

# Intellectual Property Holding Companies: Current Tax Issues

Prepared for

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# Intellectual Property Holding Companies: State Tax Systems

- > Tax jurisdiction/nexus
- > Unitary-state taxes corporation(s) with nexus on income of all members of unitary group (ex.: CA)
- > Forced combined returns – state requires filing combined or consolidated return if transactions between group members not at arm’s-length (ex.: NY)
- > Separate accounting
  - State taxes corporation on its income only; possibly subject to state authority to adjust or reallocate inter-company payments (MA)



## Intellectual Property Holding Companies: State Tax Systems (continued)

- > Tax benefit in separate accounting states can be achieved:
  - If corporation can deduct payments to out-of-state affiliate
  - If out-of-state affiliate earns income

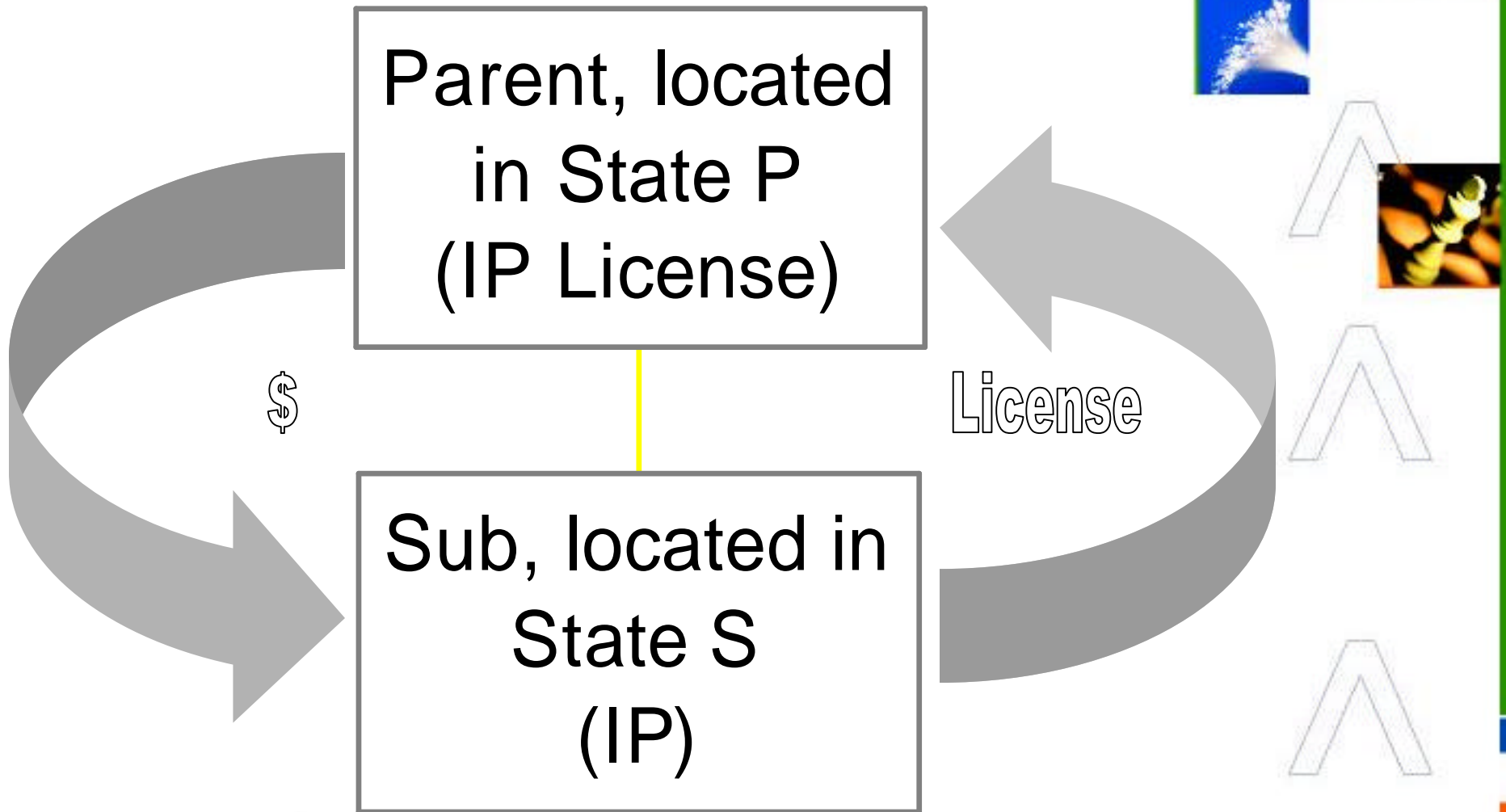


# Intellectual Property Holding Companies: Typical Structure

- > U.S. company (Parent) operating in high-tax state (State P) with valuable intellectual property (IP) identifies a state (State S) that does not tax holding companies on income from intangible investments
- > Parent creates a new subsidiary (Sub) in State S
- > Sub establishes offices and independent presence in State S
- > Parent contributes IP into Sub
- > Sub's activities to be limited to maintenance and management of intangible investments and collection and distribution of income from investments
- > Parent and/or other third-party customers enter into agreements to license IP from Sub



# Intellectual Property Holding Company Structure



## Intellectual Property Holding Companies: Potential Business and Tax Benefits

- > Arm's-length IP licenses between Sub and Parent may provide good information about market value of IP; useful if IP later sold to third parties and for tax/accounting purposes
- > May be easier to contract for license of IP to third parties because Sub's primary business role is to maximize profit from IP
- > Potentially easier sale of IP to third parties because IP is already "isolated" within Sub



## Intellectual Property Holding Companies: Potential Business and Tax Benefits (continued)

- > For State P tax purposes, Parent deducts license payments to Sub, and may mitigate “net worth” taxes
- > For State S tax purposes, Sub does not pay tax on license income because of its status as a holding company
- > Parent and other affiliates can access cash in Sub through loans, dividends, payments for services, etc., depending on what is most tax-efficient



