Traditional IP Holding Company Structure

Parent Corporation

License of Intangibles

Royalties

IP Company

Tax Favorable Jurisdiction

Contribute Trademarks & Other IP

Loan or Dividend
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

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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 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 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Repealed in OR eff. 1/1/13 and in RI eff. 1/1/15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

• 3\textsuperscript{rd} 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

Original Owner Of IP

Foreign Operating Company

U.S. Operating Company

IP Company

License

License

License
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

Cautionary Tales

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

- Vendor
- Sale of Merchandise
- Drop Ship
- Sale @ Mark-Up
- Retail Store Company
- Purchasing Co. (IP Owner)
- Royalty Free License of IP Or Nominal “Signage” Fee
International Entrepreneur Structure

- U.S. Parent (R&D)
- Irish HoldCo (IP Owner)
- Puerto Rico Manufacturer (Entrepreneur)
- Canadian Distributor

Cost Share Payments For R&D

Sale of Goods (Pricing Based on Target Residual Profit)

License of IP
IP Company Unwind

Parent Company

IP Company

Distribute IP vs Merger vs Dissolution vs LLC Conversion
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