

Tax and the strategic management of intangibles

Intangible assets can create much more value when they are managed in a tax-efficient manner. A number of European countries offer incentives for companies exploiting intangible assets in those jurisdictions

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According to a study carried out in 2007, more than 60% of executives in the technology sector estimated that their companies could extract significantly more value from their intellectual assets by means of active IP management, but that IP management was often treated more as a legal issue than as a business issue. With total global licensing revenues estimated at around US\$500 billion by 2015, efficient exploitation of a group's intellectual assets beyond mere creation, registration and protection has become a must.

Strategic management of an intellectual asset portfolio should aim to achieve additional value via extensive exploitation of the assets and a multi-stage approach. A preliminary IP audit – essentially, a diagnostic of the group's IP functions – would in most cases represent a first step in this direction. Among other things, it would aim to achieve:

- Identification of all intangible assets of the group, including non-registered assets.
- Review of the protection level in order to determine whether it is still accurate and in line with the company's business plan.
- Identification of dormant assets versus active assets, and whether dormant assets are still expected to be used in the production of the group currently or

going forward.

- Identification of new intra-group licensing flows and opportunities for sale or licensing of dormant assets outside of the group.
- Review of existing internal and external licensing agreements in terms of level and calculation of royalty rates, infringements and effective use of the underlying intangible assets by the group's entities.
- Valuation of the whole intangible asset portfolio.
- Synergies which can be created in the group in terms of value creation through centralised holding of the intangible assets (whether fully centralised or on a regional or product line basis).

While the above list is not exhaustive, three aspects are paramount in terms of starting to extract additional value from the company's portfolio: identification of all intellectual assets, valuation of the intangible assets and identification of additional means of exploitation in terms of intra-group or external third-party licensing or sale.

In this regard, companies often concentrate their attention on only a part of the intellectual property (eg, patents, trademarks, software), while other types of intangibles/intellectual capital remain unaccounted for (eg, customer lists, client relationships, calculation algorithms, know-how). While the extent of the focus on IP management is intrinsically linked to the industry in which the company operates, practice shows that such patterns exist more in the services industry than in the product sector, and more in the non-financial services sector than in the financial sector.

But clearly, without proper identification and valuation of the existing

Tax and an efficient IP management strategy

In a nutshell, an efficient IP management strategy should achieve the following tax results:

- Reduction of the effective tax rate (ETR) incurred on royalty income and capital gains resulting from the sale/disposal of the IP rights.
- Minimisation of the withholding tax on the royalty flows paid by the various subsidiaries of the group or external parties.
- Full deduction of royalty payments at the level of all operational entities that use any of the group's intangible assets.
- Localisation of IP joint ventures at the level of entities that can benefit from a specific tax regime with a favourable effective tax rate and possibility of repatriation of the funds out of the joint venture with no additional tax leakage.

In this context, close collaboration between the group's IP counsel and tax director, in terms of understanding each other's strategic plans in relation to utilisation of the group's intellectual assets, is not only profitable, but also necessary for any company intending to sustain a profitable IP management strategy.

intellectual asset portfolio, an efficient IP management strategy cannot achieve its anticipated objective: ultimately, to convert the use of the group's intangibles into additional profits.

Value through efficient intra-group management

To some extent, putting the group's intangibles to better use is often equated with the external exploitation of such intangibles by third parties (eg, via the sale or licensing of dormant IP rights or the conclusion of new licensing arrangements). However, significant value with a direct impact on the net profits of the group can also be extracted through efficient intra-group management of the intellectual assets.

Practice shows that in some cases confusion exists between entities and locations where some rights are created, the entities which are supposed to hold the (legal) title and the entities which exploit those rights (economic ownership). To overcome this, a first step is to identify and value all group intangibles and the entities holding the title to them. In the same way, it is advisable to identify the group entities that use the intangibles in practice, the types of intangibles they use and whether a licensing arrangement is already in place. In some cases group subsidiaries (eg, with production, manufacturing, distribution or marketing functions) use group intangibles

either without or only partially under structured licensing arrangements with appropriate remuneration.

