



MAYER|BROWN

IP ACQUIRED IN M&A DEALS: REDUCING TAX AND IP RISKS

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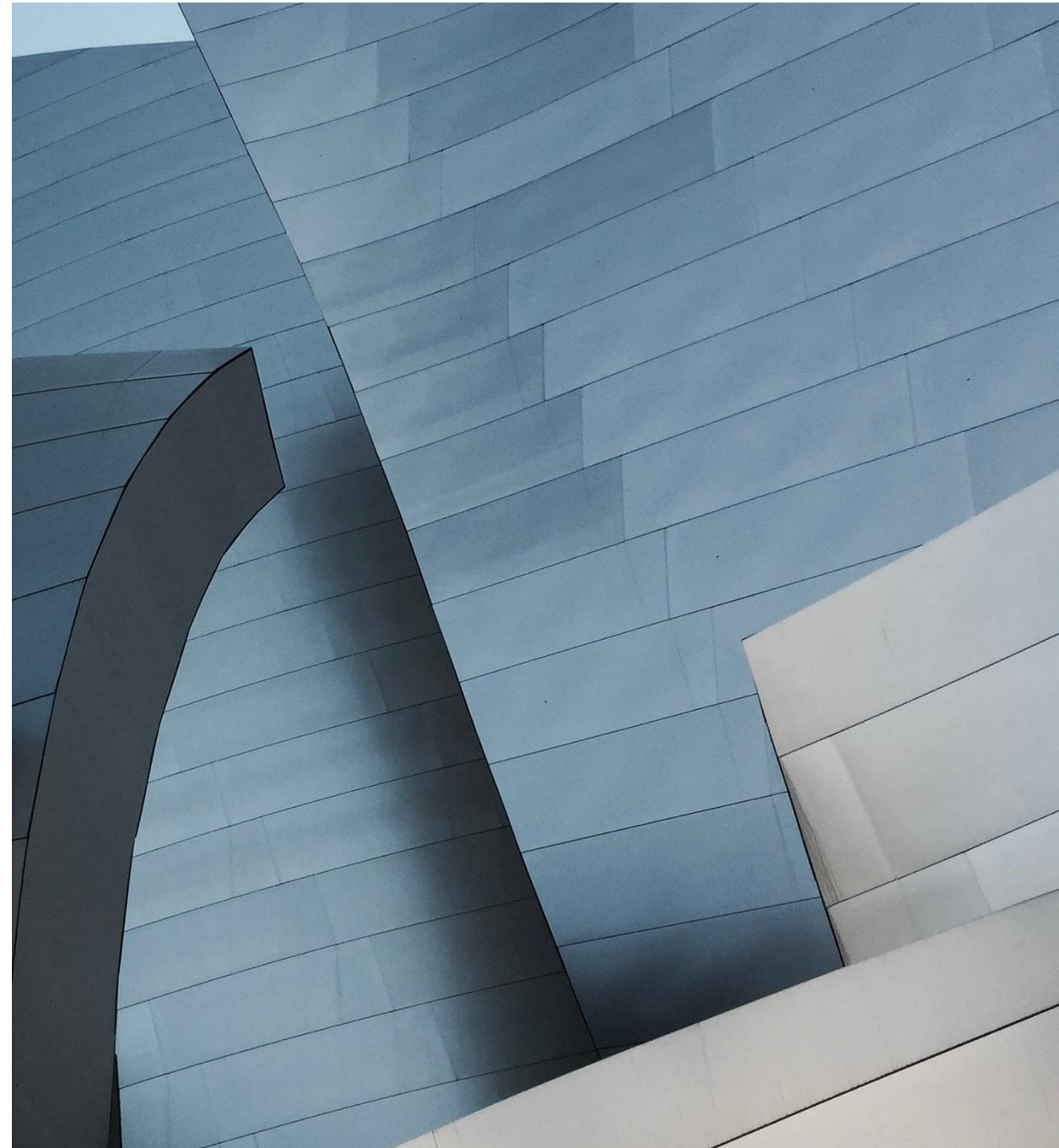
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OVERVIEW

- After closing an M&A deal, the acquiring company will often want transfer or license the acquired company's IP to affiliates in different jurisdictions
- However, this process may lead to both a substantial tax liability and a weakened IP portfolio
- Today, we will describe (1) the tax and IP risks arising from post-closing IP integration; and (2) the pre-closing steps an acquiror should take to mitigate those risks





WHAT WE'LL COVER

- The Importance of Integration in M&A Deals
- Why IP Is So Key in M&A Deals
- How Acquiring Companies Integrate the New IP
- Tax Risks Arising from Post-Closing IP Integration
- IP Risks Arising from Post-Closing IP Integration
- How to Mitigate the Risks: A Pre-Closing IP-Tax Review



01

IP INTEGRATION IN M&A DEALS



THE IMPORTANCE OF INTEGRATION IN M&A DEALS

- Integration refers to the process of combining two companies or businesses after a merger or acquisition to achieve synergies and maximize the value of the combined whole
- Key integration aspects include operations, employees, financial reporting, infrastructure, IT systems and culture
- Benefits include value creation, efficiency/cost savings, increased revenues and improved innovation/productivity
- Frequently complex and time-consuming but integral to achieving successful M&A outcomes



THE IMPORTANCE OF IP INTEGRATION IN M&A DEALS

- The integration process must also address the target company's IP, which in many cases is a major driver of the acquisition
- In these cases, the acquiror believes that synergies exist with the target's IP, which will enable the acquiror to sell new products, conduct new R&D or license new technologies
- Even if IP is not a major deal driver, the target company will often have IP that must be integrated into the acquiror's existing licensing structure.
- For this reason, the IP integration process often requires the drafting of new assignments and inter-company licenses.

