MAYER • BROWN

How to Manage Corporate Tax & IP Considerations

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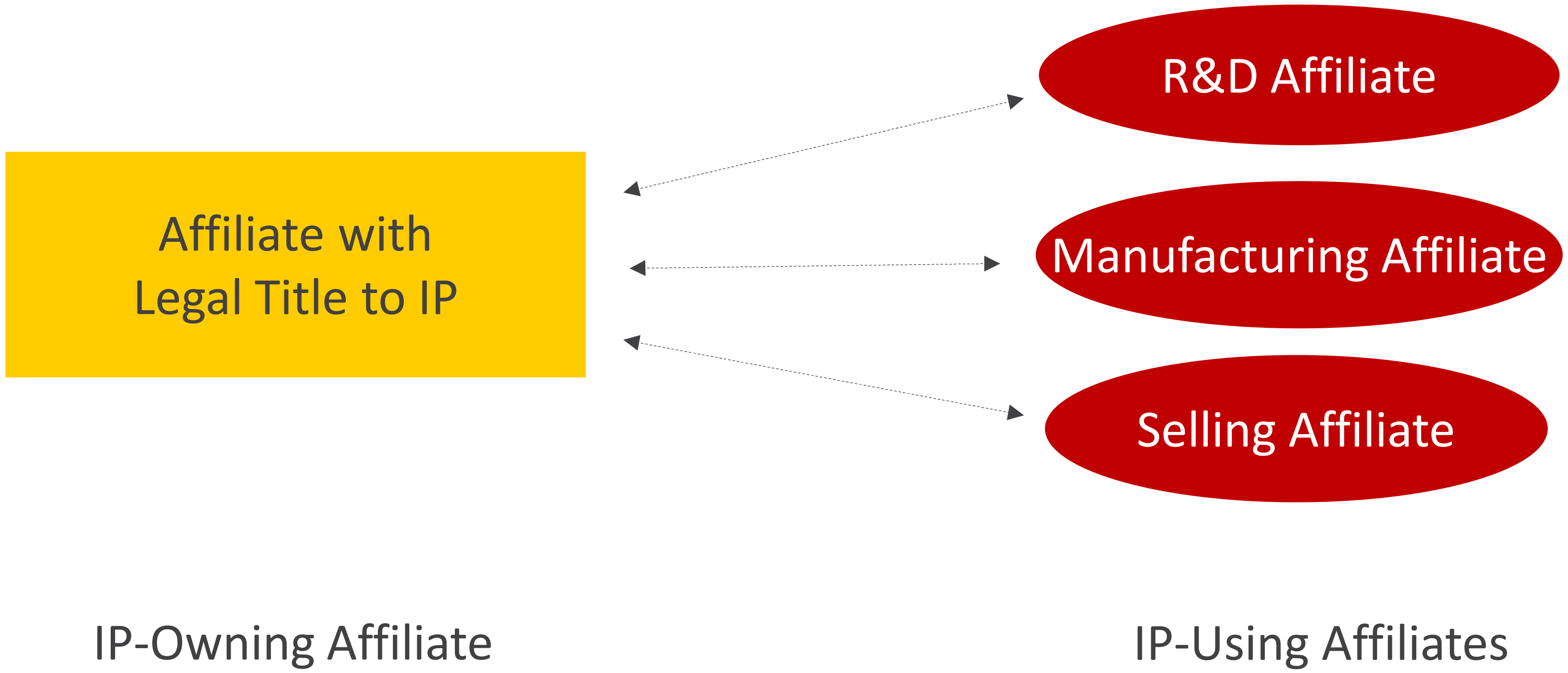
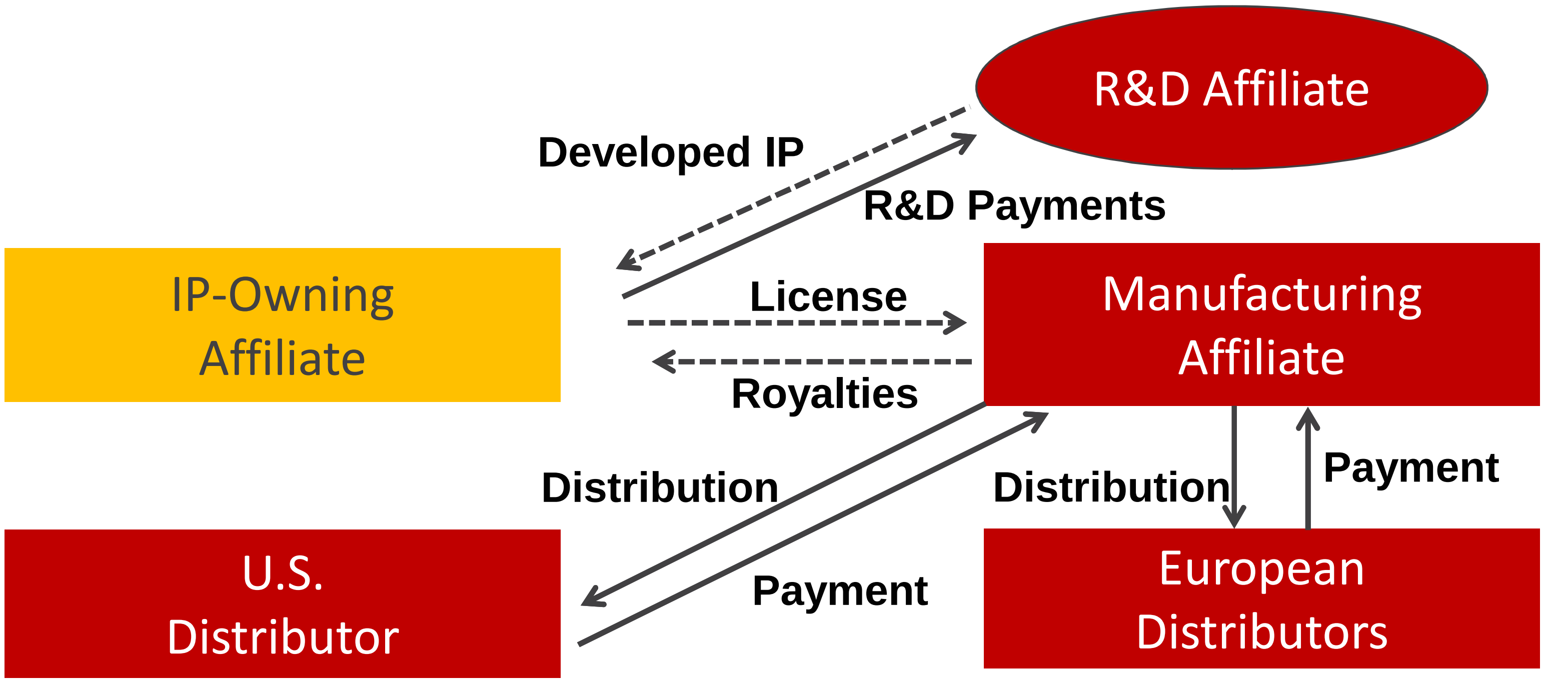
Introduction: Major Themes

