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## U.S. TAX IMPLICATIONS OF OFFSHORE MIGRATION OF INTELLECTUAL PROPERTY

BY JOHN D. HOLLINRAKE, JR. · APRIL 14, 2016

### Challenges of Transferring IP Offshore

What constitutes intellectual property ("IP") has long been a contested issue in tax practice, but generally includes intangible assets as wide-ranging as patents, copyrights, secret processes and formulas, goodwill, trademarks, and trade brands. IP is extremely valuable as a tax asset because it often takes years to develop, which allows the taxpayer to incur losses and expenses, which can offset a taxpayer's U.S. source income. In addition, intangible assets are highly portable, making it easy for taxpayers to transfer them to lower-tax jurisdictions when they become income-producing assets. Many U.S. tax reforms in recent years have been aimed at curbing this practice, making their "portability" less so.<sup>[1]</sup>

In addition, an increasing number of foreign jurisdictions are offering attractive "patent regimes" or "innovation boxes" that offer preferential tax treatment on income attributable to IP. These incentives were first implemented in Ireland in the 1970s and have since been adopted by other European countries including Belgium, France, Luxembourg, Spain and the U.K. This proliferation of favorable IP regimes abroad has led U.S. taxpayers to seek ways to transfer their IP to these jurisdictions. In recent testimony to the U.S. Senate Finance Committee International Tax Reform group, U.S. businesses reported increasing pressure by their stakeholders to transfer their U.S. IP overseas to access the tax savings available under these regimes.<sup>[2]</sup>

The U.S. itself appears reluctant to adopt an innovation box of its own to compete with those offered by the European countries.<sup>[3]</sup> Instead, U.S. tax authorities have sought to deter transfers abroad by introducing new punitive rules aimed at preventing these transfers. In August and September of 2015, the Internal Revenue Service ("IRS") and Treasury issued proposed regulations that would:

- tax outbound transfers of goodwill and going concern value ("GW/GCV"), often valuable intangible assets, which were previously exempted under an "active trade/business exception",
- eliminate the bright-line rule providing certainty to taxpayers regarding the length of the useful life

of intangibles, and

- impose additional requirements, many of which are ambiguous, on how to value assets sold to, or used by, related taxpayers on an “aggregate” rather than item-by-item basis.

These new rules make it increasingly difficult for U.S. taxpayers to transfer existing IP to a foreign jurisdiction in a tax efficient manner.

#### *Active trade/business exception*

Section 367 of the 1986 Internal Revenue Code, as amended, (the “Code”)[4] taxes the outbound transfer of U.S. assets by disallowing “nonrecognition,” or tax-free treatment, in otherwise tax-free transactions, such as contributions to capital of a corporation, the liquidation of a corporation’s subsidiaries, and corporate reorganizations. Section 367 essentially “turns off” the gain nonrecognition rules granting tax-free treatment under Sections 332, 351, 354, 356, and 361 when the transferee corporation is foreign.

However, Section 367’s required taxation of gain on such outbound transfers has a notable exception under Section 367(a). If the outbound transfer of U.S. assets is to a foreign transferee for use in the foreign transferee’s active trade or business (the so-called “ATB Exception”), tax-free treatment is preserved. Assets considered for this ATB Exception previously included intangible assets such as goodwill and going concern value (“GW/GCV). Goodwill is the residual value of a business operation after all other tangible and intangible assets have been identified and valued.

The legislative history explained that GW/GCV was deliberately included. Committee reports expressly stated that “no gain will be recognized on the transfer of goodwill and going concern value for use in an active trade or business.”[5] Because goodwill and going concern value are created in the process of generating income, not as a result of incurring deductions, transfers of these assets to foreign corporations were perceived to be less likely to be motivated by the avoidance of federal income tax, and hence were accorded special treatment.

#### *Deemed royalty provisions*

In addition to the ATB Exception for GW/GCV, Section 367(d) also provided a useful exception (the “deemed royalty provisions”). These deemed royalty provisions treat a transfer of intangibles to a foreign corporation as a deemed sale, whereby the seller would be required to report and pay taxes on the deemed purchase price consisting of arm’s length annual payments, as determined by the IRS. These payments were required to be reported and taxed over the asset’s “entire useful life”. However, GW/GCV is excluded from the assets whose transfer offshore would be considered a sale, possibly because GW/GCV are continually self-regenerating assets whose useful life is difficult to determine.

