

Maximizing Tax Benefits from Intangible Property Development and Ownership

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The Issue

Veritas Software Case

- Veritas US and Veritas Ireland entered into a cost sharing arrangement. Pursuant to the cost sharing arrangement, Veritas Ireland made buy-in payment of USD 166 million (later reduced to USD 118 million) to Veritas US for the rights to use certain pre-existing intangibles
- Did Veritas Ireland made an arm's length buy-in payment to Veritas US as consideration for intangible property transferred to Veritas Ireland in connection with the CSA?
- IRS proposed a buy-in valuation of USD 2.5B (later adjusted to USD 1.675B) and asserted USD 303 million in TP penalties
- Complete Taxpayer victory: Court upheld Taxpayer's use of "unbundled" OEM CUT royalties "ramping down" in rate over 4 year useful life (reflecting gradual obsolescence of "static" IP) as Best Method to calculate arm's length buy-in payment for preexisting IP

Veritas Software Case: Tax Court Opinion

- Litany of IRS errors in Veritas:
 - Respondent “employed the wrong useful life, the wrong discount rate, and an unrealistic growth rate”
 - Court rejected IRS’s “akin to a sale” theory that buy-in should be calculated as if Taxpayer sold its EMEA and APJ operations to the Irish affiliate
 - Court rejected the IRS’s income method
 - Court rejected IRS’s “aggregate” valuation approach that (i) included untransferred or insignificant IP (e.g., assembled workforce), (ii) failed to value individual IP separately, (iii) included future as well as preexisting IP and (iv) assigned perpetual useful lives to short-lived IP
 - “his testimony was unsupported, unreliable and thoroughly unconvincing. Indeed the credible elements of his testimony were the numerous concessions and capitulations”

The Challenge

Intangibles

- Intangibles
 - Offer significant tax planning opportunities to minimize the global effective tax rate
 - A common source of transfer pricing disputes
- Reasons
 - Uncertainty about definition
 - What is an intangible
 - Unique economic attributes of intangibles
 - Different valuation methods and (very) different outcomes possible

The Alternatives

IP Tax Planning

- IP Owner can realize profits attributable to the IP by licensing or selling the IP or by manufacturing the products using the IP and selling the products
- Basic principle IP tax planning:
 - Reduce effective tax rate by earning intangible profits in a lower taxed jurisdiction
 - Additional tax benefit: royalty payments by licensees deductible against higher tax rates
- Business reasons for IP migration: tax planning should be supportive to business and should not obstruct business
- However, IP migration should be properly structured and implemented
- Timing of IP migration

Income Tax Considerations in IP Migration

- Effective tax rates and taxation of IP income in destination state
- Cross border royalty flows
- Transfer pricing limitations
- Anti-deferral and anti-abuse regimes
- Tax effects of restructuring
 - Exit charges – possibility to use tax attributes (e.g., losses or FTCs) to cover exit charges, especially if expiring?
 - Possible structures to transfer IP to IP Co tax free?

IP Migration Techniques

- Choice impacted by type of intangibles
- Common approaches:
 - License
 - Treatment for tax purposes: sale versus license
 - Consideration: lump sum, installments, royalty
 - Legal versus economic ownership

IP Migration Techniques

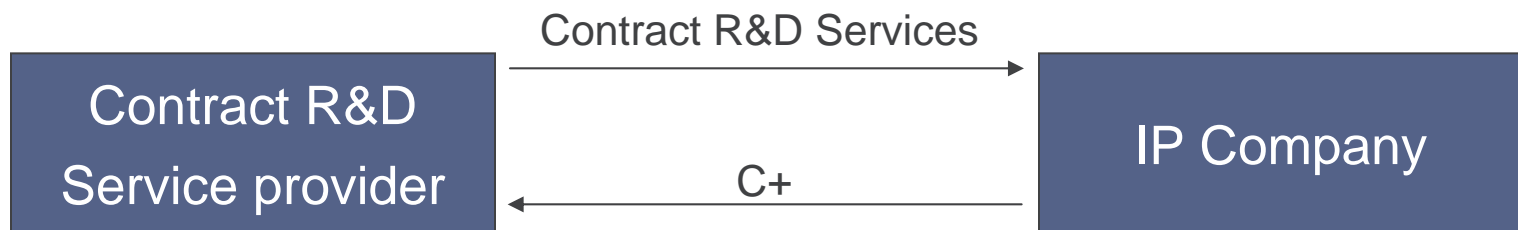
- Common approaches (cont'd):
 - Contract R&D (in combination with license)
 - Cost contribution arrangements/cost sharing arrangements (in combination with license)
 - Other
 - Outbound contributions
 - Options