1. Any corporate transaction involving IP will create significant tax and IP issues
2. These issues are particularly complex when multinational corporations separate IP ownership and IP use
3. Failure to coordinate the Tax and IP Groups can compromise tax or IP positions

Setting the Stage:
Separation of IP Ownership and IP Use



Separation of IP Ownership and IP Use



Result? Inter-affiliate agreements become necessary.

Setting The Stage:
Transactions Resulting in IP Acquisition or Migration

- Acquisitions of IP-Owning Companies
  - **Issue:** Which affiliates will own and use the **acquired** IP?
- Corporate Reorganizations
  - **Issue:** Which affiliates will own and use the **existing** IP?
- Corporate R&D
  - **Issue:** Which affiliates will own and use the **developed** IP?

- **Common Issue:** What will the Inter-Affiliate Licensing Structure look like?

TAX PRINCIPLES

A Tax Primer on IP: *Key Issues*

- Tax and IP concepts are not always consistent
- A few key tax concepts that often vex non-tax people:
  1. Transfer Pricing and the Arm's Length Principle
     - Some jurisdictions follow the OECD's Base Erosion and Profit Shifting ("BEPS") project's transfer pricing guidance
     - Penalties of up to 40% in addition to tax due
  2. Legal Ownership vs. "Economic" Ownership
     - Under BEPS, functional analysis of the **D**evelopment, **E**nhancement, **M**aintenance, **P**rotection, and **E**xploitation ("DEMPE") of IP is critical
  3. Cost Sharing Arrangements

Transfer Pricing in 30 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
  - 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.
- So tax law needs a tool to police arbitrage games that might be played in related party contexts

US 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. <u>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.</u>

Transfer Pricing: *Setting the "Right" Price*

- Benchmarking an arm's length price for IP transactions is often difficult
  - IP is often unique
  - IP often drives substantial value
  - IP is often transferred before its full profit potential can be known
- As a result, IP pricing can generate tax disputes
  - Heavily fact dependent
  - Like any valuation issue, economic assumptions drive results (battle of the experts)
  - High $ impact

Legal vs. Economic Ownership

- IP is often highly mobile, and legal ownership can easily be shifted to lower-tax jurisdictions, so tax law needs to police ownership, too
- Legally protected IP: The sole legal owner shall be
  - Legal owner under the IP law of the relevant jurisdiction, **OR**
  - Holder of rights constituting an intangible pursuant to contractual terms (such as a license) or other legal provision
- Not Legally Protected: entity with “control” of the IP, based on all facts and circumstances
- Economic Substance: such ownership will be respected unless inconsistent with the economic substance

Who Owns Intangible Property?

