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Deferral Structures Based on Licensing Models under Potential Tax Reform

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Although the exact nature of U.S. tax reform still remains largely uncertain, U.S. multinational companies contemplating intangible property structures should take into account potential changes in U.S. tax law. This article explains why companies in this situation should consider a licensing model.

Comprehensive U.S. tax reform has been identified as a top legislative priority by the Trump Administration and the Republican-controlled Congress.[1] While whether or not comprehensive tax reform can be achieved in 2017 remains to be seen, Republicans have indicated their desire to achieve tax reform in 2017.[2] To the extent something is enacted, it could be legislation that fundamentally overhauls the current tax code (i.e., comprehensive tax reform) or legislation that temporarily cuts tax rates or makes other smaller changes (i.e., perhaps through budget reconciliation).[3] In an attempt to

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1 *See* Joseph Lawler, *Paul Ryan promises tax reform in 2017: 'We cannot let this once-in-a-generation moment slip by'*, Washington Examiner (June 20, 2017); KPMG LLP, Understanding the Tax Reform Process: FAQs (Updated for What's Happened Lately), at 2 (June 21, 2017) (the "KPMG FAQs") (with the control of the White House and both chambers of Congress, Republicans have a strong interest in showing that they can achieve tax reform), *available at* https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/06/tnf-new-faq-jun22-2017.pdf.

2 *House Speaker Ryan's 'first major speech on tax reform'*, KPMG TaxNewsFlash (June 20, 2017) (House Speaker Ryan stating, "We are going to get this done in 2017. We need to get this done in 2017."). However given that it requires 60 votes in the Senate to avoid a filibuster, it is unclear that the Republicans which currently hold 52 seats can obtain the necessary votes for pass legislation. KPMG FAQs, at 7.

3 KPMG FAQs, at 4.

establish broad based goals for tax reform, the Trump Administration on April 26, 2017, released its core principles for U.S. tax reform (the "Trump Administration Plan").[4] The Trump Administration Plan and its core principles may be a starting point for tax reform; however, the House Republicans' current proposals would likely be based on a House Blueprint released on June 24, 2016 (the "House Blueprint").[5]

The Trump Administration Plan and House Blueprint both propose to reduce the U.S. corporate tax rate from the current 35 percent to as low as 15 percent.[6] Beyond a reduction in the corporate tax rate, both the Trump Administration Plan and House Blueprint represent a fundamental change of the U.S. tax system away from a worldwide, income tax-based approach towards a more territorial system. Unique to the House Blueprint, though largely undeveloped at this time, is the introduction of a cash flow based border adjustment tax ("BAT").[7] These potential changes to the U.S. tax system come at the same time countries are implementing many of the Organisation for Economic Co-operation and Development's ("OECD") base erosion and profit shifting ("BEPS") initiatives that challenge the typical intangible property ("IP") structure that moved IP and the corresponding profits offshore.

A common structure adopted by many U.S. multinational companies for IP in the past was a cost sharing arrangement ("CSA") under which some or all foreign IP rights were transferred to an offshore company, generally resident in a low-tax or no-tax jurisdiction. However, in light of the proposed changes to the U.S. and global tax landscape, U.S. multinational companies not already engaged in a CSA that are seeking a mid- to long-term tax efficient IP structure could still possibly consider a licensing model as an alternative. This article discusses the licensing model as a potential option that may still yield certain U.S. tax deferral benefits, even under U.S. tax reform including the proposed BAT, in addition to avoiding some of the difficulties associated with adoption of the OECD's BEPS initiatives.

U.S. Federal Tax Reform Policy and Proposals Generally

As a result of the November 2016 election, Republicans gained control of the White House and hold majorities in both the House of Representatives and Senate. Ostensibly, a key component of the economic agenda for Congress is comprehensive U.S. federal tax reform, as opposed to settling for just a tax rate reduction. Although the particular details of U.S. federal business tax reform remain a subject for debate and the likelihood of U.S. tax reform legislation becoming enacted remains uncertain, an

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4 *Trump Administration releases tax reform principles*, KPMG TaxNewsFlash (Apr. 26, 2017).

