

Risky Business – Pitfalls of IP Holding Companies

American Bar Association
Section of Intellectual Property Law
30th Annual Intellectual Property Law Conference

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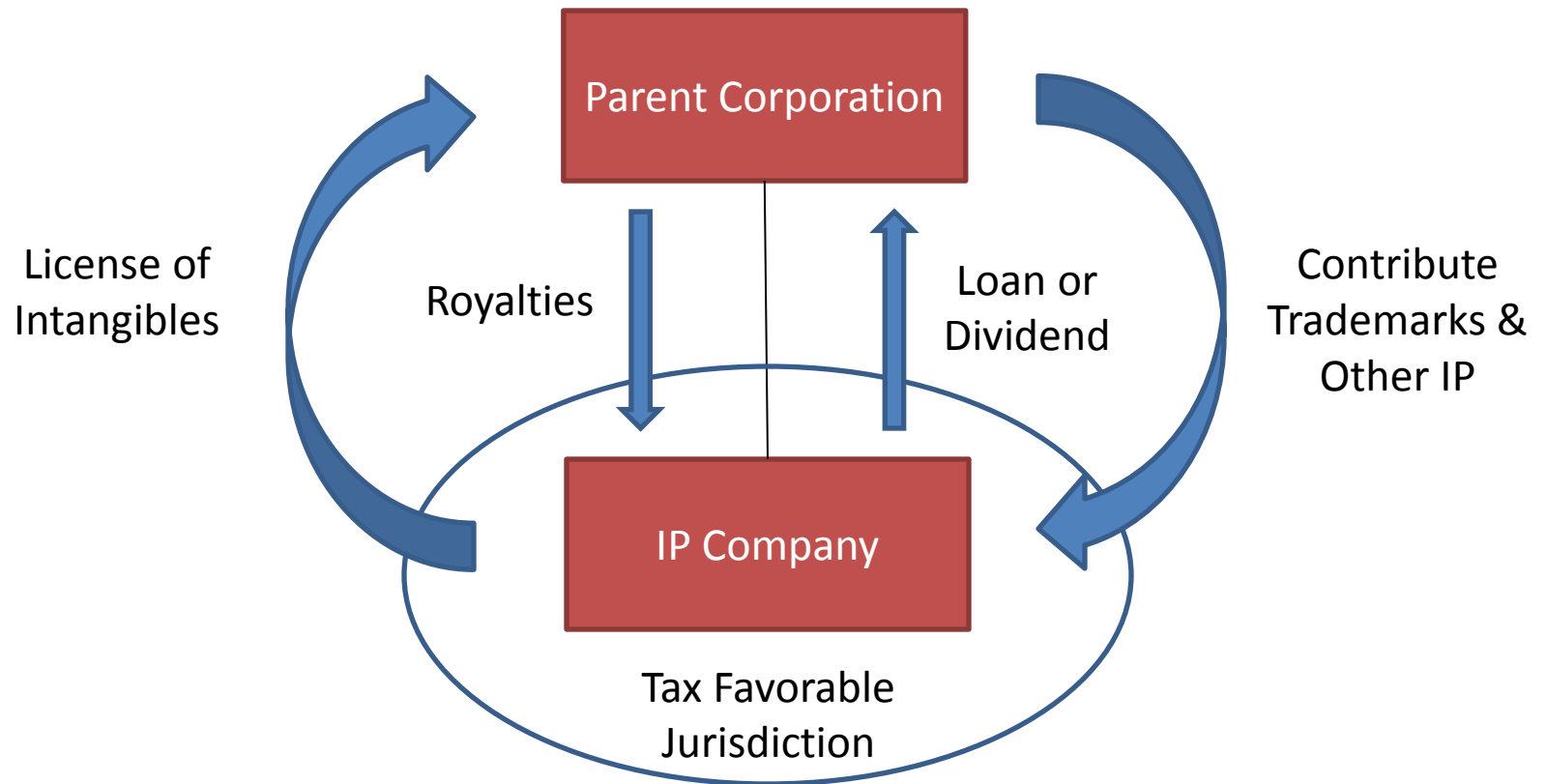
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Traditional IP Holding Company Structure



General Tax Benefits

- Royalty payments give rise to income tax deduction for licensee.
- If properly structured, intangibles can be transferred in a non-taxable manner.
- Business activities of IP Company are easily controlled to manage jurisdictions that could tax the royalty stream.
- IP Company domiciled in jurisdiction that either does not tax the royalty income or taxes it at a reduced rate.