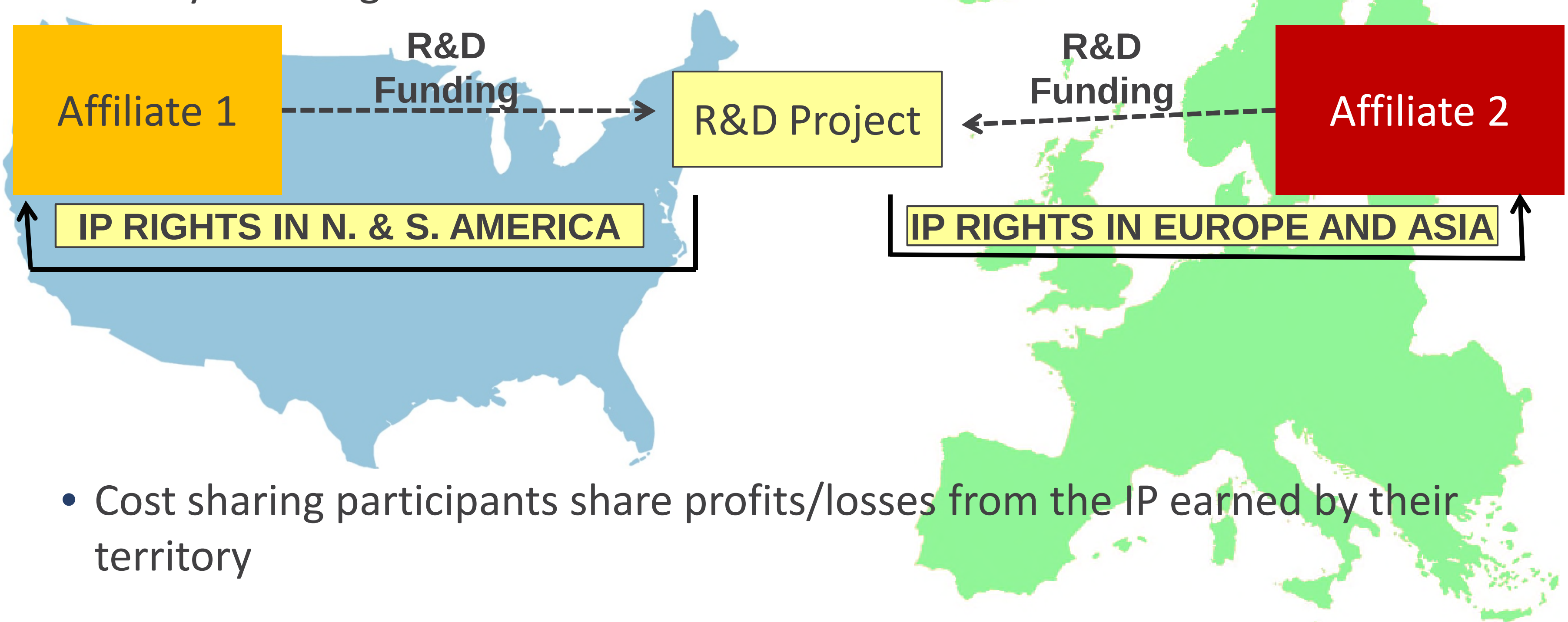
- In a typical situation, only one member of a controlled group will be considered the owner of an intangible
- If another member assists the owner in developing or enhancing the value, an arm's length price is paid to the assistor
- Still, there are cases where intangibles are co-owned
- Ownership is critical because the <u>owner</u> is entitled (required) to earn compensation for use of the intangible

Cost Sharing in 30 Seconds

- Cost sharing is a joint venture whereby two or more entities agree to co-develop an asset
- The co-developed asset is often IP or a product embodying IP
- In a cost-sharing arrangement, there is no transfer of property
  - Each participant receives a proper return on its investment
  - The IRS would presumably be indifferent

Mechanics of Cost Sharing Arrangements

- Affiliates share R&D costs in exchange for an economic ownership interest in any resulting IP



- Cost sharing participants share profits/losses from the IP earned by their territory

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)

The Continued Fight Over IP Ownership

- Recent and ongoing cases
  - Cost Sharing: *Amazon.com, Inc. v. Commissioner*, decided in the Tax Court March 23, 2017
  - Licensing: *Coca-Cola Co. v. Commissioner*, petition filed December 14, 2015; trial scheduled for March 2018

