

Tightening the Tax Screws on International IP Structures

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For many years prudent international tax planning for multinational enterprises has included structures designed to minimize global taxes by developing or holding intangible property (IP) in foreign subsidiaries located in low-tax jurisdictions. As the IP is exploited, royalty revenue recognized by the owner of the IP (either directly or embedded within products sold) results in little or no income tax due to special tax regimes or low statutory tax rates in the country where the IP is held. This allows for low-taxed earnings to be accumulated and redeployed for further growth of the business. Now, a confluence of pressures threatens to diminish or eliminate the attractive tax implications of such IP holding structures. These include recently finalized U.S. tax regulations, standards adopted under Organisation for Economic Co-operation and Development (OECD) global initiatives, and the prospects of significant international tax reform. **Final Regulations Modify Active Royalties**

Exception For U.S. multinationals, recently finalized regulations strengthened certain anti-deferral provisions relevant to cross-border licensing structures. In particular, The U.S. Treasury and the IRS modified the active royalties exception under the so-called Subpart F rules of the U.S. Tax Code (see Treasury Decision 9792). Under Subpart F, certain types of passive income classified as "foreign personal holding company income" (including royalties) that are received by a controlled foreign corporation (CFC) are taxable to the direct or indirect U.S. shareholders of the CFC without regard to whether the income is distributed by the CFC. As an exception to foreign personal holding company income, however, royalties derived in the active conduct of a trade or business and which are received from an unrelated person will not be taxed currently under the Subpart F rules. This exception can be satisfied either through an active development test or an active marketing test. Falling within the exception can be crucial for U.S. tax planning because IP held in a low-tax CFC subsidiary is tax beneficial only if the U.S. shareholder can defer the recognition of U.S. income with respect to royalties received by the CFC. The recently finalized regulations modify the definition of foreign personal holding company income under Treas. Reg. § 1.954-2 so that a CFC must perform the relevant activities required to satisfy the active development test through its own officers or staff of employees. Thus, taxpayers can no longer rely on non-employee agents or contract service providers to develop or add substantial value to IP under this test (the active marketing test already

required that qualifying activities be performed through the CFC's own officers or staff of employees). Further, the final regulations clarify that payments made by a CFC licensor under a cost sharing arrangement will not cause the CFC's officers and employees to be treated as undertaking the activities of the cost sharing participant to which the payments are made. Structuring operations to fall within the active royalties exception to Subpart F income remains a viable tax planning strategy. However, it may be necessary to strengthen the substantive activities occurring within the foreign entity that holds the IP. **OECD BEPS Project Targets Tax-Advantaged IP Holding**

Structures Certain efforts of the OECD under its Base Erosion and Profit Shifting project (BEPS) are targeted at artificial profit shifting under regimes that provide preferential tax treatment for income arising from IP without regard to whether the IP owner conducts corresponding substantive activities within the jurisdiction (often referred to as "IP boxes" or "patent boxes"). Pursuant to Action 5 of the final BEPS report, it was agreed that OECD member states will require a minimum substance level with regard to preferential tax regimes applicable to income generated from IP. Under a "nexus approach" adopted by consensus of participating members, a licensor is allowed to benefit from an IP regime only to the extent the licensor has borne its own R&D costs during the development of the licensed IP, and engaged in substantial activities relative to such development. Moreover, new country-by-country (CbC) reporting required by Action 13 of the BEPS project imposes annual disclosure obligations on large multinational enterprises that will highlight the existence of IP royalty structures to governmental taxing authorities around the world. Under CbC reporting regulations adopted in the United States (issued in June 2016) the ultimate parent of a U.S. multinational group must file a form with its U.S. federal tax return disclosing multiple items for each "constituent entity" of the multinational group, including the identities of such constituent entities, the amount of revenues and income tax paid by such entities as well as the number of employees and other details relevant to the activities carried out in the country where the constituent entity is organized or is resident for tax purposes. Such details could directly highlight or expose facts that may lead tax administrations to investigate whether companies have engaged in practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. Notwithstanding that a company's existing IP structure may be compliant and ultimately withstand scrutiny, the additional burdens imposed by BEPS and the mere threat of potential examination by taxing authorities might cause companies to rethink their existing IP structures. **International Tax Reform May Alter Landscape for Cross-Border IP Tax Planning** Potentially game-changing international tax reform may be on the horizon. For several years U.S. legislators have sought to bring about international tax reform, introducing a large number of bills with international tax proposals. However, due to partisan gridlock in Congress and the ever-present threat of presidential veto, such efforts went nowhere. With the new presidential administration and a Republican-controlled Congress, prospects of international tax reform have increased significantly. Even before President Trump won the election, a GOP Tax Reform Task Force tackled the challenges of tax reform and in June 2016 released its "Blueprint" to legislative change. Among the recommendations reached, the Blueprint would replace existing U.S. tax rules with a territorial approach imposing a destination-based cash flow tax that depends on location of consumption rather than location of production.

Although details were not provided, such a tax system would purportedly eliminate the incentives of moving IP to locations outside the United States. Ultimately, significant international tax reform likely still faces many hurdles before enactment. Nevertheless, prospects of reform represent a further pressure on the future effectiveness or benefit of existing IP royalty structures. Although these developments are pressuring IP royalty structures, rather than abandon existing IP structures multinationals should closely monitor further developments and modify their international structure as necessary to conform with changes.

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