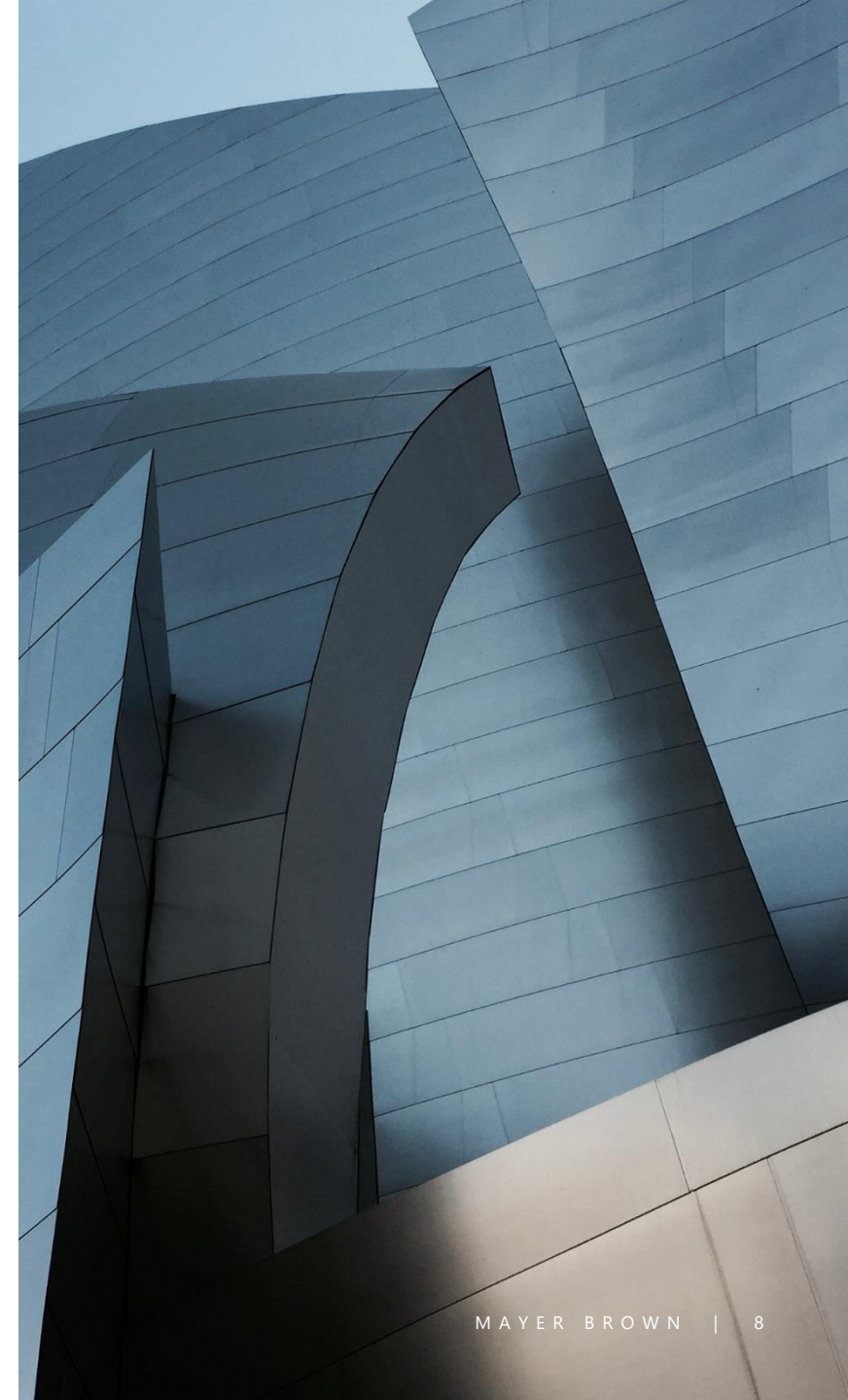


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INTEGRATING NEWLY-ACQUIRED IP:
THREE LICENSING SCENARIOS

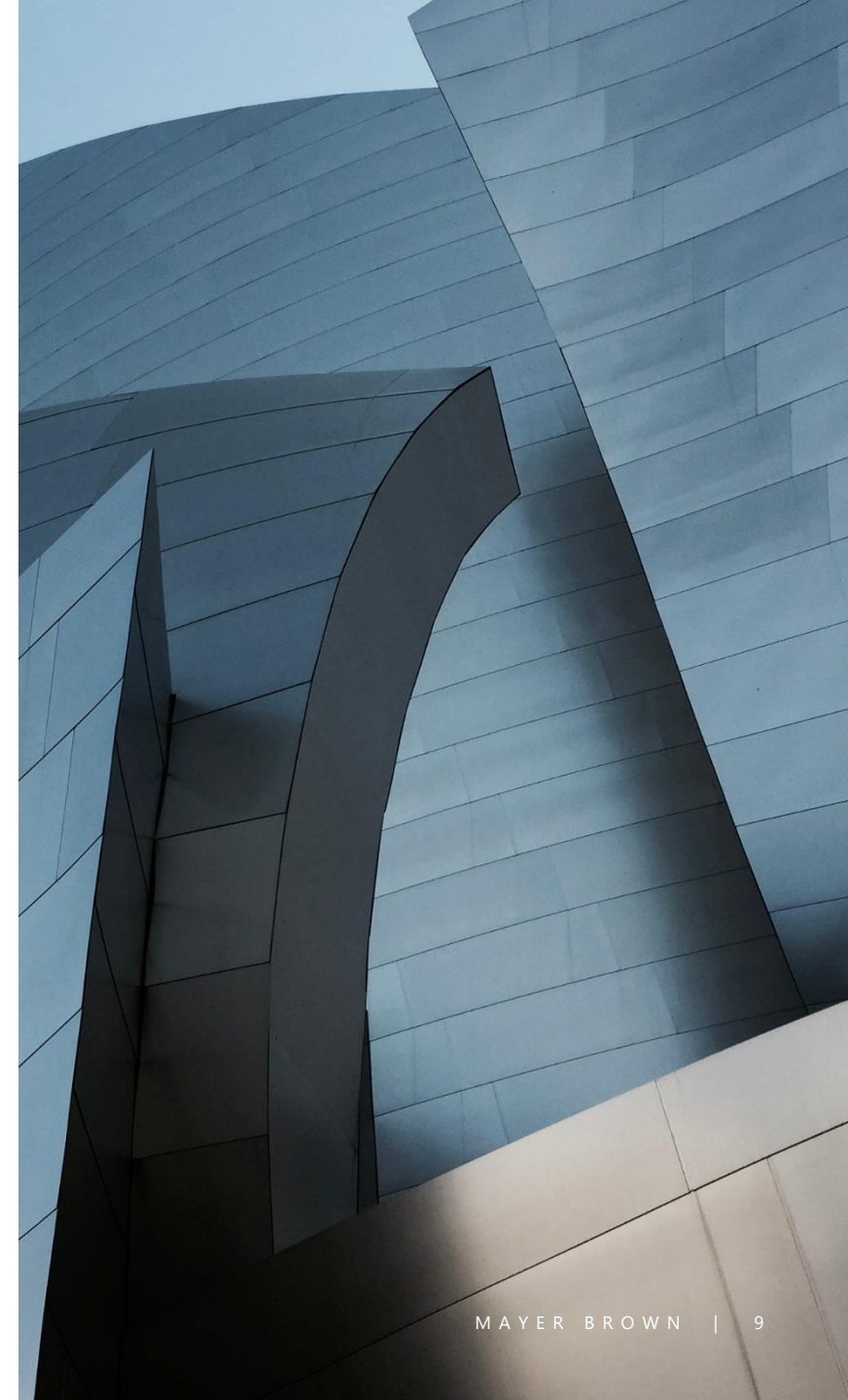
INTEGRATING NEWLY-ACQUIRED IP: PRELIMINARY ISSUES

- To integrate the new IP, the acquiror must first determine:
 - What IP is involved—patents, trade secrets, etc.
 - What affiliate is going to own the new IP?
 - What affiliates are going to be licensees of the new IP?
 - Will any affiliates perform R&D to enhance the new IP?
 - What kinds of licenses will the affiliates have?
 - Will cross-border assignments or licenses be needed?

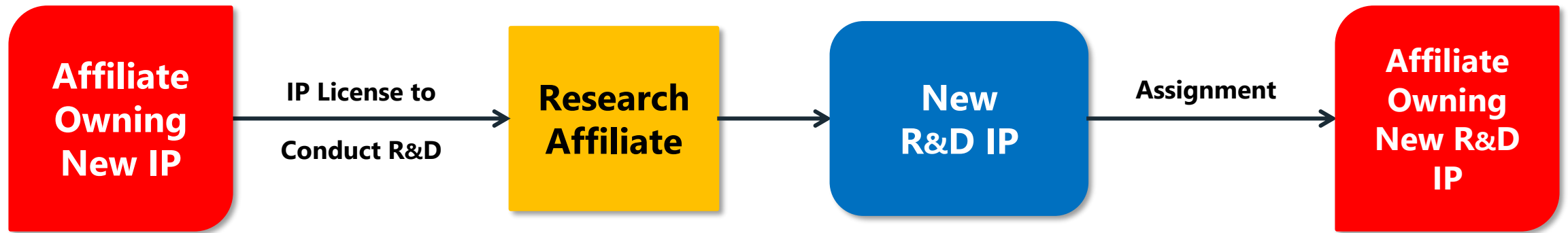


INTEGRATING NEWLY-ACQUIRED IP: PRELIMINARY ISSUES

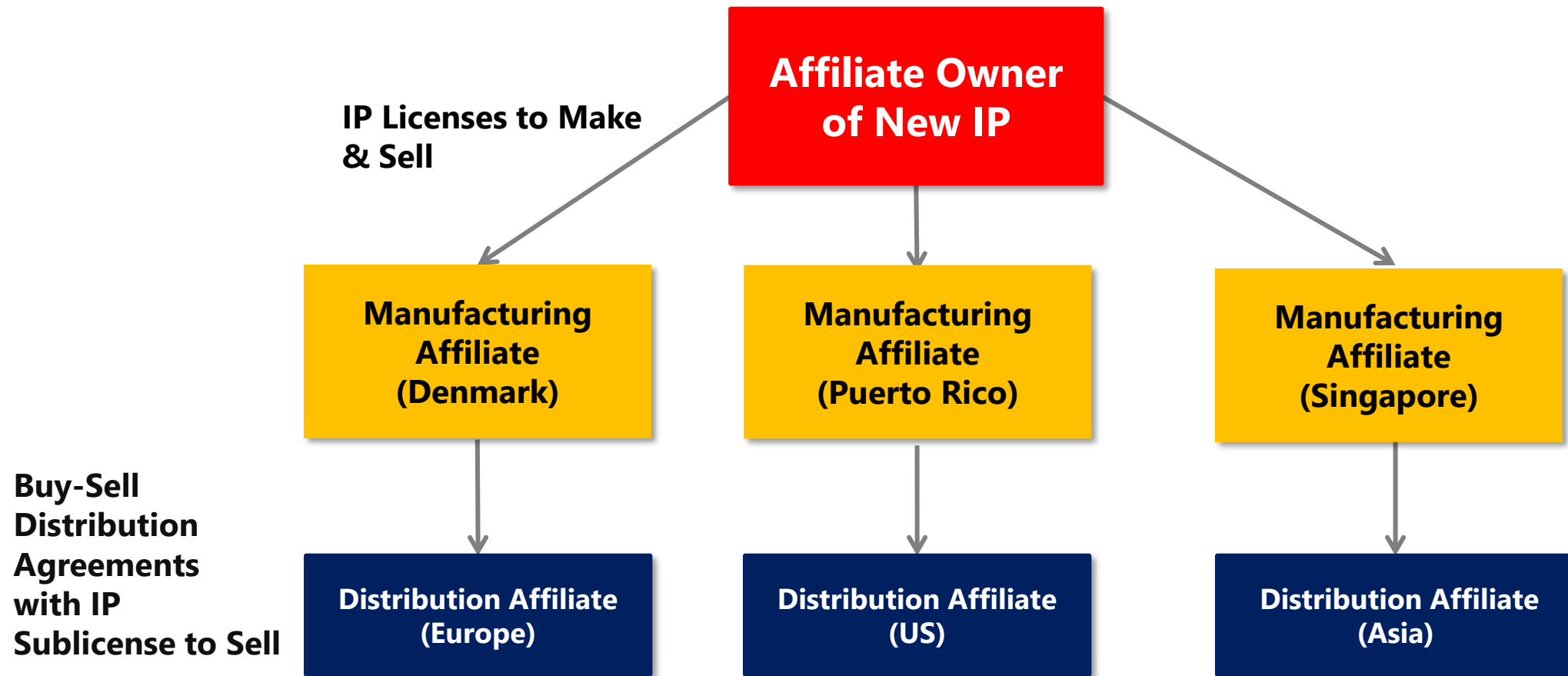
- These issues will largely depend on how the acquiror intends to use the new IP.
- Three possible scenarios:
 - To conduct new lines of R&D
 - To make and sell newly-acquired products
 - To license new technologies to third parties