5 Tax Reform Task Force, A Better Way: Our Vision for a Confident America (June 24, 2016) (the "House Blueprint"); *see* Kaustuv Basu & Colleen Murphy, *Trump Tax Plan Is Starting Point: House Republicans*, 80 DTR G-7 (Apr. 27, 2017); *House Speaker Ryan's 'first major speech on tax reform'*, KPMG TaxNewsFlash (June 20, 2017) (House Speaker Ryan indicating that the House and Senate are working with the president to turn the Trump Administration's core principles for tax reform into a "transformational tax reform plan.").

6 The House Blueprint proposes a 20 percent corporate tax rate while Trump has proposed a 15 percent corporate tax rate.

7 While the House GOP supports the BAT there is concern that support for it might be lacking in the Senate and White House. *See* Peter Nicholas, Kate Davidson & Nick Timiraos, *White House Banks on Sweeping Tax Plan*, The Wall Street Journal (Apr. 20, 2017) (White house officials privately warn that border adjustment provision would fail in the Senate).

analysis of the predominant tax reform proposals may be useful for U.S. multinational companies contemplating IP restructuring in the future.

The Trump Administration Plan is an outline of key policy objectives. While the Trump Administration Plan shares certain principles with the House Blueprint, it fails to address key provisions of the House Blueprint (e.g., border adjustability, interest expense deduction, and full expensing). However, the absence of an express provision in the Trump Administration Plan does not does not mean it has been ruled out.

The political environment and perceived need for U.S. tax reform has also revived interest in a previous proposal from the former Ways and Means Committee Chairman Dave Camp. His Tax Reform Act of 2014 ("Camp Proposal") provided for a mandatory deemed repatriation and other revenue raising provisions, in exchange for a lower tax rate of 25 percent and a more territorial system.[8]

The three tax reform proposals vary from reasonably detailed (Camp Proposal), to well outlined (House Blueprint) and to very briefly outlined (Trump Administration Plan). As a general matter, the Trump Administration Plan, House Blueprint, and Camp Proposal all propose to reduce tax rates for businesses and dramatically simplify the U.S. Internal Revenue Code.[9] The stated goal of all three U.S. tax reform proposals are to promote U.S. economic growth, investment, and job creation.[10] All three proposals move the United States away from its current worldwide taxation system, but each proposal varies slightly in how it implements a territorial system. Below, the U.S. international tax aspects of the three proposals are outlined and discussed in the following order: Trump Administration Plan, House Blueprint, and Camp Proposal.

Trump Administration Plan

The Trump Administration Plan provides for the largest corporate tax rate reduction from the current 35 percent rate to a 15 percent rate.[11]

The Trump Administration Plan's core principles for tax reform call for a shift from a worldwide tax system to a territorial tax system "to level the playing field for American companies."[12] This is an

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8 Mindy Herzfeld, *News Analysis: Revisiting Camp's Repatriation*, 154 Tax Notes 1456 (Mar. 20, 2017); Emily Foster, *Advocates Aim to Preserve Like-Kind Exchange in Tax Reform*, 2017 TNT 84-1 (May 3, 2017).

9 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

10 *See* House Blueprint, at 5-6; *see also Trump Administration releases tax reform principles*, KPMG TaxNewsFlash (Apr. 26, 2017).

11 Trump's campaign plan lowered the corporate tax rate to 15 percent with no deferral of U.S. tax on foreign earnings. *See* Donald J. Trump, Tax Reform That Will Make America Great Again (the "Trump Campaign Plan"), *available at* https://assets.donaldjtrump.com/trump-tax-reform.pdf. The current Trump Administration Plan includes a bullet point adopting a territorial system for the U.S., but does not detail how a 15 percent corporate tax rate would operate to generate sufficient tax revenue under a proposed territorial system.

