I.P. CONTRACTS FROM A U.S. TAX PERSPECTIVE

GENERAL DATA PROTECTION REGULATION AND INTELLECTUAL PROPERTY: AN UNPRECEDENTED PAIRING

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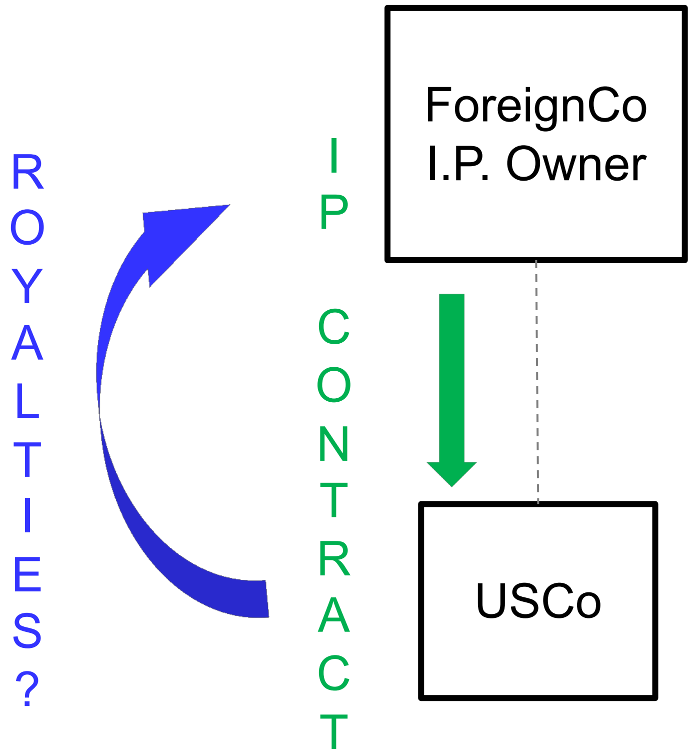
I.P. Contracts and U.S. Tax Implications – Key Items

- Tax Clause
- Scope
- Payments
- Who are the parties to the I.P. agreement?
- Where is the recipient located?
- Further Considerations

Royalties

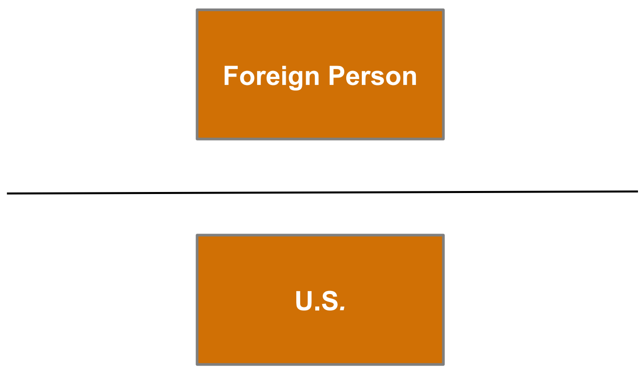


- Is the income E.C.I. or F.D.A.P.?
- Is the income U.S. source?
- Character of income
- Are the parties related?
- Is an income tax treaty between the U.S. and ForeignCo's jurisdiction in place?
- Documentation/reporting obligations
- Anti-abuse provisions

U.S. Federal Income Tax

- As part of a comprehensive tax reform enacted end of 2017, U.S. Federal income tax is imposed at a flat rate of 21% for corporations from 2018 onwards.
- New law introduced, *inter alia,*
  - a deduction for foreign derived intangible income ("F.D.I.I."), as well as
  - Global Intangible Low Taxed Income ("G.I.L.T.I."), a new type of foreign income which will be subject to the C.F.C. immediate tax rules at lower rates of U.S. tax.
- The reduced corporate rate, the deduction available to F.D.I.I., the expanded C.F.C. rules, and the introduction of G.I.L.T.I. eliminated the incentive for shifting income to foreign jurisdictions.
- From an inbound perspective, the 30% U.S. withholding tax ("W.H.T.") rate on certain payments to non-U.S. persons remained unchanged.

