# TRANSFER PRICING - THE IP PARADIGM - U.S. CONTEXT

1. MEDTRONICS CASE
2. IP VALUATION METHODS
3. CASE STUDY

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# The IP Paradigm

- Move IP offshore from the U.S.
- I.P. moved to a lower taxed country
  - Little or no upfront U.S. tax cost
- I.P. exploited by lower taxed country entity
  - Licensed to affiliates in higher taxed countries
- No Current U.S. Subpart F Tax
- Overall lower worldwide effective tax rate on exploitation of IP

# MEDTRONICS

A Cautionary Tale

# Medtronics and the IP Paradigm

- Currently in litigation in the U.S. Tax Court
- I.R.C. 936 “Possession Company” provisions sunset requiring IP formerly licensed to the possession company by the U.S. to be licensed to a C.F.C.
- I.R.S. IP related positions:
  - The possession company transferred IP to the C.F.C in a taxable transaction (either good will or developed).
  - The C.F.C.’s compensation for the IP was not arms-length either under a cost sharing buy-in or license fee arrangement.
  - The C.F.C.’s subsequent intercompany pricing for property or services must account for transferred IP in the form of goodwill from the possession company which must be valued.

# Medtronic's Position

- 2000-2002 Memorandum of Understanding (MOU) establishing arms-length license fee for IP licensed to possession company is controlling.
- MOU reflected on 2003-2006 tax returns.
- I.R.S. IP position increases post 2002 royalty rates
- Medtronics then argues an affirmative adjustment from MOU rates for post 2002 to arms-length under CPM Profit Split/CUT
- I.R.S. counters with CPM Return on Assets methodology (addressing the goodwill and any IP developed by the possession company)

# Medtronics Take-Aways

- Goodwill represents valuable IP that must be separately valued.
- Possession corporation added value to the IP it licensed from the U.S.  justifying a higher royalty to the U.S. from the C.F.C.
- The I.R.S. will ignore a MOU.
- The I.R.S. will challenge CPM/CUT IP transfer pricing.

# THE IP PARADIGM-IP VALUATION METHODS

Recognized Valuation Methodology

# Identified Valuation Methods

Transactional; Financial reporting; Litigation; and Bankruptcy settings

- Cost Based Approach
- Comparable Market Transactions Approach
- Income Approach
- Relief from Royalty Approach

# Identified Valuation Methods (cont'd)

- Cost Based Approach
  - Measure future benefits of owning IP
  - Measure based on incurred development costs or on amount required to replace future service capability of the asset
  - Negative aspect: Can lead to an excessive valuation where high levels of expenditure have been incurred on a less successful asset.
  - Query: do IP development costs accurately reflect IP income potential?

# Identified Valuation Methods (cont'd)

- Comparable Market Transactions Approach
  - Value of IP determined by reference to prices obtained for comparable IP in recent transactions
  - Requirements: active market, exchange of comparable assets, access to price information, transactions reflecting market values
  - Query: Are there non-market factors that will affect the IP value?

# Identified Valuation Methods (cont'd)

- Income Approach
  - Value = the present value of future cash flows generated over the useful life of the IP
  - Focuses on the future risks and the economic life of the IP
  - Requirements: detailed projections of US and ex-US businesses, benchmarks for allocation of routine returns, understanding of useful life, and derivation of discount rates.
  - Query: are there too many variables with too much subjectivity in the determination thereof?

# Identified Valuation Methods (cont'd)

- Relief from Royalty Approach
  - Value = capitalized value of after-tax royalties that the company is relieved from paying due to its ownership of the IP (for transfer pricing purposes computations are performed on pre-tax basis)
  - Determined by standard industry values, practices or comparable transactions
  - Key consideration: appropriate royalty rate
  - Query: How accurate is the delta to the business forecasted results "sans" the IP?

