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# Global Strategies

DOING BUSINESS INTERNATIONALLY



## Competing Tax and IP Issues in Multinational Corporate Reorganizations, Acquisitions and License Agreements

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## Agenda

- Overview and Background Principles
- Case Studies
- Best Practices

## Introduction

- The management of IP creates significant tax and IP legal issues for multinational corporations
- Tax and IP management teams are often large, influential and unrelated
- Failure to coordinate the two departments can compromise tax positions or undermine a company's ability to defend its IP
- Tax and IP departments may be able to improve a company's position in both areas through close coordination to ensure that both tax and IP considerations are fully considered

## When the IP Group Affects Tax...

- Transactions Involving Third Parties
  - Recognition Timing
    - Acquisitions and Dispositions
  - License v. Sale Treatment
- Transactions Involving Related Parties
  - Issues above
  - Cross-jurisdictional use of IP raises transfer pricing concerns
    - Tax exposures for royalties
    - Must be documented annually
    - Up to 40% in penalties in addition to tax due
- Initiating or Concluding Patent Litigation

## When Tax Affects IP Enforcement...

- Tax may sell or license ownership or economic benefit of existing IP
  - This may result in the separation of IP title and IP profits which will require intercompany agreements
- Tax initiated internal corporate reorganizations that transfer IP
  - Post-acquisition restructuring
- Tax initiated intercompany agreements concerning the ownership and use of IP

## When Corporate Transactions Affect *both* Tax and IP

- Mergers and acquisitions
- Corporate reorganizations
  - Example: IP Holding companies
- Agreements with third-parties
  - Licensing agreements
  - Joint ventures
  - Partnerships
  - Third party R&D agreements

## A Tax Primer on IP: Key Issues

- Tax and IP concepts are not always consistent
- A few key tax concepts with respect to IP
  - Transfer Pricing and Arm’s Length Principle
  - Legal Ownership
  - “Economic” Ownership
  - Cost Sharing Arrangements
- Focus today on legally protectable intangibles (patents and trademarks).
  - Separate rules for other intangibles (marketing intangibles and goodwill)

## Transfer Pricing in Thirty Seconds

- "Transfer pricing" refers to prices charged, or the process of arriving at prices, for goods and services transferred between related persons.
- Prices charged after bargaining between unrelated persons are commonly called "arm's length" prices.
- Prices charged between related parties that are equivalent to those between unrelated persons are also called "arm's length"
- When unrelated persons deal at arm's length, their opposing interests are presumed to result in an arm's length price.
- By contrast, no such incentives exist in dealings between related persons.
  - A subsidiary corporation engaged in manufacturing may sell its output to an affiliate (say, a marketing distributor in another country) at an artificially high or low price, in order to place income in a tax-advantaged jurisdiction. This does not affect the overall income of the group – only the distribution of income within the group.



## Section 482: Designed to Police Transfer Pricing

- In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

## Setting the “Right” Price

- Setting an arm’s length price for intangibles is difficult and complex.
  - The intangibles are often unique
  - The intangible is often transferred before its full profit potential can be known
  - Certain intangibles would never be transferred to independent parties, complicating the search for comparables
  - Intangibles are often highly mobile, and the legal ownership can easily be shifted to lower-tax jurisdictions
  - Regulatory restrictions might affect the application of the arm’s length range (e.g., government approval required for import of technology and ceiling on royalty rates)

## Legal vs. Economic Ownership

- For patents and trademarks, legal ownership is simple: the legal owner is the registered owner
- Economic ownership is equivalent to determining who is entitled (or required) to earn the profits from the exploitation of IP
- For example, A may be legal owner of a patent, but B has funded and directed all development of IP resulting in the patent: B is probably the economic owner

## Who Has Economic Ownership of Intangible Property?

- Absent any specific agreement, generally only one member of a controlled group will be considered as the owner of an intangible
- If another member assists the owner to develop or enhance the value, an arm's length price is paid to the assistor but economic ownership is not transferred
- However, tax law permits co-ownership of intangibles when the parties have agreed to it
- Economic ownership is critical in tax, because the owner is entitled (required) to earn compensation for use of the intangible

## Introduction to Cost Sharing

- Cost sharing is basically a joint venture whereby two entities agree jointly to co-develop an asset
- In the transfer pricing world, the co-developed asset is almost always an intangible, or a product embodying an intangible
- There are many reasons that two separate businesses might want to share the cost of creating an asset or some other investment.
- In the oil and gas business, for example, it is common for co-owners to take extracted minerals in matching proportion to their expenditures.
- In a pure cost-sharing arrangement, there is no transfer of property or other interests among the participants.
  - Each participant receives a proper return on its investment.
  - The IRS would presumably be indifferent.