A review of the intra-group arrangements related to creation and research and development (R&D) is often a good idea. This allows the reviewer to find out whether contracts are in place in relation to the subcontracting of R&D or cost sharing and which recognise the owner entity.

Something else to consider is the pricing arrangements in relation to all intra-group flows. For example, what is the level of the royalty flows? What is the basis of the cost-sharing payments? Are there any opportunities in terms of increase or decrease of the flows in order to optimise the profitability of the licensor or licensee entity? In this context, a review of these flows from a transfer pricing perspective is paramount; for example, in order to support the deductibility of the costs at the level of the licensee and recognition of the related income at the level of the licensor.

Ultimately, all of the above allows for the identification of synergies which can be created through centralisation of the intellectual assets at the level of a regional or global IP holding company.

Why tax matters

Beyond the proper regularisation of intra-group flows, the impact of an effective IP management strategy on the group's bottom

“Where the company's intangibles are put to use in order to generate additional profits, a further improvement in the net results can be achieved through a coherent tax optimisation strategy”

Table 1. Main types of eligible IP rights

Country	Patents	Trademarks	Design and models	(Software) Copyrights	Domain names	Other
Belgium	✓	✗	✗	✗	✗	✗
Ireland	✓	✓	✓	✓	✓	✓
Luxembourg	✓	✓	✓	✓	✓	✗
Netherlands	✓	✗	✗	✗	✗	✓

line result also derives significantly from the tax savings that the group can make by implementing a coherent strategy.

The relationship between tax and efficient IP management strategy can be seen in a number of ways.

The sale or licensing of dormant assets to external parties means that additional profits will be subject to tax in the country where the seller/licensor entity is located; reducing the effective tax cost on these gains results in a corresponding increase in the resulting net profit. Intra-group licensing of the intangibles equally means taxation of the royalty income at the level of the licensor in the country where it is located; reducing the tax cost on these income flows equally increases the resulting net profit.

In most cases royalty flows trigger the application of withholding taxes in the country of the licensee, which can vary from 0% to 40% depending on the location. In certain circumstances part of the taxes may be recoverable via tax credits. Reducing them through the application of double tax treaties results in a direct improvement to the cost structure. Proper structuring and pricing of the licensing agreements allows for deductibility of the royalty charge at the level of the licensee, thus improving its net profit after-tax position.

Basically, in all circumstances where the company's intangibles are put to use in order to generate additional profits, a further improvement in the net results can be achieved through a coherent tax optimisation strategy that adequately follows the company's business strategy.

While much can be said about the various tax strategies which can be envisaged in relation to the optimisation of a group's IP management plan, there are several main features that can be identified.

Global or regional centralisation of the intangible assets at the level of a group entity can benefit from a specific tax regime for IP holding activities (hence, in relation to royalty income and capital gains) and where the group has capacity (eg, in terms

of staff location) to carry out the related IP holding activities (intra-group licensing, external third-party exploitation, contracting or R&D, monitoring of registration and protection). Within the current international framework, the IP holding company should be based in a location that matches the group's business strategy and can ensure the localisation of the IP-related functions (as opposed to a mere passive holding entity). Not all functions need be centralised – some can remain subcontracted to other group entities – but the core functions will in most cases be included in the centralisation.

As mentioned previously, in some cases certain group entities may not actually pay royalties for use of the group's intangibles and are thus unable to benefit from a cost deduction against their profits. This can change if there is a focus on optimising the net result of the group's operational entities via licensing of all intangibles by use of proper tax planning. The importance of proper pricing of the royalty flows from a transfer pricing is extremely important in this framework, in order to allow the subsidiary effectively to deduct all of the licensing cost.

Structuring of the intra-group royalty flows to minimise the withholding tax burden on the royalty payments can be achieved via proper choice of the location of the licensor in order to maximise the use of double tax treaties. In Europe, the use of tax directives that reduce the amount of withholding tax on royalty payments is also possible.

Where to locate IP in Europe?

In terms of choosing a jurisdiction for the centralisation of IP rights, an IP holding company wish list would include the following, at a minimum:

- A specific and stable tax regime allowing for a relatively low effective tax rate for both income and capital gains.
- The possibility to benefit from the regime even if only economic ownership over the IP rights is held by the IP holding company – thus allowing legal

title to remain in other group entities if necessary for other reasons (eg, bank covenants and guarantees).

