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Intra-Corporate IP Licensing Structures: Tax and IP Issues

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The intra-corporate licensing of a company's patents and other intellectual property carries important implications for both its tax position and its IP interests. Indeed, if a company does not implement a proper intra-corporate licensing structure, this failing may result in either an increased tax exposure or a compromised IP portfolio.

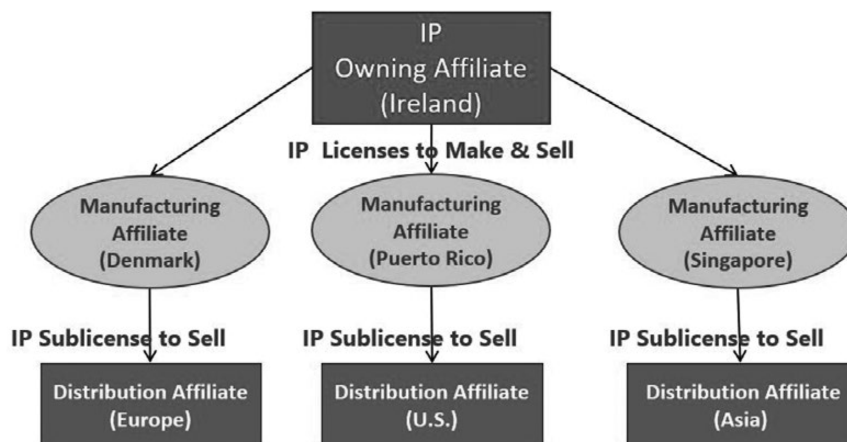
These issues can arise in at least four different scenarios: (1) the intra-corporate licensing of IP covering products sold by the company; (2) the intra-corporate licensing of IP acquired through the company's research and development activities ("R&D"); (3) the intra-corporate licensing of IP acquired through mergers and acquisitions ("M&A"); and (4) the employment agreements governing the protection and ownership of a company's IP rights.

In each of these scenarios, the company faces significant risks if it fails to develop a licensing structure that accommodates both its tax interests and its IP concerns. Accordingly, as shown below, a company using or creating intellectual property should consider a targeted audit of its licensing structure to determine if it is adequately protecting both its tax and IP positions.

1. The Sale (or Licensing) of IP-Protected Products

The first scenario involves the intra-corporate licensing structures used to sell or license IP-protected products. In a typical structure, an IP-owning affiliate grants to one or more manufacturing affiliates an IP license to make, use and sell the IP-protected products. Each of the manufacturing affiliates then grants sublicenses to distribution affiliates to market and sell the products to customers in specific jurisdictions.

From a tax perspective, a key issue arising from these types of licensing structures is what affiliate should be the "economic owner" (as opposed to the legal owner) of the key patents and other IP? Under relevant tax principles, the affiliate incurring the greatest costs in developing the IP is often deemed to be its economic owner—and thus subject to the greatest tax exposure. Consequently, to improve its tax position, a company might cause a patent-owning affiliate in a high-tax jurisdiction to license all the relevant patent rights to an affiliate in a preferred



tax jurisdiction so that the licensee-affiliate can then develop the patented invention and thus qualify as the economic owner. In such a case, the economic owner might then use "limited risk distributors" to market and sell the patented products in different jurisdictions. By limiting the economic risk born by the distributors, this strategy seeks to justify a lower return to the distributors, with the residual profit or loss inuring to the economic owner in the preferred tax jurisdiction.

These types of strategies can often result in substantial tax benefits, but they can also create significant IP risks. The most basic risk is that the affiliate selling or licensing the IP-protected product does not have a valid license to do so, either because the relevant license has expired or because the company never put a license in place.

When this occurs, the selling affiliate has no legal right to use the underlying IP, and it therefore cannot enforce such rights against third parties. In addition, if the selling affiliate is *licensing* the product or technology (for example, a software program or other IT-related product), the license will be invalid because the affiliate has no rights to license. As a result, any disclosure of proprietary information to the third party will be unprotected by contractual restrictions because no valid license is in place. As a result, the data will likely lose its trade secret protection.