U.S. Taxation of Foreign Persons



- When is a foreign person a non-U.S. person?
- Whether a foreign entity is treated as separate legal entity or 'pass-thru'
- Three types of income that a foreign person may receive:
  - Fixed and Determinable, Annual and Periodic Income ("F.D.A.P.")
  - Effectively connected income ("E.C.I.") from the conduct of business operations
  - Income and gains from the disposition of investments in U.S. real estate (taxable under the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."))

U.S. Taxation of a Foreign Person (cont.)

- F.D.A.P.
  - F.D.A.P. income is subject to 30% U.S. WHT. The tax can be reduced or completely eliminated under an applicable income tax treaty.
  - No deductions are allowed to reduce the base on which the 30% is imposed.
  - F.D.A.P. income generally consists of income from passive activities such as dividends, interest, triple net lease rents and royalties arising from U.S. sources, as defined.
- E.C.I.
  - E.C.I. consists of income attributable to the conduct of a trade or business in the U.S.
  - Whether a corporation is engaged in a U.S. trade or business depends on the facts and circumstances. The determination is based on the nature and extent of the corporation's economic activities in the U.S. that are carried on directly or through an agent, partnership, trust, or estate. The activities must be considerable, continuous, and regular for a trade or business to exist.
  - F.D.A.P. income can be treated as E.C.I. if either of the following tests are met:
    - The asset-use test – in which assets used in a trade or business are sold or otherwise disposed
    - The business-activities test – in which the income that is F.D.A.P. result from the active conduct of a trade or business, such as interest income of a bank
  - Passive rental income can be treated as E.C.I. where an election is made by a foreign corporation.
  - E.C.I. is subject to taxation on a net basis in the U.S.

Royalties – U.S. Trade or Business

- Whether an foreign person is "engaged in the conduct of a trade or business within the United States" ("U.S.T.B.") includes a two-prong test:

  (i) whether the person is engaged in a trade or business; and

  (ii) whether the trade or business is treated as conducted within the U.S.. A nonresident alien may clearly be engaged in extensive "trade or business" operations *outside* the U.S. but his business contacts with the U.S. may be so minimal that a court would not find that he is engaged in trade or business *within* the U.S..

- Except in narrow circumstances, the Code does not contain a definition when a foreign person is engaged in a U.S.T.B.. Consequently, the standards for measuring what constitutes a U.S.T.B. have developed over the years through rulings published by the I.R.S., a few private letter rulings, and various court decisions.

- The Code and regulations do not provide a quantitative definition of U.S.T.B. or easy guidelines. In general, a U.S.T.B. exists if those activities are "considerable, continuous, and regular." See *Pinchot v. Commr.*, 113 F.2d 718, 719 (2d Cir. 1940); *de Amodio v. Commr.*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); *Spermacet Whaling & Shipping Co. v. Commr.*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

Royalties – U.S.T.B.

- This test has both qualitative and quantitative elements. Whether the foreign person is engaged in a U.S.T.B. depends on both the type and the amount of its activities in the U.S.
- Due to the highly factual nature of the inquiry, the I.R.S. ordinarily will not issue advance rulings on whether a foreign corporation is engaged in a U.S.T.B..
- The question whether licensing and selling of intellectual property could rise to the level of a U.S.T.B. has not been fully addressed in any case.
- However, the principles developed under case law should be applicable in this context.
  - Accordingly, some kind of continuous business contacts with the U.S. are usually required in order for a nonresident individual to be U.S.T.B..
  - For example, the Tax Court has held that an activity that is considerable may nevertheless not constitute a trade or business unless it is continuous and regular.
  - Thus, participation in an isolated transaction would not suffice to create a U.S.T.B.. *Pasquel v. Commr.*, 12 T.C. Memo 1431 (1953).