12 2017 Tax Reform for Economic Growth and American Jobs, *available at* http://www.cnbc.com/2017/04/26/heres-the-white-house-memo-on-president-trumps-proposed-tax-plan.html.

apparent departure from then-candidate Trump's campaign tax plan, which retained the worldwide tax system and called for an end to deferral of offshore earnings.[13] The plan does not include details regarding the territorial tax system. Under a traditional territorial tax system, all foreign-sourced income, including royalties, may be excluded from U.S. taxable income.[14] Also included in the Trump Administration Plan is a one-time tax on the earnings of U.S. multinational companies offshore. The details of the repatriation tax are not known and the exact rate of tax imposed on offshore earnings is to be determined in consultation with Congress.[15]

Although the current Trump Administration Plan does not mention a BAT, President Trump has previously discussed the possibility of import tariffs on any products made overseas and imported into the U.S. market.[16] The Trump Administration Plan and its prior iterations may lead other countries to retaliate by denying deductions by foreign subsidiaries on payments to U.S. related parties imposing similar reciprocal tariffs.

Furthermore, to the extent the Trump Administration Plan does not address issues such as tax transparency, favorable tax deals for corporations, and low-taxed profits earned outside the United States, others have speculated if the proposal could potentially lead to the United States being included in the European Union ("EU") black list of tax havens.[17]

House Blueprint

The House Blueprint proposes lowering the U.S. federal corporate tax rate to 20 percent. In addition to rate reduction, the House Blueprint would provide for a territorial tax system, ostensibly consistent with the approach used by the U.S.'s major trading partners.[18] The House Blueprint would accomplish this by exempting 100 percent of dividends received from foreign subsidiaries from U.S. tax. The House Blueprint would also repeal most of the anti-deferral rules under subpart F, which were mainly intended to discourage U.S. multinational companies from conducting certain activities overseas.[19] The House Blueprint would retain the foreign personal holding company rules that focus on passive foreign income, however, such as dividends, interest, and royalties that are earned by a controlled foreign corporation ("CFC").[20] As the foreign personal holding company income would not be for an "export" and is easily moveable income, these rules are likely retained to keep investments in the United States and to

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13 Note that Trump's campaign tax plan called for a one-time deemed repatriation of corporate cash held overseas at a 10 percent discounted tax rate. *See* Trump Campaign Plan.

14 The current U.S. tax treatment of nonresidents may be an appropriate analogy as the U.S. does not tax nonresidents on their worldwide income, but rather is limited to U.S. source income that is either subject to withholding tax or the standard graduated rates if effectively connected with a U.S. trade or business. Sections 871, 864, 881

15 *Trump Administration releases tax reform principles*, KPMG TaxNewsFlash (Apr. 26, 2017).

16 Alan Rappeport, *Lawmakers and Trump Hold Talks on Imports*, New York Times (Feb. 3, 2017).

17 Jan Hildebrand, Moritz Koch & Ruth Berschens, *E.U. May Declare U.S. a Tax Haven*, Handelsblatt Global (Feb. 1, 2017).

18 House Blueprint, at 27.

19 *Id.*

20 *Id.*

discourage U.S.-based companies from conducting certain passive activities outside the United States.[21]

In addition to a territorial system, the House Blueprint also proposes a BAT, which purports to be like a value added tax ("VAT") in that it allows for border adjustments to exports and imports that reduce the cost borne by exported products and increase the costs borne by imported products.[22] It would move the U.S. towards a destination-based tax system in which the income would be subject to tax where the goods are sold or services are provided.[23] The BAT would have the effect of exempting income earned from U.S. exports (e.g., royalties) from U.S. federal taxation, while subjecting U.S. imports to tax on a gross receipts basis.[24] The BAT is a source of a growing debate between the Trump Administration, the Senate, and the House over the design of U.S. tax reform.[25] Recent public statements from the House, Senate, and Trump Administration call the support for BAT into question.[26]