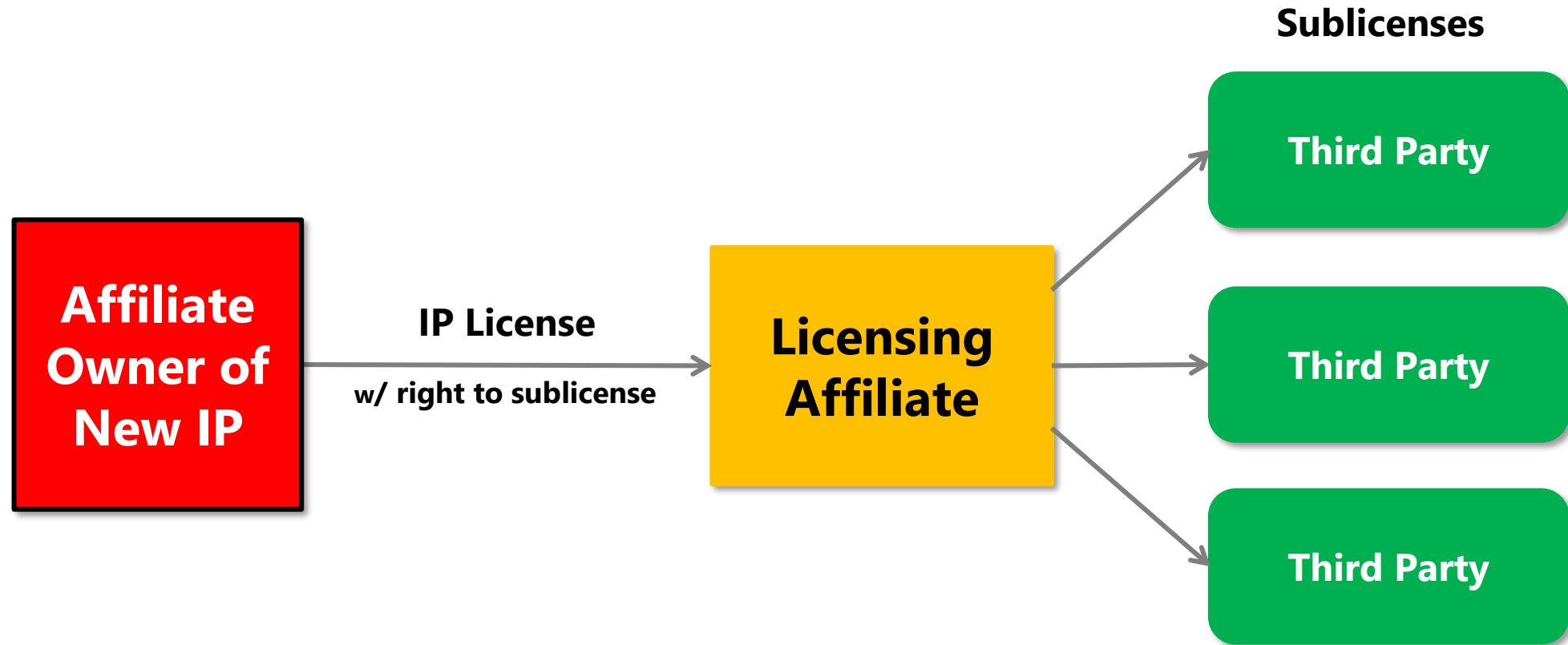
INTEGRATING NEWLY-ACQUIRED IP: SCENARIO 1: USING NEWLY-ACQUIRED IP FOR R&D



INTEGRATING NEWLY-ACQUIRED IP: SCENARIO 2: USING NEWLY-ACQUIRED IP TO SELL PRODUCTS



**INTEGRATING NEWLY-ACQUIRED IP:
SCENARIO 3: LICENSING THE NEW IP TO THIRD PARTIES**





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POST-CLOSING IP STRUCTURES:
TAX ISSUES

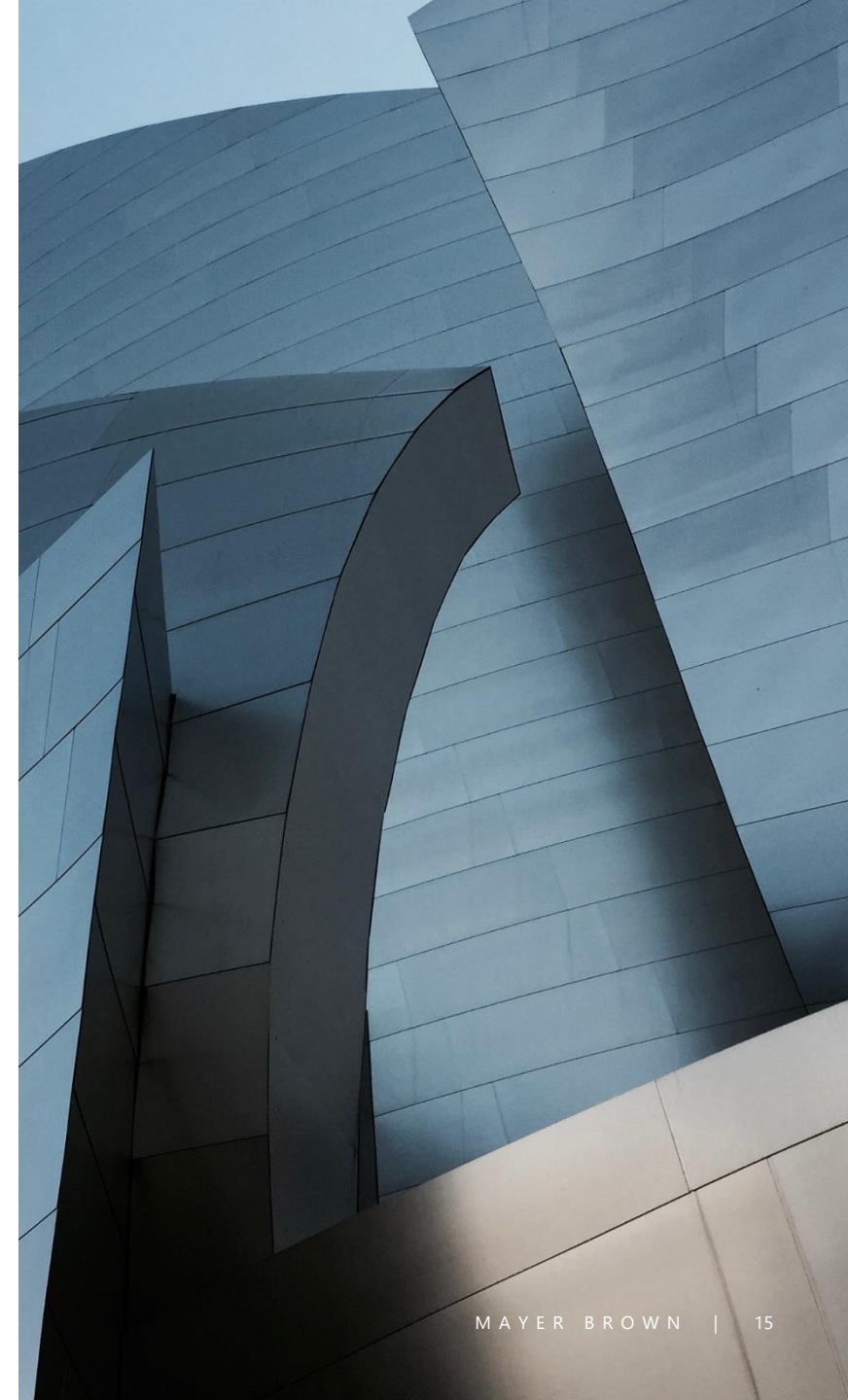


WHY IP IS SO IMPORTANT TO TAX

- IP is often the crown jewel asset of a company
- It is also an intangible asset that can be easily moved within a multinational group to a lower tax jurisdiction
- As a result, tax planning based on IP can optimize profitability, particularly in multinational companies
- Because IP is a key driver of profitability and thus taxable income, tax administrations often focus audits on (among other issues):
 - Whether transfer pricing for post-acquisition IP transfers and licensing transactions complies with the arm's length principle; and
 - Which affiliate(s) is the “economic owner” of IP entitled to the income from exploitation of the IP

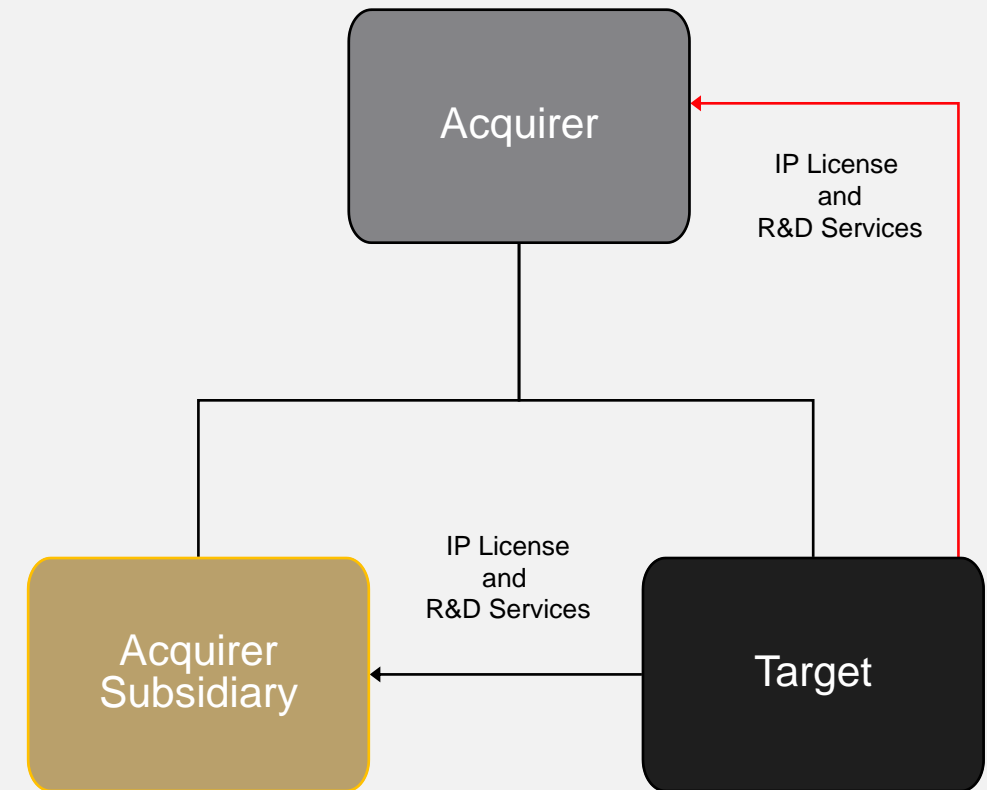
POST-ACQUISITION TAX CONSIDERATIONS: LEGAL v. ECONOMIC OWNERSHIP

- Tax law recognizes a distinction between ***legal and economic ownership*** of IP as applied to both IP transfers and on-going exploitation
- This distinction allows for ***flexibility in structuring***, for example, multinational groups can:
 - Allocate economic ownership based on geographic territory or field of use to align with business objectives; or
 - Centralize legal ownership in a single entity for administrative convenience without materially impacting economic rights
- But also gives rise to ***pitfalls***:
 - Tax administrations can fail to respect an intended transfer of economic ownership, or alternatively, find that economic ownership was transferred when no such transfer was intended



ECONOMIC OWNERSHIP – THE PERILS

- In a recent case, a court found that a recently acquired subsidiary (Target) transferred economic ownership of its IP through:
 - **broad post-acquisition licenses** that granted the Acquiror and its legacy subsidiary an unrestricted right to use the IP, while reserving no rights to Target; and
 - **post-acquisition R&D services agreements** that designated the Acquiror and legacy subsidiary as the owners of any new intangibles developed with the licensed IP.
- Other key findings:
 - License was retroactive; and
 - Target ceased business operations several years after acquisition.
- Based on these and other factors, the court found that the post-acquisition structure **transferred the key risks and IP management functions out of the Target**, even though the Target continued to hold legal title to most of the IP.
- On this basis, the court held that the Target was subject to “exit tax” liability estimated to exceed nearly 80% of the original acquisition price.