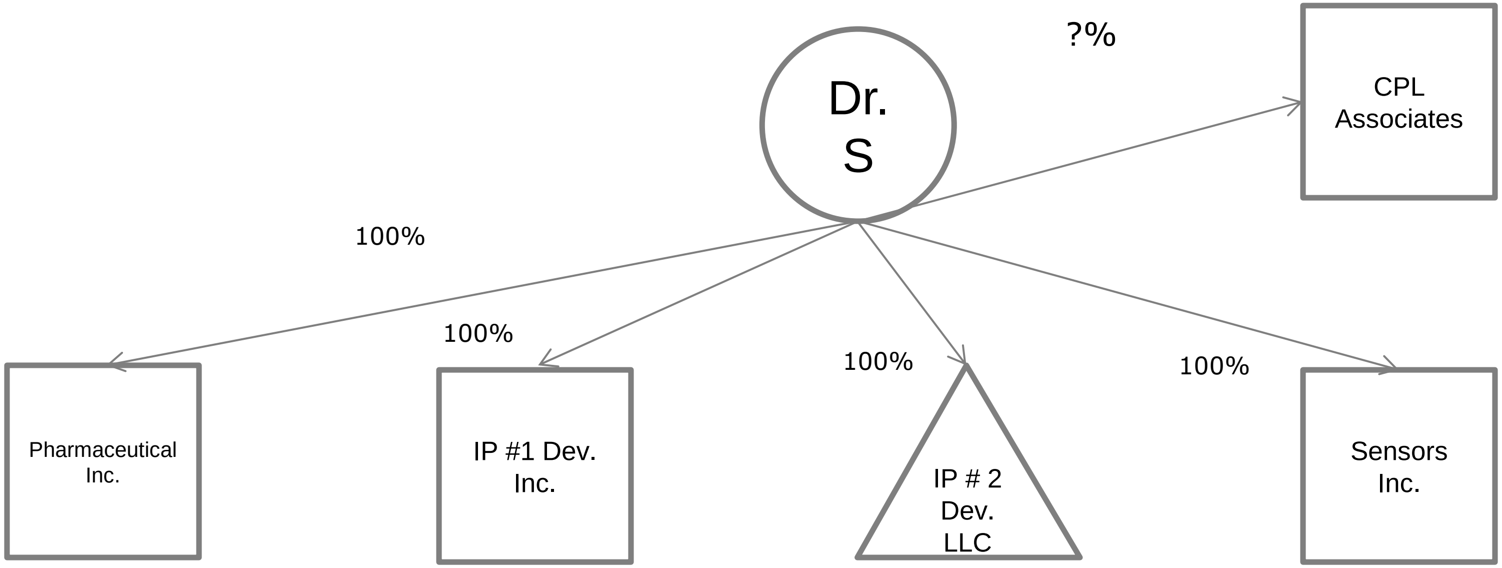
# U.S. CASE STUDY

Migration of Pharmaceutical IP to Europe

# Overview of Engagement

- Background
  - Relevant Existing Legal Entity Structure
  - Identification of IP
  - Relevant Existing/Pending Commercial Agreements
- International Business Strategy
  - Future Business Scenario
- Tax/Valuation Aspects of Future Business Scenario
- Conclusions/Recommendations/Path Forward

# Relevant Legal Entities



# Identified IP

- Four Product Applications, Related R&D and Patent and Patent Applications from internally developed Metabolic Platform
  - Metabolic syndrome oral medication
  - Medical Devices to monitor the  body’s reaction to various pharmaceuticals, cancer and sepsis
  - Oral Insulin
  - Alzheimers
- Trademarks
- Research and consulting service ability