Tax Favorable Jurisdictions for IP Companies

State

- Delaware
- Nevada
- Combined Reporting States
- Single Sales Factor/Market Sourcing

International

- Ireland
- Luxembourg
- Switzerland
- Singapore
- Tax Havens

Common Tax Risks

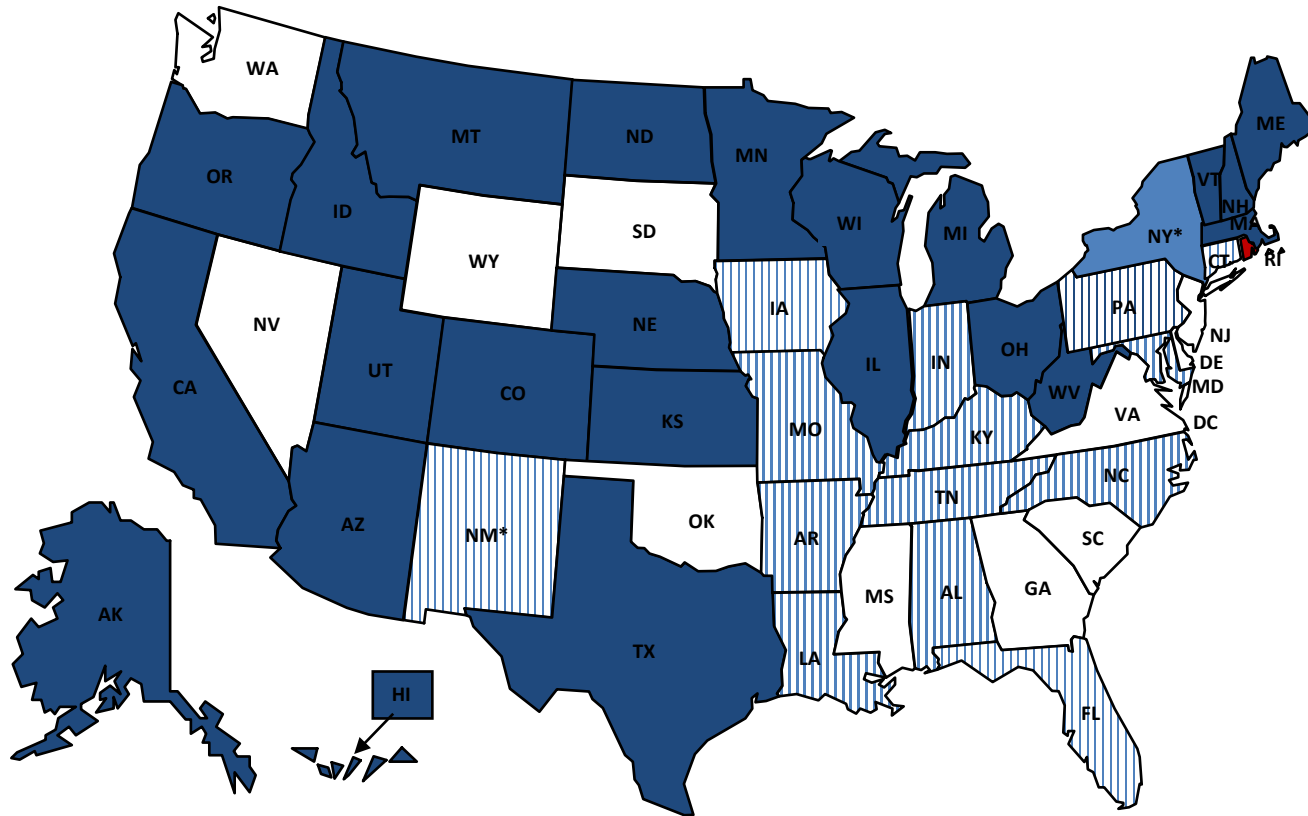
State

- Transfer Pricing
- Combination/Sham Transaction
- Economic or Attributional Nexus
- Statutory Add Back
- Alternative Apportionment

Federal/International

- Transfer Pricing (I.R.C. § 482)
- Sham Transaction/"Cash Box"
- Income Recognition on Outbound Transfer of IP (I.R.C. § 367)
- Withholding Tax
- Taxation of Earnings Repatriation