Lastly, the House Blueprint includes a deemed mandatory repatriation provision for the untaxed and unrepatriated earnings of foreign subsidiaries, similar to the provision contained in the Camp Proposal. Foreign earnings would be taxed at an 8.75 percent rate or 3.5 percent rate, with the higher rate imposed on earnings held in cash or cash equivalents.[27]

Because BAT is a new type of tax that favors exports over imports, it may lead to foreign retaliation in a similar manner as the Trump Administration Plan. In addition, a BAT may be subject to foreign challenge under the World Trade Organization ("WTO") rules as an illegal trade subsidy.[28] To survive a WTO challenge, the BAT may need to be cast more like a VAT (i.e., indirect tax). However, if the BAT is

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21 *See* KPMG LLP, House Republican Tax Reform "Blueprint"—Initial Observations (June 28, 2016), *available at* https://home.kpmg.com/us/en/home/insights/2016/06/tnf-legislative-update-house-republican-tax-reform-blueprint-initial-observations.html.

22 House Blueprint, at 27.

23 *Id.*

24 *See id.*

25 *See* Kaustuv Basu, *Border Tax Could Be Negotiating Position for GOP Leaders*, 128 DTR G-2 (July 6, 2017); Richard Rubin & Peter Nicholas, *Trump Warns on House Tax Plan*, The Wall Street Journal (Jan. 17, 2017) (reporting that "Mr. Trump, in his first comments on the [BAT measure], called it 'too complicated.'"); John Herzfeld, *Border Tax Not Dead Yet: Former Hill, Treasury Officials*, 80 DTR G-1 (April 27, 2017) (aspects of the BAT may still make it into final tax reform legislation); Luca Gattoni-Celli, *With Tax Reform on Horizon, Practitioners Eye Trade Law*, 2016 TNT 244-2 (Dec. 16, 2016) ("In a December 16 C- SPAN interview, House Ways and Means Committee Chair Kevin Brady, R-Texas, said that Republicans plan to move forward with a tax reform plan that will include border adjustability.").

26 *See* Andrew Soergel, Paul Ryan: *Border Adjustment Tax Not 'Dead,' But Not Going to Pass As Is*, U.S. News & World Report (June 20, 2017) (House Speaker Paul Ryan conceding border adjustment tax lack support); Peter Kasperowicz, *Mark Meadows: Border adjustment tax now slowing down overall tax reform plans*, Washington Examiner (June 26, 2017); Laura Davison & Kaustuv Basu, *Cohn, Mnuchin Oppose Border Tax, Hatch Says*, 80 DTR G-5 (May 10, 2017); *but see* Luc Gattoni-Celli, *White House Insists That Border Tax Stance Is Unchanged*, 2017 TNT 90-5 (May 11, 2017) (stating that a White House aide said that the White House has concerns with the BAT but are open to reviewing it if the House revises it).

27 House Blueprint, at 27.

28 Ken Brewer, *Conflate-Gate: Disguising an Income Tax as a Consumption Tax*, 154 Tax Notes 1279 (Mar. 6, 2017).

treated as a VAT, it may not be eligible for reduced rates under current income tax treaties as it may not qualify as an income tax.

Like the Trump Administration Plan, the House Blueprint also could potentially lead to the United States being placed on the EU blacklist as a tax haven because the BAT may be seen as a way to erode the profits from countries outside the United States, while excluding those "export" profits from the U.S. tax base.

Camp Proposal

Of the three U.S. tax reform proposals, the Camp Proposal retains the highest corporate tax rate at 25 percent, but this rate still represents a significant reduction from the current 35 percent corporate tax rate.

