
Exploring the Intersection Between Tax and Intellectual Property

*By Tamsen Valoir**

Tamsen Valoir demonstrates that intellectual property assets can be successfully migrated to low-tax jurisdictions without jeopardizing the value of the asset if one is aware of and accommodates the intellectual property rules in the various jurisdictions.

The migration of intellectual property assets to a low tax jurisdiction is an area of growing interest and much has been written about the topic. However, most of the discussion seems to center on the advantages of one structure or jurisdiction over another and on the proper method of arriving at a reasonable arm's-length price for the transaction. In contrast, little has been written concerning the effect of the tax planning on the ability to maintain and enforce the intellectual property rights.¹ Transfer pricing typically involves the migration of intellectual property assets, and without careful attention to the exact form of the transaction, it is possible to inadvertently compromise the enforceability of that asset. With knowledge of the overlap between the intellectual property and tax issues, however, it is possible both to minimize taxes and to preserve the value of the intellectual property asset.

Competing Interests

Tax and intellectual property have different goals, causing an inherent tension between these two groups of lawyers. Although these tensions cannot be eliminated, they can be minimized, and

the starting point is to make each group aware of the differences.

For example, tax lawyers seek to minimize taxes by migrating assets to a low tax jurisdiction in a manner acceptable to taxing authorities. They also prefer to minimize the value of those intellectual property assets to minimize taxes on the actual transfer. Intellectual property lawyers, on the other hand, seek to make intellectual property asset maintenance and enforcement as easy as possible and to maximize the value of the asset. A low valuation may be beneficial for tax reasons, but may be less than helpful when trying to establish a high reasonable royalty rate in an infringement litigation. As such, it may be important to be able to distinguish the tax valuation from any arrangements with outside parties based on the timing, rights, geography or the terms of arrangement.

One of the most important differences between the two groups is a linguistic one—each has a very different concept of “ownership.” When intellectual property lawyers discuss ownership, they mean who owns the “legal title” and is “recorded” as the legal title owner in the relevant office. In contrast, tax lawyers usually mean “beneficial ownership” as indicated by a royalty stream and who is taking the financial “risk” if the business does not proceed as planned. Being aware of the differences in the way the two groups conceptualize ownership and taking care to articulate which meaning is intended will make communications easier.

Tamsen Valoir, Ph.D., is a partner in the Houston office of Baker & McKenzie, LLP. She has a J.D. and LL.M. in Intellectual Property, a doctorate in molecular biology from Rice University, and her practice is primarily in intellectual property in the area of biotechnology.

Maintenance and Enforcement

An intellectual property asset must be maintained and enforceable or its value is lost, and this can be tricky in some jurisdictions. In the United States, for example, only the legal title owner of a patent is entitled to bring an enforcement action. An exclusive licensee may join the suit, but a nonexclusive licensee may not.² Additionally, the exclusive licensee may not bring suit alone, except for certain limited circumstances, but must join the legal title owner.³ Finally, to obtain lost profits in an enforcement action in the United States, there must be actual lost sales by a party in suit. Therefore, the party making actual sales must be either the patent owner or an exclusive licensee.⁴

For these reasons, many intellectual property migrations are structured (at least in part) as exclusive, rather than nonexclusive, licenses. For example, the highly simplified, three intercompany structure in Figure 1 shows that USCo retains legal title and the rights to maintain and enforce the intellectual property. However, USCo, gives OffshoreCo an exclusive license and OffshoreCo makes and sells product to the U.S. distributor, SalesCo, who also has an exclusive sublicense that is styled as an exclusive distributorship. Some portion of the profit is therefore earned in the low tax jurisdiction, providing tax relief for at least that part of the income stream. In this simple structure, USCo would bring any need intellectual property infringement lawsuits, but OffshoreCo and SalesCo would have the right to join the suit and each could collect lost profits.

With knowledge of the overlap between the intellectual property and tax issues, however, it is possible to both minimize taxes and preserve the value of the intellectual property asset.