Combined Reporting – 2014



Combined Reporting Proposals Considered Recently and/or Currently Proposed



Unitary/Combined States *(now including the Ohio CAT, Texas Margin Tax and Michigan Business Tax)*

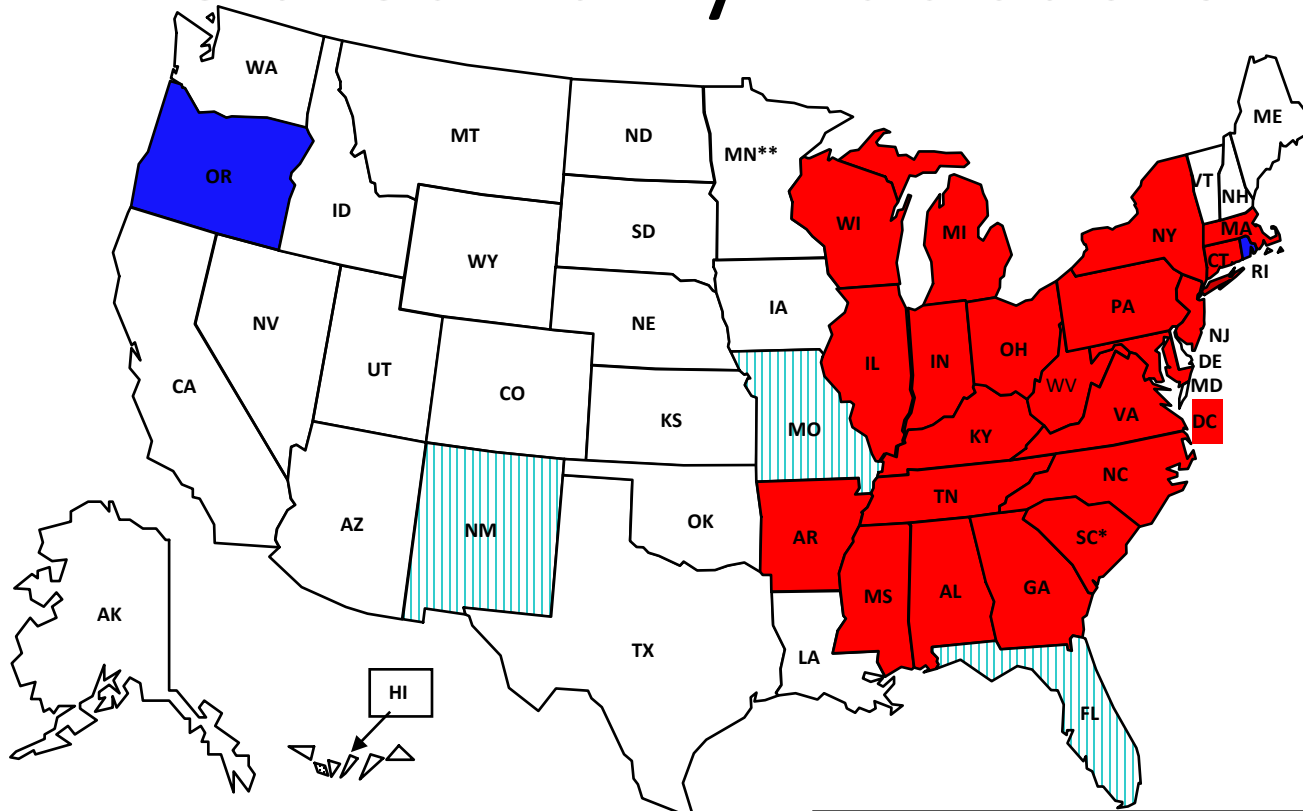


Remaining Separate Entity or Elective Consolidated Reporting/Other

**New York and Rhode Island adopt unitary combined reporting in 2015*

**New Mexico requires certain unitary large retailers to file combined returns (2014).*

Related Party Addbacks



- Related member expense addback required (including DC, NYC)
- Related member expense addback legislative proposals considered in recent years
- No related party addback provisions imposed
- Repealed in OR eff. 1/1/13 and in RI eff. 1/1/15

*South Carolina disallows deductions for an expense between related parties where a payment is accrued, but not actually paid and on interest deductions on obligations issued as a dividend or paid instead of a dividend

**Minnesota requires addback of interest and intangible expenses, losses, and costs paid, accrued, or incurred by any member of the taxpayer's unitary group to a foreign operating corporation that is a member of the taxpayer's unitary business group,

Tax Planners' Responses to Audit Risks: The Evolution of IP Companies

- 2nd Generation – Combine other business operations with licensing activities.
 - Dilutes “apportionment” to mitigate taxation of royalty income.
 - Done in response to economic nexus challenges.
 - Commonly termed an “east/west structure”.
 - Frequently used by companies headquartered in combined reporting states.