Royalties – Taxation on a Net Basis vs. Withholding Tax

- F.D.A.P. treated as E.C.I.?
  - Asset-use test
  - Business activities test
  - U.S. office or fixed place of business
  - U.S. agent
- Exemption from E.C.I. under certain conditions (limited scope)

Royalties – U.S. Sourcing Rules / Characterization of Income

- Royalties from I.P.: Place where I.P. is used
- Personal services: Place of Performance
- Sale: Depending on category of property
- Special case: Contingent sales

Characterization of Income – Performance of Services vs. Royalties

- *Pierre Boulez v. Commr.*, 83 T.C. 584 (1984)
  - Sales related compensation for recordings
- *Karrer v. U.S.*, 152 F. Supp. 66 (Ct. Cl. 1957)
  - Because the U.S. drug company was the owner of the property rights to Karrer's discoveries, and, hence, income related solely to research services he performed in Switzerland for the U.S. drug company, payments were recast as personal service income, rather than royalty income).
  - In *Karrer*, the government, not the taxpayer, argued for royalty treatment of the payments for the right to exploit Karrer's scientific discoveries in the U.S. The government made this argument because the payments as royalties would have been treated as arising from U.S. sources under the place-of-use source rule for royalty income. U.S. source royalties received by a N.R.A. individual are generally subject to U.S. income tax, unless a treaty provision exempts the royalties from tax.
- *Goosen v. Commr.*, 136 T.C. 547 (2011)
  - Endorsement contracts (see also *Garcia v. Commr.*, 140 T.C. 141 (2013))

Characterization of Income – Royalties vs. Sale

- Any transaction in which an owner of intangible property permits another person to acquire or use the property in return for a payment is described as a transfer, and the agreement of transfer may be either a sale or a license.
- How the parties "label" the agreement is not decisive and may, in fact, be misleading whereas reference to the rights transferred is essential.
- The general rule was laid out by the U.S. Supreme Court in *Waterman v. MacKenzie,* 138 U.S. 252 (1891).
- Transfer of an intangible property right may encompass assigning, granting or conveying either

  (1) the whole patent, comprising the exclusive right to make, use and vend the invention throughout the U.S.; or

  (2) an undivided part or share of that exclusive right; or

  (3) the exclusive right under the patent criteria and throughout a specified part of the U.S.
- Any assignment or transfer, short of one of these, is a mere license, giving the licensee no title in the patent and no right to sue at law in his own name for an infringement.

Characterization of Income – Royalties vs. Sale (cont.)

- An indicator of whether the agreement is a license or a sale is the exclusive transfer by the owner of "*all substantial rights*" in the technology. *Bell Intercontinental Corp. v. U.S.*, 381 F2d 1004 (Ct. Cl. 1967).
- The factors that determine whether a foreign person has disposed of all substantial rights in an intangible include

  (i) geographical considerations,

  (ii) retaining a security interest,

  (iii) reserving a right to use, and

  (iv) the duration of the transferred rights for its entire economic useful life for a defined geographic area.
- If the agreement stipulates the transfer of rights in perpetuity, with no retained rights of use in a specific geographic area, it is generally a sale. On the other hand, a geographic limitation or retaining a security interest, in and of itself, may not change a sale into a license. See*, e.g.,* *Kaczmarek v. Commr.*, T.C. Memo 1982-66; *Franz Martini*, 38 TC 168 (1962).

Eligibility to Treaty Benefits – Limitation on Benefits Article

- Treaty benefits are allowed to foreign recipient NV only if meets one of the tests set forth under the Limitation on Benefits (”L.O.B.”) Article. This is an inherently factual determination.
- Several tests are provided under the L.O.B. Article. The recipient must meet one of those tests in order for it to claim treaty benefits.
  - An individual
  - A State, or a political subdivision or local authority
  - A company, if (i) the principal class of its shares is listed on a recognized stock exchange and is regularly traded, unless the company has no substantial presence in the State of which it is a resident or (ii) shares representing at least 50% of the aggregate voting power and value of the company are owned directly or indirectly by five or fewer companies entitled to benefits under clause (i) of this bullet, provided that, in the case of indirect ownership, each intermediate owner is a resident of either the U.S. or the Netherlands, and meeting other tests if it has a second class of shares with disproportional rights
  - An exempt pension trust, if certain tests are met
  - A not-for-profit organization

Eligibility to Treaty Benefits – Limitation on Benefits Article (cont.)