- An extensive double tax treaty network.
- The possibility, but not the obligation, to carry out R&D activities in the same country – while in many cases this will be a plus, because jurisdictions often offer incentives for R&D activities located within their territory (eg, tax credits, subventions) and highly qualified specialised personnel may be available, the possibility for the group to retain the option, rather than the obligation, to relocate R&D functions is very important.
- A sophisticated jurisdiction in terms of general IP practice, registration and protection, with reputable IP practitioners.
- A stable and reputable legislative and economic environment, with a specialised and sophisticated workforce and service providers.

When deciding on the most attractive country in which to locate and exploit intellectual property, multinational groups must thus consider both tax and non-tax related matters. However, the tax aspects often play a crucial role in this decision, given the additional costs savings that can be achieved.

While many countries – such as Switzerland, Spain (including the Basque region), France and a number in the Asia-Pacific region – offer efficient tax regimes for IP owners, in this article we focus on a few European jurisdictions: notably Luxembourg, Belgium, the Netherlands and Ireland.

In each country featured, patents qualify as eligible under the IP tax regime, while application of the regimes to other types of

intangible assets is restricted in certain cases. This has particular significance for those sectors which are not patent originators and where the intangible assets consist of know-how, non-patented technologies or formulas, databases and so on. In such cases, it is important that the IP tax regime can cover the broadest possible range of intangible assets.

The European tax regimes for exploiting IP rights provide either for a reduction in the corporate tax to be paid or for a partial exemption of the IP income and gains. The IP tax regimes apply in principle to corporate taxpayers exploiting their IP rights for which they receive an IP income.

Eligible IP rights

The different types of eligible IP rights per country are compared below, while the different types of IP rights that qualify for the tax regimes in the different European countries are set out in Table 1.

Belgium

Belgium introduced a patent income deduction that is applicable as of the tax year starting on 1st January 2007. The deduction applies to new patents and extended patent certificates, which are improvements to existing patents. Other IP rights are not covered by the deduction and will be subject to the standard corporate tax rate of 33.99%.

Ireland

Ireland enhanced its existing IP tax regime in May 2009. The eligible IP rights are broadly defined and include patents; registered designs; trademarks and brand names; copyrights and publishing titles; domain names; know-how; service marks; authorisations to sell medicines; the products of designs, formulas, processes or

Table 2. Main characteristics of eligible IP rights

Country	ETR (on IP exploitation)	Legal ownership not required	Qualifying IP income	Qualifying capital gains	Basis for reduction
Belgium	0%-6.8%*	X	✓	X	Deduction of 80% on gross income
Ireland	12.5%	X	✓	✓	Capital allowances
Luxembourg	0%-5.8%	✓	✓	✓	80% exemption on net come
Netherlands	0%-5.0%	X	✓	X	5% reduced rate

* The ETR mentioned for Belgium is based on gross income

inventions; and goodwill, to the extent that it relates to the rights covered.

Luxembourg

Luxembourg introduced its IP tax regime applicable from 1st January 2008. The eligible IP rights include patents, trademarks, copyrighted software, domain names, designs and models.

Netherlands

The Netherlands introduced its latest innovation box regime applicable from 1st January 2010. The eligible IP rights include self-developed patents, intellectual property from innovation (patented or R&D certificate), and plant breeders' rights.

Characteristics of the tax regimes

A second aspect in the comparison of available regimes is the extent of the tax benefits available in terms of:

- The effective tax rate for the eligible IP rights.
- Whether legal ownership of the IP rights is required.
- The type of income (eg, licence income, capital gains) that is subject to the IP tax regime.
- The basis for the reduction.

Belgium

Under Belgium's patent income deduction regime, income derived from eligible IP rights is exempt for 80% of the gross income obtained through the licensed patents. In addition, with a deduction of qualifying R&D expenses, the effective tax rate ranges between 0% and approximately 6.8%. However, capital gains that may arise in case of disposal are not covered by the deduction and remain subject to the normal tax rate. In order to benefit from the deduction, both legal and economic ownership of the IP rights is required at the level of the Belgian holding entity.