Tax Planners' Responses to Audit Risks: The Evolution of IP Companies

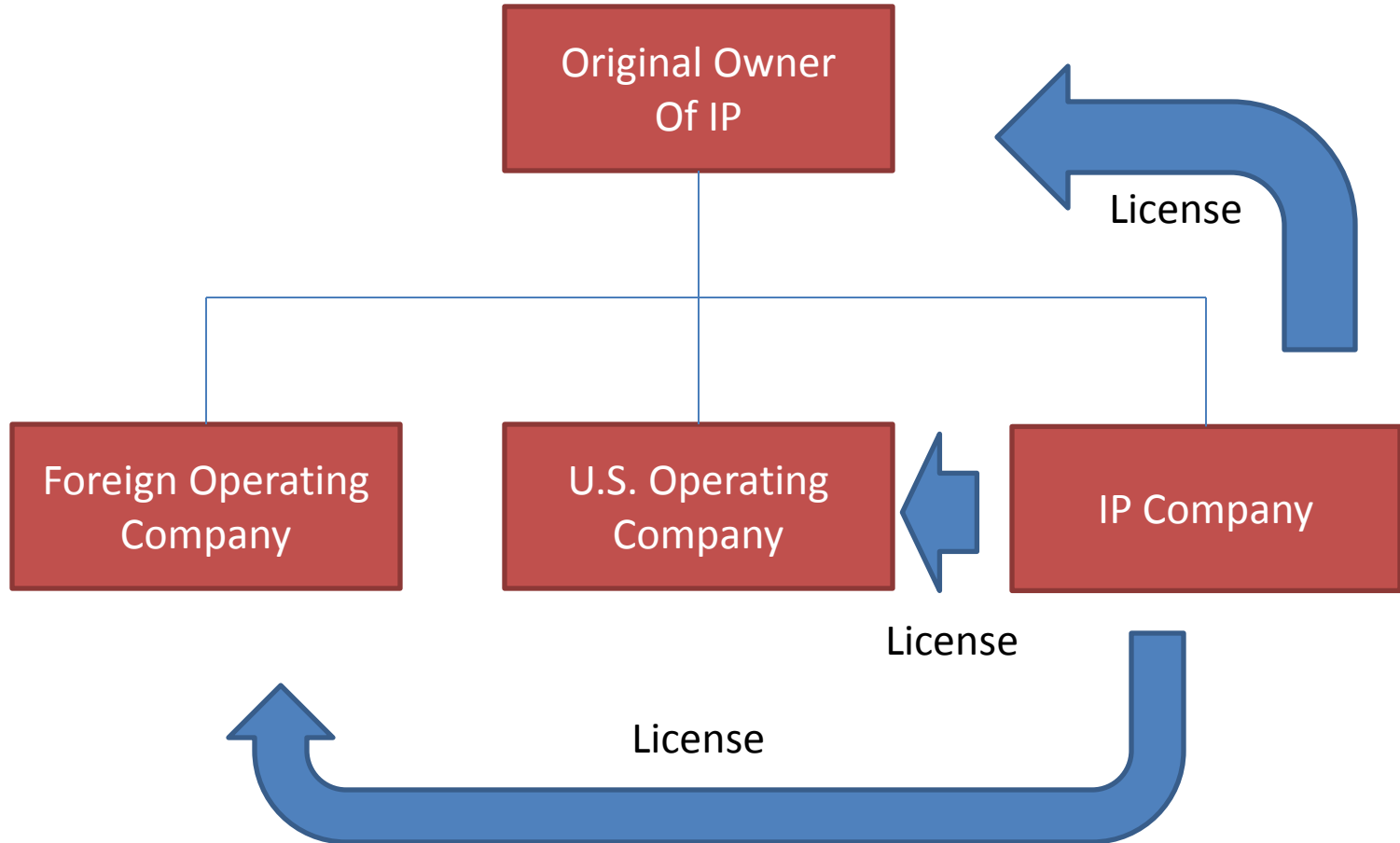
- 3rd Generation - Recharacterization of License
 - Compensation for use of IP secured through a service charge, mark-up on intercompany sale, or other non-royalty.
 - Common structures include procurement companies and management companies.
 - Done in response to economic nexus, sham transaction, and related party add back challenges.
 - Commonly termed an “embedded royalty” by auditors.

