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Collaboration Between Company's Tax And IP Experts: Part 2

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The protection and management of intellectual property within a multinational enterprise (MNE) is complex and expensive. Internal coordination, particularly between the tax, legal and IP management professionals is essential to ensure that the strategic and financial objectives for IP assets are achieved while minimizing potential risks.

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In the first part of this two-part article, we discussed the benefits of collaboration between the various internal professionals of an MNE responsible for managing and enhancing the MNE's valuable IP.

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In the final part, we focus on the importance of coordination between tax, legal and IP departments of an MNE in order to:

1. mitigate risks that can arise during tax inquiries or litigation; and

2. understand the impact of legal versus economic rights to IP when defending an IP portfolio.

Overview

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Cooperation, close communication and planning among the tax, IP, and legal teams can help mitigate risk if the company's intercompany licenses, transfer prices and/or transfer pricing documentation are produced in subsequent IP litigation. In patent litigation, for example, defendants routinely request plaintiffs produce all valuations of, and licenses for, the patents-in-suit. It is not uncommon for either the plaintiff or defendant to seek discovery regarding intercompany licenses, prices, and any supporting transfer pricing documentation and underlying contemporaneous information. A potential risk arises when transfer pricing information appears to be inconsistent with opinions and assertions made in the IP case. Since a company's tax filings are attested to by an officer of the company, a jury or judge must be educated on why valuation assertions in a patent case may be justifiably different than those represented to a tax authority. This is much easier to accomplish if the tax, IP and legal departments have coordinated their efforts and mitigated this risk by proactively generating documentation to help explain or reconcile any differences between the two contexts.

When Transfer Pricing Documentation and IP Valuations Differ

Consider the following example of when transfer pricing documentation and IP valuations differ:

An operating company has multiple products that it manufactures and sells primarily in the U.S. and Europe. Due to the variety of products and large numbers of patents that relate to some of the products, the U.S. parent company, which owns the patents, executed intercompany patent portfolio license agreements with each of its foreign manufacturing subsidiaries. The company has both transfer pricing documentation and a valuation of a patented product.

- Transfer Pricing Documentation: Indicates that the arm's-length interquartile royalty rate range was between 1.5 percent and 6.5 percent of net sales for each entity. The intercompany patent portfolio license agreements use a 2.5 percent royalty rate on net sales of each entity. The tax manager understands that this rate is necessarily a weighted average based on the mix of products and patents included in the intercompany licenses.

- The IP Valuation: IP managers recently obtained a valuation of a patented product with a low sales volume and a high profit margin for purposes of potentially licensing the patented technology to unrelated parties in Asia. This separate valuation analysis, done in the context of the litigation, indicates a royalty rate of 6.5 percent.

In this example, the company believes a reasonable royalty rate for the infringed patent should be at least 6.5 percent. However, the transfer pricing and valuation analyses performed for both transfer pricing and a potential transaction have royalty rates that are lower. The existence of the intercompany agreements and valuation analysis documents presents a risk that the judge or jury may undervalue the infringed patent. For example, the infringer's counsel may question company executives on why they represent the value of the company's patents to tax authorities at one rate, but are seeking a reasonable royalty rate at least three times higher.

The risk of having disparate royalty rates can be mitigated by having transfer pricing documentation that either:

1. includes a specific valuation for the patents to be licensed in Asia, or

2. clearly indicates why the intercompany blended portfolio royalty rate applied to all products may not apply to individual patents to be licensed to or enforced against a specific party, such as a direct competitor.

The existence of such apparent discrepancies between transfer pricing documentation and IP valuations may only be known if the IP and tax managers coordinate during the transfer pricing study process.

How Legal vs. Economic Ownership of IP Impacts Defense of an MNE's IP Portfolio

The distinction between legal and economic ownership of an intangible is particularly important to tax practitioners and regulators. For example, in the United States, under the Lanham Act, legal trademark ownership remains with the registrant or assignee of the trademark. However, for U.S. tax purposes, the Internal Revenue Service analyzes ownership in two distinct ways: (1) legal ownership/registration

and (2) the contribution an entity has made to create or increase the value of the intangible that results in the entity being an economic owner of the intangible. The consideration of both legal and economic ownership for tax purposes may be viewed as inconsistent with the approach under trademark law and may give rise to conflicts between underlying economic and legal standards.

Coordination and communication between the tax and legal departments of an MNE will ensure that that there is an understanding of which subsidiaries of an MNE holds legal and/or economic ownership of intangibles. Understanding this distinction is important when developing an IP strategy.

IP Litigation — Enforcement and Potential Remedies Depend Upon Legal Ownership and/or Licensed Rights of Plaintiff

The ability to fully enforce patent rights is an important element of an offensive patent strategy. In the U.S., there are various remedies available to patent owners and exclusive licensees, including an exclusion order to prevent the import of infringing products (by filing a complaint at the U.S. International Trade Commission), obtaining an injunction on the infringing activity within the U.S., and seeking monetary damages for past infringement. The ability to enforce patent rights and pursue various remedies depends upon the legal standing of the plaintiff as a patent owner or licensee.

Transfer Pricing — Economic Ownership Determines Allocation of Profits

Economic ownership of IP determines the basis of how profits are allocated between entities.

Consider the following example:

A company located in France manufactures and sells vaccines in France and owns the IP, but has a subsidiary in Ireland that sells products manufactured by the French company. The profits earned by the Irish subsidiary are not taxed in France.

In this example, both the French and Irish tax authorities would require that the company prove the profit reported in each country is consistent with what a third party would earn (i.e., profits reported in each respective country adheres to the arm's-length principle). Therefore:

- the Irish subsidiary is only entitled to profits for its distribution functions, and
- the French entity, as IP owner, is entitled to the remaining profits.

When Tax and IP Planning Collide

It is not unusual for MNEs to maximize value and minimize costs within the operational demands of a global company and one way of doing so, is to reduce tax expenses by locating the economic ownership of IP in a lower tax jurisdiction. Now consider the following:

The French company now sells the Irish territorial rights to the IP to the Irish subsidiary.

This results in:

- the Irish subsidiary now having economic IP ownership and its profits, earned in Ireland (assumed to be a lower tax jurisdiction), will increase to take into account this ownership.

From a tax perspective, it makes sense to implement such a strategy because by doing so tax expenses will be reduced, but how does this impact the MNE's overall IP strategy? Such a tax structure may preclude the company from pursuing certain remedies important to the company's competitive position and patent strategy. U.S. courts generally allow a party to sue for damages only if the legal entity seeking damages is the patent owner, or an exclusive licensee. If the patent-owning entity does not sell products or services that have been harmed by the infringement, then an award of lost profits is generally not recoverable.[1]

Conclusion

Early and effective communication between a company's tax and IP managers can help assess the risks and benefits of a corporate/tax structure in light of the potential loss of value to the company and its patents. In addition, including certain specific terms and conditions in intercompany patent license agreements may help mitigate some of these risks (for example, providing exclusive intercompany licenses, with the right to sue). Again, these issues can only be addressed if there is collaboration between the company's tax, IP and legal teams.

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[1] Mars, Inc. v. Coin Acceptors, Inc., 527 F3.d 1359 (Fed. Circ., June 2, 2008) at 1365 ("[The Court of Appeals for the Federal Circuit] held that a patent holder is not entitled to recover under a lost profits theory as a result of sales lost by a sister corporation, absent a showing that the patent holder itself had lost profits.").

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