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Cross-Border Licensing of Intangible Property: Tax and Legal Issues in the Life Sciences Sectors

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Introduction

Success in the life sciences industry can depend on a company's ability to share knowledge and collaborate with strategic partners while simultaneously protecting from its competitors the valuable information on which its business is based. This valuable information consists of intangible property in its many forms, all of which have substantial value independent of the services of any individual.[1] According to the U.S. Department of the Treasury (the ''Treasury''), intangible property includes patents, inventions, formulae, processes, designs, patterns, know-how, copyrights, trademarks, franchises, licenses, methods, systems, procedures, studies, forecasts, estimates, customer lists, and technical data, among others.

As a business seeks to expand its research and development, manufacturing, or sales operations beyond the shores of the United States, it may choose to take advantage of the operational and tax efficiencies that can be achieved through licensing its intangible property to its overseas affiliates in exchange for a royalty. Because the United States has a worldwide system of taxation as opposed to a territorial one, without proper planning a U.S. business that transfers technology overseas will find itself paying U.S. tax on the revenue its expansion activities have generated abroad. Fortunately, granting a license to use intangible property in exchange for a royalty can help a business minimize its effective tax rate in the United States while promoting international growth of the business.

Protecting Your Rights: Licensing Terms & Conditions

Transferring rights related to intangible property requires some very tangible negotiation and documentation. Technology licensing negotiation begins with two parties: the licensor, or the party that owns the intangible rights and that grants the ''out-license''; and the licensee, the party that wants to use the intangible rights as the recipient of the ''in-license.'' We will assume that from a business perspective, the parties have already evaluated their options and determined that the best result for both is a license of the intangible rights (rather than an acquisition, joint venture, or other business partnership).

A license arrangement for the use of intangibles can take many forms, including assistance, training or development of other technology, manufacturing rights or capabilities, supply of products or equipment for sale, use of a patent, copyright, trade secret, trademark or logo, or a right to enable compliance with a technical standard or specification. However, regardless of the form or business objectives, it is highly recommended that the licensee and licensor draft and execute a written agreement or contract in order to document the relationship between the parties and clearly articulate their respective rights and obligations with respect to the use of the property. This licensing agreement typically grants the licensee the specific right, often subject to limitations such as a specific term or in a certain territory, to use the intangible property in exchange for some form of consideration (discussed in next section).

Limiting the licensee's use of the property to a certain length of time and to a particular geographical region spreads risk. For example, a limited term license can protect the licensor's upside should market conditions improve, or enhance opportunities in markets where the licensor has no experience. The licensor could seek to uphold its rights through the legal system, including by preventing third party use of the trademark, copyright, or other intangible property.

[1] *See* Treas. Reg. § 1.482-4(b).

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A licensing agreement helps to protect the licensee by memorializing the licensor's promise not to sue the licensee for the latter's use of the intangible property. Without such an enabling device, any use or exploitation of the property by a third party would amount to infringement.

A primary function of a licensing agreement is to protect the legal rights associated with the intangible property and related confidential information. Achieving robust protection of the holder's rights could require extensive identification and documentation of those rights, including registering with the U.S. Patent and Trademark Office or U.S. Copyright Office when applicable. Also essential to adequate protection of intangible property and related rights is clarity surrounding the identity of the economic (or beneficial) owner, which may or may not be the same as the legal owner.

Paying for the Privilege: Consideration

Naturally, a holder of valuable intangible property will not grant a license without due compensation. The consideration passing from the licensee to the licensor can assume a variety of forms, such as a royalty that is typically a periodic payment based on a percentage of the revenue generated by the licensee's use of the property. Since a royalty is a contingent stream of payments, the more successful the licensee is in exploiting the property, the greater the resulting financial benefit for the licensor. Alternatively, a licensor who wants to ensure a steady stream of income could require either regular fixed payments or an upfront lump sum payment from the licensee. So-called ''milestone'' payments offer a hybrid arrangement whereby the licensee agrees to pay fixed amounts based on achieving specific contingent objectives, such as reaching a stage of development or sales target.

In a cross-border context, the payment of a royalty from a licensee in one country to a licensor in another country may be subject to a ''withholding tax.'' Depending on the country, this withholding tax is considered a substitute for income taxation when the licensor does not conduct business in the country where the licensee is resident.