Of course, real life is not quite as simple as is shown in Figure 1. The appropriate transfer pricing must reflect an arm’s-length negotiation, and it is important not to transfer too many rights to avoid the IRS treating the license as a sale with the resulting tax consequences. Fortunately, it is possible to license only a single stick on an exclusive basis, rather than the whole bundle of sticks that make up the intellectual property rights. For instance, it is possible to exclusively license the sale rights, but license the make and use rights on a nonexclusive basis. Alternatively, one could carve the rights up

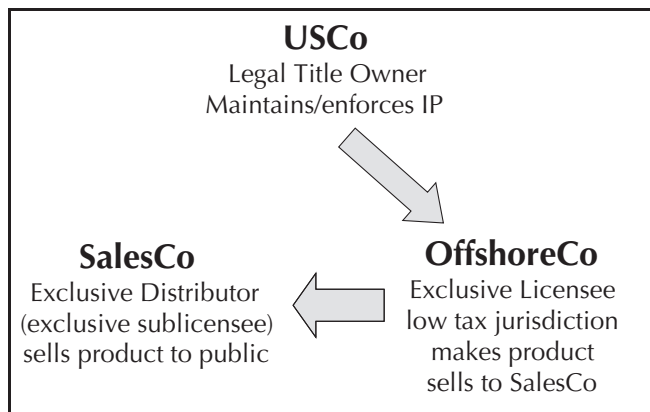
geographically, by field of use, by commercial versus research uses, by third-party versus inter-company sales, or by time. The exact structure will of course vary depending on the needs of the company. Further, if needed, even exclusive licenses can be subject

to reservations, for example, where the legal owner needs to reserve a right to use a patented invention. Alternatively, co-exclusive or joint exclusive licenses can be granted, for example, where needed to ensure adequate and uninterrupted supply of goods.⁵ Thus, the exclusivity is not exclusivity in fact, but rather a legal right to control one or more of the sticks in the intellectual property bundle.

In the past, many tax driven transactions have been structured as nonexclusive licenses to maximize flexibility, avoid sale treatment or achieve other tax planning objectives. It is important to realize that the law in this area has been evolving and there are recent instances where this structure has prevented the seller from recuperating any lost profits in a later patent infringement litigation. *Poly-America v. GSE Lining Technology* is a patent infringement case where the patentee attempted to join its selling subsidiary in order to collect its lost profits.⁶ The Federal Circuit held that the sister company could not collect lost profits because it was only a bare licensee, not an exclusive licensee. Therefore, the patentee could only recover a reasonable royalty on those lost sales—a smaller measure of damages than the lost profit would have been.

The patentee argued that they were sister companies and should be treated as a “single economic unit” for patent infringement purposes, but the

Figure 1.



Court refused to set aside the corporate formalities stating “While we do not speculate concerning the benefits that the two companies reap from dividing their operations and separating the owner of the patent from the seller of the patented product, Poly-America and Poly-Flex may not enjoy the advantages of their separate corporate structure and, at the same time, avoid the consequential limitations of that structure—in this case, the inability of the patent holder to claim the lost profits of its non-exclusive licensee.”⁷ The PolyAmerica case illustrates the potential intellectual property difficulties with a tax structure that involves nonexclusive, rather than exclusive, licenses. For another recent example of a taxpayer committing an unnecessary foot-fault that damaged its intellectual property rights, see *Novozymes A/S v. Genencor Int’l, Inc.*,⁸ which was decided earlier this year. If your company has a long-standing tax structure, it may be time to review the arrangement and determine whether it is up to date, especially if it has some of these potential weaknesses. By consulting your tax and intellectual property counsel now to see if those agreements should be revisited, you could avoid substantial aggravation later.

A low valuation may be beneficial for tax reasons, but may be less than helpful when trying to establish a high reasonable royalty rate in an infringement litigation.

Jurisdiction

Obviously tax lawyers will prefer a jurisdiction with low tax rate, that is a participant in relevant tax treaties, and that is otherwise sufficiently legally sophisticated so as to be suitable for maintaining an ongoing business. However, the same jurisdiction may also have unfavorable intellectual property laws, although jurisdictional issues are much less important where the migration is structured as a license, rather than as an actual assignment legal title.