So while the transfer of patents, formulas, franchises, trade names, and customer lists would be considered a sale that the seller would be required to report as foreign-source ordinary-income each year equal to an arm’s length royalty over the asset’s useful life, a transfer of GW/GCV was previously not subject to such a regime. This exception has existed for thirty years.

#### *Section 482 standards for inter-company sale/purchase of IP*

Section 482 sets out detailed transfer pricing rules associated with the way that a company prices goods, services, and intangibles transferred to, or used between, affiliates domiciled in different taxing jurisdictions. These rules generally require that prices reflect the “arm’s length principle” as if the parties were not related. To determine what would be “arm’s length” values, detailed transaction-based and profit-based methods are set forth in the applicable regulations.

### *New proposed regulations*

The rules in the newly proposed regulations no longer provide special treatment for GW/GCV and add increasing uncertainty to the already difficult practice of determining arm’s length values.

Under Proposed Treasury Regulations sections 1.367(a)-1 and 1.367(a)-2(b), GW/GCV would no longer be assets that could qualify for the ATB Exception. Under Temporary Treasury Regulations section 1.367(d)-1T, GW/GCV would no longer be assets excepted from the deemed royalty treatment. Moreover, Proposed Treasury Regulation section 1.367(d)-1(c)(3) would eliminate the bright-line 20-year useful life rule, instead defining “useful life” as the “entire period during which the exploitation of the intangible property is reasonably anticipated to occur.” Taxpayers could potentially have deemed royalties from the offshore transfer of GW/GCV forever, unless they could prove that the useful life had been exhausted. This vague definition of “useful life” increases the administrative burden for both the taxpayer and for Treasury.<sup>[6]</sup>

Treasury perceived that these new proposed rules were necessary because taxpayers were claiming an “inappropriately large share” of their outbound transfers of property consisted of GW/GCV in an attempt to “avoid recognizing gain or income attributable to high-value intellectual property.”

In addition, these new rules target transactions relating to the sale and use of IP in intercompany transactions. Treasury issued proposed regulations to target the perceived abuse that taxpayers were undervaluing transferred assets, and hence, the amount subject to tax, by focusing on the values attributable to each single asset transferred, rather than valuing the transferred assets as a collective enterprise that account for synergies and interrelated values.

However, these proposed regulations fail to offer clear definitions of terms such as “value” or “synergies” or illustrative examples, creating additional uncertainties for taxpayers.<sup>[7]</sup>

The new regulations indicate that U.S. tax authorities are increasingly scrutinizing IP transfers. The transfer of intellectual property from the U.S. to foreign jurisdictions, many of which offer attractive “patent box” tax incentives, will likely only grow in complexity.

### **Advance Planning Opportunities**

The difficulties presented in transferring U.S. IP to a foreign jurisdiction demonstrate the importance of early planning for the “exit” or sale of IP. To avoid U.S. tax on intangible income, taxpayers should, from the beginning, take care to avoid having U.S. entities own IP. Instead, companies with multinational operations should form foreign affiliates in low or zero-tax jurisdictions to incur the cost and risk of developing IP, own the IP, and eventually sell the IP. However, a foreign affiliate with U.S. owners must be careful to avoid “subpart F income”, which is immediately taxable in the U.S., as well as potentially adverse tax consequences related to “passive foreign investment corporations” (PFICs).

## *Placement of IP in Low-Tax Foreign Subsidiaries*

Profits earned by foreign subsidiaries of U.S. taxpayers are generally not taxable until repatriated. In addition, stock sales of foreign subsidiaries are generally exempt from capital gains tax in the foreign country.

This means that the taxpayer should plan for a foreign subsidiary to be the developer or owner – and eventual seller – of the IP. The choice of foreign jurisdiction should consider the tax rate, local incentives, as well as tax treaties that may provide additional tax efficiencies.