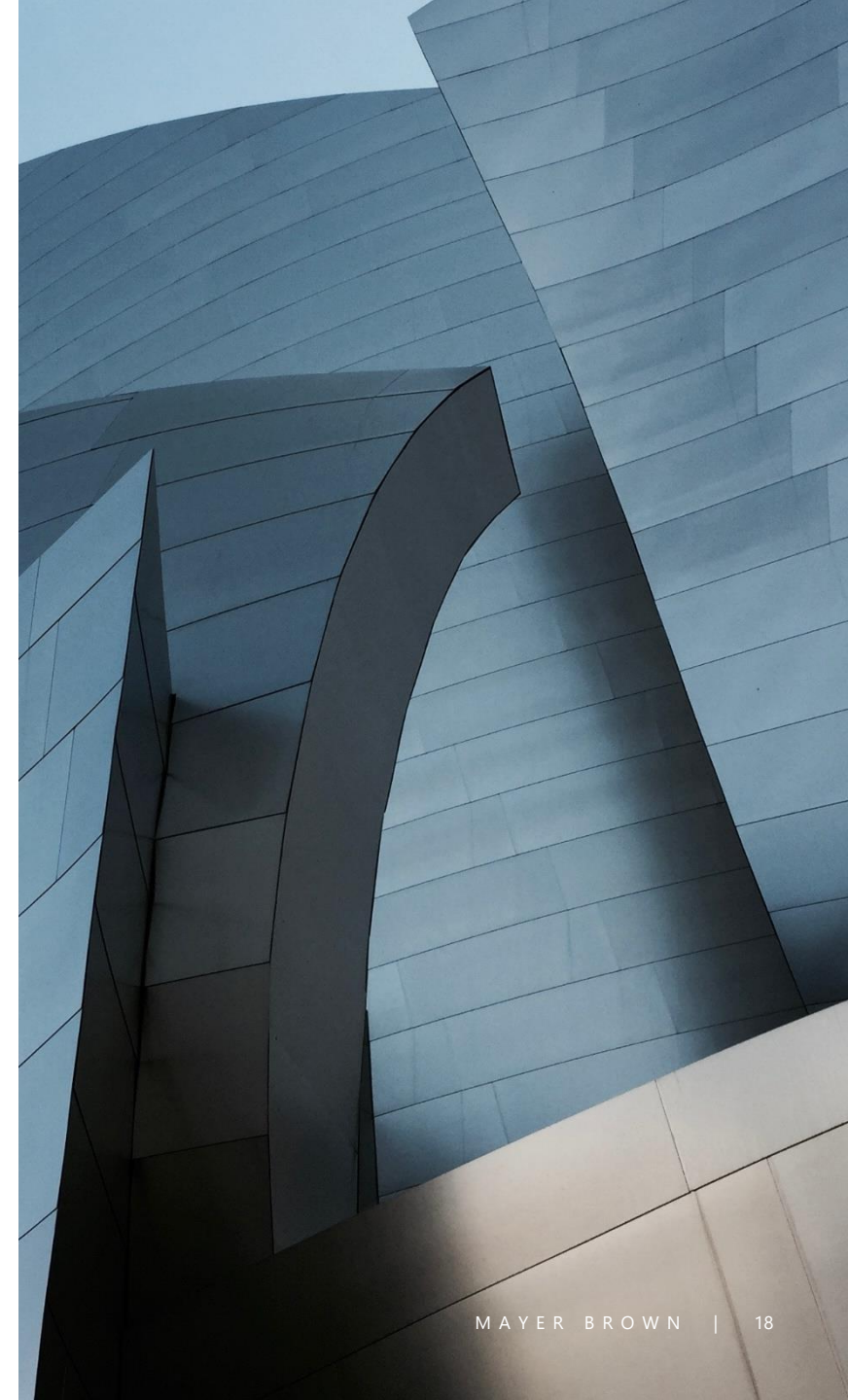


LEGAL v. ECONOMIC OWNERSHIP – US LAW BASIS

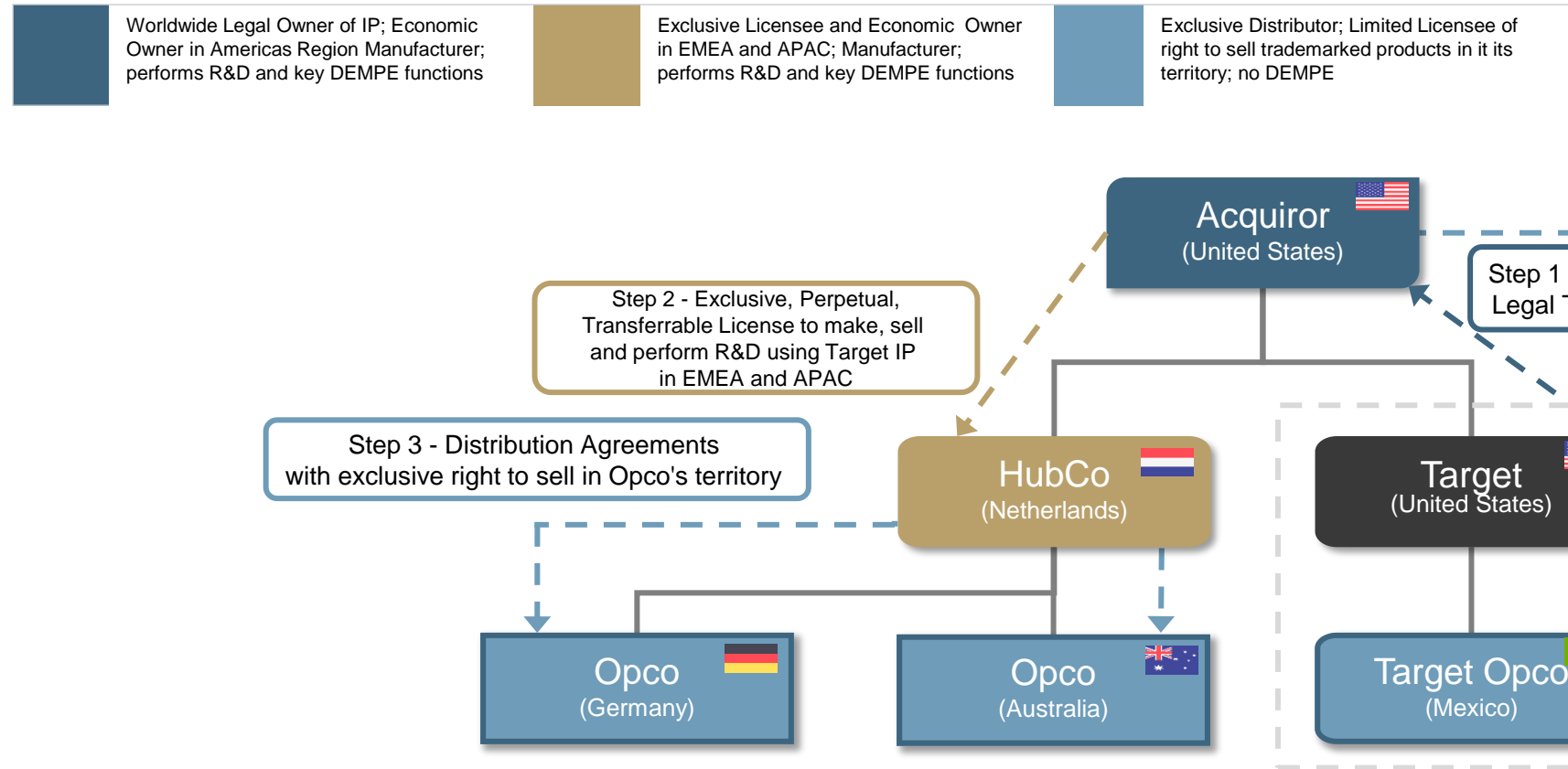
- Sales are distinguished from licenses based not on form, but whether “***all substantial rights***” in the IP were transferred. IRC §§ 1222 and 1235.
 - Legal owner generally treated as “***sole owner***” of an intangible for transfer pricing purposes, *but with several caveats*:
 - IRS can disregard legal ownership if it is inconsistent with the ***economic substance*** of the parties’ transactions with respect to the IP;
 - If an intangible has no recognized legal owner under IP law, the affiliate with ***control*** over the intangible is treated as the sole owner;
 - ***A license is considered a separate intangible asset*** from the underlying licensed IP; and
 - If an affiliate ***develops or enhances*** IP owned by another affiliate, the former affiliate must be compensated at arm’s length.
- Treas. Reg. §1.482-4(f)(3)-(4).

LEGAL v. ECONOMIC OWNERSHIP – OECD GUIDELINES

- OECD Transfer Pricing Guidelines make strong distinction between legal and economic ownership based on **DEMPE functions** (development, enhancement, maintenance, protection, and exploitation):
 - “[I]f the **legal owner** of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles **it must perform all of the functions, contribute all assets used and assume all risks related to the development, enhancement, maintenance, protection and exploitation of the intangible.**” Guidelines, ¶ 6.51.
- But, an affiliate need not perform all DEMPE functions itself to enjoy returns from an intangible. **Outsourcing of DEMPE functions** to other related parties (e.g., R&D services) is sufficient to attribute intangibles-related profits, but only if the intangibles owner **controls** the DEMPE functions that are outsourced. Guidelines, ¶6.53.



POST-ACQUISITION INTEGRATION – AN EXAMPLE



SOME POST-ACQUISITION TAX CONSIDERATIONS FOR IP

ETR

- What will be ETR impact of an affiliate owning/developing IP post-acquisition considering:
 - Special IP incentives (e.g., R&D tax credits, or patent or innovation box regimes)?
 - Minimum taxes (e.g., Pillar Two and US GILTI regime)?
 - Attributes (e.g., NOLs)?