Tax Planners' Responses to Audit Risks: The Evolution of IP Companies

- 4th Generation - Entrepreneur or Residual Profit Structures
 - Owner of IP does not license IP to related parties, but rather contracts out limited risk/low profit activities to related persons.
 - Primary benefit is isolation of income in tax advantaged company with no need for royalty.
 - Done largely in response to related party add back statutes.

Panel Discussion of Alternative Structures and Associated Diligence Considerations

The Delaware Holding Company



Structural Considerations

- Consider business need other than tax advantages
 - Improve quality control
 - Easier profit analysis
 - Insulate marks from parent company liabilities

Structural Considerations

- Enter into formal license agreement between IPHC and operating company
 - Royalty rate
 - Consider using an independent valuation firm to establish rate
 - Provide quality standard to be followed by operating company
 - Give IPHC right to inspect operating company's use of the IP and its facilities
 - Require periodic reporting, including sales and royalty reports

Structural Considerations

- Management
 - Full-time employees
 - Separate director structure for IPHC and operating company

Structural Considerations

- Operating guidelines
 - Actively involved in registration, protection and enforcement of IP
 - Implement specific quality control plan
 - IPHC retains ability to license marks to third parties
 - Establish active and involved IP counsel

Cautionary Tales

- *Poly-America, LP v. GSE Lining Technology, Inc.*, 383 F3d 1303 (Fed. Cir. 2004).