Licensing

- The IP owner grants certain rights to the licensee for a specified period (e.g., geographic rights, exclusive versus non-exclusive rights, and sub-licensing rights)
- The baseline against which other approaches are measured
- Viable if licensee can earn residual profit after payment of royalties:
 - Reliable CUPs that leave profit for the licensee
 - Residual profit split where licensee brings IP to the table
 - Avoid TNMM?
- Especially beneficial for marketing intangible

Contract R&D

- IP company funds all R&D activities of contract R&D service providers and owns all the IP resulting from those activities
- Application of cost plus method scrutinized (e.g., Netherlands):



- Still must licence the pre-existing IP

Cost Contribution Arrangement

- A contractual agreement agreed among business enterprises to share costs and risks of developing, producing, obtaining assets, services, rights
- Buy-in payment:
 - When a new participant in already active CCA obtains an interest in results of prior CCA activity
 - Transfer of pre-existing rights must be compensated: a “buy-in” payment
 - Amount should be based on arm’s length value

The Definition of IP

Economics of Intangible

- Main value drivers from intangibles
 - Non-scarcity (non-rivalry)
 - Scalability
 - Network effects
- Main cost drivers
 - Excludability (partial)
 - Inherent risk
 - Non-tradability

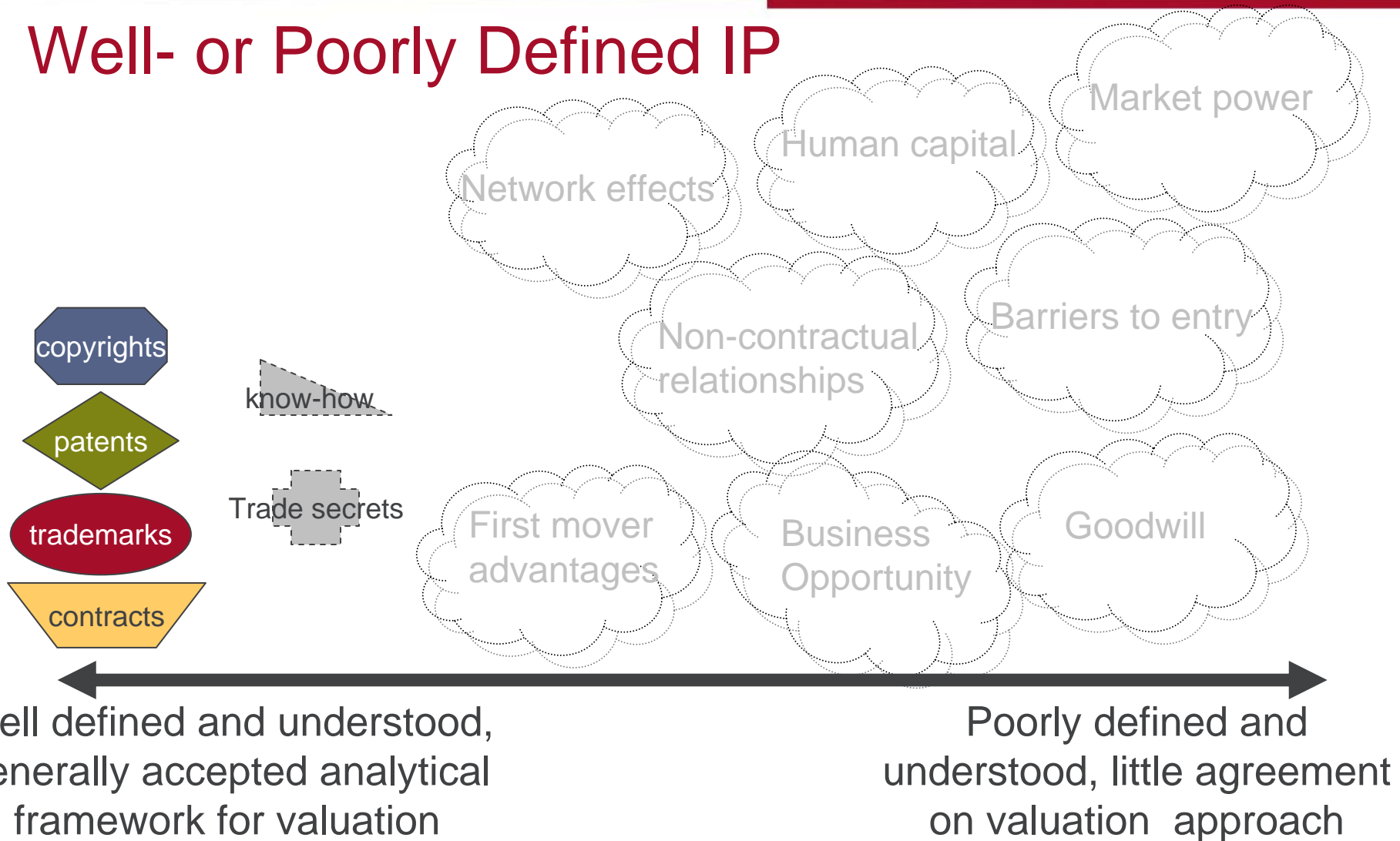
Measuring economic performance, competitive advantage and IP