For example, the Cayman Islands imposes no corporate tax. A Cayman Islands subsidiary's sale of its assets would not be taxable to the Cayman subsidiary. However, the Cayman Islands does not have tax treaties that eliminate "withholding taxes" which could be imposed on payments from the Cayman Islands to the U.S. These payments could occur, for example, when the Cayman Islands subsidiary pays royalties to the U.S. affiliate.

Another increasingly popular alternative is Ireland, which offers a "Knowledge Development Box" regime where business profits from patents are taxed at a low 12.5%. In addition, unlike the Cayman Islands, Ireland has a wide tax treaty network that makes 0% withholding tax rates available for royalty payments.

Common tax efficient structures for U.S. tax purposes include executing contracts for a foreign affiliate to: (1) conduct R&D and the licensing of IP, (2) share costs related to IP R&D and the licensing with a U.S. entity, or (3) form a partnership with a U.S. entity to conduct R&D and the licensing of IP.

A contract R&D and licensing arrangement is a structure in which the foreign affiliate funds the costs of all R&D performed by other affiliates and owns all interests in the resulting intangibles. For example, if it is preferable to keep the R&D in the U.S., the foreign subsidiary can contract the R&D of the IP to the U.S. operations, but remain the owner of the IP. However, because the U.S. entity and foreign affiliate are related parties, the IRS may scrutinize the contract under the Sec. 482 rules discussed before. The U.S. entity will generally be required to compensate the foreign affiliate through arm's length royalty payments that are "commensurate with income."<sup>[8]</sup>

Alternatively, a cost sharing arrangement is a structure in which all affiliates share the *costs* of R&D as well as the ownership of the *interests* in the resulting intangibles. The payments between the affiliates are generally not royalties and hence do not need to satisfy the "commensurate with income" standard, but rather must comply with other transfer pricing rules under Section 482. These rules would generally determine the "appropriate" transfer price under one of six prescribed methods including: comparable uncontrolled services price, the gross services margin method, the cost of services plus method, the comparable profits method, the simplified cost-based method, and the profits split method.<sup>[9]</sup>

Finally, a partnership is an arrangement between two or more parties that share the income from the partnership, but may or may not share the costs of development – thus distinguishing itself from a cost sharing arrangement. A joint venture is an example of a typical partnership.

## *Avoiding Subpart F income*

To choose the appropriate structural arrangement with a foreign affiliate, the taxpayer must consider each arrangement's "subpart F" consequences. As stated before, U.S. income earned by foreign subsidiaries is generally not taxable until repatriated to the U.S. However, U.S. tax authorities have become concerned with what they perceive as U.S. taxpayers "abusively" using foreign corporations to shelter income abroad and deferring U.S. taxes by accumulating income in foreign "base" companies located in low-tax jurisdictions. The U.S. government is concerned with deferral of two particular types of income they perceive as particularly manipulable: passive investment income and income derived from transactions between related corporations.

If these types of income are earned by a "controlled foreign corporation" ("CFC"), that income will be immediately taxable to the "U.S. shareholders" of the CFC. A CFC is a foreign corporation whose "U.S. shareholders" hold more than 50 percent of the corporation's interests, by vote or by value. A "U.S. shareholder" is a U.S. person owning at least 10 percent or more of the total combined voting power" of that foreign corporation.

The use of a foreign affiliate corporation risks creating a CFC and incurring the associated subpart F income tax inclusions.

To avoid immediate taxation on subpart F income, check-the-box elections can be used to treat eligible foreign affiliates as pass-through entities and ownership interests can be minimized to avoid CFC classification. For example, if the foreign subsidiary makes a check-the-box election to be taxed as a partnership, it is no longer a foreign "corporation" for purposes of subpart F income.<sup>[10]</sup> In addition, proper planning can ensure that 50% of the ownership of the foreign subsidiary is held by a non-U.S. person, or that all U.S. persons own 10% or less of the ownership in the CFC.