## Intellectual Property Holding Companies: Certain Potential Tax Risks

- > States have been aggressive in auditing holding company structures
- > State P may attempt to disallow deductions for amounts paid by Parent to Sub, disregard existence of Sub as a sham, or treat Sub as an “alter ego” of Parent – thereby eliminating tax benefits in State P
- > State P may argue that licensing IP to licensees in State P creates nexus for Sub in State P  
*Geoffrey Inc. v. South Carolina Tax Commission, 437 S.E. 2d 13 (S.C. 1993)*





## Intellectual Property Holding Companies: Certain Potential Tax Risks (continued)

- > Certain states may require combined reporting for Parent and Sub, thereby potentially eliminating or mitigating tax benefits
- > Certain states have recently adopted “add back” or “anti-passive investment company” statutes requiring that otherwise deductible amounts paid by Parent to Sub be added back to Parent’s income
- > Creating Sub typically will generate some additional franchise taxes



# Intellectual Property Holding Companies: Recent Court Challenges

## CONNECTICUT

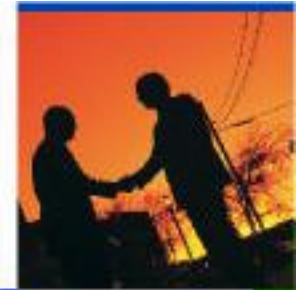
*Carpenter Technology Corp. v. Commissioner*, 256 Conn. 455 (2001). Interest paid on loan from Sub deductible where Court found Sub had economic substance and business purpose, although Parent borrowed after contributing the funds to Sub.

## MARYLAND

*Maryland Controller of Treasury v. SYL, Inc. and Crown Cork & Seal Company*, No. 76, September Term 2000, 6/9/03. Maryland Court of Appeals reversed Maryland Tax Court and Circuit Court and concluded Maryland not prohibited from taxing Subs under commerce and due process clauses of U.S. Constitution.

## NEW YORK

*Sherwin-Williams Co.*, N.Y. Tax App. Trib., DTA No. 816712, 6/5/03. Tax Appeals Tribunal overturns decision of Administrative Law Judge and concludes New York can force IP Subs to file combined report with Parent.



# Intellectual Property Holding Companies: Recent Court Challenges (continued)

## MASSACHUSETTS

*Syms Corp. v. Commissioner of Revenue*, 436 Mass. 505 (2002). The Massachusetts Supreme Judicial Court upheld the Appellate Tax Board disallowance of royalties paid to Sub, where transfer and license back had no practical economic effect and tax avoidance was the only business purpose:

- Plan was proposed by tax advisor
- Royalties were immediately returned to Parent
- Maintenance of marks and related expense remained with Parent