The least territorial-like aspect of the Camp Proposal is a participation exemption system that retains some aspects of worldwide taxation[29] This is effectuated by means of a 95 percent dividend received deduction on dividends from foreign corporations owned by U.S. shareholders.[30] The subpart F rules are amended to only include low taxed foreign income. Additionally, a new type of subpart F income is created, foreign base company intangible income ("FBCII"). FBCII is any profit attributable to IP, determined by calculating the excess profits of a CFC, and is included in the U.S. taxable income of the U.S. shareholders, provided the profits are subject to a low foreign tax rate.[31]

Related to FBCII, income from the foreign exploitation of intangibles owned by a U.S. entity (e.g., foreign-source royalties) continues to be taxable in the United States, but there is a deduction available that would exempt 40 percent of the income, resulting in a net 15 percent rate.[32] This deduction as well as FBCII is meant to tax income from intangibles at a similar preferential rate regardless of whether the income is earned domestically or internationally, similar to a "Patent Box."[33]

Finally, there is a deemed mandatory repatriation of the untaxed and unrepatriated foreign earnings of U.S. multinational companies. Foreign earnings held in liquid assets like cash or cash equivalents would be taxed at 8.75 percent, and other earnings invested in non-liquid assets are taxed at a 3.5 percent tax rate (e.g., plant and equipment).[34] A U.S. multinational would have eight years to pay the tax on the deemed repatriation.[35]

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29 Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title VIII – Deadwood and Technical Provisions, as prepared by the Staff of the Joint Committee on Taxation on February 26, 2014, JCX-19-14 (the "JCT Report on Camp Proposal"), *available at* https://www.jct.gov/publications.html?func=startdown&id=4561.

30 *Id.*

31 *Id.*

32 *Id.*

33 Kyle Pomerleau & Andrew Lundeen, The Tax Foundation, The Basics of Chairman Camp's Tax Reform Plan (Feb. 26, 2014).

34 JCT Report on Camp Proposal.

35 *Id.*

Of the three proposals discussed, only the Camp Proposal seems clearly consonant with international norms, assuming the preferential IP regime conforms to the OECD's modified nexus approach, i.e., substantial economic are performed in the country taking into account some outsourcing of research and development ("R&D") activity.[36]

While the exact nature of U.S. tax reform still remains largely uncertain, a U.S. multinational company that is contemplating an IP structure should take into account any potential changes in U.S. tax law based on current U.S. tax reform legislative developments.

Common Deferral Planning—Cost Sharing Arrangements

As mentioned above, a CSA has been a typical deferral structure for U.S. multinational companies to defer U.S. tax on foreign profits attributable to valuable IP. Tax deferral or a lower worldwide effective tax rate through use of a CSA is not a guarantee. If the IP proves to be unsuccessful or not as valuable as anticipated, the losses associated with the foreign rights will be attributed to the foreign cost participant and may be trapped in the foreign jurisdiction, which may have a lower tax rate than the United States. The result could be that the losses cannot be used in the United States and the tax cost on a worldwide scale is greater.

The regulations providing for CSAs are under section 482. Under section 1.482-7, controlled participants to a CSA agree to share the costs and risk of developing IP in proportion to their share of reasonably anticipated benefits under the arrangement.[37]

Under a CSA, each controlled participant must receive an exclusive, non-overlapping interest in cost shared intangibles.[38] Typically, a controlled foreign participant owns the non-U.S. territorial rights to the cost shared intangible and is entitled to receive the profits or losses in foreign markets generated by the exploitation of that IP. The foreign controlled participant is often times subject to a rate of tax in a jurisdiction that is lower than the U.S. tax rate. Assuming the foreign controlled participant's earnings are not distributed or deemed distributed under subpart F anti-deferral rules, the United States does not generally tax the foreign profits currently, thereby creating a benefit from the deferral of U.S. tax on the earnings.[39] The foreign controlled participant may even permanently reinvest its earnings, thereby potentially deferring payment of U.S. tax indefinitely. These earnings would likely be subject to tax through a mandatory deemed repatriation under the various U.S. tax reform proposals.

To the extent a controlled participant contributes any resource, capability, or right ("pre-existing IP") for joint development of IP under a CSA, the controlled participants are required to engage in a platform

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[36] *See* OECD/G20 Base Erosion and Profit Shifting Project, Action 5: Agreement on Modified Nexus Approach for IP Regimes (2015), *available at* https://www.oecd.org/ctp/beps-action-5-agreement-on-modified-nexus-approach-for-ip-regimes.pdf.

