6). Lump sum payments are also subject to periodic upward adjustment as future experience is realized. *See also* Treas. Reg. 1.482-4(f)(2).
[30] For U.S. tax purposes, the transfer price between two foreign subsidiaries can be adjusted when it has a U.S. tax impact.
[31] *See, e.g., SNF (Australia) Pty. Ltd. v. Comm'r of Taxation*, [2010] ATC 20-190, [2010] FCA 635.
[32] I.R.C. §871(a).
[33] *See, e.g.,* Jay Darby, *Everyone goes to Zug*, Practical European Tax Strategies (June 2006).
[34] Note also that there is a planning opportunity here with regard to the IP end user's local jurisdiction taxes. That is, clearly identifying the exported royalty payments reduces the manufacturing and distribution income left for local taxation. That payment, however, must pass the "arm's length standard" or "commensurate with income" type tests imposed locally.
[35] To qualify for tax advantaged status, the branch must be somewhat independent of its head office, including the right to enter into contracts on its own behalf. It need not, however, have any capital of its own. Once qualified, the 35% Swiss withholding tax will not be applied. In addition, earnings attributed to the Swiss branch will not be subject to double taxation per treaties with Luxembourg and others.
[36] Treas. Reg. 1.7701-3(c)(allows certain qualified foreign entity to elect its status for U.S. tax purposes).

[37] The transfer out of the U.S. is accomplished tax efficiently by use of a Cost Sharing Arrangement that leaves the non-U.S. rights in the top-tier Irish subsidiary's hands. *See* discussion *infra (Migrating Currently Held IP Offshore)*. Note also that Ireland's transfer pricing rules differ from those of the United States and allow, for the time being at least, the royalty payment from S2 to S1 can be set so as to minimize S2's Irish earned income. *See Transfer Pricing Profile for Ireland, available at http://www.oecd.org/dataoecd/40/54/37841011.pdf*.
[38] Transshipping orders through a Dutch company (the so-called "Dutch sandwich") can further reduce taxes since Ireland does not impose a withholding tax on receipts from certain European Union member states.
[39] U.S. – Irish tax treaty, Article 12 (signed Jan. 1, 1998, amended Sept. 24, 1999).
[40] I.R.C. §954(c)(3)(A); Treas. Reg. 1.954-3(a)(4).
[41] I.R.C. §§951(a), 952(a), 954(c).
[42] I.R.C. §367(a), (d).
[43] I.R.C. §§367(b), 332, 337, 351.
[44] I.R.C. §381(a), (c).
[45] The target subsidiary is deemed to have made a contribution to the IP company, and is taxable to the extent that amount is greater than its basis in the shares. I.R.C. §304.
[46] I.R.C. §§902, 1248.
[47] APA's between companies and foreign governments are also becoming more common.
[48] *See, e.g.,* Rev. Proc. 2008-31 (IRS June 9, 2008). *See also Report to Hon. Bryon L. Dorgon*, GGD-00-168 (GAO Aug. 14, 2000)(APA's are prospective agreements between the taxpayer and the IRS on appropriate transfer pricing methodologies and their likely results).
[49] *See, e.g.,* IR-2007-09 (first APA between the U.S. and the People's Republic of China finalized regarding transfers by Wal-Mart Stores, Inc. In 2006 40 of the 82 APA's concluded were bilateral agreements between taxing jurisdictions.)
[50] I.R.B. 2006-2 (Dec. 19, 2005).
[51] I.R.C. §482.
[52] *See* Treas. Reg. 1.482-7T.
[53] Treas. Reg. 1.482-7T(a)(1), (b).
[54] Treas. Reg. 1.482-7T(b)(these shares are subject to ongoing adjustment as the reasonably anticipated benefits expectations change).
[55] Treas. Reg. 1.482-7T(a)(1)(the interests received must be in proportion to the shared costs borne by each party).
[56] I.R.C. §§909, 954(c).
[57] State of the Union address, Jan. 25, 2012.
[58] In 2010 alone Congress acted to limit the use of the time-tested foreign source income management techniques of income splitting events and hopscotch dividends. I.R.C. §§909, 960(c).
[59] I.R.C. §§367(a), 368.
[60] I.R.C. §7874(a)(2).
[61] I.R.C. §7874(b)(depending on the percent of stock in the new parent owned by shareholders of the old parent this treatment could be limited to a ten year period).
[62] I.R.C. §7874(a)(2)(B)(iii). The "expanded affiliate group" is one or more chains of includible corporations connected through stock ownership with a common parent, where only fifty percent ownership rather than the usual 80 percent, is required. I.R.C. §§1504(a), 7874(c)(1).
[63] Treas. Reg. 1.7874-2T(g)(1),(3)(now superseded).
[64] Treas. Reg. 1.7874-2T(d)(1)-(4)(now superseded).
[65] T.D. 9453 (June 12, 2009), §F.1.
[66] T.D. 9592 (July 12, 2012), §A.
[67] T.D. 9592 (July 12, 2012) §B; Treas. Reg. 1.7874-3T(a), (b).
[68] T.D. 9592 (July 12, 2012) §B.2; Treas. Reg. 1.7874-3T(b)(2), (d)(5).
[69] Recall that the top tier Irish corporation is managed from the island haven. It is therefore seen by Ireland as domiciled in the island haven and by the United States as domiciled in Ireland.
[70] Richard Ainsworth & Andrew Schact, *Transfer Pricing & Business Restructurings – Intangibles, Synergies and Shelters,* Boston University School of Law Working Paper No. 11-24 (June 3, 2011).