## Mechanics of Cost Sharing Arrangements

- Related parties share intangible development costs (“IDCs”) in exchange for an economic ownership interest in any resulting intangibles
  - Ownership interests cannot overlap
  - Division of interests can be based on territory, field of use, or other unspecified bases
- Cost sharing participants share profits/losses from the intangible property earned by their territory

## So Why is Cost Sharing a Transfer Pricing Issue?

- Cost sharing can effect a disguised transfer between related parties for less than arm's length consideration in two ways:
  - Each participant may not receive a benefit in proportion to its cost contribution; one participant in effect is subsidizing the other
  - One participant may contribute intellectual property for the other to use, the use of which is not fully compensated (“buy-in” or PCT)

## Primary Issue in CSAs: Valuation of “Platform” Intangibles and Related Resources

- When a CSA participant wishes to contribute existing IP to a CSA, the IP must be contributed by way of a “platform contribution transaction” (“PCT”)
- PCT can be an exclusive license or an outright assignment (treated as a sale for tax purposes)
- The other participant in a CSA must pay for this “platform contribution transaction” (“PCT payments”)
- The PCT value is determined by IRS regulations
- IRS will closely audit valuation of PCT payments



## PCT vs. CSA: Which Governs IP Rights?

- PCT: a License Agreement that licenses and governs “Acquired Intangibles”
  - Those acquired with Target in an acquisition and in existence on the date of the PCT
- CSA is a joint development agreement with cross license that governs “Cost Shared Intangibles”
  - Those developed under the CSA, after the date of the PCT Agreement

## IP Ownership: PCT vs. CSA

PCT	Licensor Territory	Licensee Territory
Legal Ownership (Title)	Licensor	Licensor (not required by Tax)
Economic Ownership (Tax)	Licensor	Licensee

CSA	Licensor Territory	Licensee Territory
Legal Ownership (Title)	Either	Either
Economic Ownership (Tax)	Licensor	Licensee

## Key Advantages of Cost Sharing

- Each participant owns IP that it paid to develop
- Income not subject to reallocation
- Sharing of risks and costs associated with IP development

## Issues in IP Enforcement

- The separation of IP ownership and IP use can raise at least four major issues for IP enforcement
  - Standing to Sue
  - Recovery of Lost Profits
  - Availability of Injunctive Relief
  - Computation of Damages

## Standing to Sue

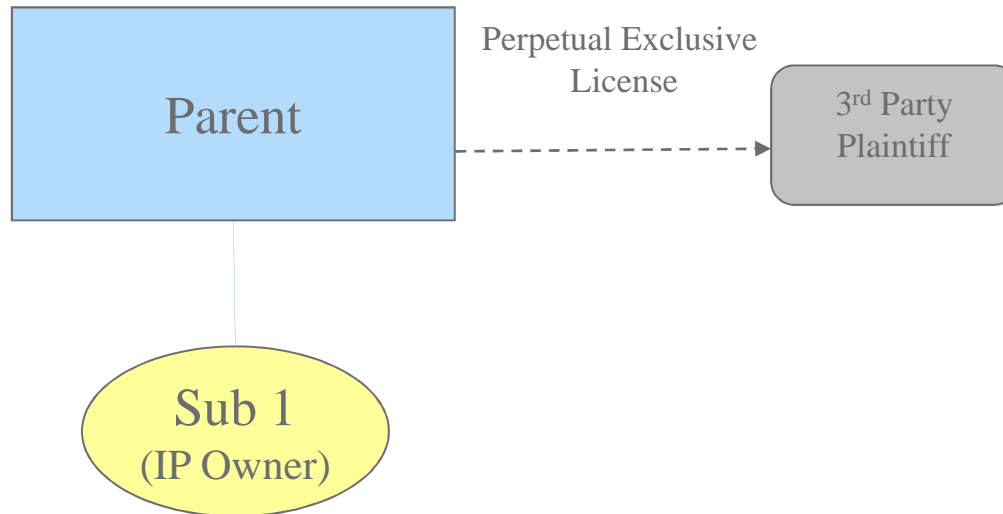
- Standing Requirements for Patent Litigation

Patent owner *must* be a plaintiff

- Exclusive licensee *can* be a co-plaintiff
  - Exclusive distributor *can* be a co-plaintiff
  - Non-exclusive licensees *cannot* be a co-plaintiff
- Issue: Are the intercompany agreements sufficient to establish standing?