The withholding tax rate could be as high as 35 percent, although many countries reduce the rate or eliminate it entirely under an income tax treaty, provided the recipient is able to establish proof of residency. For example, the withholding tax rate on payments from a U.S. resident to a resident of Bermuda is 30 percent, but is reduced to 10 percent when the recipient is a resident of Australia, and further reduced to zero when paid to a Belgian resident. It should be noted that in order to qualify for treaty benefits under the U.S. Model Income Tax Convention (''U.S. Model Treaty''), which is the framework from which the Treasury begins its negotiation of tax treaties with foreign nations, the recipient must meet a number of conditions, including being a qualified person as determined under the Limitation of Benefits article.[2]

On the other hand, some countries, such as the Netherlands and Switzerland, do not impose any withholding tax on royalties under federal law. This fact can make them ideal locations for licensees to exploit intangible property and for licensors to enter into license agreements where they are not able to utilize foreign tax credits.

It is also possible that no monetary consideration passes between the parties at all—that is, the licensor accepts compensation in a form other than money. A common example is when two parties each desire to utilize the intangible property of the other and agree to a reciprocal ''cross-license.'' The parties to a cross-licensing agreement may have pursued such an arrangement in an effort to avoid litigation or to settle an infringement dispute. For example, if the patents that each party owns cover a different essential aspect of a given commercial product, a cross-license prevents a legal battle while permitting each party to maintain their freedom to bring the commercial product to market. However, some care should be exercised in cross-license arrangements in a cross-border context, as taxing authorities will carefully scrutinize the arrangement in order to evaluate whether the intent of the parties is to avoid withholding taxes.

Potential Pitfalls: Characterization of Income

Not surprisingly, there are a number of things that can go wrong when structuring a cross-border license of intangible property that can cause some or all of the income generated by a foreign affiliate's use of the property abroad to be treated as income that is taxable to the U.S. holder. One of the first opportunities for trouble arises while drafting the terms of the licensing agreement.

The goal of the U.S. holder of the intangible property is to license it to a foreign licensee, which seems straightforward enough provided that the license is not actually a disguised sale of the property. Whereas a sale of an intangible property right such as a copyright involves a complete transfer of *all* of the benefits and burdens of ownership, a license effects the transfer of only *some* of the rights associated with outright ownership of the property, such as the right to use the property for a particular purpose, for a specified time, or in a certain location.

Whether the payment passing from the licensee to the licensor is characterized as a royalty or proceeds from a sale is important because that characterization dictates the source of the income for purposes of taxation. Crucially for the U.S. holder of the intangible property who wants to license the property abroad, royalty income is sourced to the country where the property is to be used. However, income from a sale of the same property is sourced to the residence of the seller—in this case, the United States[3]

Therefore, in order to avoid having the payment(s) for the use of the intangible property be characterized as income from a sale and thus taxable as U.S. source income, the licensing agreement should specify that the payment(s) is contingent on the productivity, use, or disposition of the intangible property and should avoid a transfer of so many of the rights associated with a fee simple for so long a period of time as to look like a perpetual license. For purposes of the U.S. Model Treaty, the term ''royalty'' refers to ''payments of any kind received as consideration for the use of, or the right to

[2] In response to the evolution of the United States' relationship with the international community since an earlier version was promulgated in 2006, the Treasury released a revised version of the U.S. Model Treaty in February 2016.

[3] IRC §§ 861(a)(4), 865(a) and (d).

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use, any copyright of literary, artistic, scientific or other work (including cinematographic films); any patent, trademark, design or model, plan, secret formula or process; or for information concerning industrial, commercial or scientific experience.''[4] In order to avoid having the payments for say, the use of a patented gene, characterized as income from a sale and thus taxable as U.S. source income, the licensing agreement should specify that they are contingent on the productivity, use, or disposition of the intangible property and the agreement should avoid a transfer of so many of the rights associated with a fee simple for so long a period of time as to look like a perpetual license. In particular, the license should be non-exclusive and non-transferable, and the licensor—as opposed to the licensee—should retain the right to sue for infringement.