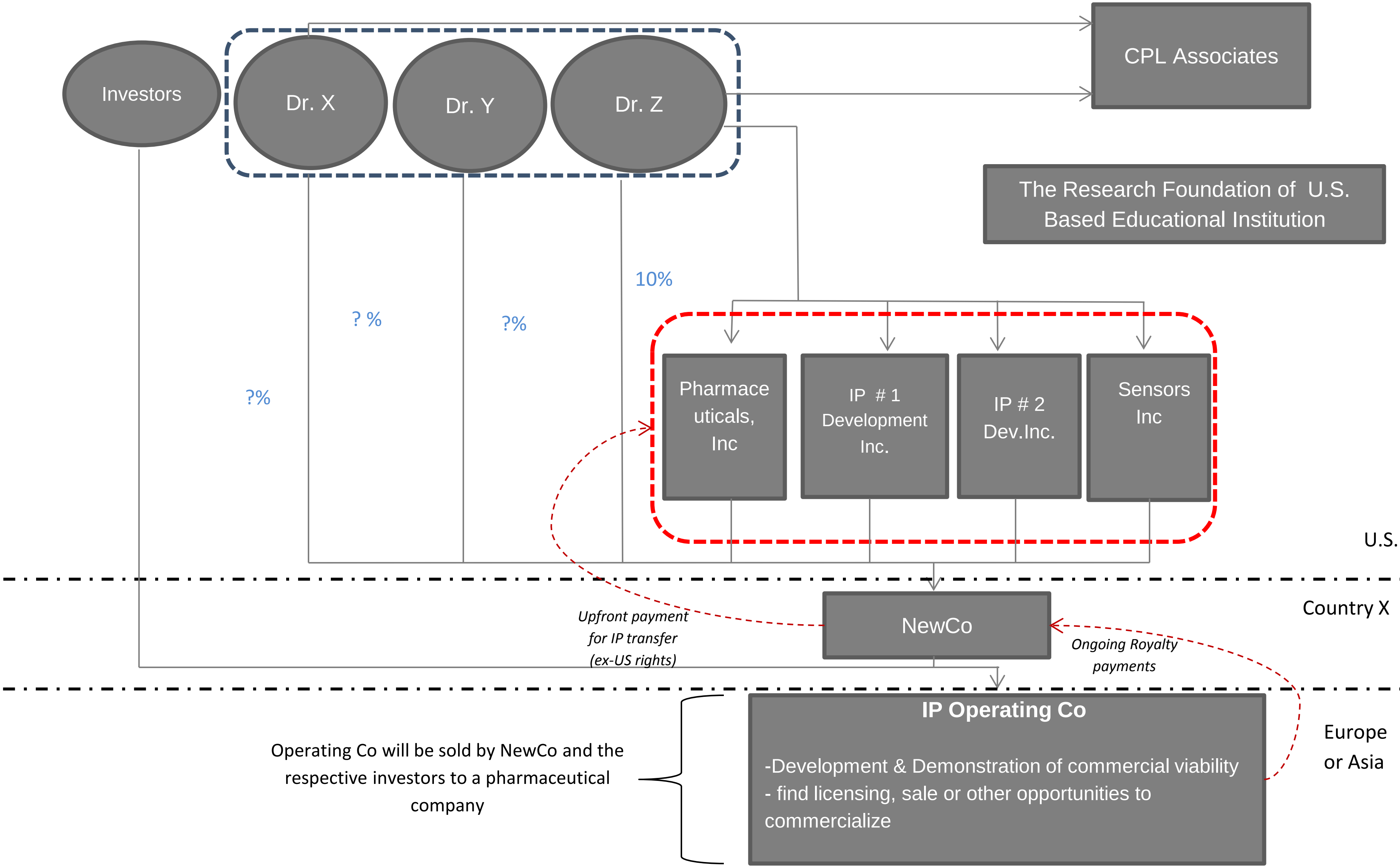
# Relevant IP Agreements

- Oral Medication LLC
  - Licensed from Client Companies
  - Contract with CPL Associates for Conduct of Clinical Trials
- Client Companies
  - License of IP from individual inventors
  - License to U.S. Educational Institution Medical Facility of Oral Medication

# Future Business Scenario

- Migration of IP outside the U.S. With Minimum U.S. Taxation
- Establishment of Non-U.S. Operating Companies
  - Europe
  - Asia
  - Middle East
- Non-U.S. IP Holding Company
- Leverage Non-U.S. Markets Receptiveness to IP Particularly Oral Insulin
- Position for a Future Revenue Event (Sale etc.)