Poly-America Providing Integrated Waste Solutions

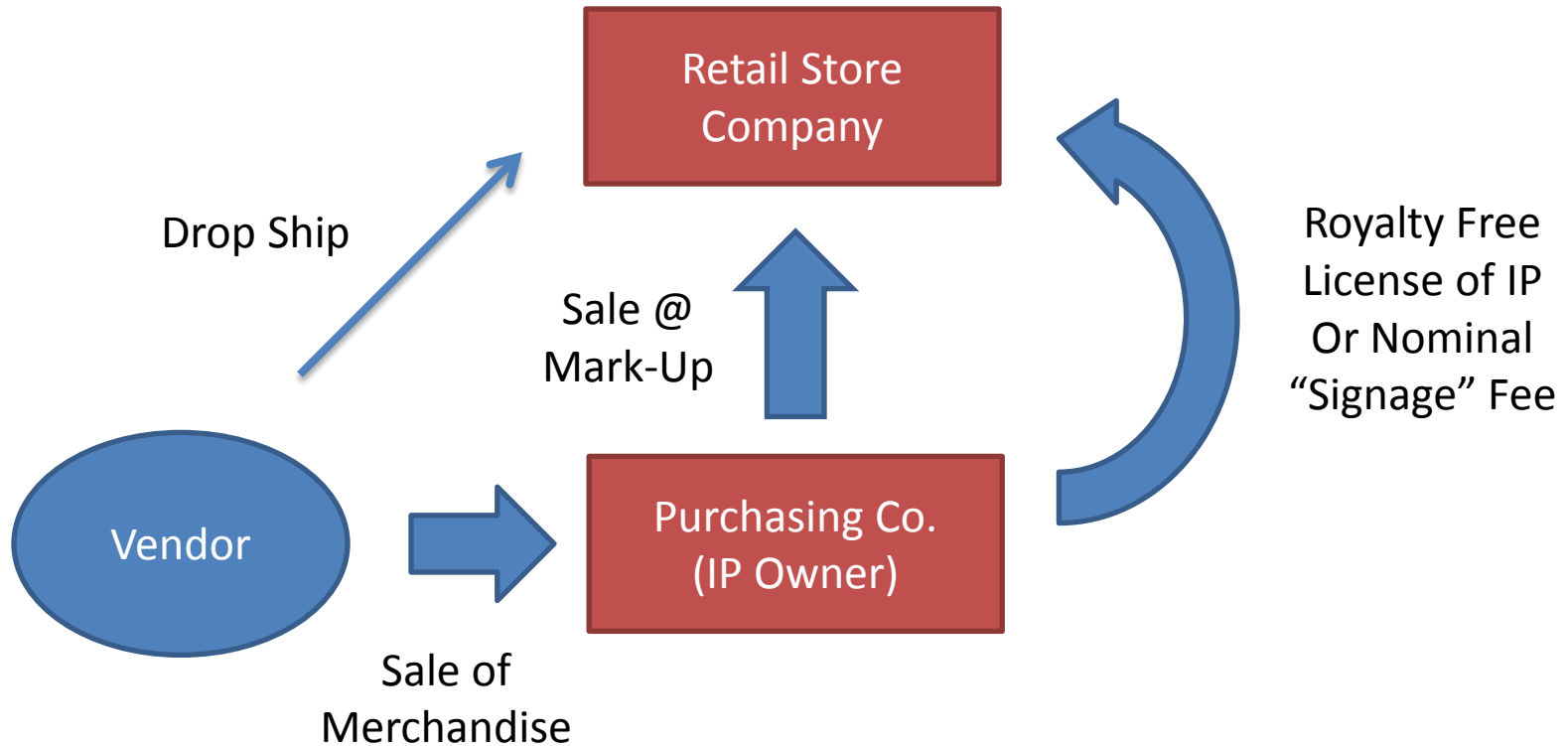


Cautionary Tales

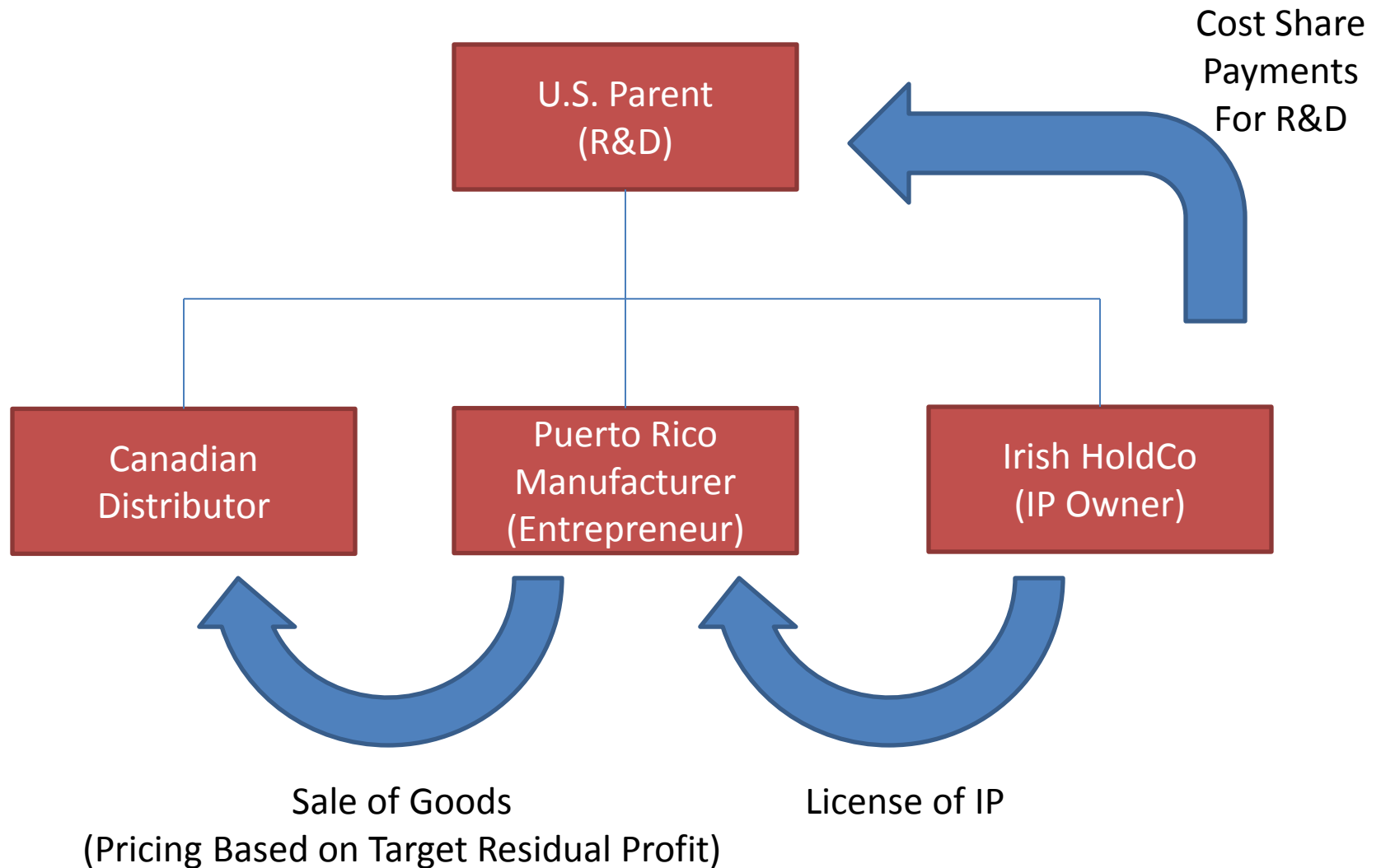
- *Geoffrey Inc. v. S.C. Tax Comm'n*, 437 SE2d 13 (SC 1993).