Other U.S. Income Tax Considerations: SUBF

Even if the license payments from the foreign affiliate are not determined to be U.S. source, Subpart F of the Internal Revenue Code (''IRC'') may operate to include them in the U.S. licensor's taxable income anyway. Subpart F aims to prevent U.S. taxpayers from setting up controlled entities, called Controlled Foreign Corporations (''CFCs''), in low-tax jurisdictions and then deferring payment of U.S. tax on the CFC's income by choosing not to send any of it back to the U.S. entity. The Subpart F rules include in the U.S. taxpayer's taxable income all Foreign Personal Holding Company Income (''FPHCI'') earned by a CFC, which includes passive income such as royalties, even if the CFC does not actually distribute any money to the U.S. entity in a given year.[5] Fortunately, there is an exception for certain royalties that can prevent the U.S. holder from getting caught in this snare.

Royalties are excluded from Subpart F income and therefore from the U.S. property holder's taxable income if they are received in an active trade or business and from a person unrelated to the CFC.[6] Royalties are received in an active trade or business if they satisfy either the ''active development test'' or ''active marketing test'' set forth by the Treasury. To satisfy the active development test, the officers and employees of the CFC must engage in activity that adds ''substantial'' value to the intangible property and the CFC must be regularly engaged in the development, creation, production, or acquisition of that same type of intangible property.[7] Alternatively, the active marketing test requires that the CFC, through its own employees located in a foreign country or countries, operate an organization in such foreign country or countries that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property.[8] Furthermore, this organization must be ''substantial'' in relation to the amount of royalties derived from the licensing of the property.[9]

[4] U.S. Dep't of Treasury, United States Model Income Tax Convention, Article 12, § 4 (Feb. 17, 2016).
[5] IRC §§ 951(a)(2), 952, 954(c).
[6] *See* Treas. Reg. §§ 1.954-2(d)(1), 1.954-2T(d)(1).
[7] Treas. Reg. §§ 1.954-2(d)(1)(i), 1.954-2T(d)(1)(i).
[8] Treas. Reg. §§ 1.954-2(d)(1)(ii), 1.954-2T(d)(1)(ii).
[9] Treas. Reg. § 1.954-2T(d)(1)(ii).

Related Party Aspects of Cross-Border Licensing: Transfer Pricing and Valuation of Intangible Property Rights

When the licensor and licensee are related parties the issue of consideration becomes more complicated than simply haggling over what price a licensee is willing to pay for the privilege of exploiting the intangible property. It might seem as if the fact that the parties are related should instead make it easier to effect a transfer of rights, since the transaction seems akin to paying oneself. However, the transfer pricing guidelines promulgated by the Organization for Economic Cooperation and Development (''OECD'') prevent a licensor from transferring intangible property rights to a related entity at a discounted rate or from simply making a gift of them.

The purpose of the OECD guidelines, and of the IRC's provision permitting the Secretary of the Treasury to reallocate income and deductions or credits among related entities, is to clearly and accurately reflect the income attributable to the transaction and prevent entities in high-tax jurisdictions from shifting profits to their related entities domiciled in jurisdictions with very low, or perhaps no, taxation (resulting in so-called ''base erosion'' in the higher-tax jurisdiction).[10] For example, suppose a U.S.-based developer of a synthetic drug candidate molecule wants to license it to its affiliate in Country X, where the affiliate will further develop the molecule and ultimately manufacture and distribute a best-selling pharmaceutical product. Further suppose that Country X imposes a very low tax rate on the income the affiliate earns through selling the product in Country X. The less the U.S. licensor charges to the foreign affiliate licensee, the greater the affiliate's profits in Country X will be (since its costs, which include the cost of the license, will be lower). Since Country X has such a low tax rate, the profits available to send back to the U.S. licensor or to reinvest in the affiliate's Country X operations will be greater than if the U.S. licensor had demanded a higher royalty. Moreover, the less the affiliate pays in licensing fees back to the U.S. licensor, the less income the U.S. holder of the intangible property will have subject to the higher U.S. tax rates.

Transfer pricing is not all doom and gloom for multinational businesses, however. It should be noted that correct transfer pricing benefits the taxpayer by avoiding international double taxation. In the example above, if the United States thought the royalty paid by the affiliate was too low it could try to tax an additional chunk of the income earned by the affiliate in Country X. Meanwhile, if Country X disagreed with the U.S. taxing authorities and persisted in taxing all of the affiliate's income, a portion of the affiliate's income would be taxed both by Country X *and* by the United States, resulting in a double tax.