Each of the above arrangements that include a foreign affiliate would also have different subpart F consequences. A contract R&D and licensing arrangement generally leads to royalty income received by a foreign affiliate from a related party. This could cause the foreign affiliate to earn subpart F income immediately taxable to its U.S. parent. However, a cost-sharing arrangement, where the foreign affiliate itself performs some portion of the R&D, would generally cause the foreign affiliate to earn its income in the form of sales income, which may not be treated as subpart F income.<sup>[11]</sup> Sales income and royalty income are subject to different rules under the subpart F regime. In general, sales income from the sale of IP is not subpart F income if the IP is used by the seller in a trade or business as defined in Section 162, and royalty income from the licensing of IP is not subpart F income if received from related parties for use in the same country as the CFC, or if received from unrelated parties for use in an active trade/business by the CFC.<sup>[12]</sup>

A partnership arrangement generally avoids subpart F income if it is formed as a partnership and not a corporation. However, partnerships are generally not tax-efficient because they generally lead to a U.S. taxable presence for the foreign partner, or a foreign taxable presence for the U.S. affiliate. But such an arrangement is not entirely without tax benefits: the partners would generally be entitled to claim tax deductions for each partner's share of R&D expenses.<sup>[13]</sup>

#### *Avoiding PFIC status*

The immediate taxation of subpart F income only results for "U.S. shareholders." To tax those U.S.

persons who own less than 10 percent in foreign corporations, Congress enacted an additional set of rules for passive foreign investment companies ("PFICs").

A PFIC is generally defined as a foreign corporation, where at least 75 percent of the corporation's income is passive income, or where at least 50 percent of the corporation's assets are held for the production of passive income.

Passive income is defined by the same definitions in Section 954 that define subpart F income for CFC purposes with a few notable exceptions that pertain only to PFICs. These exceptions include a 25-percent subsidiary look-through rule as well as a related party look-through rule where otherwise passive income is excepted from PFIC calculations if it is earned as "active" income by the affiliate.<sup>[14]</sup> Additional rules regarding whether royalty income is earned in the "active" conduct of a trade or business also apply for these purposes.

Proper planning to ensure qualification for these exceptions is important to managing the tax risks associated with these structures.

[1] "Innovation Boxes and Their Potential Role in International Tax Reform," Checkpoint Daily Newsstand, March 16, 2016

[2] *Id.*

[3] "An Innovation Box would be a Bad Innovation for American Tax Policy," Assistant Secretary of Tax Policy Mark Mazur, March 11, 2016.

[4] Unless otherwise provided, all references to Section herein are to the U.S. Internal Revenue Code of 1986, as amended.

[5] S. Rep't. No. 169, 98<sup>th</sup> Cong., 2d Sess., at 364; H. Rep't. No. 432, 98<sup>th</sup> Cong., 2d Sess., at 1319.

[6] "NYSBA Tax Section Offers Suggestions on Proposed Intangibles Regs," February 23, 2016.

[7] Jeffrey Korenblatt, "Recent Developments in the Taxation of IP Transactions: A Quickly Changing Landscape for US taxpayers, Corporate Taxation (WG&L), March/April 2016.

[8] Treas. Reg. sec. 1.482-4(e)(3)(i). See also Prop. Treas. Reg. sec. 1.482-2(f)(11), Ex. 6, 57 Fed. Reg. 3571 (Jan. 30, 1992).

[9] Treas. Reg. sec. 1.482-4(f)(3).

[10] However, for U.S. tax purposes, all income and losses would flow-through the foreign subsidiary to its U.S. owners.

[11] Treas. Reg. sec. 1.954-2(d).

[12] See, Sec. 954(c)(2)(A), Sec. 954(c)(3)(A)(ii), Sec. 954(c)(1)(A).

[13] See generally, Sec. 721.

[14] The related party look thru rule states that otherwise passive income received by a related party

allocable to non-passive activity of that related party is not passive income to the recipient for the purposes of calculating whether the recipient is a PFIC. Thus, royalty payments from a related party that derives the income to make that payment through an active licensing business would not be considered passive income. See Sec. 954(d)(3).

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### John D. Hollinrake, Jr.

John has over twenty-five years of experience advising clients on the federal income tax aspects of international and domestic mergers and acquisitions, reorganizations and restructuring, corporate distributions and other transactions with shareholders, debt and equity financings, entity formation, securitizations and structured finance. His practice focuses on business formations, joint ventures, acquisitions, combinations, sales, and tax planning. He has assisted clients with incorporations, tax-free corporate mergers, asset purchases and sales, cross-border transactions, strategic alliances, and joint ventures as well as general and limited partnerships and limited liability companies.

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