Amazon.com, Inc. v. Commissioner

- Cost-Sharing arrangement between Amazon US and Amazon Lux, with $254.5 M buy-in payments for pre-existing US IP
  - (1) Software and other technology intangibles; (2) Marketing intangibles; and (3) customer lists
- The IRS adjusted buy-in payments to $3.6 billion
  - Discounted cash flow (DCF) from all non-US business operations
  - Thus, instead of valuing discrete items of IP, IRS valued entire business, including workforce in place, goodwill, and going concern value
- Tax Court
  - IRS abused its discretion by including value of IP subsequently developed, and therefore “owned” by Amazon Lux
  - Court then revalued each of the three discrete items of IP

Coca-Cola Co. v. Commissioner

- Licensing agreement between Coca-Cola and 7 foreign affiliates for TMs and non-patented technology (formula)
  - Affiliates make concentrate for sale to third-party bottlers
- IRS adjusted royalty up $9.4 billion for 2007-09 tax years
  - Approach: "routine returns" to affiliates
- Coca-Cola argues affiliates bear "entrepreneurial risks and expenses for their markets" and are economic owners entitled to non-routine profits
- **Is IRS inconsistent?**
  - Coca-Cola Canada: IRS apparently assigned non-routine profits on theory Canada was the economic owner
  - Glaxo (settled 2006): IRS argued US sub of foreign parent was economic owner and entitled to non-routine profits

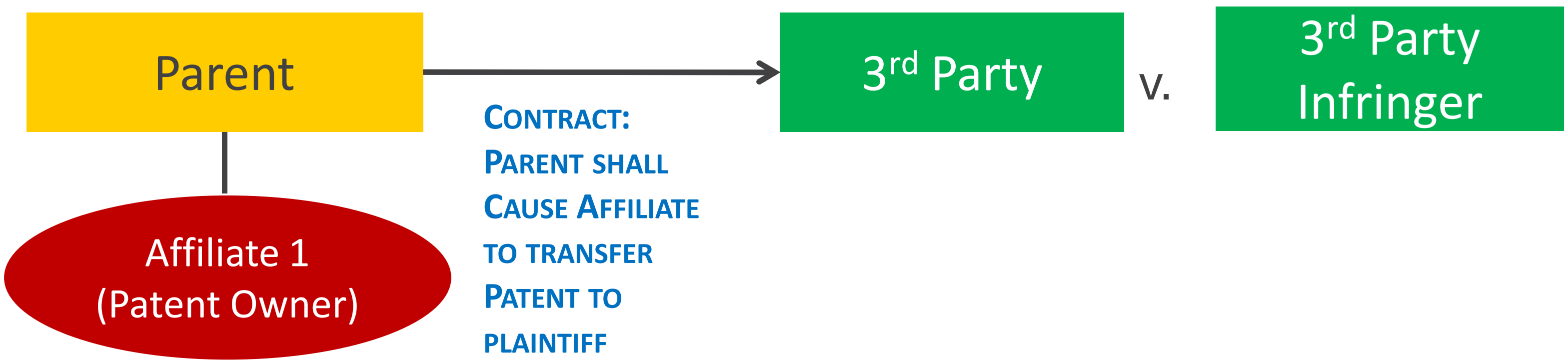
IP ISSUES

Issues in IP Enforcement

- The separation of IP ownership and IP use can raise at least two major issues for IP enforcement
    1. Standing to Sue
    2. Damages
        - Reasonable Royalty
        - Recovery of Lost Profits
        - Injunctive Relief

Legal Formality is Critical

- Case 1: Promise to Assign is Not an Assignment



- Contract providing that patent owner "agrees to assign" patent to another party is only a promise to assign the invention in the future
  - The contract therefore did not vest legal title in the assignee
- **Result: Purported assignee has no standing to enforce patent**
- *Abraxis Bioscience, Inc. v. Navinta, LLC*, 625 F.3d 1359 (Fed. Cir. 2010)

