New Tax Rules Affect Licensing

BY JOHN WILLS*

How to be prepared to defend your technology transactions when the tax man raises questions under the new U.S. regulations

The purpose of this article is to explain what licensing executives need to know about new U.S. tax regulations affecting licenses of technology and other "intangible corporate assets." I avoid tax-technical detail entirely, and focus instead on practical suggestions that may be of help to R&D managers and licensing executives.

My work brings me into contact with a number of corporate R&D and licensing advisors as well as with tax directors. It is my impression that, in most companies, the two groups have only limited interaction. Tax directors generally stay out of the business aspects of technology transfer. Licensing executives usually have a general idea of some of the tax aspects of technology transfers, but usually leave these to the tax director. Certainly, such a division of labor basically makes sense.

At the same time, however, new U.S. tax rules greatly expand the range of issues on which the tax director must take not merely a legal position, but also a *factual* position. Such matters include the comparability of different technologies, the value of technologies, and so on. These factual issues arise in two contexts: *Audits* by the U.S. Internal Revenue Service of tax returns submitted in the past, and *planning* decisions being taken now to avoid such audits in the future. As a result, I am seeing tax directors turn to licensing and R&D personnel to a much greater degree than in the past.

WHAT ARE THE ISSUES?

There are two broad sets of tax issues that are relevant to the licensing executive: Those that pertain to *all* technology transfer transactions, and those that apply only to transactions with *related parties*. Exhibit 1 lists the broad issues.

TAX ISSUES ASSOCIATED WITH TECHNOLOGY TRANSFER

I. Issues That Apply to All Transactions
   License vs. sale
   Capital gain vs. ordinary income
   Character of payment for foreign tax purposes
II. Issues That Apply to Transactions With Related Parties
   Have intangibles been transferred without royalty?
   Are terms of the transaction "at arm's-length"?
   Is the royalty amount "commensurate with the income" attributable to the technology?
   Are R&D costs shared fairly?

Exhibit 1

By far the most controversial issues today, and the focus of this article, are those that deal with transactions with related parties, that is, transactions with corporate affiliates, subsidiaries, or parent companies located in other countries. This article does not discuss general tax issues, because (a) they are less controversial and less likely to create disputes with the IRS, and (b) even when such disputes arise, they are almost entirely tax-legal issues in which a licensing executive is unlikely to be involved.[1]

The tax issues surrounding technology transactions with related parties have become so controversial that if you have such transactions, it is highly likely that the IRS will inquire into them and ask your company to justify its practices. And if your transactions involve licenses of technology into tax-havens like Ireland, Singapore, or Puerto Rico then IRS inquiry is a virtual certainty.

The tax definition of "related parties" is quite broad. The counterparty to the transaction need not be a legally controlled corporation in order to be a related party. 50/50 joint ventures with outsiders, for example, can be treated as related party transactions to which these rules apply. And the IRS has recently begun to argue, in the case of Japanese kereitsu (or corporate "families") that even small cross-stock holdings can create a related party. Generally speaking, however, a related party is who you would expect it to be: A parent corporation, a subsidiary corporation, or a brother/sister corporation.

WHY ARE THESE ISSUES ARISING NOW?

When evaluating related-party transactions, the tax authorities of virtually every country subscribe to the "arms-length" standard: The terms of the transaction will be acceptable if they are the same as those that would have been adopted by unrelated parties under the same facts and circumstances. When you're dealing with homogenous products with well established markets (for example, aluminum ingots) the arm's-length standard makes a lot of sense. But when you're dealing with unique products or technology, there are few

1. A general survey of general income tax issues associated with technology transfer, written for the layman, is Johnson, Steven K. and John Teemley, "Avoiding the Tax Bite on Technology Transfers. Part I: General Income Tax Considerations, "*The Licensing Journal*, 10 No. 9 (October 1990), 3-5.

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market benchmarks, and whether a transaction was at arm's-length becomes inherently judgmental and uncertain.

The U.S. IRS and many government policymakers have become convinced that taxpayers are using artificial license terms to shift income outside of its reach. There have been several Congressional hearings and a number of reports in the press on this subject. With respect to *outbound* transactions (U.S. licensor, foreign licensee), the IRS has alleged that the royalty practices of a number of corporations resulted in moving technology offshore without arm's-length compensation.