# Standing to Sue

Case 1

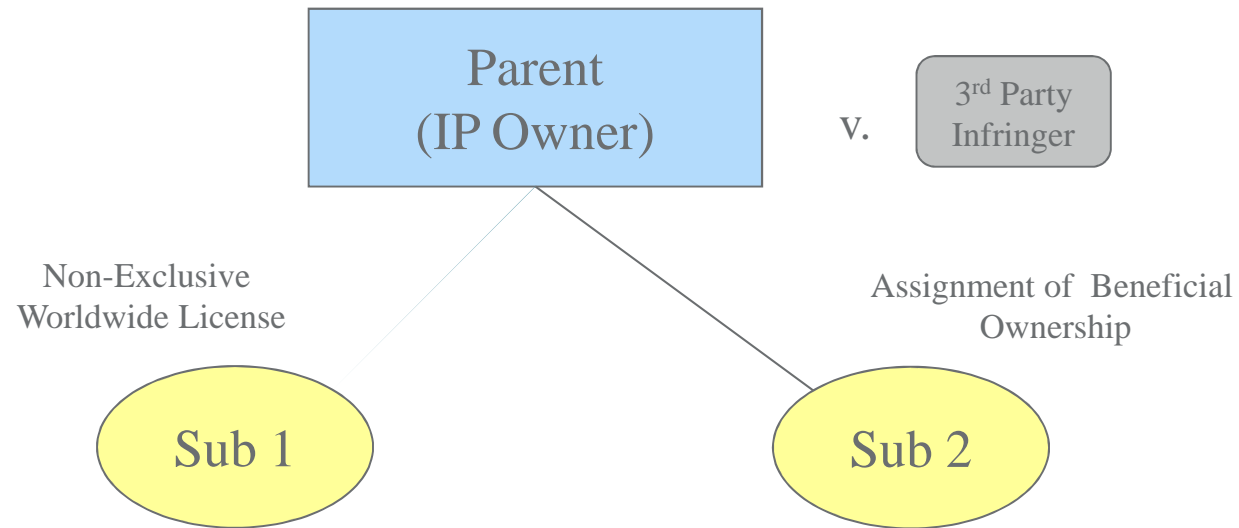


- Court dismissed a patent case after finding that plaintiff did not obtain any rights in the patent under a purported IP transfer agreement
- Transfer held invalid because the agreement was executed by the parent rather than by the subsidiary that actually owned the patent
- Court held that a parent is not “automatically deemed” to be authorized to transfer the IP rights of its wholly-owned subsidiaries

*Quantum Corp. v. Riverbed Tech. Inc.*,  
Case No. 3:07-cv-4161, 2008 WL 314490 (N.D. Ca.)

# Standing to Sue

## Case 2

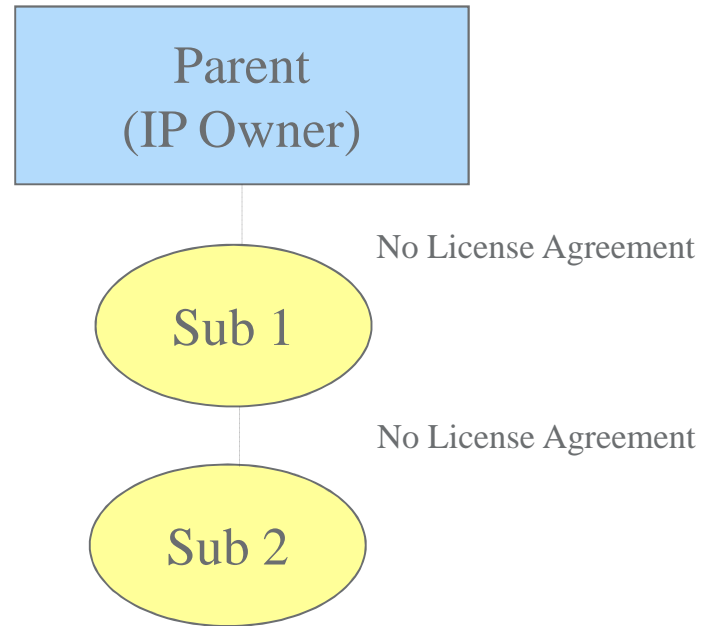


- Parent argued that it had given an exclusive license in the U.S. to Sub 2 by assigning its beneficial interest in the patent
  - The parent also granted a non-exclusive *worldwide* license to Sub 1
- Court held that Sub 2 did not have standing because it was not an exclusive licensee

*Mars Inc. v. Coin Acceptors, Inc.*,  
527 F.3d 1359 (Fed. Cir. 2008)

# Standing

## Case 3



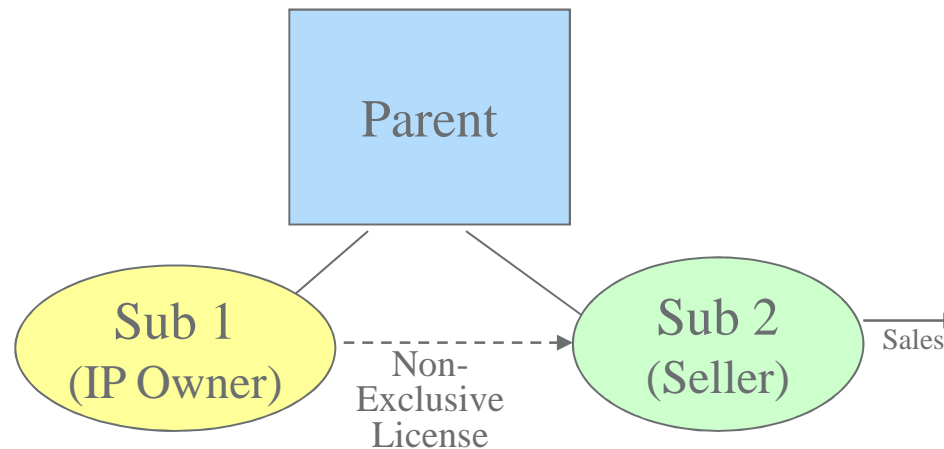
- Court held that an implied license existed between the parent and the two subsidiaries
- Court further held that a disputed factual issue existed as to whether the implied licenses were exclusive
- As a result, the issue of the exclusivity of the licenses will have to be decided at trial

*Novartis Pharm. Corp., Novartis Pharma AG and  
Novartis Int'l Pharm. Ltd. v. Teva Pharm. USA, Inc.,  
Case No. 05-CV-1887 (D. Mass.)*