[37] Section 1.482-7(b).

[38] Section 1.482-7(b)(4)(i).

[39] Foreign profits effectively connected to operations in the United States (e.g., sales through an office or fixed place of business) may be currently taxed by the U.S. *See, e.g.,* section 865(e) (the profits from sales attributable to a nonresident's U.S. office will be sourced to the United States).

contribution transaction ("PCT").[40] The value of the PCT is based on arm's length principles under specified methods, such as an income method, described in section 1.482-4(a).[41] The arm's length amount of PCTs has been a common subject of IRS audits, although litigation related to these audits has often been decidedly favorably for taxpayers.[42]

The likelihood of a reduced U.S. tax rate in the future under U.S. tax reform could cause U.S. multinational companies to enter into CSAs. For example, an offshore controlled participant typically makes PCT payments to a U.S. controlled participant, which increases the U.S. controlled participant's U.S. taxable income. If U.S. tax reform reduces the corporate tax rate, then any PCT payments included in the U.S. cost participant's income prior to U.S. tax reform would be subject to a higher 35 percent tax rate. Thus, the U.S. controlled participant runs the risk of paying high cash tax in the U.S. before tax reform.

For example, if the PCT is structured as a lump sum payment, the amount could not be trued down, except on a timely filed tax return.[43] However, PCTs are not required to be structured as single, lump sum payments.[44] Instead, they may be structured as installment or contingent payments over the life of intangibles. [45] Contingent PCTs paid over a longer period of time in the future could be a hedge against the risk of paying tax on PCT income on higher rates today because the income may be pushed out to later years.

International developments may affect CSAs as well. For example, OECD transfer pricing guidelines released in October 2015 could limit the profits attributable to cost shared intangibles without each controlled participant assuming the functions and risks associated with the development, enhancement, maintenance, protection, and exploitation ("DEMPE") of the IP.[46] Absent DEMPE, the profit attributable to cost shared intangibles could be limited to a risk-free, investor's return.[47] A cost share participant that

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[40] Section 1.482-7(c)(1)(ii). For a discussion on the form of PCT payments, see Thomas M. Zollo & Stephen Blough, *Determining the Form of PCT Payments*, KPMG's What's News in Tax (Sept. 8, 2014) (discusses the pros and cons of alternative PCT forms).

[41] *See* section 1.482-4(a) (arm's length amount charged in a controlled transfer of IP must be determined under one of four methods: (1) the "comparable uncontrolled transaction" (CUT) method, (2) the "comparable profits" method, (3) the "profit-split" method, or (4) other unspecified methods).

[42] Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009) (the U.S. Tax Court rejected IRS's claim that the PCTs should be higher based on the indefinite life of the contributed IP).

[43] Section 1.482-1(a)(3) (no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions.)

[44] See section 1.482-7(h)(2) for rules on payment forms.

[45] Thomas M. Zollo & Stephen Blough, *Determining the Form of PCT Payments*, KPMG's What's News in Tax (Sept. 8, 2014); Section 1.482-7(h)(2)(iv).

[46] *See* OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports, at 65 (Oct. 5, 2015) ("OECD BEPS, Actions 8-10") (a related corporation providing funding should only be entitled to a risk-free return), *available at* http://www.oecd-ilibrary.org/docserver/download/2315351e.pdf?expires=1490721358&id=id&accname=guest&checksum=CA779BB68DDB0B465738556312FEBC02.