APPROXIMATE SHARE OF INCOME AVOIDING U.S. TAX USING TAXPAYER'S PROPOSED ROYALTY RATES

Company/ Product	Share of Income Avoiding U.S. Tax	Affiliate Located In
Eli Lilly/ Darvon	81%	Puerto Rico
Bausch & Lomb/lens spin-casting technology	94%	Ireland
Sundstrang/ Aircraft generator speed governor	95%	Singapore

Exhibit 2

Exhibit 2 illustrates recent cases that the IRS has brought to court. Moreover, the IRS believes that not only are U.S. companies shifting income to their foreign subsidiaries, but foreign parents are also stripping income out of their U.S. subsidiaries by the mechanism of non-arm's-length prices and royalty rates. This allegation is partially based on the observed disparity of profitability between subsidiaries of U.S. vs. of foreign parents, as illustrated in Exhibit 3.

RATE OF RETURN ON INVESTMENT EARNED

By Affiliates Abroad of U.S. Parents	By U.S. Affiliates of Foreign Parents
6.5%	1.0% - Overall
	1.5% - Canada
	1.4% - EC Countries
	0.2% - Japan

Exhibit 3

In response to these concerns, the IRS convinced Congress to take a number of steps. One step Congress took was to enact new penalties. The penalties take effect whenever the IRS determines that the company's royalty rate differs from the arm's-length rate by more than a factor of two (or one-half). The penalties are nondeductible and nondiscretionary. They put a premium on getting your intercompany royalty rate at least in the right ballpark.

In addition the IRS has argued that companies were moving their "crown jewels" offshore, and that industry average royalty rates didn't reflect the true value of the transferred technology. So Congress in 1986 added a single sentence to the relevant statute, saying that when a company licensed technology abroad, the royalty it brought back had to be "commensurate with the income attributable to the technology." This is commonly called the "super-royalty" provision. It is usually interpreted to mean that a royalty for a high-profit intangible must be set at an extraordinarily high rate in order to repatriate all of the income associated with it. And the income associated with the technology was to be measured as any profits in excess of a fairly modest level.

In January of the year the IRS finally released its proposed regulations to govern this area. The regulations, which are 150 pages long, generally adopt the tough position that the IRS has been taking all along with respect to technology royalties. Companies must justify their intercompany royalty rates. Evidence from allegedly comparable transactions with unrelated parties will be allowed only if a very stringent test of "comparability" is met. And the ultimate test of whether an intercompany technology transfer was at arm's length is the amount of profit that it generates for licensee and licensor.

The IRS has provided one "out" from these regulations, however. Companies can avoid levying *any royalty at all* on their affiliates if they engage in R&D cost-sharing joint ventures with them, and if those ventures meet the several tests established for them by the IRS. We will describe this "out" in greater detail below.[2]

The tough tenor of the proposed regulations should not be cause for panic. For one thing, the regulations may be modified before they are finalized. Moreover, the illustrations I have used are the most dramatic cases. IRS field auditors don't necessarily treat every company like Lilly, nor every product like Darvon. But clearly a much higher degree of justification of licensing practices will be required in the future than has been the case in the past.

WHAT DOES THE LICENSING EXECUTIVE NEED TO KNOW?

What does the licensing executive need to know about these regulations? I've identified two sets of questions that licensing experts are most likely to be asked: Questions about licensing practices and questions about R&D cost sharing arrangements. Exhibit 4 shows the first set.

MOST FREQUENTLY ASKED QUESTIONS PERTAINING TO LICENSING

1. Have we transferred technology?
2. What are prevailing royalty rates for similar technologies?
3. Are those technologies and markets "comparable"?

Exhibit 4

1. Have we transferred an intangible? At first glance this seems obvious. Either you have or you haven't. But it's surprising how many companies have inadvertently transferred intangible assets offshore. In the first place, the definition of covered intangibles is fairly extensive, and includes "patents, inventions, formulas, processes, designs, patterns, or know-how" as well as a host of marketing-oriented intangibles.[3] In addition, intangibles are sometimes transferred in conjunction with other goods or services, so-called "embedded intangibles." Software embedded

2. A second "out" is available through prenegotiated agreements with the IRS. Negotiating such agreements requires essentially the same information as does an audit defense.

3. The full list is contained in section 936(h) of the Internal Revenue Code.

in hardware is the most obvious of these, but there are others, including technology embedded in technical services. So the first task of the licensing executive is identifying and advising with respect to what intangible assets have been transferred.