# Recovery of Lost Profits

## Case 1

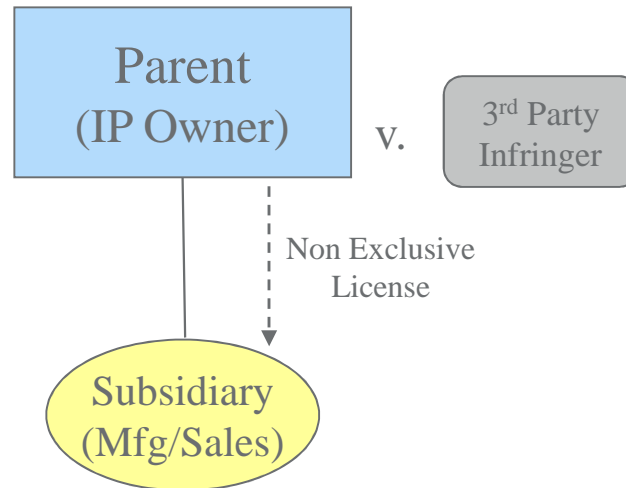


- The court held that the patent owner (Sub 1) could not recover “lost profits” because it did not actually sell the patented product
- The court held that the selling subsidiary (Sub 2) could not be a co-plaintiff in the patent case because it was only a non-exclusive licensee
- Net result: Neither subsidiary could recover lost profits

*Poly-America L.P. v. GSE Lining Technology, Inc.*,  
383 F.3d 1303 (Fed. Cir. 2004)

# Recovery of Lost Profits

## Case 2

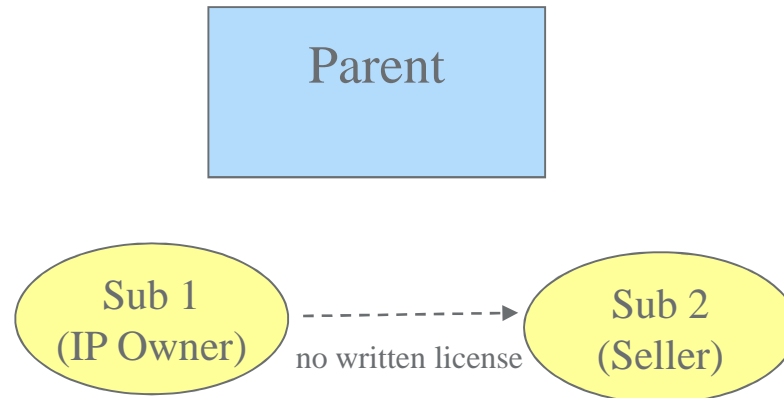


- The selling subsidiary could not be a plaintiff because it was only a non-exclusive licensee
- The court rejected the parent’s claim that it “inherently lost” the profits of its subsidiary
- Net Result: Neither parent nor subsidiary could recover lost profits

*Mars Inc. v. Coin Acceptors, Inc.*,  
527 F.3d 1359 (Fed. Cir. 2008)

# Recovery of Lost Profits

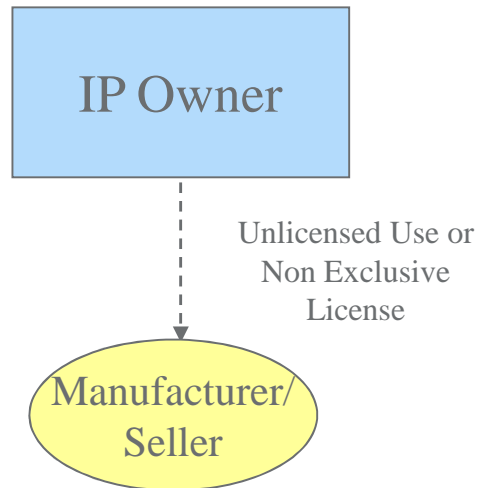
## Case 3



- The court held that the patent owner (Sub 1) could not recover “lost profits” because it did not actually sell the patented product.
- The court held that the selling subsidiary (Sub 2) could not be a co-plaintiff in the patent case because it could not prove that it had exclusive rights.
- Net result: No corporate entity could recover lost profits.

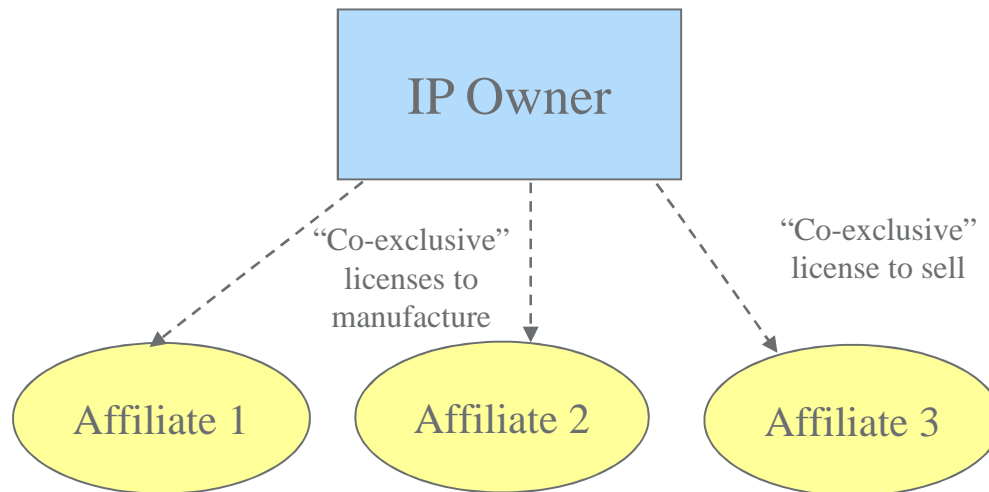
*Spine Solutions, Inc. v. Medtronic, Inc.*,  
620 F.3d 1305 (Fed. Cir. 2010)