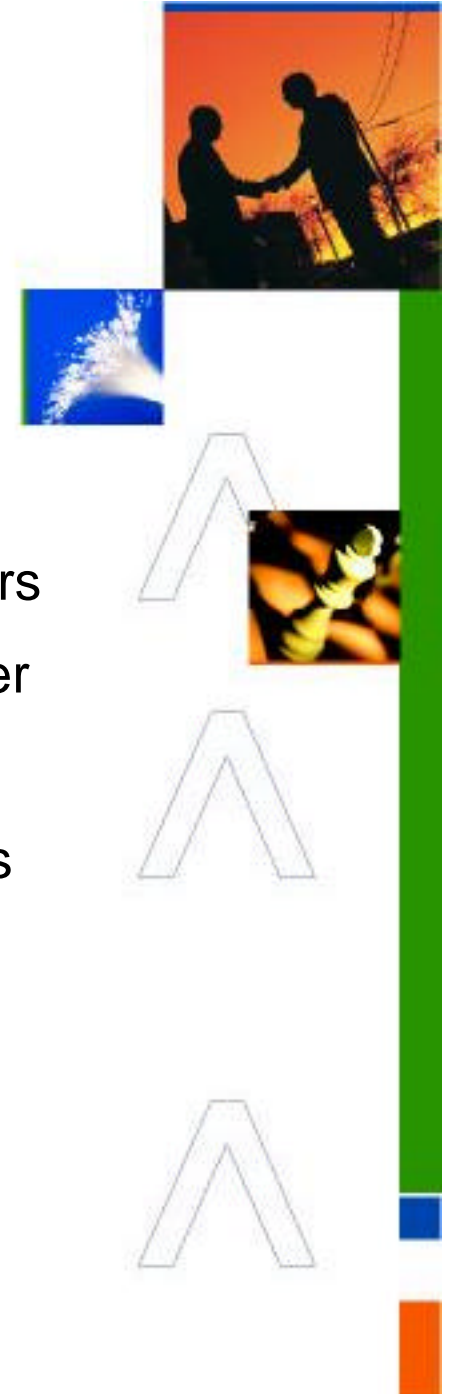


# Intellectual Property Holding Companies: Recent Court Challenges (continued)

The Board had found that the following business purposes were not substantiated by the Parent:

- Transfer would protect the marks from claims of creditors
- Transfer would protect the marks from a hostile takeover
- Transfer would result in better management of marks
- Formation of Sub would enhance ability to borrow funds

However, Court acknowledged there may be important business purposes for the transfer and licensing back of intangible assets.



# Intellectual Property Holding Companies: Recent Court Challenges (continued)

In *Sherwin-Williams Company v. Commissioner of Revenue*, 438 Mass. 71 (2002), Court upheld deduction and reversed the Appellate Tax Board, noting:

- Parent must prove that transactions had practical economic effects beyond creation of tax benefits
- Need only show **either** Sub formed for substantial business purpose **or** Sub actually engaged in substantive business activity
- There was sufficient evidence of the economic substance:
  - Legal title and physical possession of the marks actually transferred to Sub
  - Benefits and burdens of owning marks were transferred to Sub
  - Sub entered into genuine obligations with unrelated third parties



# Intellectual Property Holding Companies: Recent Court Challenges (continued)

- Sub received royalties and invested with unrelated third parties
- Sub incurred substantial liabilities to unrelated third parties and to aren't to maintain, manage and defend the marks

Unlike the *Syms* case:

- Original plan not proposed by tax advisor
- Royalties not immediately returned to Parent
- Sub bore burden of trademark maintenance
- Corporate niceties meticulously observed



# Intellectual Property Holding Companies: Recent Legislative Challenges

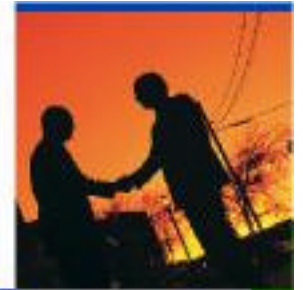
## CONNECTICUT

Statute: Amended Conn. Gen. Stat. § 12-226A and affirmed that facts of *Carpenter* case amply satisfy improper reflection of income standard and were properly subject to adjustment by Commissioner. (Public Acts 01-2 May Special Session.)

## NEW YORK

Statute: Add back statute for intangible expenses enacted 2003. Tax Law Article 9-A, Section 208(9)(o), A.B. 2106, Laws of 2003, as amended by A.B. 8388, Laws of 2003.