2. What are prevailing rates? This is the most frequently asked question in my experience, and the one that's rarely answered adequately. The key point is that anecdotes don't qualify as answers, only documents do. And it's hard to lay your hands on technology licenses, for obvious reasons. But there is one thing you can do that's low cost, namely, acquire licenses for similar technologies filed by public companies with the Securities and Exchange Commission (SEC) as "material contracts." Carrying out a search strategy requires some planning, but there are commercial firms that specialize in locating documents at the SEC.

3. Are these technologies comparable? Exhibit 5 lists the criteria the IRS uses in evaluating comparability. There is no bright line test for comparability. It is frequently a contentious issue with the IRS. There's no guarantee that your assertions of comparables will ultimately stand up. But at least you should have a formulated position, and this is a factual issue that is typically entirely beyond the tax department's competence to address.

COMPARABILITY: ECONOMIC CONDITIONS AND CONTRACTUAL TERMS

Economic Conditions

- Relative size of each market
- Economic development and competition
- Product acceptance
- Collateral transactions or on-going business relationships between the parties
- Functions performed and economic risks undertaken by each party

Contractual Terms

- Amount and form of consideration
- Duration of contracts and any termination/renegotiating rights
- Accelerating or delaying payment
- Functions performed by each party, including ancillary services (i.e. technical assistance, marketing, etc.)
- Interest in intangible and limitations on use

Exhibit 5

WHAT ABOUT COST SHARING?

Many companies are entering into R&D cost-sharing joint ventures with affiliates to try to avoid these super-royalty provisions. A properly constructed R&D joint venture can indeed get you around these regulations, but the key thing to remember is "properly constructed." Not only must the shares of cost borne by each partner pass muster with the IRS, but if one partner (typically the U.S. parent) has gotten the ball rolling by kicking in partially developed technology, then the IRS wants to see any additional "buy-in" payment from the other partners.

The evaluation of whether replacing licenses with R&D cost sharing makes sense for your company is itself a technical issue. But assuming that you've decided to go ahead with it, the R&D director will have a number of questions to answer. The questions that arise most frequently are listed in Exhibit 6.

MOST FREQUENTLY ASKED QUESTIONS REGARDING COST SHARING

1. What part of our R&D spending should be shared?
2. Are we owed a "buy-in" payment for work in progress or "foundation" technology?
3. How should we phase out royalties on old technology?

Exhibit 6

With respect to R&D cost sharing, the right cost tracking system is the key. The name of the game is to minimize the importance of abstract valuation questions (like "how much is/are partially developed software, which only we can use and which we think has good market prospects, but aren't sure, worth on today's market?") In many cases, these terribly difficult valuation questions can be avoided and replaced with much more objective and readily understandable cost allocation questions, *if* you have the right kind of cost tracking system. Because valuation issues are fertile grounds for breeding disputes with the IRS, it is best to avoid them whenever possible.

The key to avoiding valuation issues is to have an R&D cost tracking system that answers the right questions for you. The key feature of such a system is that it links costs incurred to products or product lines. Direct tracking or assignment of all costs may not be necessary; formulary apportionment may be sufficient provided the formula can be justified.

To explain just how such a database gets used to answer the buy-in and royalty phase-out questions is beyond the scope of this article. Basically, there are tradeoffs between the degree of detail kept and the strength of the defensive record that is built. What position to take on these tradeoffs depends on your own assessment of how much exposure you face.

That exposure, in turn, depends on characteristics of the technology (i.e. how similar are the technologies underlying different products?) and profitability of different product lines. But the cost tracking system need not be excessively complicated. In my experience, many firms already have much of the system in place for financial reporting purposes. And getting your R&D costs into a suitable system is, by a mile, less burdensome than answering the types of questions that arise when the IRS gets into the act.

In sumamry, the licensing executive is increasingly called upon to help establish and defend, before the tax authorities, a company's technology transactions with its affiliates. To do so effectively, the licensing executive should:

1. Anticipate the questions the IRS is going to ask. This article has given you a sense of what those will be.
2. Answer them to the best of your ability. Even if you can't answer them perfectly, don't just ignore them.
3. Document your answers, and do so *before* the IRS arrives. Your goal should be to have a file document such that, when the IRS knocks, you can pull out the document, hand it over to them, say, "Thank you for your interest," and escort them out the door.