## Obtaining Injunctive Relief



- If the “selling” subsidiary cannot be a co-plaintiff, the IP-owning entity may not be able to obtain injunctive relief
- Injunctive relief requires a showing of irreparable harm and inadequate legal remedies
- Courts are often reluctant to award injunctive relief to entities that do not sell the patented product

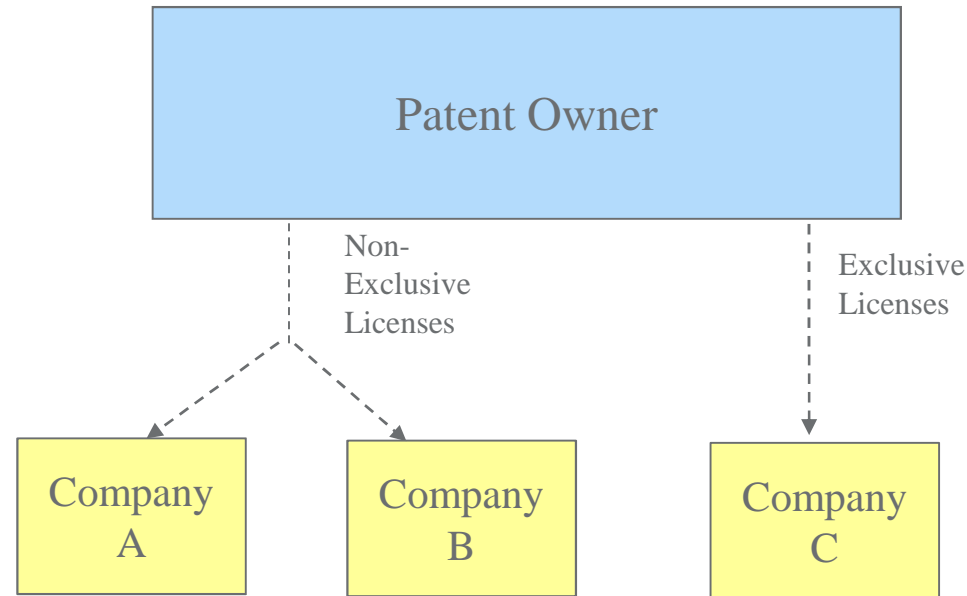
## Obtaining Injunctive Relief



- After jury found patent valid and infringed, court held that Affiliates 1, 2, and 3 were not “exclusive” licensees
- Court therefore held that Affiliates 1, 2 and 3 did not have standing
- Court further held that IP Owner could not recover lost profits or obtain an injunction because it could not show “irreparable harm”

*Medtronic, et al. v. Globus Medical, Inc.*,  
637 F. Supp. 2d 290 (E.D. Pa. 2009)

## Standing Revisited



- Federal Circuit: The key issue is whether the Plaintiff can show that it has the right to exclude the Defendant from engaging in the alleged infringing activity.

*WiAV Solutions, LLC v. Motorola, Inc.*,  
2010 WL 5256801 (Fed. Cir. Dec. 22, 2010)

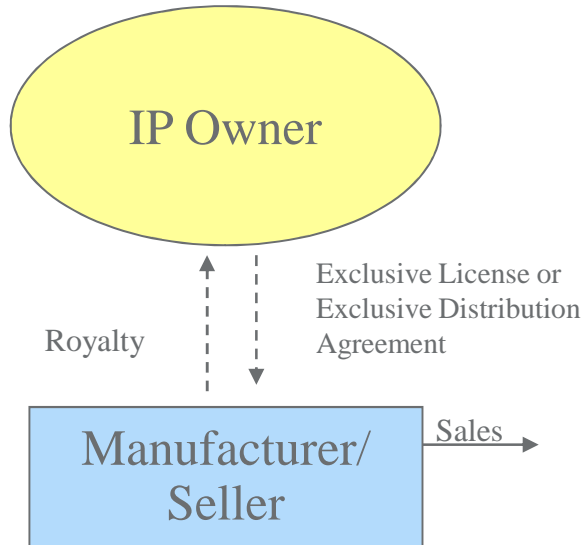
# Recovery of Lost Profits and Obtaining Injunctive Relief

## Potential Solutions

1. Undertake an exclusive license so that both the IP-owning entity and the selling entity can join as co-plaintiffs in the patent case
2. Undertake an exclusive distribution arrangement
3. Structure the relationship so that the sales made by the selling entity are booked to the IP-owning entity
  - IP-owning entity would then be the only plaintiff
  - This arrangement may not be consistent with company's tax treatment