# Proposed Structure



# Issues Presented

- Where Should the IP be Held?
- How Should the IP be Valued?
- What is the Relevant Values of the IP
- What IP should be Migrated Offshore?
- How can the IP be Migrated Offshore?

# Where Should the IP Be Held?

- Do not hold the IP a new C corporation.
  - Subjects IP to a 35% Entity Level Tax.
  - No Real Benefit Unless You Take The C Corp Public In the Near Future.

# How Should the IP Be Valued?

- By Reference to How It Generates Value to the Owners
  - Revenue Based
  - Cost Savings
  - Competitive Advantage
  - Sale
- By Reference to Remaining Useful Life
- By Reference to Legal Encumbrances
- By Reference to Barriers to Market

# Confirm the Relative Values of the IP

- Meta-Brake Most Valuable
  - LLC Offering
  - Clinical Trials Underway or Pending
- Oral Insulin Least Valuable
  - Nascent IP In More Conceptual Development Stage
- Alzheimer's & Device
  - Immaterial or Irrelevant to Future Business Scenario

# What IP Should Be Migrated Offshore

- Oral Insulin

# How Can Oral Insulin  Be Migrated Offshore?

- Special Purpose Entity In Tax Favored Jurisdiction at Fair Market Value Consideration?

# Form a Lux SARL to hold the IP. "IP Box"

- SARL stands for Société à responsabilité limitée.
  - Private limited company
  - Limited liability
- Under this structure, a Lux SARL is formed to hold the IP under Lux's favorable IP box regime.
  - SARL subject to 28.59% Lux tax.
  - However, IP box provides for 80 % tax exemption.
  - Net tax rate is 5.72%.
  - CTB to treat as partnership.