Where legal title will be transferred or where future intellectual property is to be owned offshore, consider whether the low-tax jurisdiction is also a member of the relevant intellectual property treaties, otherwise the legal title owner in such jurisdiction may be unable to take advantage of any treaty benefits. Consider as well whether the chosen jurisdiction will allow the separation of legal title

and beneficial ownership. In some countries, this is not possible and can eliminate the intellectual property right or render it unenforceable. Your intellectual property counsel can tell you which countries are members of the intellectual property treaties and inform you of local intellectual property rules that may prove problematic for maintenance or enforcement of an asset.⁹

Recordation

Recordation of legal title is required in the United States because intellectual property assets are subject to a *bona fide* purchaser rule,¹⁰ the same as real property. This is true in many other jurisdictions as well, and in some jurisdictions failure to record legal title can eliminate the intellectual property asset. Yet, in many non-U.S.

jurisdictions, recording legal title is quite onerous, requiring the owner to determine the current legal requirements in each country, obtain assignments in the language of each country, determine the value of the transfer, and often requiring that the instrument be validated by apostille or legalization. Recordation may be trivial for a single asset, but when you consider the hundreds of patents and thousands of trademarks that a company may own, it can quickly erode the tax advantage of the migration and a large deal can take upwards of a year to finish recording.

These recordation requirements are another reason that intellectual property migrations are typically structured as an exclusive license, rather than actual assignment of legal title. However, even licenses must be recorded in some jurisdictions and a license structure will not eliminate all recordation. Check local intellectual property requirements to see if licenses should also be recorded in the relevant jurisdictions, and don’t forget to follow-up the deal with any required recordations.

Trademark Maintenance

Generally speaking, in the United States there is a “use” requirement to maintain a trademark, and it is a little more difficult to establish use by a li-

censee than an owner. Further, there are “quality control” requirements in the United States, and the trademark cannot be assigned separately from the “goodwill.” Make sure that all licenses involving U.S. trademarks consider these aspects of maintaining a trademark right.

Sometimes, the ownership of intellectual property assets is separated into different entities on a regional basis for tax reasons. This can also lead to difficulty maintaining an enforcing a trademark. How can an owner prove a mark is famous, when it is used and owned by three different legal entities? It is not impossible, but it is more difficult, adding to the expense of maintaining the mark.

Conclusion

This article does not purport to provide an optimal tax strategy or tax jurisdiction, nor to provide an in depth study of intellectual property licensing principles, but only to demonstrate that intellectual property assets can be successfully migrated to low tax jurisdictions without jeopardizing the value of the asset if one is aware of and accommodates the intellectual property rules in the various jurisdictions. To help you successfully migrate intellectual property assets without jeopardizing the value of the assets, see the Intellectual Property Migration Checklist.

Intellectual Property Migration Checklist

- Obtain complete and accurate list of intangibles, including both serial and publication numbers, and ensure that the ownership actually lies with the assigning or licensing party
- Decide whether the migration will be in the form of a license or assignment
- If a license, consider what slice(s) must be exclusive to convey standing to each seller of product
- Consider the interplay with existing third party licenses and include any reservations that may be needed to accommodate third party licenses and the patentees own needs
- If actual legal title is to transfer or if improvements are to be owned offshore, confirm the jurisdiction is suitable in tax terms, as well as being a member of the relevant intellectual property treaties
- Confirm the jurisdiction’s intellectual property rules are suitable for the transfer and will allow asset maintenance and enforcement after transfer
- Check each jurisdiction’s recordation requirements and confirm that the cost of transfer won’t eliminate the tax savings
- Confirm that intellectual property counsel has drafted or reviewed the actual migration instruments and that the instruments adequately address special trademark licensing requirements and allow for asset enforcement
- Ensure that any required recordation’s are made after the transfer

ENDNOTES

* Special thanks to Stewart Lipeles of the Palo Alto office of Baker McKenzie, LLP for valuable contributions to this article, especially with regards to its tax aspects.

¹ There is one nice treatment of the intellectual property holding company by Robert Matthew, *A Potential Hidden Cost of a Patent-Holding Company: The Loss of Lost-Profits Damages*, 32 A.I.P.L.A.Q.J. 503 (2004).