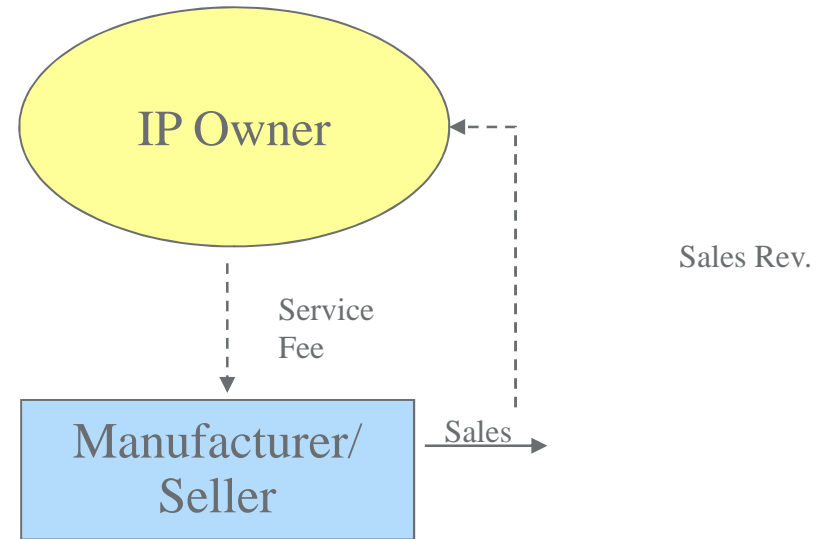
# Recovery of Lost Profits and Obtaining Injunctive Relief

Some “Solution” Scenarios:



- Exclusive License

- Patent owner and exclusive licensee (or exclusive distributor) can jointly recover full damages as co-plaintiffs
- Note that exclusivity is also often more consistent with the parent’s transfer pricing positions



- Service Agreement

- All sales booked to IP owner
- IP owner is the only plaintiff
- Sales of infringing product cause losses to patent owner



## Damages Calculation

**Are the intercompany royalty rates comparable to claimed damages?**

- Intercompany royalty rates could become relevant in calculating the “reasonable royalty” in patent infringement cases
- The accused infringer could argue that the royalty rate reported for tax purposes represents for the patent
- A party may be estopped from taking a position that is different from the position it took before a taxing authority
- Similarly, IP owner’s distribution relationships may be used to limit “lost profits” claims

## Sale v. License Concepts in IP and Tax

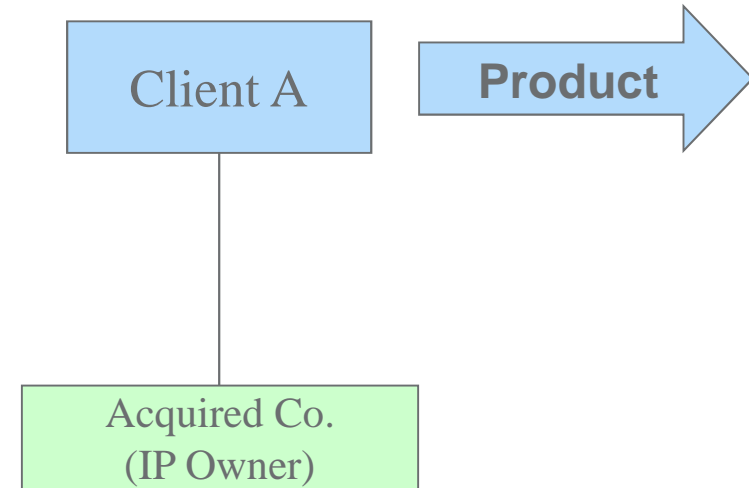
- Sale: transfer of all substantial rights in IP
  - Exclusive licenses often do this
- License: less than all substantial rights
  - Exclusive licenses with retained substantial rights can maintain license characterization
    - Quality Control Limits
    - Termination Provisions
    - Duration/Renewal Provisions
    - Contingent Payments
- Patent law has analogous concept for when a transaction constitutes an assignment