In any case, the question remains: How much should the licensor charge a related licensee? The answer is the ''arm's length'' price, or the price that the licensor would otherwise charge to an unrelated independent licensee. When there is an active market in comparable intangible property like a reagent formula such that it is possible to identify transfers made under similar conditions, there are three market-based methods for deter-

[10] *See* IRC § 482.

mining the value of the rights being transferred. Depending on the information available and the type of arrangement between the parties, they should select the valuation method that will best provide a reliable indication of the property's fair market value. A royalty ranging from 5 percent to 10 percent of the licensee's gross sales is generally the optimal market-based measure of the worth of the license. Unless the market for the product is extremely inelastic, a licensor who is tempted to charge a higher royalty should be mindful that doing so could reduce overall sales volume, thereby ultimately decreasing royalty income.

First, the Comparable Uncontrolled Transaction (''CUT'') method assumes that the parties have access to robust information concerning a transfer of comparable intangible property, used in a similar product or process, in the same general industry, with similar potential for generating a profit.[11] Since the goal is to base the pricing on as near to an identical transaction as possible, akin to how real estate brokers might decide to price a house, the more similarities among the transactions the more reliable the estimation of a true market price will be. The U.S. Department of Treasury regulations (''Treasury Regulations'') encourage taxpayers to consider similarities in the terms of the license (including its duration and geographic scope), the stage of development of the intangible, the licensee's right to receive any updated versions of the property, the uniqueness of the property and the period for which it may remain unique, and any economic or products liability risk to be assumed by the licensee, among other factors.[12]

In some cases, two parties may agree to share the various costs associated with researching and developing intangible property by entering into a cost-sharing agreement (''CSA'') rather than a typical licensing agreement. The parties may choose to use the Market Capitalization Method (''MCM'') or the Acquisition Price Method (''APM'') to determine the arm's length value of the pre-existing intangible property that either or both parties are bringing to the table, and therefore the price that a party must pay to ''buy in'' to the CSA and take advantage of the intangible property resource contributed by the other while sharing the risks associated with its development. The MCM aims to estimate the value of the property by calculating its residual value in the hands of the original holder. Beginning with the total value of that entity based on a combination of its market capitalization (the value of shares outstanding) and its liabilities, subtracting the value of the holder's assets and that of any other intangible property of which the value is already known will yield a residual value that can be used to estimate the worth of the intangible property in question.[13]

Alternatively, the APM enables the parties to back out the value of the property using a method similar to the MCM when it is not possible to determine the market capitalization of the property holder, for example, because it is not a publicly traded company such that the value of its outstanding shares is not readily known. When the holder has acquired the property by way of its acquisition of another entity, subtracting the value of the target's tangible property and of any other intangible property from the purchase price of the target's stock or assets (increased by the purchaser's assumption of any of the target's liabilities, if the latter) yields an estimated value of the relevant intangible property.[14]

When information regarding comparable transfers is scarce or simply nonexistent such that using a market-based valuation method is impracticable, the parties may base the cost of buying in to the CSA on the present value of the income they expect the shared intangible property to generate. Proper application of this ''income method'' requires taking into account the present value of each party's ''best realistic alternative'' to entering into the CSA (meaning licensing the property without any agreement between the parties to share the research and development costs) and determining not only the appropriate discount rate to apply to each alternative, but also the useful life of the property and the magnitude of the expected earnings and operating costs.[15]

Conclusion

As U.S.-based holders of intangible property seek to expand their business operations across the globe, it can be advantageous from a legal and tax perspective to do so through a properly planned licensing arrangement. Cross-border licensing can help a business achieve its twin goals of growth through increased collaboration and knowledge-sharing, and protection of what may constitute the business's most valuable assets.

[11] Treas. Reg. § 1.482-4(c)(2)(iii)(B).
[12] *Id.*
[13] Treas. Reg. § 1.482-7(g)(6).
[14] Treas. Reg. § 1.482-7(g)(5).
[15] Treas. Reg. § 1.482-7(g)(4).

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