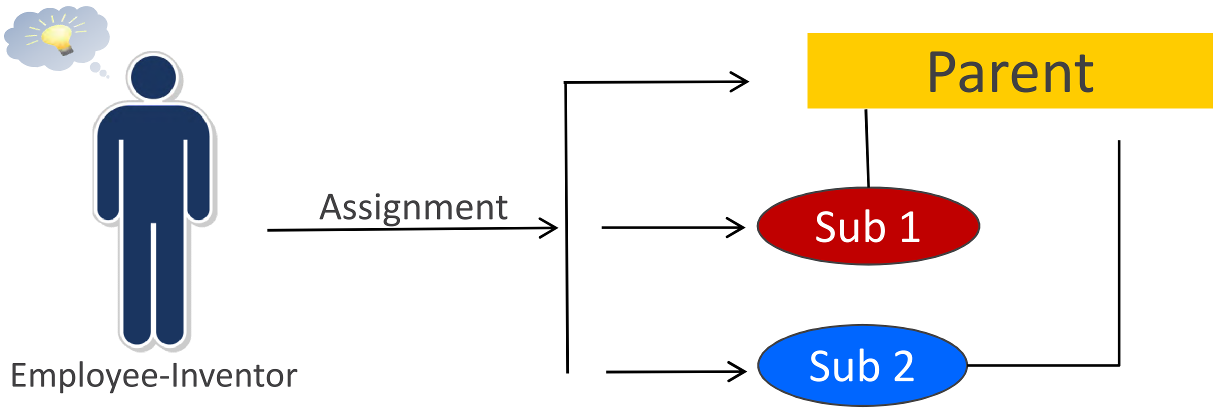
Legal Formality is Critical

- Case 2: License from Parent Invalid Where Sub Owned the Patent

- License held invalid because the agreement was executed by parent rather than by subsidiary that actually owned the patent
- Court held that a parent is not "automatically deemed" to be authorized to transfer the IP of its wholly-owned subsidiaries
- **Result: Case dismissed**
- *Quantum Corp. v. Riverbed Tech. Inc.*, Case No. 3:07-cv-4161, 2008 WL 314490 (N.D. Ca.)

Legal Formality is Critical

- Example 1: Employee agreement re Inventions



- Employee “hereby assigns” all future patentable inventions to “Company”.
- Agreement defines “Company” as the Parent and all of its subsidiaries.
- Assignment is effective the moment the invention comes into existence.
- **Issue: Does every subsidiary become a co-owner of the patented invention?**
- *Janssen Biotech, Inc. v. Celltrion*, Case No. 1:17-cv-11008 (D. Mass.) (Oct. 31, 2017)

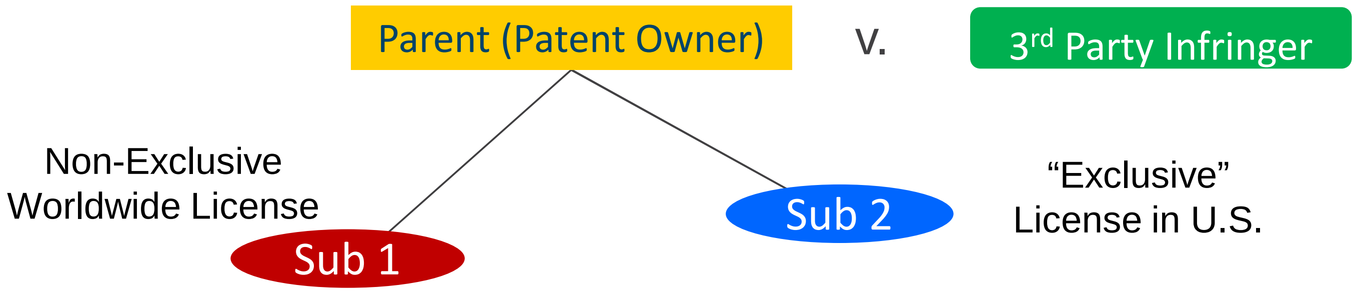
Standing to Sue

- US
  - 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 inter-affiliate agreements sufficient to confer standing?

Standing to Sue

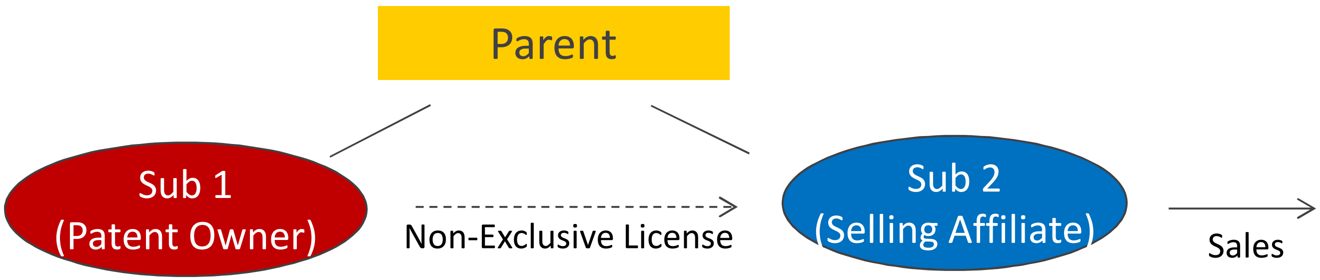
- Case 3: No Exclusive License If Another Sub Has Worldwide Rights



