IP Migration Strategies for Life Sciences Companies

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June 1, 2015

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POTENTIAL OBJECTIVES

- Develop an international business structure that optimizes worldwide value creation and minimizes global taxes, with particular reference to IP assets
- Locate international operations in a jurisdiction which has available skilled employees, excellent infrastructure, etc.
- Obtain local tax and financial incentives if available

U.S. TAX CONSIDERATIONS

- A U.S. corporation is subject to U.S. tax on its worldwide income
- Under current law, such a corporation is generally **not** subject to U.S. tax on income earned by its foreign subsidiaries until that income is distributed (i.e., U.S. tax is deferred)
- Deferral does not apply to subsidiaries' income that is considered "Subpart F income" of a "controlled foreign corporation" ("CFC") or "passive income" of a "passive foreign investment company ("PFIC")
- To avoid Subpart F and PFIC consequences, the activities and assets of the overseas subsidiaries must be managed by employees located in the subsidiaries' home countries

MECHANICS

- Formation of IP holding subsidiary in appropriate country
- Secure valuation of existing ex-U.S. rights
- Enter into rights transfer agreement from U.S. parent to IP holding subsidiary
  - Typically structured as a license
- Enter into cost sharing agreement to manage ownership of future intangibles
- Form second-tier subsidiaries (below IP holding company) in jurisdictions where exploitation will take place and sub-license relevant portions of ex-U.S. rights to them
  - This step can be deferred if IP is not yet ready to be commercialized

TRANSFER OF IP ECONOMICS

- A properly structured exclusive license of ex-U.S. IP rights will be treated as a sale of those rights for U.S. tax purposes, effectively shifting future appreciation to the IP holding subsidiary
  - Consideration can be a royalty, a lump-sum “buy-in” payment, or a combination of the two
  - The level of consideration must reflect the market value of the IP at the time of the license (outside valuations are recommended, though recent financing rounds can provide useful data points)
- Ownership of ex-U.S. rights to future IP is managed through cost-sharing agreement
- Exploitation in overseas markets, manufacturing, etc. managed through intercompany operating licenses

STRUCTURES

- In many cases, the most favorable structures involve entities organized in either Ireland or the Netherlands
- Alternatives exist in Luxembourg and Switzerland, as well as some other “up-and-coming” jurisdictions; and Bermuda is often used in conjunction with other countries to leverage benefits and manage timing
- With the Irish and Dutch structures the effective tax rate is likely to be somewhere in the range of 5% to 12.5%, possibly lower

LICENSING CONSIDERATIONS

- A typical partnering strategy for U.S. biotechs is to out-license ex-U.S. commercialization rights while retaining U.S. commercialization rights
- In some cases, it may be advantageous for a U.S. company that plans to retain U.S. commercialization rights to move ex-U.S. IP rights to the holding company while retaining U.S. rights in the U.S. company
- Partnering strategy typically leads holding company strategy

LICENSING CONSIDERATIONS (CONT.)

- Consider how IP rights and licenses will be allocated to implement the desired IP holding structure
  - Are there any upstream licenses from third parties that will be assigned to the IP holding company?
  - Do the assignment clauses in the upstream licenses permit assignment? Does assignment trigger any agreement consequences?
  - If IP or an upstream license agreement is assigned, is a license or sublicense back to the assigning entity required?
  - Will IP or upstream license rights be licensed or sublicensed (rather than assigned) to the IP holding company?
  - Are there applicable sublicense income clauses or restrictions on sublicensing/further sublicensing in upstream licenses from third parties?

LICENSING CONSIDERATIONS (CONT.)

- Third party licensees may require a parent guarantee or a stand-by license if the ultimate parent and/or the IP owner is not the licensing entity
- In the license or other agreement transferring rights, consider whether the ultimate parent and/or IP owner should (nonexclusively) retain rights to develop or manufacture outside any retained territory in order to support the retained territory
- In the license or other agreement transferring rights, patent prosecution and enforcement coordination provisions are often desirable

EXAMPLE OF IRISH STRUCTURE

- “Double-Irish” structure involving
  - An Irish nonresident company organized in a selected low-tax third country that owns the IP
  - an Irish resident company to which the IP is licensed and that exploits the IP worldwide (outside the United States)
- Generally requires a ruling from the Irish tax authorities - anticipated effective tax rate varies with the third country chosen and the availability of incentives
- Low withholding taxes on most outbound payments
- R&D credit, other incentives may be available
- Recently curtailed, but still possible

EXAMPLE OF DUTCH STRUCTURE

- “Two-tier” structure involving
  - a Dutch cooperative that elects to be treated as a corporation for U.S. tax purposes
  - a Dutch corporation that elects to be disregarded for U.S. tax purposes
- Generally requires a ruling from the Dutch tax authorities - anticipated effective tax rate is between 4 and 7%
- No Dutch withholding taxes on dividends or royalties
- No special tax or financial incentives available

EXAMPLE OF BERMUDA STRUCTURE

- “Two-step” structure involving
  - an initial transfer of ex-U.S. IP rights to a Bermuda subsidiary
  - a subsequent IP transfer or licensing transaction with one or more overseas affiliates
- No ruling required
- No Bermuda income or withholding taxes
- No special tax or financial incentives available

OTHER STRUCTURES

- Luxembourg
  - potential for low tax rate ("patent box" legislation) and good treaty network for third-country exploitation
  - can be unwieldy, and ongoing "Lux leaks" scandal adds uncertainties
- Switzerland
  - can be more expensive to manage
  - may become more attractive if current pressure from European Union on national IP incentives leads to cutbacks in the Netherlands or Ireland (<u>e.g.</u>, the effective foreclosure of Bermuda as a participant in "double Irish" structures established after 2014)

ADDITIONAL CONSIDERATIONS

- Establishing robust structure can be costly and time-consuming, and requires locating some true managerial or operational functions overseas
  - "Sunk" costs if IP commercialization fails
- Is tax deferral worth the effort?
- Where will R&D be done going forward? – locating R&D overseas means foregoing U.S. tax deduction for associated costs
  - Which entity should own future IP?
  - What are the U.S. tax costs of the "sale" to the IP holding subsidiary? Does the parent have losses to shelter tax?
- Need to monitor U.S., other legislative proposals

THE DECISION PROCESS

- The medium- to long-term benefits of a well-chosen international IP structure for the global exploitation of intellectual property can be enormous
- But the investment is not trivial
  - because of tax considerations, the earlier the “bet” is made the lower the tax cost (but the greater the strain on cash flow and the higher the risk of unwind due to project failure)
- In many cases the “pros” of early action on this front outweigh the “cons,” if the costs can be managed

Questions?

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