Ireland

Under the Irish IP tax regime, income derived from eligible IP rights qualifies for a maximum deduction of 80% of the related trading income by way of capital allowances. This results in an effective tax rate of 12.5% (net income basis). However, capital gains that may arise in case of disposal are not covered by the IP tax regime. Depending on the type of IP asset, capital gains are generally subject to a tax of 12.5% (trading asset) or 25% (capital asset). Intellectual property that is disposed of within a (holding) period of 10 years is subject to a potential clawback, which means a potential recapture of the IP

amortisation, resulting in a higher taxable outcome. In order to benefit from the Irish IP tax regime, both legal and economic ownership of the IP rights is required.

Luxembourg

Under the Luxembourg IP tax regime, income derived from eligible IP rights qualifies for an exemption of 80% on the net income. When alternative IP planning is also taken into account, the effective tax rate ranges between 0% and 5.8% of the net income (per January 2011). Capital gains that may arise in case of disposal are covered by the IP tax regime, for which the same 80% exemption applies. In order to benefit from the Luxembourg IP tax regime, the holding of the legal title over the assets is not required; economic ownership of the IP rights is sufficient.

The Netherlands

The Dutch IP tax regime states that income derived from eligible IP rights qualifies for a 5% reduced tax rate. In addition, tax planning opportunities are available. This results in an effective tax rate of 0% to 5% (per January 2011). Capital gains that may arise in case of disposal are also covered by the IP tax regime. In order to benefit from the IP tax regime, both legal and economic ownership of the IP rights is required.

Business model is key

The key characteristics of the different European IP tax regimes are set out in Table 2. From this, it may be observed that while all of the regimes offer favourable conditions for the holding and exploitation of intangible assets, the decision of which to choose cannot be made without taking into account the business model under which the group operates its assets. For instance, if the group is actively exploiting its dormant assets via sales as opposed to licensing, a regime that covers the capital gains from the sales is a must. Equally, the possibility to retain the legal title over the assets at the level of another group entity (for internal or external reasons) while transferring only the effective exploitation of these rights to the IP holding company is an important aspect when trying to determine a suitable location.

Another point of attention is the level of substance at the IP location. (Foreign) tax authorities may focus on whether the economic IP owner has sufficient substance to manage, assume and control the related risks in respect of the IP rights. If the tax authorities could argue that there is insufficient substance, this may lead to

lower compensation for the IP owner or, in extreme cases, to the transfer of the intellectual property being disregarded. To reduce this risk, it is important, among other things, that the intellectual property be effectively managed from the jurisdiction where it is located. In this respect, practice shows that a definitive trend has emerged in recent years towards matching the location of IP holding with the location where the IP-related functions are carried out – in other words, a clear trend towards less reliance on “passive” IP holding companies.

Attention points from a tax/transfer pricing perspective

As mentioned previously, transfer pricing is an important element when exploiting your IP rights. Most (European) countries have implemented transfer pricing regulations requiring that the pricing between two or more related parties be set in accordance with the arm’s-length standard. This implies that the pricing between two related parties should be set by reference to the conditions which would have obtained between

independent enterprises in comparable transactions and comparable circumstances.

When entering into agreements with related parties, the compensation for granting the IP rights (eg, royalty payments) should be set in accordance with the arm’s-length standard. To reduce the risk of potential questions by local or foreign tax authorities, it is recommended that groups have a transfer pricing policy which includes sufficient documentation on inter-company licensing transactions, as well as on the applied compensation for exploiting the IP rights. **iam**

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Action plan



To put in place an efficient tax structure for the IP rights they own, companies should consider the following:

- Perform an IP audit/diagnostic review of the group’s intangible assets.
- Identify the right strategic management plan for the group’s intangible assets.
- Align the strategic management plan with the right tax strategies available in order to arrive at an efficient IP management strategy from both an operational and tax perspective.
- Select the right IP location for your IP rights.
- Ensure correct implementation to reduce potential adverse tax consequences relating to incorrect transfer pricing, among other things.

Timing is everything.



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