## Agenda

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- Best Practices

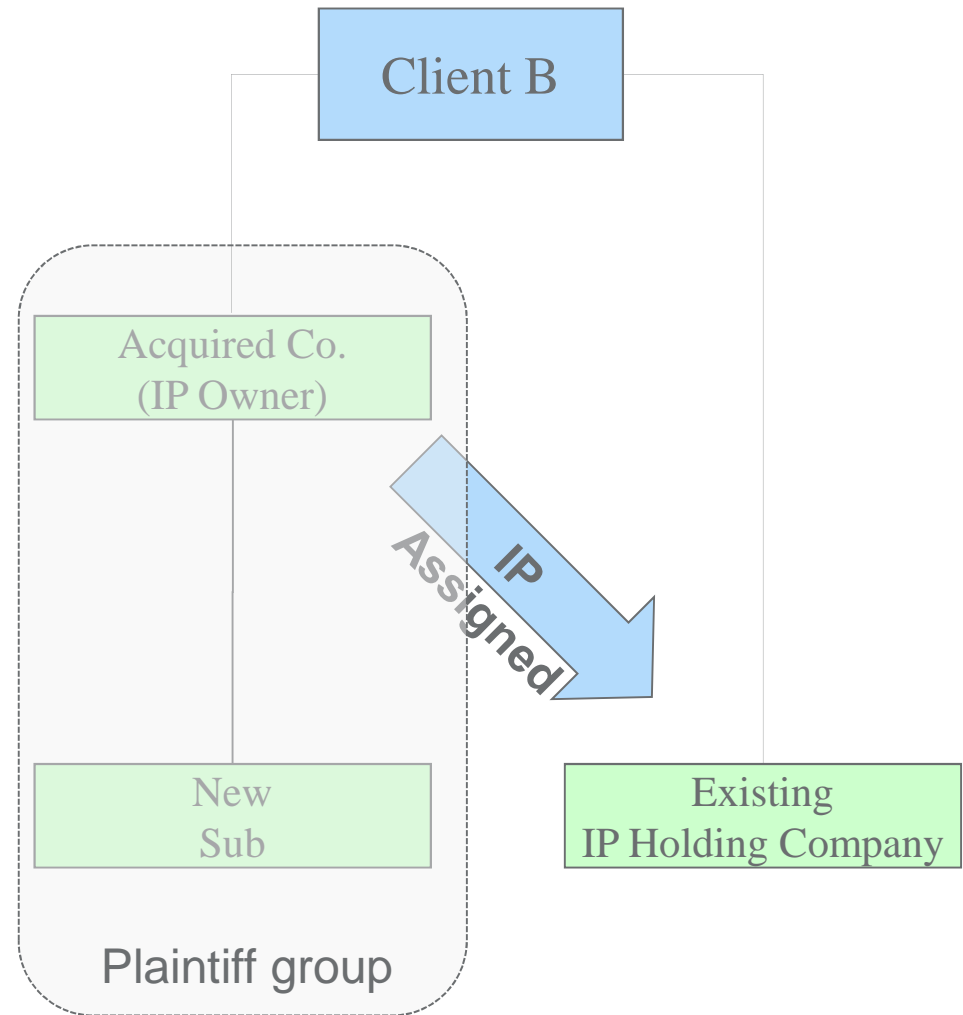
## Case Study 1: Post-Acquisition Integration

- Client A acquired another pharmaceutical company including all of its IP rights and commercial products
- Client A immediately began selling the acquired company's drugs through its own sales force while leaving IP ownership in the acquired company (now a new subsidiary)
- Client A did not enter into a license agreement with its new subsidiary
- When a competitor infringed the patent, Client A could not join as a co-plaintiff and therefore could not recover lost profits



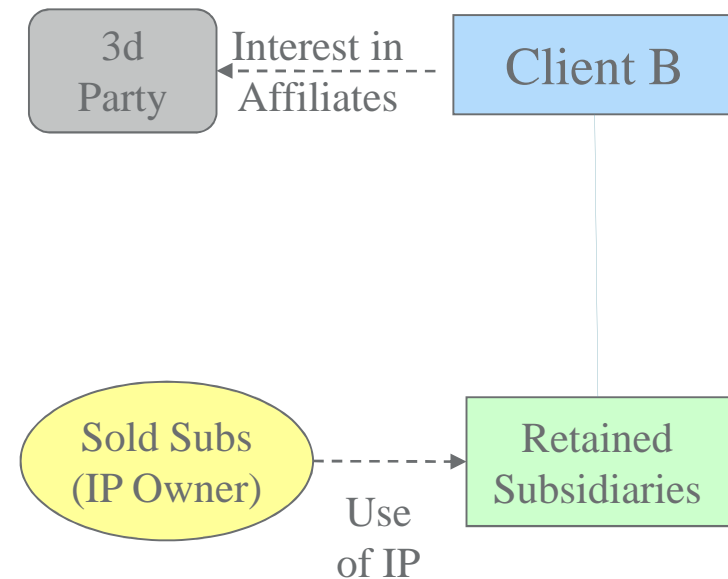
## Case Study 2: Post-Acquisition Integration

- Client B acquired a U.S. company, including all of the global IP rights and commercial products
- Upon integration, Tax Department followed its usual post-merger integration procedures and moved IP to IP Holding Company
- IP group was not aware of this procedure and Tax Department did not update licenses
- When a competitor infringed Client B's IP, Client B brought suit with acquired company and New Sub as plaintiffs
- After substantial discovery and expense, defendant successfully moved for dismissal because the wrong entity brought suit