² *Waterman v. Mackenzie*, 138 US 252, 255 (1891); *Independent Wireless Telegraph Co. v. Radio Corp. of Am.*, 269 US 459 (1926); *Abbott Lab. v. Diamedix Corp.*, 47 F3d 1128, 1131 (Fed. Cir. 1995). (“Based on the analysis in *Waterman* and *Independent Wireless Tel. Co.*, this court has recognized the following principles: The right to sue for infringement is ordinarily an incident of legal title to the patent. A licensee may obtain sufficient rights in the patent to be entitled to seek relief from infringement, but to do so, it ordinarily must join the patent owner. And a bare licensee, who has no right to exclude others from making, using, or selling the licensed products, has no legally recognized interest that entitles it to bring or join an infringement action.”)

³ Where an exclusive licensee receives “all substantial rights,” the exclusive licensee is treated as the effective patentee; the exclusive licensee thus has standing to sue on its own for patent infringement. *Sicom Systems, Ltd. v. Agilent Technologies, Inc.*, 427 F3d 971, 976 (Fed. Cir. 2005).

⁴ *Poly-America, L.P. v. GSE Lining Tech., Inc.*, 383 F3d 1303, 1311 (Fed. Cir. 2004). (“While Poly-America may have the right to sue under its patents, both as an owner and as a back-licensee, it can recover only its own lost profits, not Poly-Flex’s. ... Poly-Flex does not have exclusive rights. It is clearly identified in the license agreement as a non-exclusive licensee, and as such, it received only a ‘bare license’ and has no entitlement under the patent statutes to itself collect lost profits damages for any losses it incurred due to infringement.”)

⁵ *Flexwood Co. v. Matt G. Fausner & Co.*, 64 U.S.P.Q. (BNA) 261 (7th Cir.) (an example of a case involving “exclusive joint” patent licensees); *Allergan Sales Inc. v. Pharmacia & Upjohn Inc.*, 41 U.S.P.Q.2D (BNA) 1283, at 1286 (S.D. CA 1996) (holding that there was insufficient showing that Pharmacia

would prevail on the merits of its claim that Allergan lacks standing to bring the injunctive action because it was not an exclusive licensee, where the licensing agreement explicitly provided that Allergan was an exclusive licensee, and that in its SEC filings Staar represented that Allergan was a “co-exclusive” licensee).

⁶ *Poly-America, L.P. v. GSE Lining Tech., Inc.*, 383 F3d 1303 (Fed. Cir. 2004).

⁷ *Id.*, at 1311.

⁸ *Novozymes A/S v. Genencor Int’l, Inc.*, 474 FSupp2d 592, at 604 (D. Del. 2007) (denying standing and lost profits to the sister company with nonexclusive license and stating, “According to Novozymes, ‘[m]ultinational corporate patentees ... are not required to arrange their internal structures specifically to be eligible for full compensation [for patent infringement].’ Thus, the argument goes, this court should treat Novozymes and NZNA as a single economic unit, so that damage to NZNA may be recovered by Novozymes. I will not ignore the organizational structure of Novozymes and its subsidiaries, and, there-

fore, Novozymes may not recover NZNA's alleged lost profits. ... Like the corporations in Poly-America, Novozymes has structured itself and its subsidiaries for its own goals and purposes. Novozymes must take the burdens of that structure along with the benefits. Novozymes may not blur the legal distinction between itself and NZNA to recover damages that Novozymes has not directly suffered." [Cites omitted]). See also *Lans v. Gateway 2000, Inc.*, 84 FSupp2d

112, at 121 (D.C. 1999). ("In a second declaration, Lans states that 'since I am the only shareholder of Uniboard, it has never been a matter of concern to me, other than for tax purposes, whether I or Uniboard was the owner of the patent.' The Court believes that is precisely the point. Since Lans was clear on the distinction between himself and the corporation when it came to the tax benefits of having Uniboard handle the licensing of the patent to IBM, he was on notice that the

distinction carried over to other aspects of the patent, such as which party could properly sue for its infringement.") (Cites omitted.)

⁹ For example, the Caymans and Bermuda are not PCT members, but Ireland and Luxembourg are.

¹⁰ If the change in legal title is not recorded, then a *bona fide* purchaser for value without notice may take title to the asset unless the recordation takes place within three months of the transfer. 35 USC §261.

This article is reprinted with the publisher's permission from the TAXES—THE TAX MAGAZINE, a monthly journal published by CCH, a Wolters Kluwer business.

Copying or distribution without the publisher's permission is prohibited.

To subscribe to the TAXES—THE TAX MAGAZINE or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.



CCH

a Wolters Kluwer business