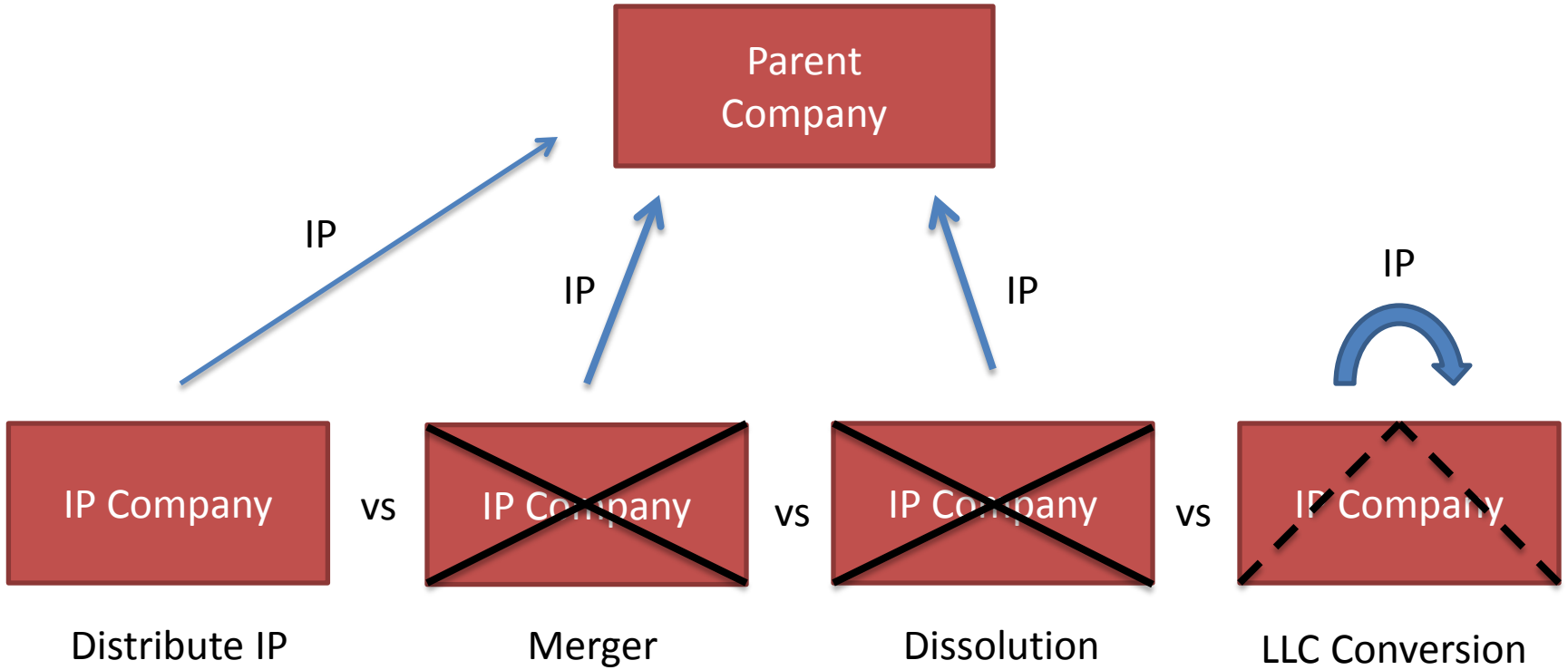
Procurement Company



International Entrepreneur Structure



IP Company Unwind



Questions?

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