Other add back statutes: AL, MS, NJ, NC, OH



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

## MASSACHUSETTS

### > Sham Transaction Codification

Massachusetts adds new sham transaction provision:

- Commissioner may assert the sham transaction doctrine or any other related tax doctrine
- Taxpayer must prove:
  - (i) a valid, good-faith business purpose other than tax avoidance,
  - (ii) economic substance apart from the asserted tax benefit, and
  - (iii) asserted nontax business purpose must be commensurate with the tax benefit claimed
- Standard of proof: clear and convincing evidence as determined by the Commissioner





# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > New Massachusetts add back sections
  - Provide for the add back of otherwise deductible intangibles and interest expenses paid to “related party”
  - Intangible property includes “patents, patent applications, trade names, trademarks, service marks, copyrights, mask words, trade secrets and similar types of intangible assets”



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

> No add back if:

- (i) the taxpayer establishes by “clear and convincing evidence as determined by the Commissioner that the adjustments are unreasonable,” or
- (ii) the taxpayer and the Commissioner agree to the alternate method of apportionment, or
- (iii) the taxpayer establishes by a preponderance of the evidence:
  - Related member paid amount to a non-related party, and
  - No tax avoidance as principal purpose



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > Retroactive Legislation (Section 84 of the Massachusetts Acts of 2003)
  - Add back sections effective retroactive to January 1, 2002
  - Legislature adopts statute that “clarifies” Legislature’s “original intention” that transactions have both: (i) a valid, good-faith business purpose and (ii) economic substance
  - Questionable constitutionality



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > Administrative Implementation (Technical Information Release 03-19)
  - DOR notes legislature stated new provisions “were intended to clarify” its “original intention”—to claim a tax benefit must show a valid, good-faith business purpose **and** economic substance
  - Contrary to Supreme Judicial Court holding that **either** valid business purpose **or** economic substance is sufficient
  - Application for tax years after 2001, taxpayer must either add back deduction to net income or prove eligibility for statutory exceptions:
    - show add back unreasonable by clear and convincing evidence
    - clear & convincing evidence: “so clear, direct and weighty” that it will permit the Commissioner to “come to a clear conviction, without hesitancy, of the validity of the taxpayer’s claim”



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > Taxpayer must complete separate schedule to return:
  - Part 1 for double taxation, i.e., where the taxpayer incurs a cost or expense to a related corporation or individual that is taxed in Massachusetts or elsewhere at similar rate
  - Part 2 for claims based on:
    - conduit royalty payment
    - double taxation
    - business purpose/economic substance
- > Must attach statements supporting an add back exception
- > Must constitute clear and convincing evidence
- > Benefit of the business purpose must be commensurate with the value of the deduction claimed



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > Attachment to schedule must include:
  - Statement of business purpose and economic substance
    - Commissioner will consider deduction of an intangible royalty payment with skepticism
    - Suggests “Syms business purposes” not valid
  - Description of the transaction – more likely to require add back if transaction based on advice of tax advisor
  - Statement there was no circular flow of funds
  - Statement as to how intangibles were obtained – more likely to be approved when the intangibles developed or purchased by related licensor



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > Tax years beginning prior to January 1, 2002 (pending cases)
  - Taxpayer must prove **both** business purpose **and** economic substance relying on the legislature's expression of "original intent"
  - Settlement possibilities



# Intellectual Property Holding Companies: Recent Legislative Challenges (continued)

- > TIR reasserts state's *Geoffrey* claim – Out-of-state corporation that receives trademark royalties or similar intangible receipts from Massachusetts is subject to the corporate excise citing Directive 96-2 in which Massachusetts announced it would follow *Geoffrey* decision
- > States generally not successful in asserting *Geoffrey* nexus





# Intellectual Property Holding Companies: Planning for the Future

## > Retaining or Establishing IP Holding Company

- Sub should establish a substantial, independent presence in State S, with its own address, telephone number, staff, etc.
- Sub's directors and officers should be different from those of Parent
- Parent and Sub should observe all corporate formalities
- Sub should execute, and when possible perform, contracts in State S, with State S law governing
- Parent and Sub should structure license in an arm's-length fashion
- Sub should seek to license its IP to third parties as well as to its affiliates
- Sub should perform and pay for all maintenance of its IP
- Be prepared to defend tax treatment



# Intellectual Property Holding Companies: Planning for the Future (continued)

## > Other Alternatives

- Intercompany pricing arrangements that reflect additional value added by Sub
  - marketing
  - advertising
  - purchasing

## > For IP Lawyers

- Importance of substantiating actual IP transfers
- Having owner of IP bear legal expenses for maintenance
- Candid advice on benefits/detriments of IP transfers