- An entity that meets an ownership and a base erosion test. The ownership test is that, on at least half the days of the taxable year, qualified residents under one of the above entities other than a publicly traded corporation with no presence in the foreign jurisdiction own, directly or indirectly, shares representing at least o 50% of the aggregate voting power and value of the entity. The base erosion test is that less than 50% of the entity's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of the foreign jurisdiction or the U.S. in the form of payments that are deductible in the treaty country, excluding arm's length payments in the ordinary course of business for services or tangible property and payments in respect of certain financial obligations.
- It is a company for which shares representing at least 95% percent of the aggregate voting power and value are owned, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries, provided it meets the base erosion test previously described. This company is entitled to all benefits under the Treaty.
- It is a company that is engaged in the active conduct of a trade or business in the Netherlands, except as provided below, and the U.S.-source income is derived in connection with, or is incidental to, that trade or business. For this purpose, certain businesses are excluded, including the making or managing investments for a company's own account, unless these activities are banking, insurance or securities dealing carried on by a bank, insurance company or registered securities dealer. The business conducted in the Netherlands must be substantial in relation to the business in the U.S. The business in the Netherlands may be carried on directly, by a partnership, or by connected persons having at least 50% common ownership.

Eligibility to Treaty Benefits – Limitation on Benefits Article (cont.)

- It is a headquarters company, as defined by reference to supervisory functions, location of members in at least five countries, each such member must generate at least 10% of group revenues, but not more than 50%, and the U.S. must represent not more than 25% of group revenue. Each 10% member company must carry on a business, and the U.S. business . A headquarters company is entitled to all benefits under the Treaty.
- It obtains a ruling from the I.R.S. that the establishment, acquisition or maintenance of the foreign recipient company or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under the Treaty.

Royalties under U.S. Income Tax Treaties

- Article 12 of the U.S. Model Treaty typically allocates the right to taxation to the residence country.
- Some treaties provide for a withholding tax the source state may levy, usually at a reduced rate compared to the one under domestic law.
- Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17, but in general advertising and sponsorship fees will fall outside the scope of Art 12.
- In the case of the U.S., unless reduced to zero, the 30% withholding tax rate under domestic law would be lowered to a rate ranging between 5% and 15%, depending on the applicable income tax treaty.

U.S. Transfer Pricing

- In the case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the U.S., and whether or not affiliated) that are owned or controlled by the same interests, the I.R.S. can re-allocate income, gain, loss and deductions among related parties in order to properly reflect the income of each party or prevent tax evasion.
- A taxpayer must select the best method among the pricing methods specified in the regulations to test the arm's-length character of its transfer prices. No hierarchy of methods exists, but the I.R.S. may require certain valuation methods to be used.
- Note that from 2018 onwards, the definition of intangible property was changed to include workforce in place, goodwill and going concern value and "any similar item," the value of which is not attributable to tangible property or the services of an individual. The Treasury Department's authority to require certain valuation methods was also confirmed under these new rules.

Further Considerations

- Who bears W.H.T., if any? – grossing-up; income to recipient
- Documentation obligation for treaty purposes – recipient to provide Form W-8 to payor
- Documentation for transfer pricing purposes
- Reporting obligations – copies of Forms 1042-S to be furnished to recipient
- Pro-forma tax return (Form 1120-F) by foreign recipient – preserving the right to deduct expenses
- Anti-abuse provisions

Important Notice

This presentation is not intended to be legal advice. Reading these materials does not create an attorney-client relationship. The outcome of each case stands on its own merits.