Finally, even if a valid license is in place, it may not be enough to enable the company to fully enforce its IP rights. This risk arises from the requirements of "standing" for patent enforcement actions against third-party infringers. In the U.S. and other jurisdictions, an affiliate lacks standing to join such an action unless it owns the patent or is an *exclusive* licensee.[1] Consequently, if the "selling" affiliate is a mere *non-exclusive* licensee (as is often the case in tax-driven structures), it will have no standing to join the lawsuit. In such a case, the company cannot recover lost profits because the only affiliate selling the patented product cannot join the lawsuit.[2] This principle applies even when the selling affiliate is a wholly-owned subsidiary of a patent-owning parent.[3] While the patent-owning parent can still bring the action (because it owns the patent), it cannot recover lost profits and it may not be able to obtain an injunction because it doesn't sell products to customers.[4]

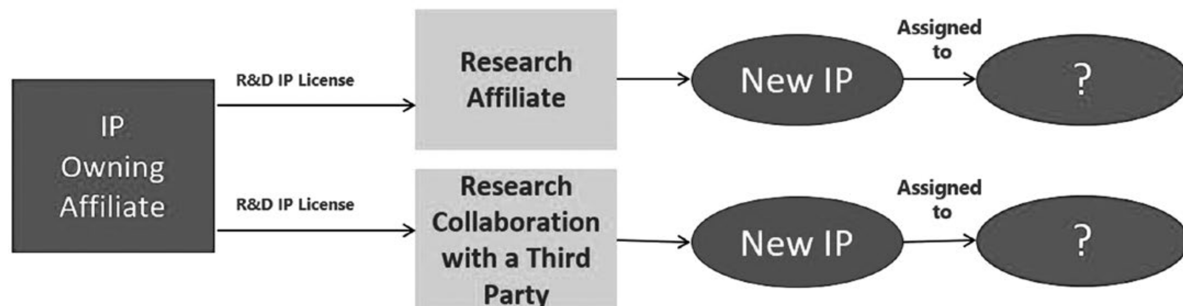
Consequently, unless a company grants its selling affiliates an exclusive license in the relevant jurisdiction, the company may not be able to recover damages from a third-party infringer. Even worse, if the company fails to grant any license to its distributors, it runs the risk of losing its IP protections altogether.

2. Creating New IP through R&D

The second scenario involves the creation of new intellectual property rights through R&D activities. In a typical structure, an IP-owning affiliate grants a license to an affiliate or a joint venture for the purpose of conducting research. The affiliate or joint venture then uses the IP to develop new inventions, new technologies and new intellectual property rights.

This scenario often gives rise to tax strategies involving the use of "cost-sharing agreements" in which two affiliates agree to share the costs of developing new intellectual property. In such a case, the affiliates will each be deemed to have an ownership interest in the new intellectual property consistent with their respective investments in its development. For example, two affiliates could invest in the development a new software program, with one affiliate acquiring ownership rights in the U.S. and the other acquiring ownership rights outside the U.S..[5] This type of arrangement enables the company to eliminate the need for one affiliate to pay royalties to another affiliate for the right to use the relevant IP.[6]

From an IP perspective, when a company develops new intellectual property rights, the creation of the new rights generates two fundamental requirements. First, the company must draft assignment documents to transfer ownership of the new IP rights from the inventors (who are deemed by law to be the original owners) to the affiliate designated for IP ownership.



Second, the company must then draft license agreements to other affiliates that will use the new IP either to market and sell the newly-developed technology or to conduct additional research. Only by addressing these requirements can the company avoid the problems discussed above involving inadequate or missing licenses.

3. Acquiring New IP through Acquisitions

The third scenario involves the acquisition of new intellectual property rights through corporate acquisitions or mergers. In this scenario, a company acquires another firm possessing its own patents, trademarks and trade secrets. When this occurs, the acquisition raises many of the same tax and IP issues discussed above, including (1) what affiliate should be the owner of the newly-acquired IP rights? and (2) what affiliates should be the licensees of the newly-acquired rights?

As before, the determination of which affiliates should either own or license the newly-acquired portfolio will often depend on tax considerations, particularly since the intra-corporate assignment of intellectual property is often a taxable event. As one example, a company might elect to "contribute" (*i.e.*, assign) the newly-acquired IP to an affiliate in a preferred tax jurisdiction, and then cause that affiliate to license the IP back to the original owner (which is now a new affiliate within the corporate organization). The licensee-affiliate can then sub-license the IP to other affiliates in different tax jurisdictions.

Once the tax decisions are made, the company will then have to ensure that the proper assignments and licenses are put in place for all relevant affiliates. As shown above, if the company fails to put the proper assignments and licenses in place, it will be severely compromised in protecting its IP rights.

4. Employment Agreements

A final scenario arises from employment agreements containing provisions defining an employee's IP-related obligations to the company. Such provisions are necessary to (1) effectively protect the confidentiality of the company's proprietary information; and (2) ensure that any innovations developed by the employee are properly assigned to the company.