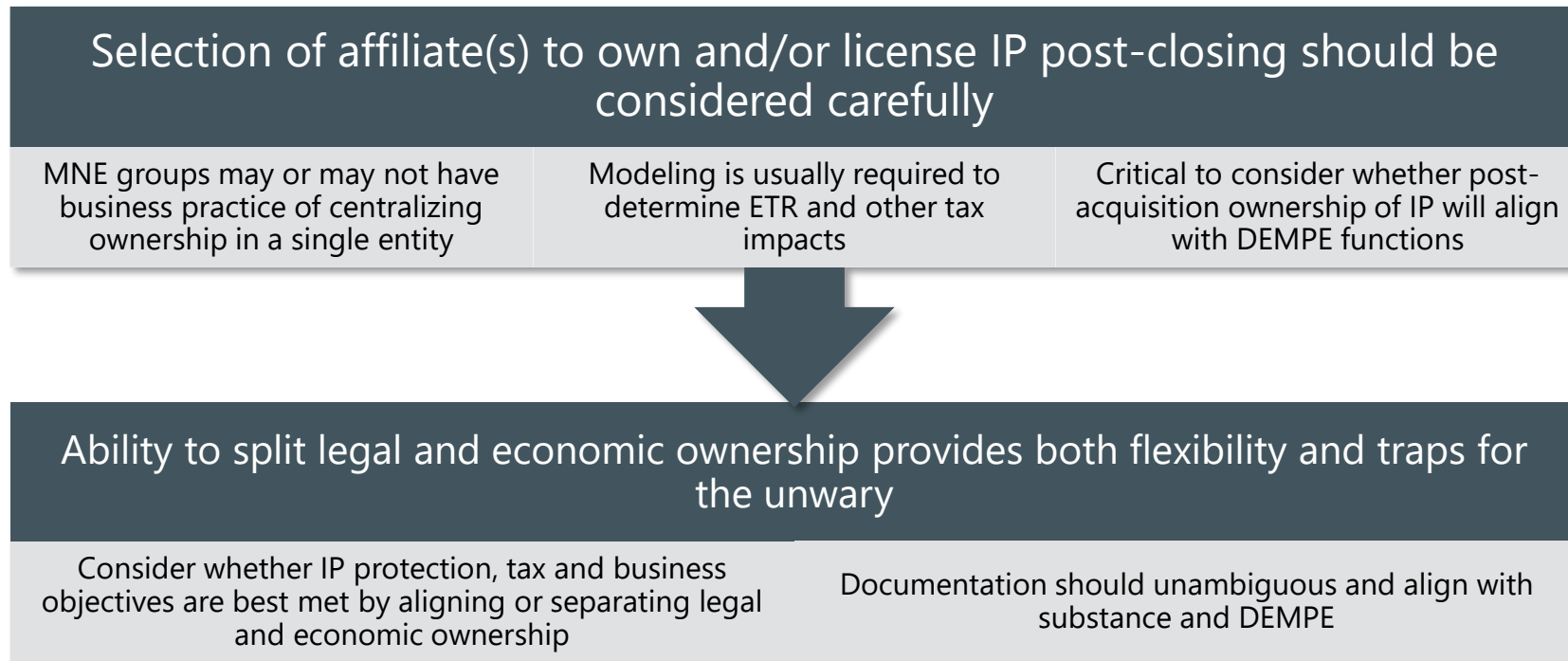
Transfer Pricing

- What legacy arrangements of the Target group will be kept in place? Are they optimal?
- How will post-acquisition IP transfers be valued? Can a PPA be leveraged?
- How will new IP be integrated and new post-acquisition arrangements be structured and priced?
- What is the customs/tariffs impact of the new pricing arrangements?

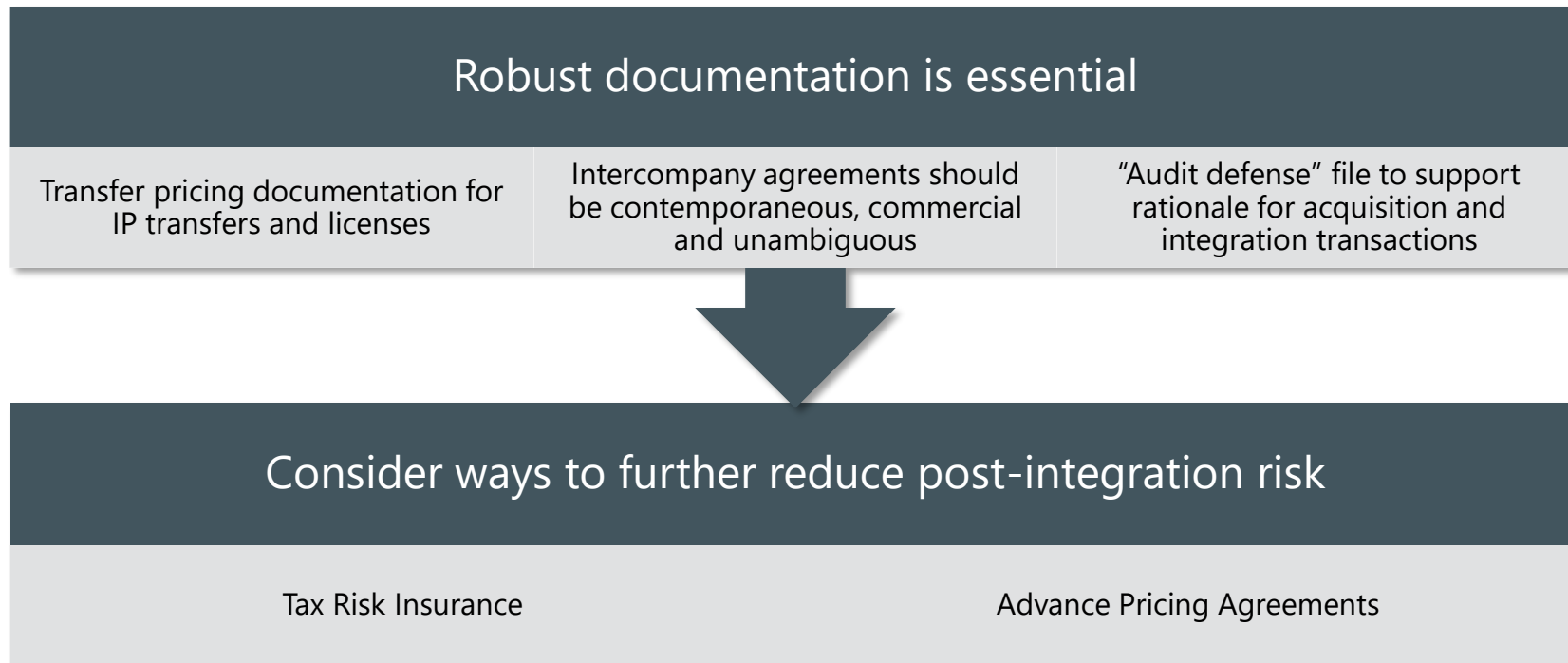
Character of Payments

- Will post-acquisition transactions result in immediate gain or on-going ordinary royalty income?
- Will any payments be subject to withholding tax in the US or any other jurisdiction?

POST-CLOSING IP INTEGRATION: TAX TAKEAWAYS



POST-CLOSING IP INTEGRATION: TAX TAKEAWAYS – CONT'D



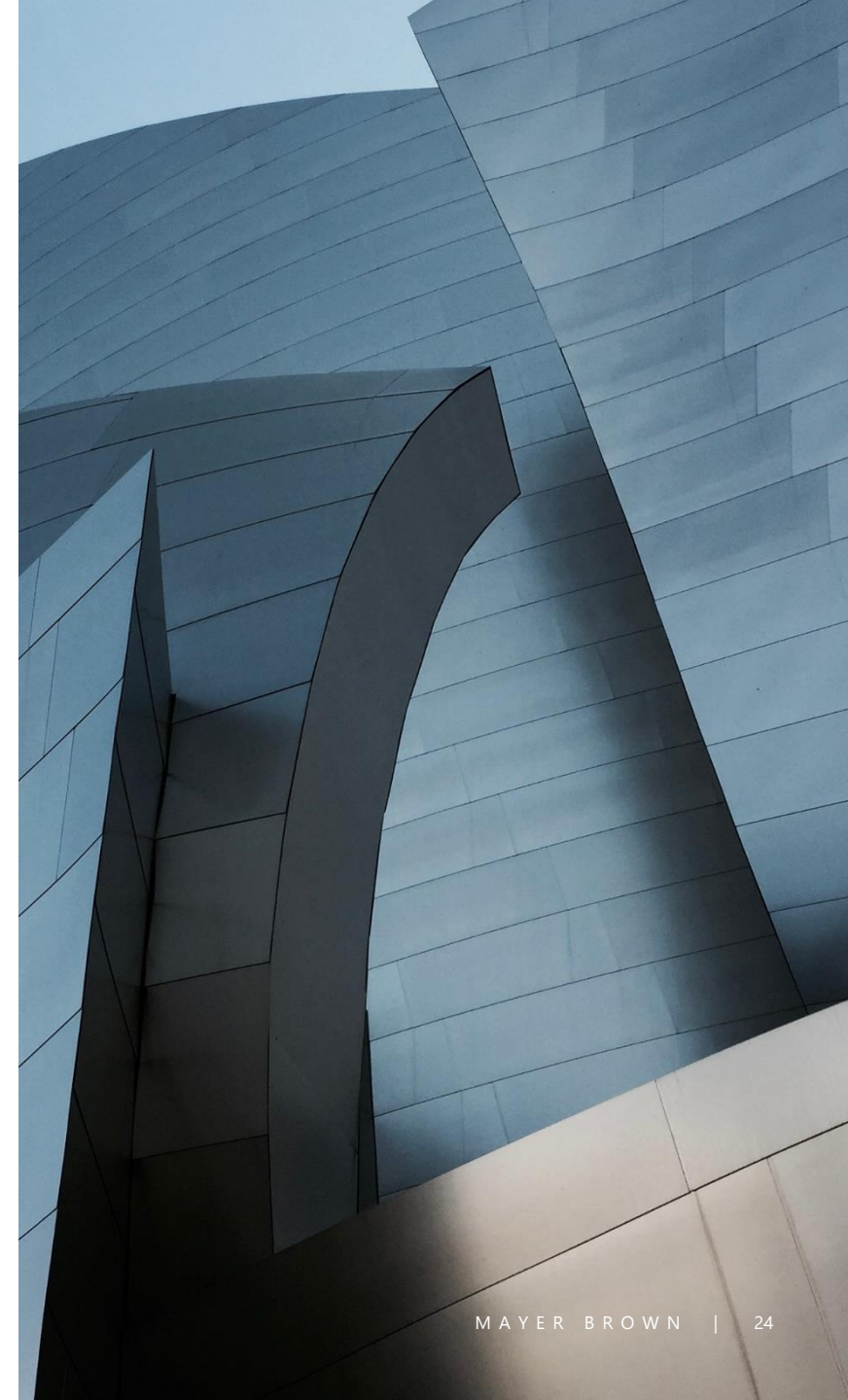


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POST-CLOSING IP LICENSING STRUCTURES: IP ISSUES

POST-CLOSING IP LICENSING STRUCTURES: **IP ISSUES**

- The Post-Closing IP Licensing Structures must adequately protect at least four potential categories of IP:
 - **Patents** (which protect inventions)
 - **Trade Secrets** (which protect proprietary data)
 - **Copyrights** (which protect works of authorship)
 - **Trademarks** (which protect names and brands)