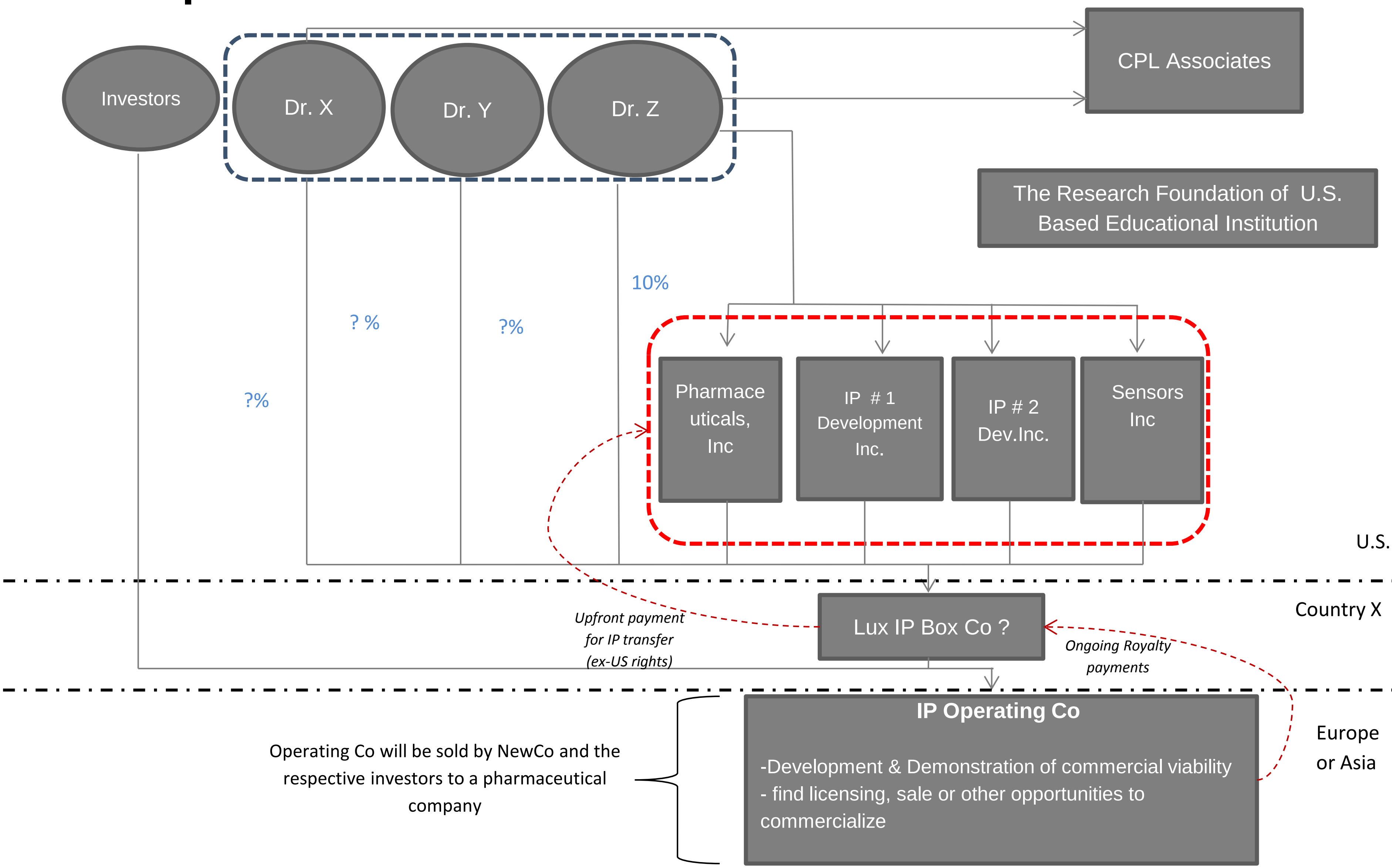
# Form a Lux SARL to hold the IP. “IP Box” - Cont’d

- Requirements
  - Eligible Entity
    - Luxembourg taxable companies, Luxembourg businesses owned by individuals (directly or through transparent entities), or Luxembourg permanent establishments of foreign companies can benefit from the IP Box.
  - Eligible Asset
    - Includes trademarks.
  - Post 2007
    - IP rights must have been constituted or acquired after 31 December 2007
  - No related party
    - Must not have been acquired from a directly related company, which means:
      - It owns at least 10 % of the share capital of the eligible entity; or
      - The eligible entity directly owns at least 10 % of the share capital of such company; or
      - A third company, holding at least 10 % of the share capital of the eligible entity is also directly holding at least 10 % of such company.

# Form a Lux SARL to hold the IP. “IP Box” - Cont’d

- Benefits of Structure
  - Corporate
    - Limited Liability.
    - Separates the IP from NY LLC liability.
  - Federal Tax
    - LTCG.
    - Long-term: if decision is made to go public & taxable as corporation, should reduce Federal income tax liability.
  - SALT
    - NY may disallow related party royalty payments (need to confirm).
    - If taxpayer moves out of NY, can escape personal income taxes on sale of shares of Lux Co.

# Proposed Structure



# Conclusions/Next Steps

- Migration of Oral Insulin IP Can be Done Without Complications of Existing Agreements
- Confirm Proper Valuation Methodology of Oral Insulin IP
- Implement Proposed Structure (Phase II)
  - Documentation of FMV IP Transfer
  - Necessary Legal Entity Formation
  - Necessary Related Party Agreements
- Incorporate B.E.P.S. Action Item 8 Protocols-Revised Chapter VI
  - Identification of IP
  - Legal ownership of IP
  - Contribution to IP development and exploitation by each affiliate
  - Confirm IP functions and risks.

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