To achieve an effective assignment, the employment agreement must affirmatively recite that the employee "hereby assigns" all future innovations to a designated corporate affiliate. With this language, the assignment will automatically take place as a matter of law at the moment the employee conceives the invention.[7] On the other hand, if the agreement merely reflects a "promise to assign," it will not be sufficient to effect the assignment.[8]

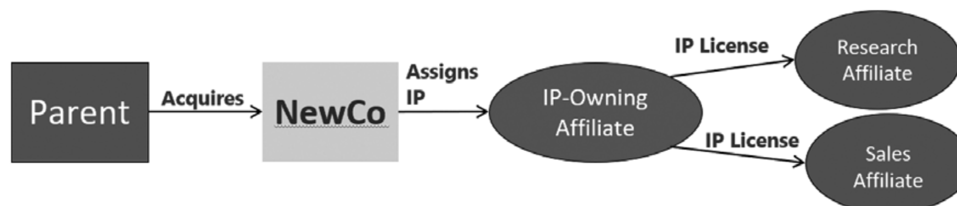
In addition, the agreement should expressly identify the specific affiliate to which the future innovations will be assigned. In many cases, the employment agreement identifies the assignee as the "Company," a defined term that includes the parent and all of its subsidiaries. However, in such a case, the future innovations will then be assigned—at the moment of conception—to every affiliate in the corporate organization, making each of them a co-owner of the invention.

Such a result could be problematic, particularly if the parent later sells or spins off an affiliate that co-owns the invention.[9] If this occurs, the now-independent affiliate will be able to use the invention for its own purposes, and the innovator company will lose control of what could be a critical business asset.

Finally, in the case of multi-jurisdictional companies, one other factor warrants serious attention: The laws governing employee rights to innovations differ widely across jurisdictions. It is therefore critical that any revisions of employment agreements take into account such cross-border differences in governing law.

The Need for a Targeted IP Audit

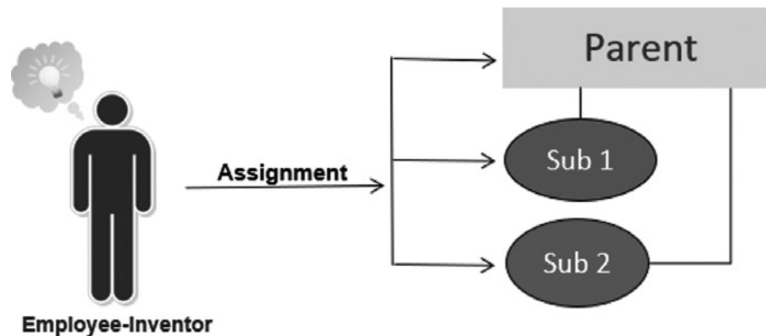
In light of the issues discussed above, every company using intellectual property should consider a targeted "IP audit" of its intra-company licensing structure. Such an audit would have a limited scope,



focusing only on the licenses governing the company's most important products and research, as well as any IP portfolios acquired through corporate acquisitions. If the targeted audit reveals IP issues, the company could enlist its tax and IP lawyers to resolve the issues by revising the license agreements to accommodate both tax and IP interests. The revised licenses could then serve as templates for future products and research initiatives.

For many of the same reasons, the company should also consider a targeted audit of the employment agreements used for its most important employees. Such an audit would focus on the provisions governing the assignment of future inventions and the confidentiality of the company's proprietary information. If the audit revealed any IP-related issues, the company could revise the agreements for its most important employees and then use the revised agreements as templates for future employees.

Through these types of audits, the company can ensure that its license and employment agreements promote its tax positions, while avoiding future problems in enforcing its business-critical intellectual property.



1. *See, e.g., Mars Inc. v. Coin Acceptors, Inc.,* 527 F.3d 1359, 1367 (Fed. Cir. 2008).
2. *See, e.g., Mars, Inc.,* 527 F.3d at 1363; *Poly-America L.P. v GSE Lining Technology, Inc.*, 383 F.3d 1303, 1311 (Fed. Cir. 2004); *Medtronic et al v. Globus Medical, Inc.*, 637 F. Supp. 2d 290, 314 (E.D. Pa.).
3. *Spine Solutions, Inc. v. Medtronic, Inc.,* 620 F.3d 1305, 1318-19 (Fed. Cir. 2010).
4. *See, e.g., Medtronic,* 637 F. Supp.2d at 314.
5. *See, e.g., https://sftaxcounsel.com/platform-contribution-rules/*
6. *Id.*
7. *See, e.g., Abraxis Bioscience, Inc. v. Navinta*, LLC, 625 F.3d 1359 (Fed. Cir. 2010).
8. *Id.*
9. *See, e.g., Janssen Biotech, Inc. v. Celltrion*, Case No. 1:17-cv-11008 (D. Mass.) (Oct. 31, 2017).

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