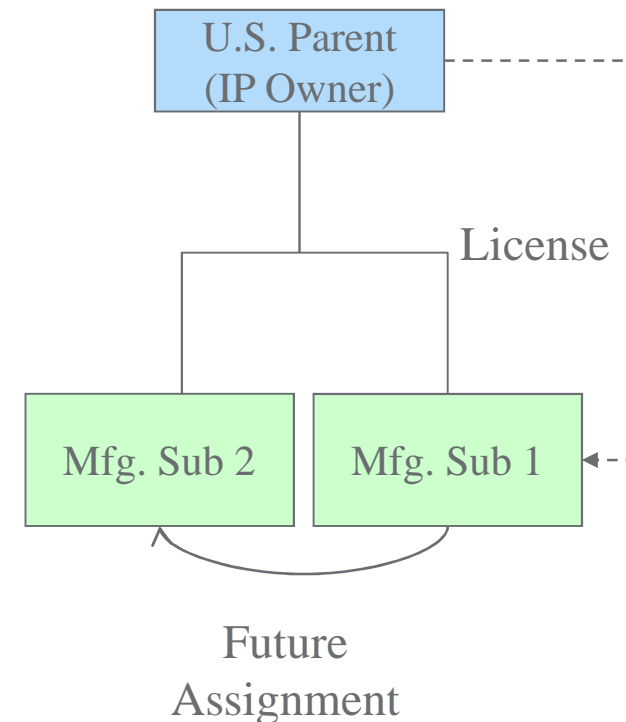
## Case Study 3: Divestiture of a Subsidiary with Global IP Rights

- Client B sought to divest a business that owned global IP rights, including rights needed by some of Client B's other subs
- Client B was willing to sell legal ownership of the IP, but wanted to retain its subs' ability to use and enforce the IP rights
- Key Issues:
  - Agreements drafted to ensure that the subsidiaries would have standing to participate in any U.S. enforcement actions in the U.S. and could recover lost profits from U.S. sales by any infringer
  - Agreements drafted to ensure consistency with the overall tax position of the company (e.g., no adverse comparables)

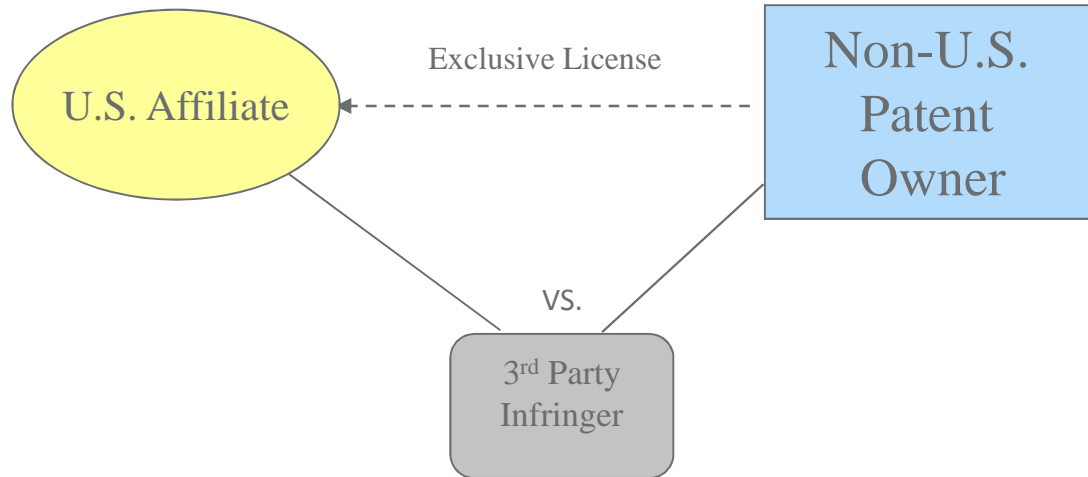


## Case Study 4: Licensing Different Subsidiaries to Manufacture the Same Product

- Client C wanted to license patents from its U.S. parent, but had not made a final decision as to which of its foreign manufacturing subsidiaries would ultimately be the manufacturer
- Client C wanted to retain the business flexibility to later shift the manufacturing operations from one subsidiary to another without compromising the enforceability of the underlying IP rights
- Key Issues:
  - Exclusive license used under which Sub 1 agreed to assign rights to Sub 2 after a predetermined period of time
  - This is an imperfect solution, but beats non-exclusivity



## Case Study 5: Settlement of Patent Litigation



- Foreign patent owner and U.S. exclusive licensee sued third-party infringer
- Litigation team drafted settlement calling for the payment of royalties *only* to the U.S. entity
- This settlement compromised company's tax position



## Agenda

- Overview and Background Principles
- Case Studies
- Best Practices

## IP-Tax Flashpoints

- Mergers and Acquisitions
- Corporate Reorganizations
- IP Deals with Third Parties
- Launch of a New Product
- IP Litigation and Settlement

## What We Have Done That Has Worked

- Facilitating communication between a tax lead and an IP lead
  - When providing tax and/or IP advice, we often act as “translators” to facilitate ongoing communication throughout a project
  - Allows early involvement and coordination
  - Avoids need for elevation of issues to senior levels
- Conduct targeted internal “summits”
  - When a “flashpoint” occurs, we have facilitated joint meetings between tax and IP management to discuss goals, objectives, and workplans
  - Typically day long or multiday session
  - Allows development of a common framework
  - May not translate into day-to-day practice without ongoing commitment
- Developing a formal processes for tax-IP review
  - We have assisted clients that wanted to formalize the coordination process by establishing protocols and principles for IP and tax projects
  - Creates official review and clear documentation of transactions
  - Requires significant time investment and advance planning

## Circular 230 Disclaimer

- This presentation may not be used to avoid tax penalties under U.S. law
- This presentation does not render tax advice, which can be given only after considering all relevant facts about a specific transaction. Consult a professional tax adviser for tax advice.

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