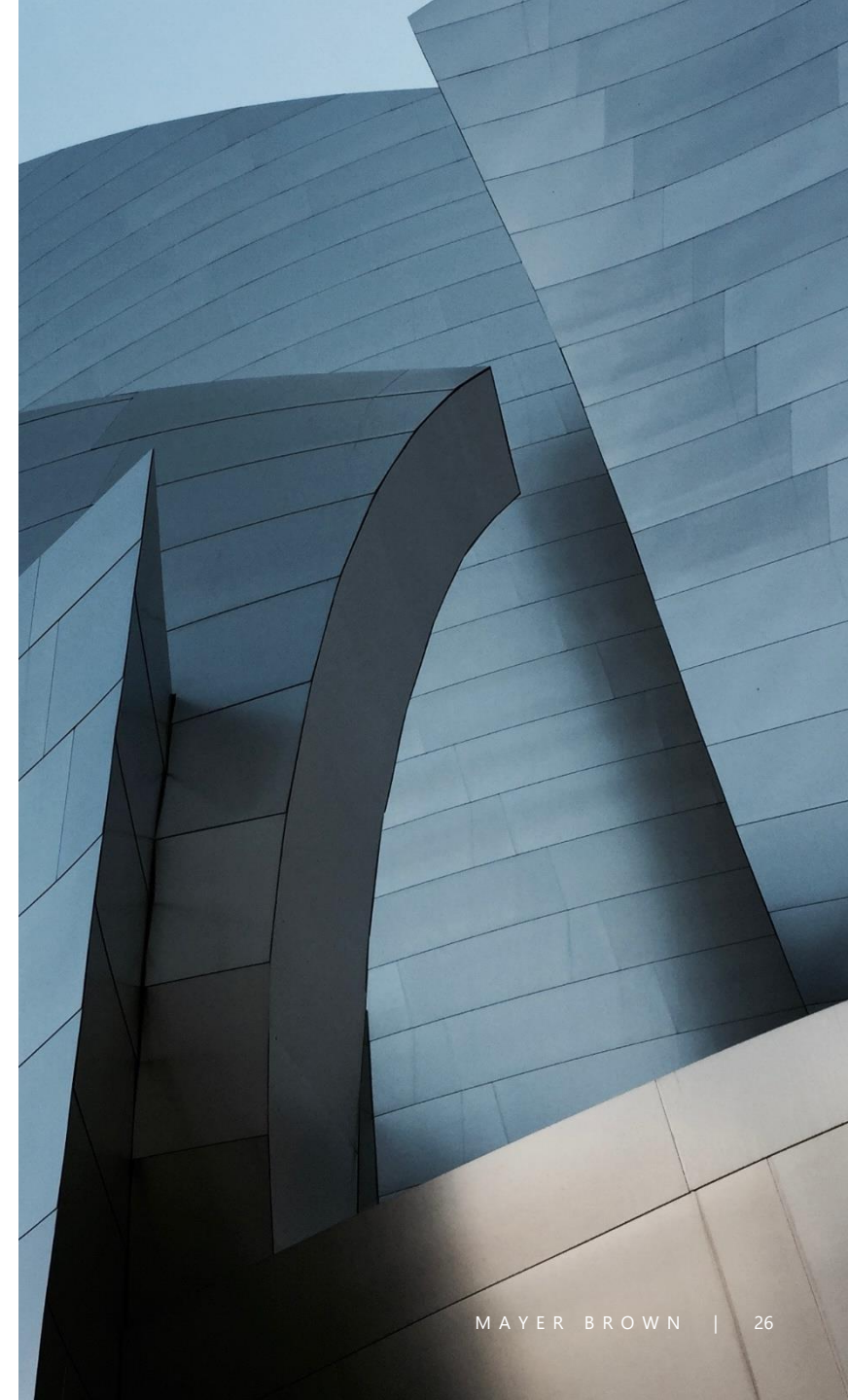


POST-CLOSING IP LICENSING STRUCTURES: KEY IP ISSUES

- Identify what kinds of IP have been acquired
- Determine what affiliates will own the new IP and what affiliates will be licensees
- Determine what kinds of licenses the affiliates will have
- Determine if the licenses are sufficient to protect the IP

POST-CLOSING IP LICENSING STRUCTURES: IP ENFORCEMENT ISSUES

- IP licensing structures can raise two major issues for IP protection and enforcement
 - Standing to sue infringers
 - Remedies
 - Recovery of lost profits
 - Injunctive relief





POST-CLOSING IP ISSUES

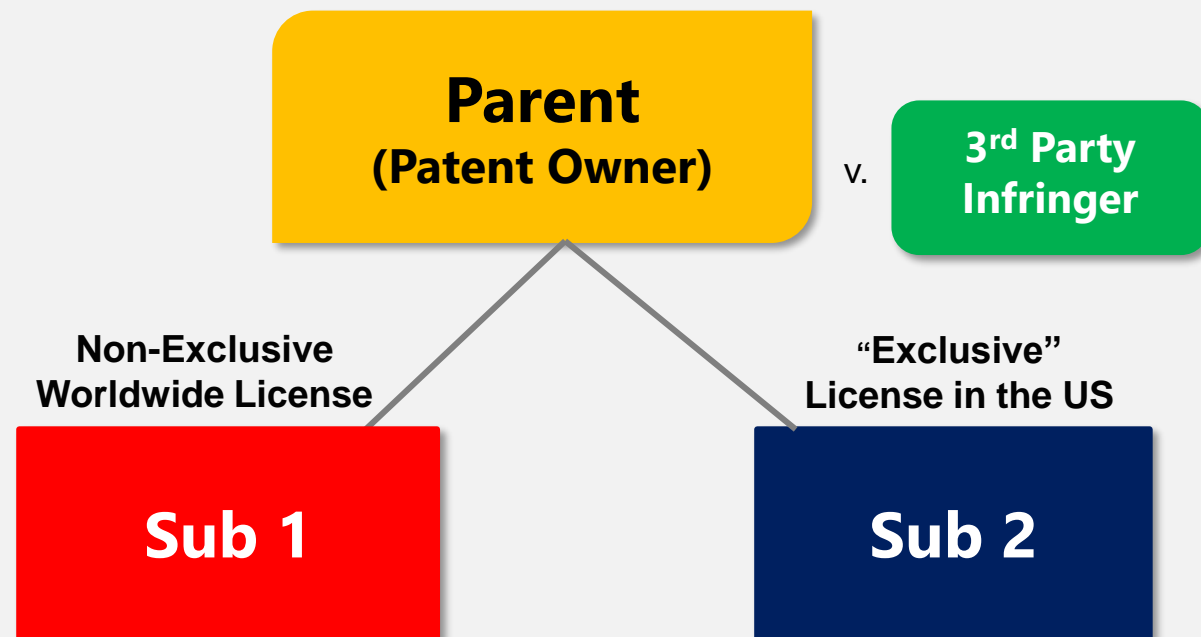
PATENTS (STANDING)

- US “Standing” Rules for Patents
 - Patent owner must be a plaintiff
 - Exclusive licensee can be a co-plaintiff
 - Exclusive distributor can be a co-plaintiff
 - Non-exclusive licensee cannot be a co-plaintiff
- **Issue:** Does the licensing structure confer standing on all necessary affiliates?

POST-CLOSING IP ISSUES

PATENTS (STANDING)

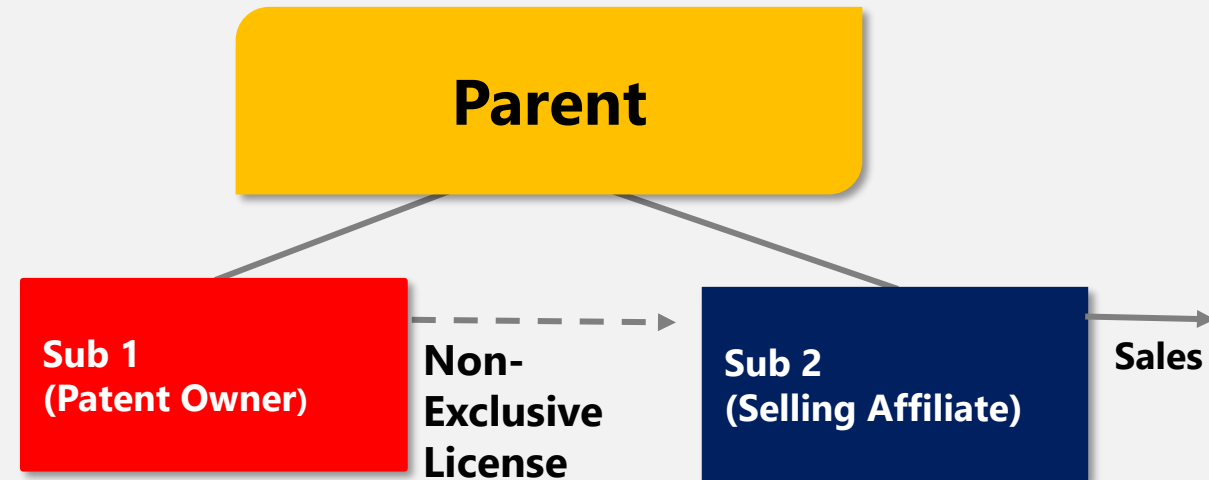
- Parent argued that it gave an “exclusive” license to Sub 2
- However, the parent had previously given a non-exclusive worldwide license to Sub 1
- Court held that Sub 2 did not have standing because it was not an exclusive licensee



POST-CLOSING IP ISSUES

PATENTS (LOST PROFITS)