- Parent argued that it had given an “exclusive” license in the U.S. to Sub 2
  - 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)

Recovery of Lost Profits

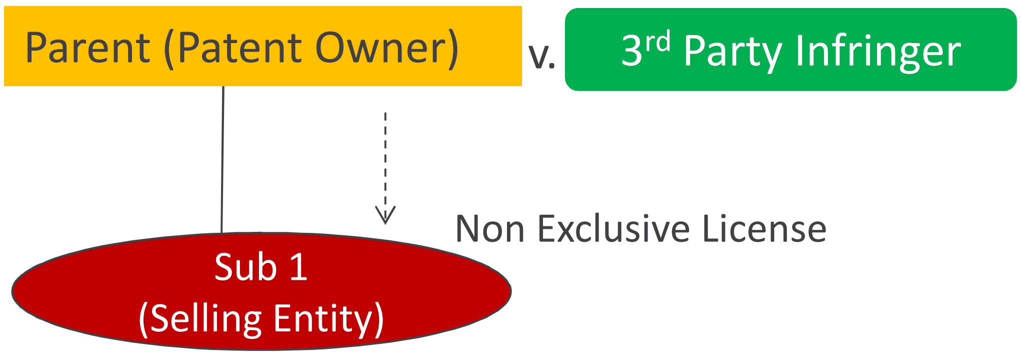
- Case 1: No Recovery of Lost Profits if "Selling" Sub is a Non-Exclusive Licensee



- The patent owner (Sub 1) could not recover "lost profits" because it did not actually sell the patented product
- The selling subsidiary (Sub 2) could not be a co-plaintiff in the patent case because it was only a non-exclusive licensee
- **Result: No recovery of lost profits**
- *Poly-America L.P. v. GSE Lining Technology, Inc.,* 383 F.3d 1303 (Fed. Cir. 2004)

Recovery of Lost Profits

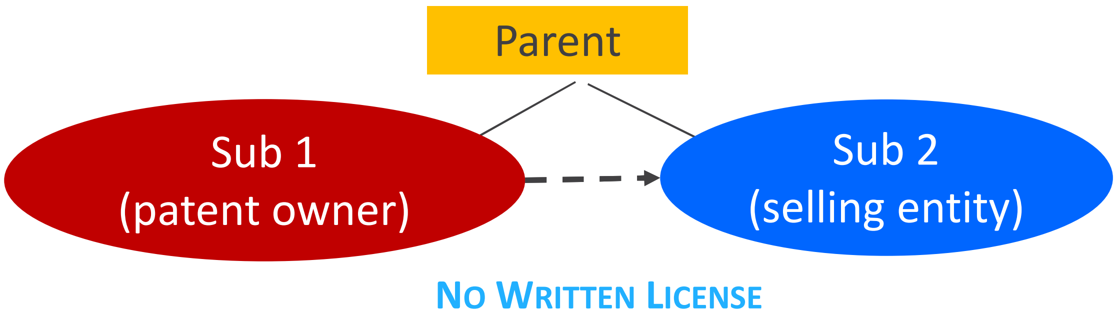
- Case 2: Wholly-Owned Sub Not Enough to Show "Lost Profits" for Parent



- 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 wholly-owned subsidiary
- **Result: No recovery of lost profits**
- *Mars Inc. v. Coin Acceptors, Inc.*, 527 F.3d 1359 (Fed. Cir. 2008)

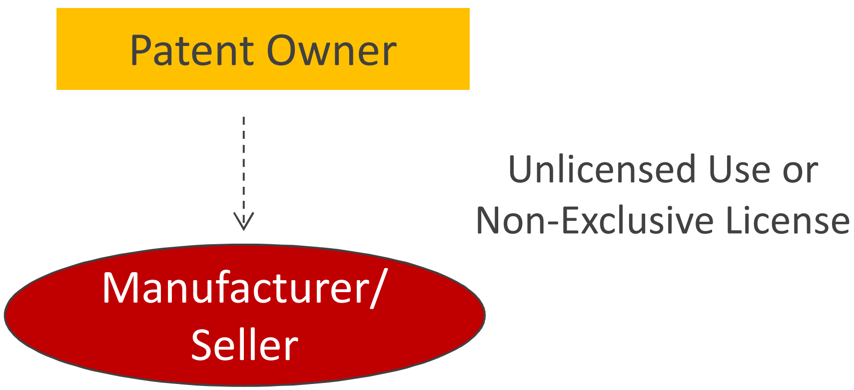
Recovery of Lost Profits (cont'd)