[47] *Id.*

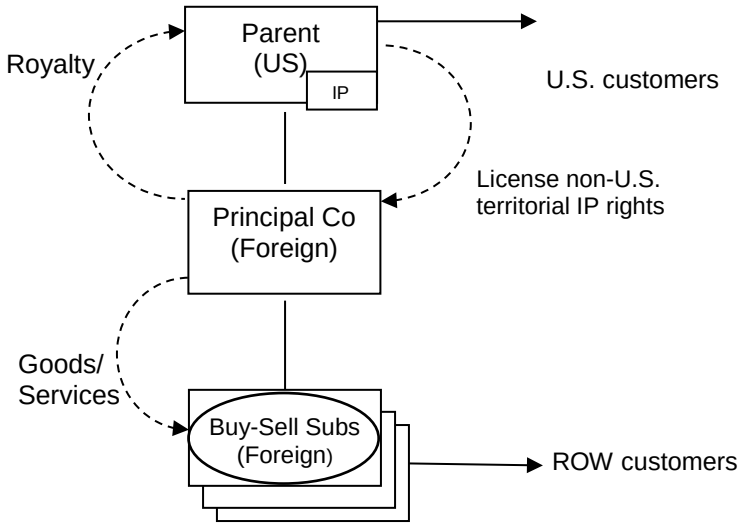
provides funding and assumes some related financial risks, but without performing any functions related to the intangible, could generally only expect a risk-adjusted return on its funding.[48] In contrast, section 1.482-7 provides that a controlled participant may be entitled to the profits or losses from cost shared IP solely by sharing in the joint funding and bearing the economic risk of development for the IP.[49] Countries adopting the OECD's approach will likely expect an entity earning high IP returns to have personnel performing DEMPE functions in addition to assuming risks associated with the development of such IP. Under the BEPS project, merely funding the development of the IP through a CSA may no longer justify the economic returns.

In conclusion, if U.S. tax reform lowers the U.S. corporate tax rate to be more competitive with lower rates provided by other countries, then a U.S. multinational company contemplating a CSA structure should carefully consider the upfront costs of moving IP offshore. It must also consider the risk that foreign jurisdictions may challenge IP returns of the controlled foreign participant for lack of DEMPE.

Licensing Model

A U.S. multinational company that is currently not a participant in a CSA, but still desires a tax efficient structure for IP management may achieve a deferral benefit from a licensing arrangement.

A typical licensing model for a U.S. multinational may be structured as follows:



- U.S. parent company ("US Parent") develops and funds the development of group IP and maintains legal and economic ownership of it.

[48] *Id.*

[49] *See* section 1.482-7(d).

- US Parent forms a foreign principal company ("Foreign Principal") and if applicable, contributes all shares of existing foreign subsidiaries ("Foreign Subsidiaries") to Foreign Principal.
- US Parent licenses non-U.S. territorial IP rights to Foreign Principal on a non-exclusive basis in exchange for arm's length royalty payments in accordance with section 1.482-4.
- Foreign Principal sells goods or services to Foreign Subsidiaries at arm's length rate that leaves Foreign Subsidiaries with an arm's length profit based on their limited functions and risks. Alternatively, Foreign Principal may contract directly with customers and make arm's length, cost plus payments to Foreign Subsidiaries for sales and marketing support services (for example).
- Foreign Principal bears the risks in its non-U.S. markets (e.g., inventory, market, currency, etc. risks).
- After payment of royalties to U.S. parent and routine, cost plus services payment to its subsidiaries, Foreign Principal may earn the profit or loss from non-U.S. sales or services in its markets.
- Foreign Principal and its Foreign Subsidiaries may not by subject to current U.S. taxation under subpart F, anti-deferral rules or taxed as income effectively connected with a U.S. trade or business, if structured adequately.

Under the Licensing Model, US Parent retains ownership of the worldwide rights in the IP.

This Licensing Model generally avoids the need for PCTs under a CSA US Parent is paid arm's length royalties from Foreign Principal for use of the non-U.S. rights to the IP. US Parent also bears the full cost of R&D expenses on an ongoing basis. Thus, US Parent is entitled to an appropriate return on its IP because it bears all the risk of R&D.

In the United States, the royalty paid by Foreign Principal must be arm's length as determined by one of the following methods set forth in the U.S. Treasury regulations: the comparable uncontrolled transaction method, the comparable profits method, the profit split method, or unspecified method that reflects an arm's length amount.[50] Regardless of the method chosen, the royalty amount should be consistent with amounts unrelated parties would agree upon to engage in the licensing transaction.