- When ROIC > WACC: sources
 - Competitive forces
 - Distinctive, resource-based capabilities
 - Dynamic capabilities (innovation)
 - Strategic networks
 - Synergies (bilateral, internal, network-related)

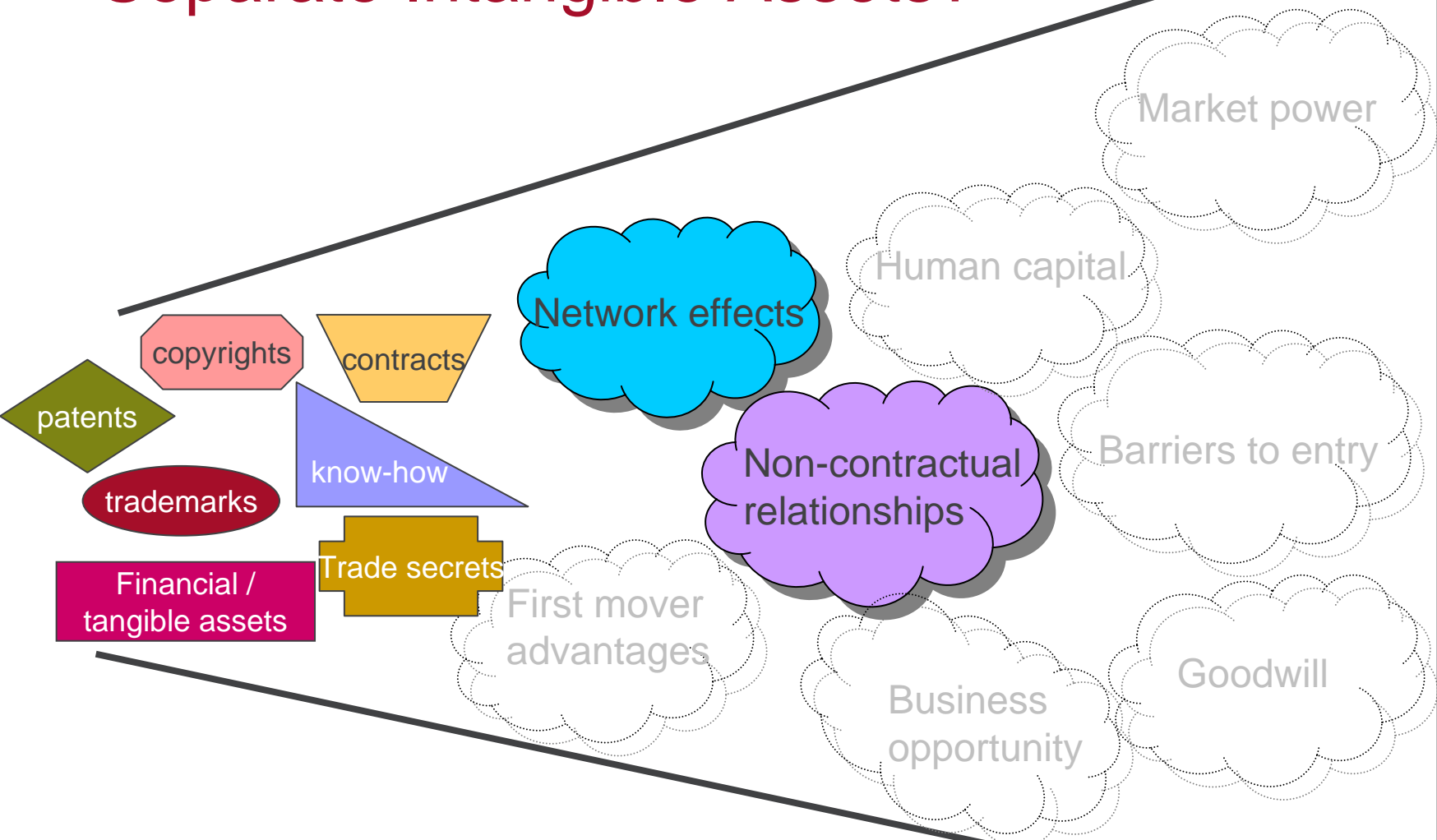
Definition: What is an Intangible

- Legally protected intangibles? (too narrow)
- IP that can be transferred from one business enterprise to another for a positive price?
- Intangibles related to the business enterprise itself such as goodwill and going concern? (too broad)