- Case 3: Informal Corporate "Organization" Not Enough to Show Exclusivity



- Patent owner (Sub 1) could not recover "lost profits" because it did not actually sell the patented product
- Without a written license, the mere fact that Sub 2 was the only entity selling the patented product was not enough to show exclusivity
- **Result: No recovery of lost profits**
- *Spine Solutions, Inc. v. Medtronic, Inc.*, 620 F.3d 1305 (Fed. Cir. 2010)

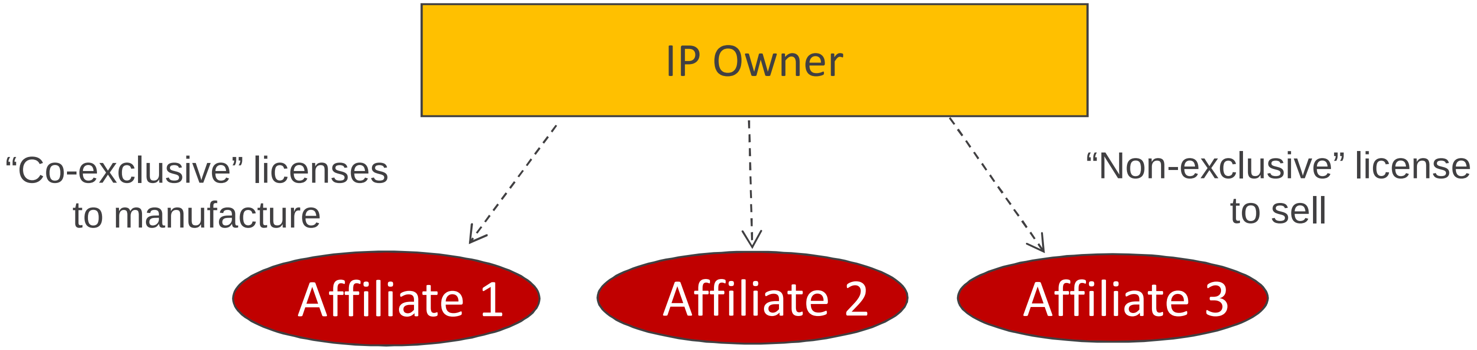
Obtaining Injunctive Relief



- 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

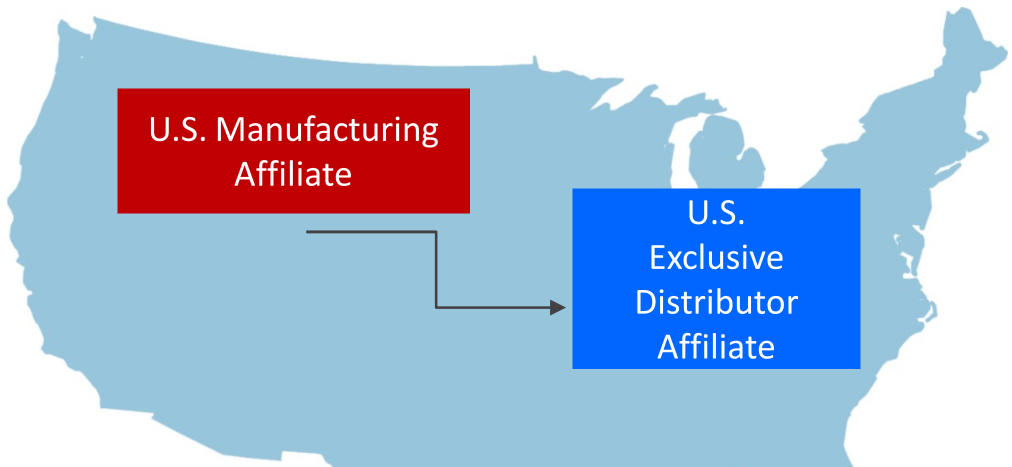
- Case 1: No Injunction if Plaintiff Is Not Selling the Patented Product



- *After* jury found patent valid and infringed, court held that Affiliates 1, 2, and 3 were not "exclusive" licensees and therefore 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)