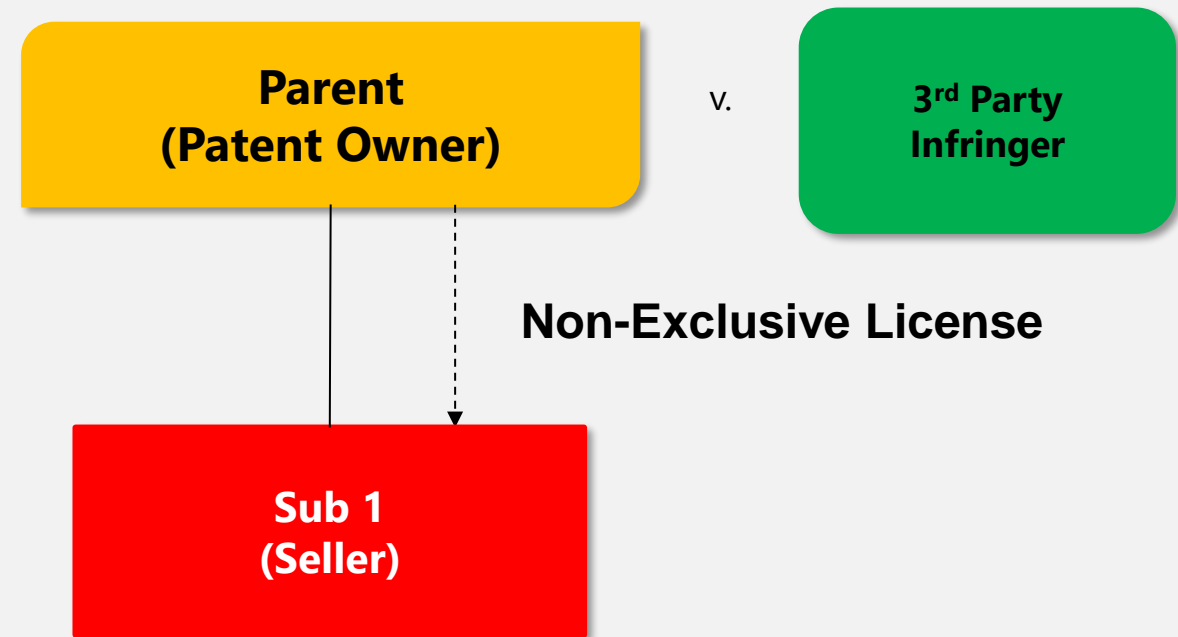
- **Sub 1** could not recover “lost profits” because it did not sell the product
- **Sub 2** could not be a co-plaintiff because it was a non-exclusive licensee
- **Result:** No recovery of lost profits



POST-CLOSING IP ISSUES

PATENTS (LOST PROFITS)

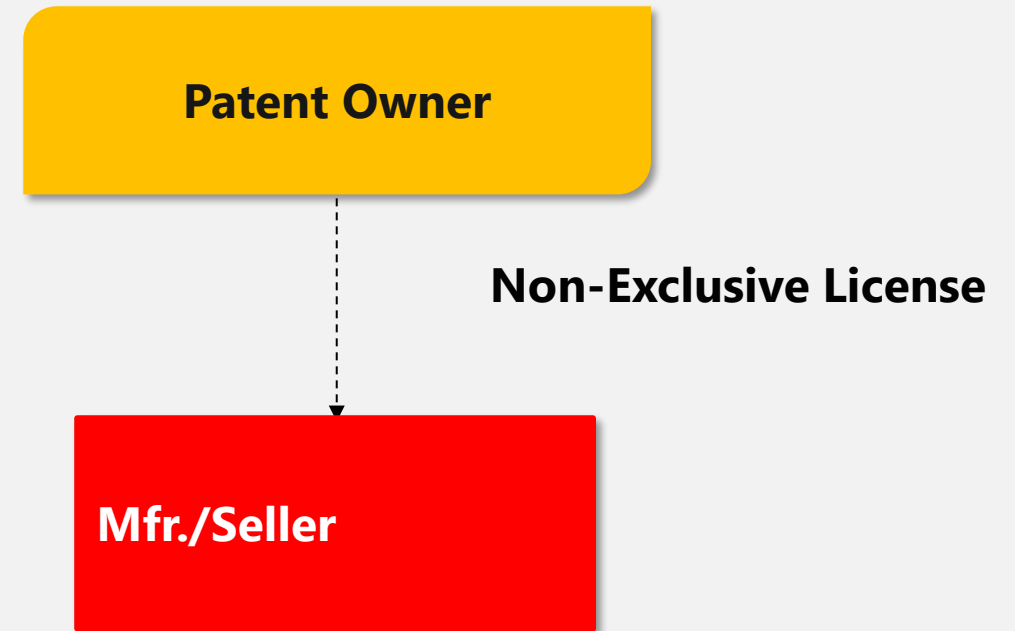
- **Sub 1** was a wholly-owned sub, but it could not be a plaintiff because it was only a non-exclusive licensee
- The court rejected the parent's claim that it "inherently lost" the profits of its wholly-owned subsidiary
- **Result:** No recovery of lost profits



POST-CLOSING IP ISSUES

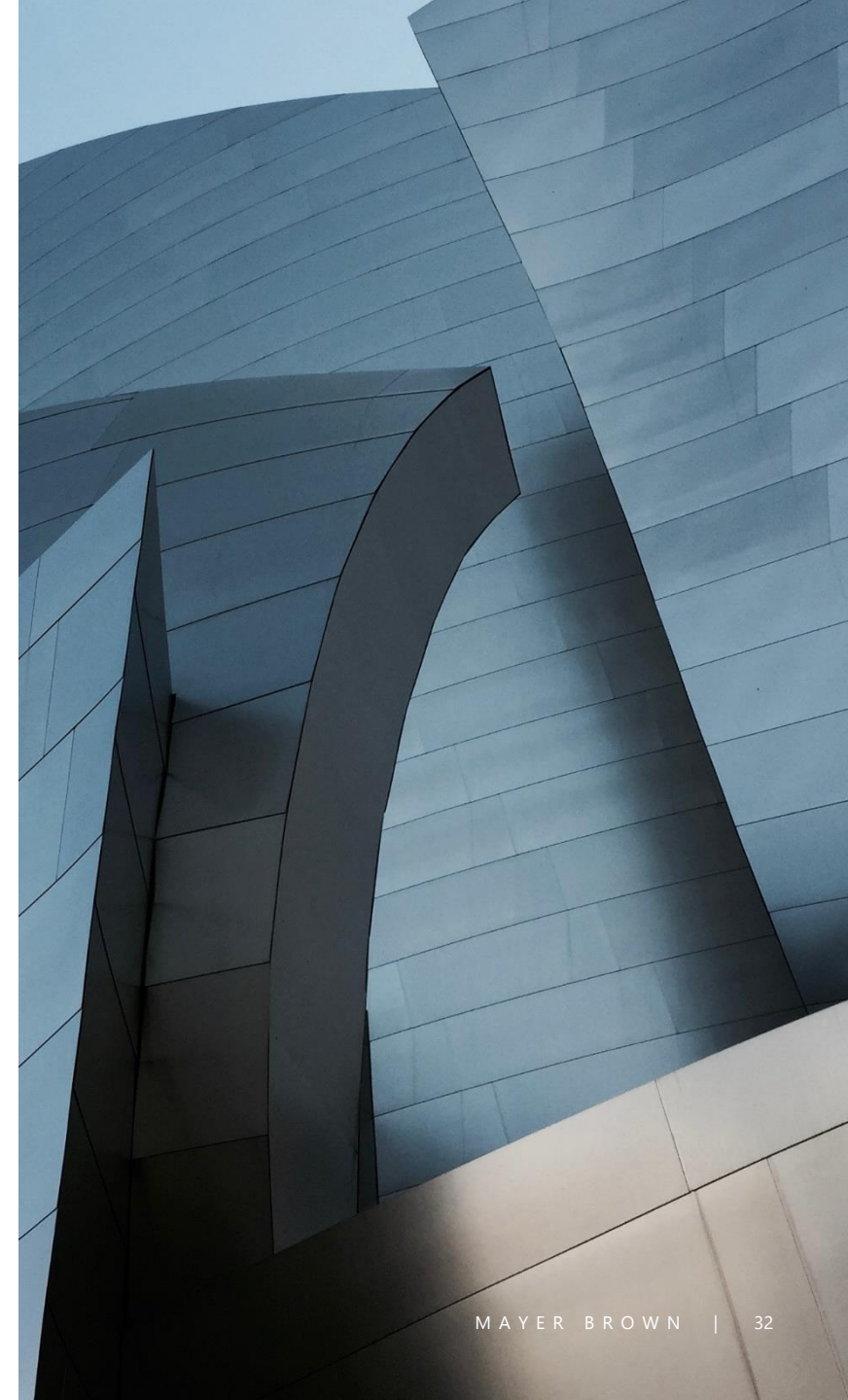
PATENTS (INJUNCTION)

- If the IP-owner is not selling the product, it may not be able to obtain injunctive relief
- Injunctive relief requires a showing of irreparable harm
- Courts are generally reluctant to award injunctive relief to entities that do not sell the patented product



POST-CLOSING IP ISSUES: **TRADE SECRETS**

- To establish an enforceable trade secret, the licensing structure must:
 - Adequately identify the relevant trade secrets;
 - Determine which affiliate will be the owner of the trade secrets and document the assignment;
 - Determine which affiliates will be the licensees of the trade secrets; and
 - Impose specific secrecy obligations on all licensees, including employee secrecy.





POST-CLOSING IP ISSUES: **COPYRIGHTS AND TRADEMARKS**

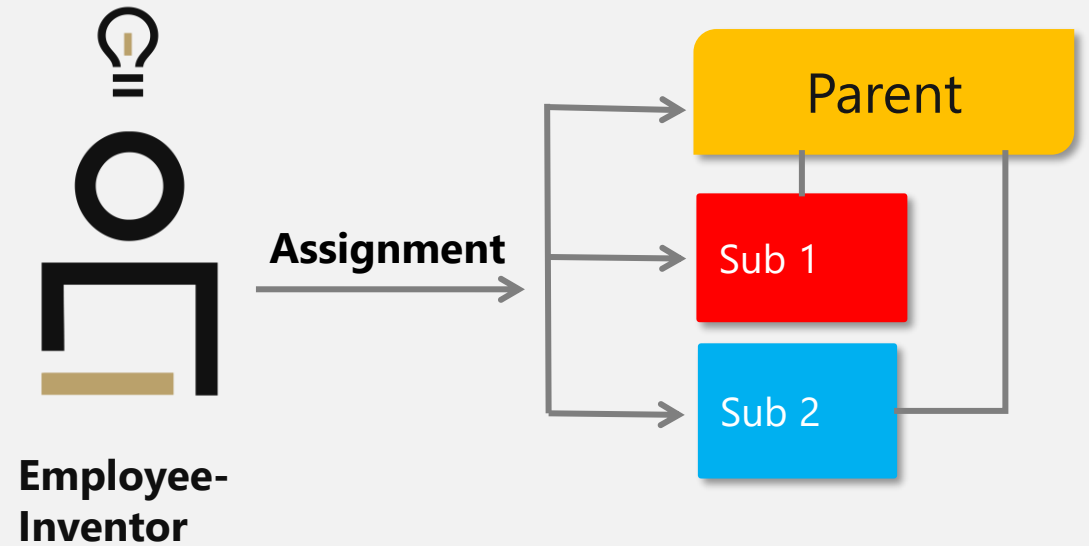
- To establish an enforceable copyright or trademark, the licensing structure must:
 - Identify the relevant copyrights or trademarks;
 - Determine which affiliate will be the owner of the copyrights or trademarks and document the assignment (including registration with the national authority); and
 - Determine which affiliates will be licensees of the copyrights or trademarks.