Well- or Poorly Defined IP



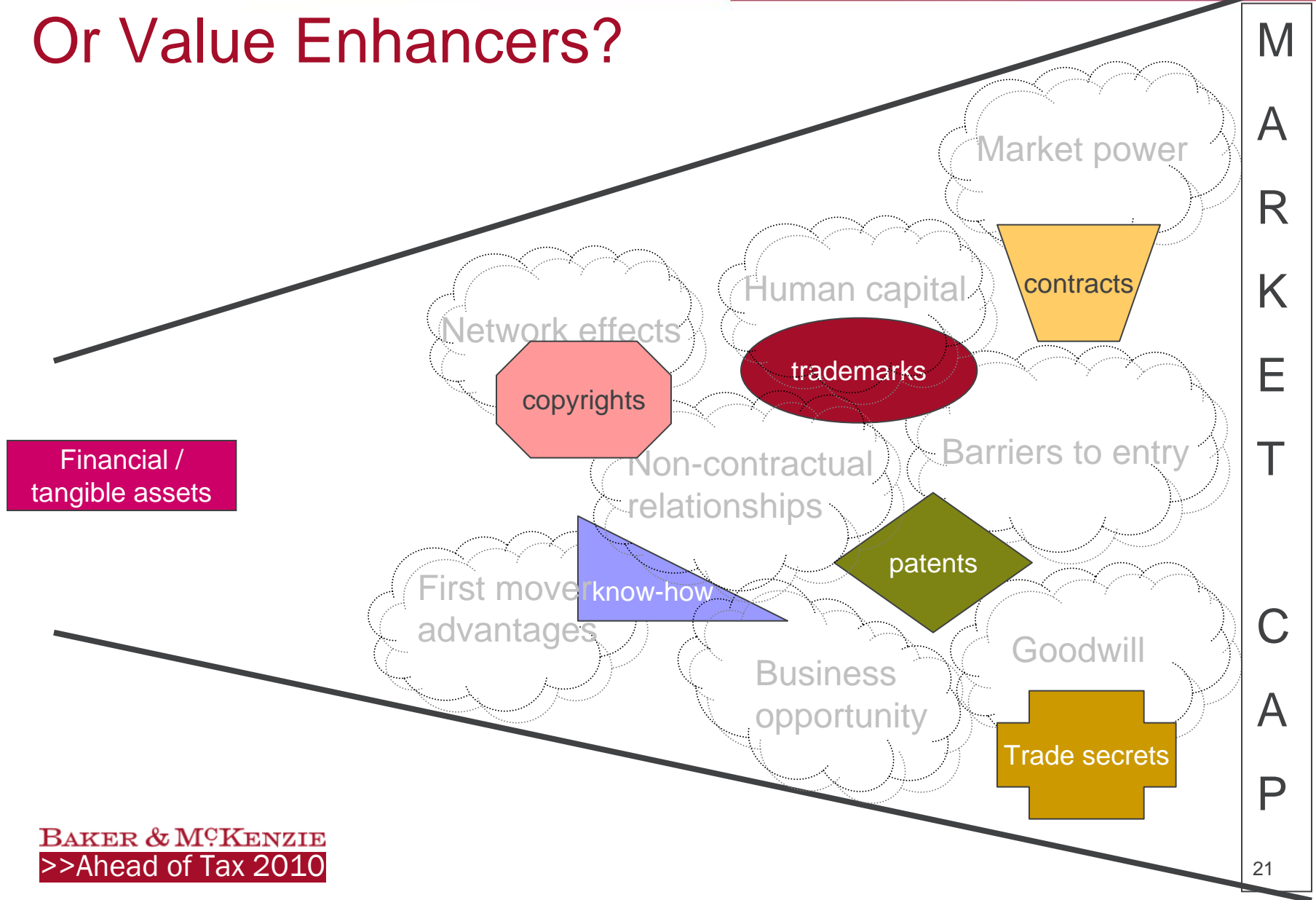
Separate Intangible Assets?