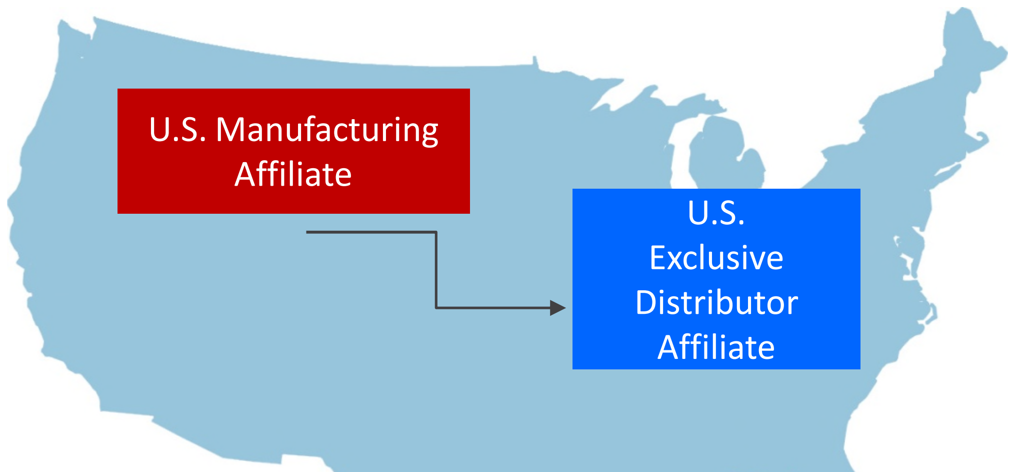
Exclusive Distributor Affiliate

- *Lexmark:*



- In *Lexmark*, the Supreme Court held that a patentee's sale of a product exhausts all of its patent rights in that product.
  - *Impression Products, Inc. v. Lexmark, Int'l.*, 517 U.S. ____ (2017)
- Does this mean the distributor cannot join a suit to enforce the patent against an infringer?

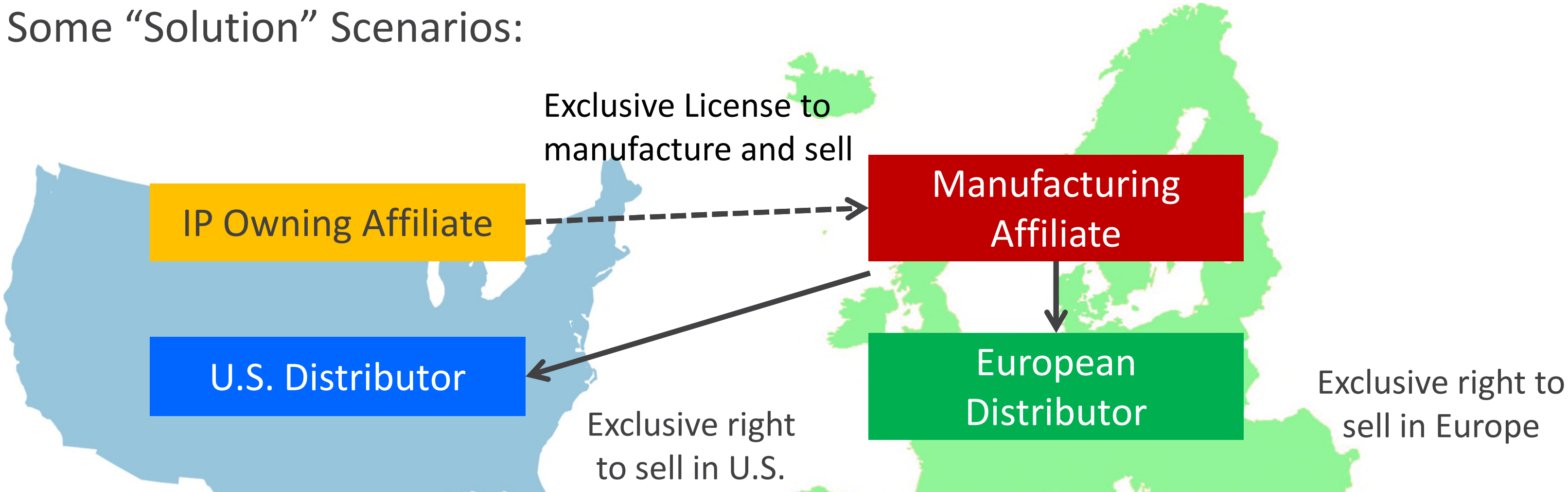
Exclusive Distributor Affiliate



- When U.S. manufacturing affiliate sells products to a U.S. distributor affiliate, does the distributor really have an “exclusive” right to sell the product in the U.S.?
- Solution: Limit the manufacturer’s license by giving it a right to sell only to the distributor, and give the distributor the exclusive right to sell to third parties in the U.S.

Recovery of Lost Profits and Obtaining Injunctive Relief

- Some “Solution” Scenarios:



- A license can be exclusive even when it grants less than all of the patent rights—*e.g.*, an exclusive right to manufacture or an exclusive right to sell in a specific territory.
- *Abbott Labs v. Sandoz, Inc.*, 2010 WL 1948185 (N.D. Ill. May 12, 2010)

Best Practices IP-Tax Flashpoints

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

Speakers

- Please submit questions by using the chat feature on the right panel of the WebEx portal
- Please email nfroelicher@mayerbrown.com with any additional questions, or reach out to us directly:

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