POST-CLOSING IP ISSUES

EMPLOYEE AGREEMENTS

- The Agreement must state that the employee “hereby assigns” all future inventions and other IP to the correct affiliate.
- The Agreement must require the employee to cooperate in executing the necessary documentation for the assignment.
- The Agreement must impose specific secrecy obligations on the employee to protect the company’s proprietary information.

Janssen Biotech, Inc. v. Celltrion, Case No. 1:17-cv-11008
(D. Mass.) (Oct. 31, 2017)





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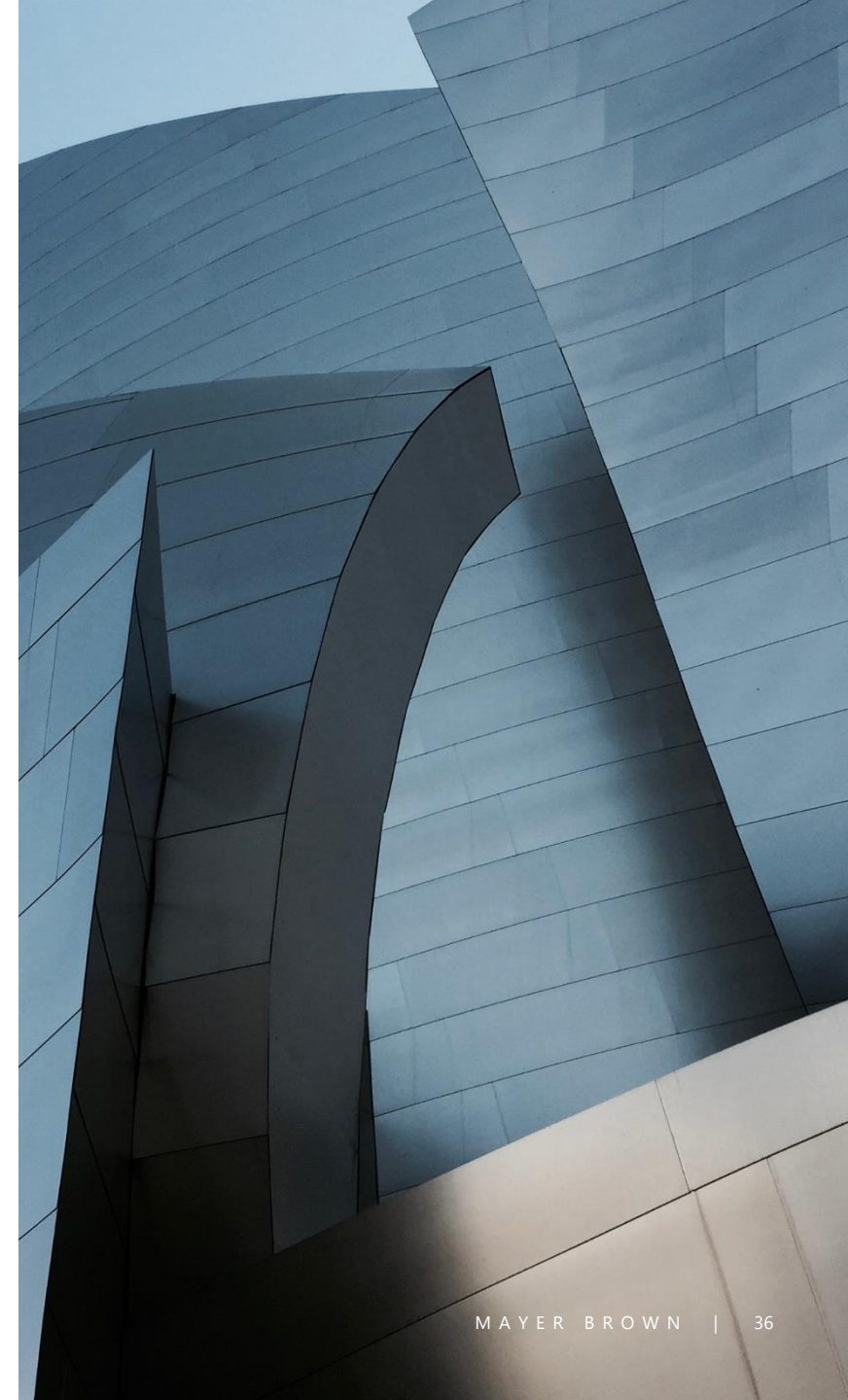
REDUCING RISKS BEFORE SIGNING:
A PRE-CLOSING TAX-IP REVIEW

MITIGATING RISKS: PRE-CLOSING TAX-IP REVIEW

- The tax & IP risks can be mitigated through a two-part pre-closing review:

1. IP Steps

- For each category of IP (patents, trade secrets, trademarks and copyrights), identify which affiliates will be the owners of the IP and which affiliates will be licensees;
- Identify what assignments will be necessary;
- Identify the nature of each of the proposed licenses (*e.g.*, exclusive or non-exclusive); and
- Confirm that the proposed licenses will contain sufficient provisions to protect the enforceability of each category of IP.





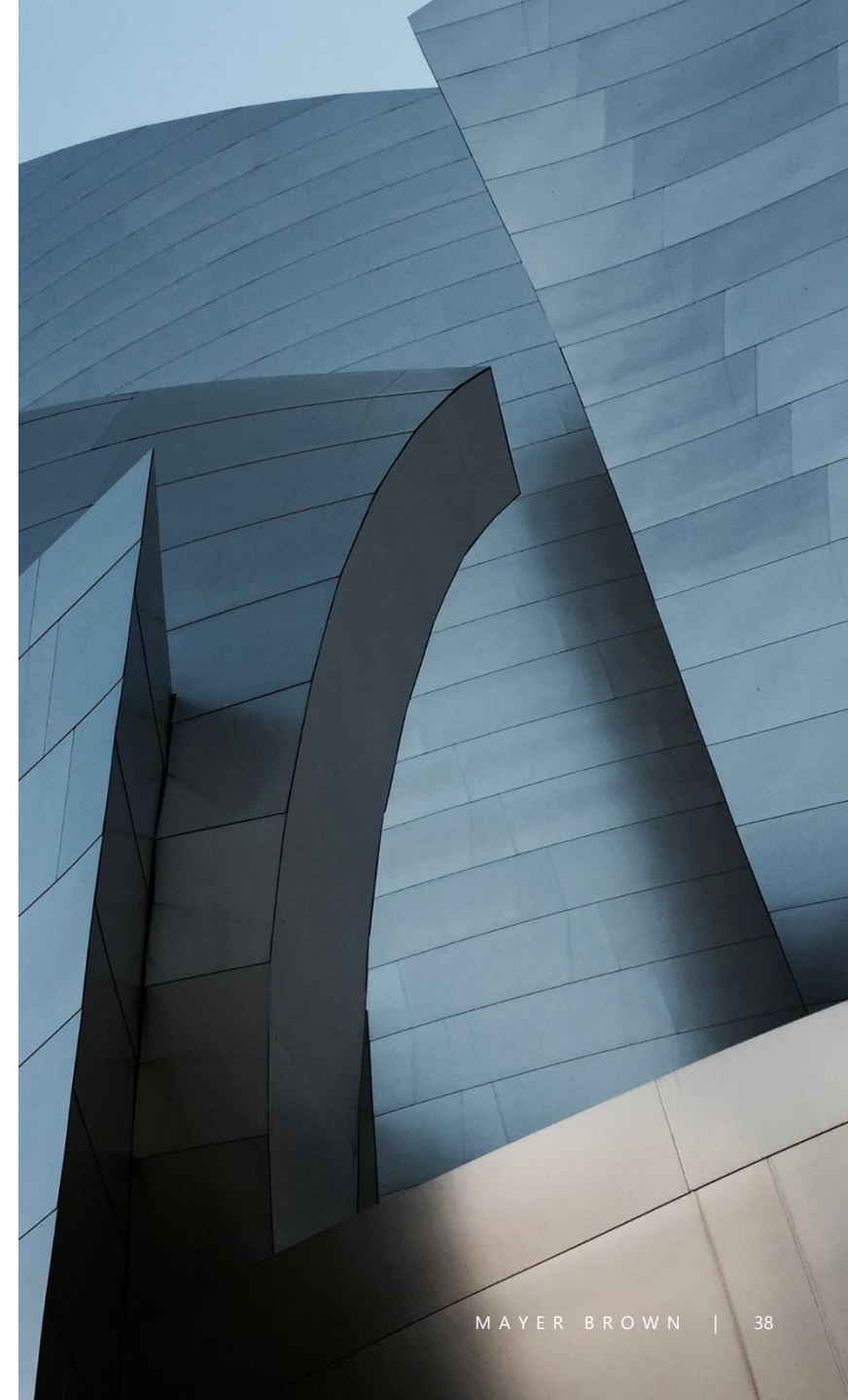
MITIGATING RISKS: PRE-CLOSING TAX-IP REVIEW

2. Tax Steps

- Review existing intercompany agreements and transfer pricing documentation;
- Identify any cross-border IP assignments and licenses that will be required;
- Identify what specific DEMPE functions will be performed by which affiliates and determine the impact on the company's existing transfer pricing model;
- Assess whether any of the potential tax risks can be mitigated by designating different affiliates to perform any of the DEMPE functions (consistent with business objectives);
- Determine what impact the above analysis has on the pricing for the transaction;
- Conduct robust transfer pricing studies for any new licenses or other transactions;
- Conclude robust, contemporaneous intercompany agreements

CONCLUDING REMARKS

- Undertake comprehensive pre-signing assessment of tax & IP risks working with relevant experts
- Consider transaction structure modifications to enhance IP use/enforcement consistent with business objectives while optimizing tax outcomes
- Consider valuation adjustments for tax inefficiencies that cannot be mitigated completely





QUESTIONS

OUR TEAM



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& DISPUTE RESOLUTION

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