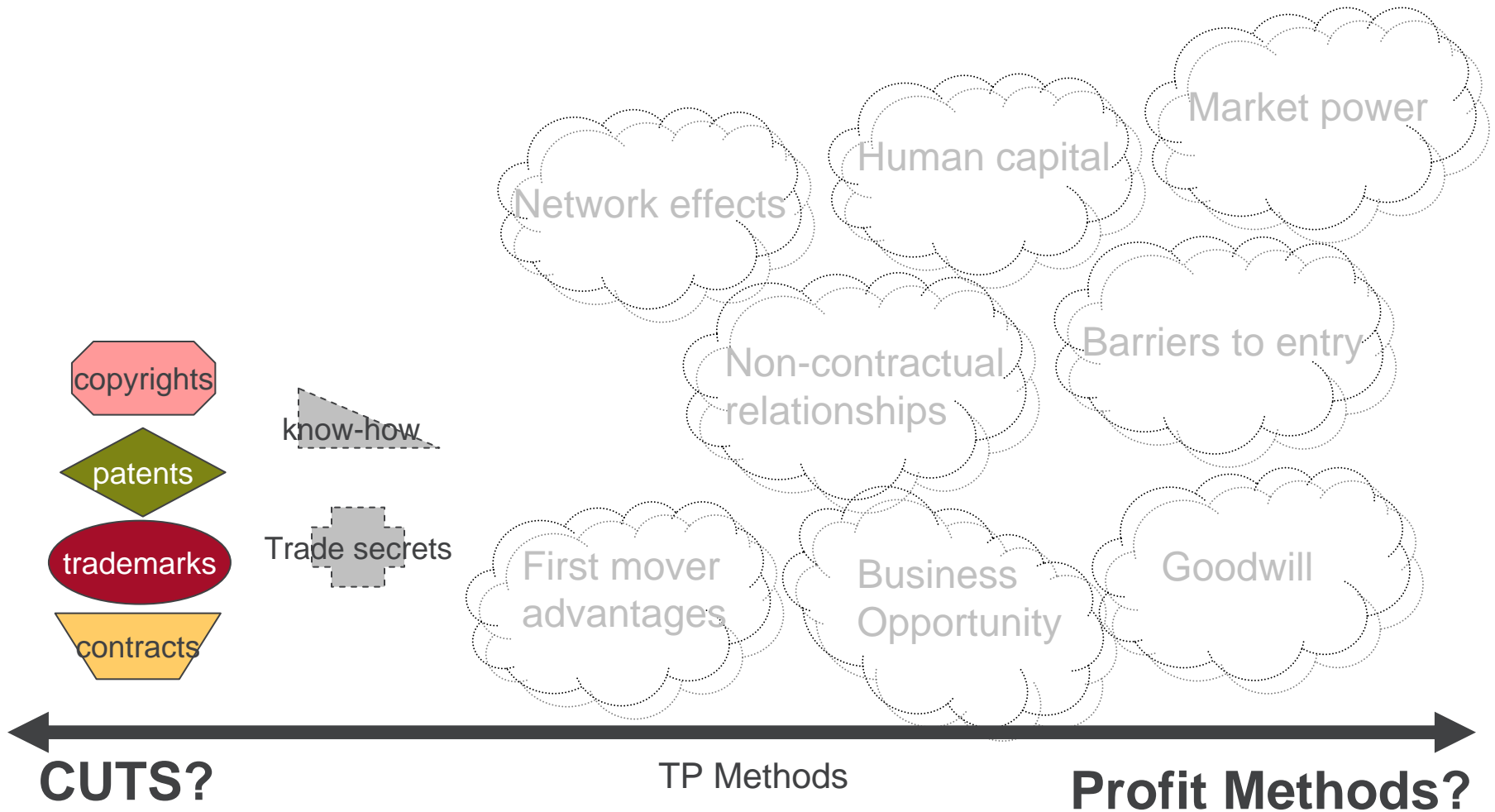
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Or Value Enhancers?



Implications for Transfer Pricing Analysis



The Valuation of IP

Valuation Issues in General

- TP method?
- Comparability requirements of CUP?
- Useful life?
- Transfer of business opportunity?
- Discount rate?
- Royalty degradation rate?
- Perspective of buyer (licensee) and seller (licensor)?
- Tax?

Valuation Techniques Overview

- Valuation of intangibles evolved as a discipline long before anyone worried about transfer prices for intangibles:
 - Market-based methods:
 - Transactions of the same/similar property
 - Income-based methods:
 - How much projected profit will be generated from the property?
 - Cost-based methods:
 - What would it cost to recreate or replace the property?

Overview – (Method Selection)

1. In general, cost methods are not definitive, since the value of an IP asset is often unrelated to the amount that was spent developing it. However, these methods may be useful as corroboration. Most often, cost methods are useful in determining a ceiling, or buyer's reservation price – particularly for IP assets such as software that it is easy to argue could be replicated.
2. Market-based methods are often difficult to implement due to a lack of sufficiently comparable data. However, when the data does exist, a market-based analysis should be done at least as a corroboration. Furthermore, even when exact comparability is not there, a “comparable profit split” observation may be possible.
3. Income-based methods are the most likely to have available data, and are the most likely to be reliable given that the value of an asset should always be a function of the expected cash flows attributable to that asset.
4. In a majority of the cases, you will probably end up using an income method, with a market or cost based method probably only used as corroboration.

The Risk Management



Risk Management Strategies

- Implementation and Ongoing Management of Structure
- Documentation
- APA
- Litigation

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