In terms of form, the arm's length royalty may be based on a percentage of sales by Foreign Principal or structured as a deductive royalty designed to target a specified operating margin for Foreign Principal.

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[50] Section 1.482-4(a).

The difference in the royalty base must be supported by the risks borne by the Foreign Principal and its ability to actually bear such risks. For example, a deductive royalty consistent with a fixed, limited risk distributor's operating margin with no potential for losses would indicate Foreign Principal is more of a routine, limited risk distributor that is not entitled to high returns. In contrast, a royalty based on a comparable uncontrolled transaction that is a relatively low percentage of sales revenues could enable the Foreign Principal to earn a higher profit, such as when risks do not materialize or Foreign Principal efficiently manages its operating costs.

For example, when the Foreign Principal assumes more risk, a sales-based royalty arrangement may be arm's length because the Foreign Principal would be required to pay a royalty even in a year in which it incurs an a loss.

Scenario A: Sales-Based (e.g., 10 percent)

	Example – Royalty as 10 % of Revenue	**$'000***
A	Revenue	1,000
B	COGS	600
C	SG&A	350
D = A-B-C	Operating Profit	50
E = A.10*	Royalty (10% of revenue)	100
G= D-F	*Taxable income*	(50)

In contra, the royalty may be structured to target a more routine operating profit when the Foreign Principal bears less risk, similar to a limited risk distributor earning a targeted operating margin:

Scenario B: Target Operating Profit (e.g., 4 percent)

	Example – Royalty calculated based on Targeted Operating Profit (e.g. assume 4% OM is arm's length)	**$'000***
A	Revenue	1,000
B	COGS	600
C	SG&A	350
D = A-B-C	Operating Profit	50
E = A.04*	Targeted 4% Operating Margin	40
F = D-E	Royalty	10
G= D-F	*Taxable income*	40

However, if Foreign Principal is incurring a loss this may mean US Parent may have to subsidize Foreign Principal with some form of payment to enable the Foreign Principal to achieve an arm's length, routine distribution return.

To support that Foreign Principal is entitled to the residual profit or loss in the foreign markets based on its functions and risks, Foreign Principal should have adequate assets, personnel and other resources to operate the business in foreign markets, such as being able to make and carry out sales, marketing, financing, supply chain, and new business development decisions.

Admittedly, under a Licensing Model, the amount of deferral may be more limited in contrast to a CSA because the Foreign Principal may only earn a full risk distributor's return at most. The returns to IP, which may be greater in terms of potential, remain taxed in the U.S. in the form of royalties. Still, meaningful earnings may still be generated by the Foreign Principal depending on its functions and risks, and if it has sufficient substance to justify its returns. The Foreign Principal's profit may be subject to a lower rate of tax compared to the U.S. To the extent the profits of the Foreign Principal can be defended and are permanently reinvested, the Licensing Model may still yield cash tax or effective tax rate benefits for U.S. parent.

Licensing Model under U.S. Tax Reform Proposals

As discussed above, the three leading proposals for U.S. international tax reform cover a range of possibilities of what a potential territorial system enacted by the United States may look like. The Trump Administration Plan appears to call for a territorial system. The House Blueprint goes beyond a territorial system with its BAT that looks more like a VAT. The Camp Proposal has a participation exemption system with special rules for intangible income.

Based on what is known about the proposals, the potential tax considerations for a foreign principal licensing structure may be as follows:

Trump Administration Plan

Under the Trump Administration Plan, the royalties paid by Foreign Principal to US Parent under a licensing arrangement would be exempt from U.S. taxation, assuming all foreign-sourced income would be exempt from U.S. taxation. This assumes that the current sourcing rules are retained, which may source the royalty paid by Foreign Principal based on the location of where the IP is used, i.e., foreign source.[51] Note that the results could be the same under a CSA, provided the PCT is structured as a license, rather than a sale.

If the Foreign Principal jurisdiction for any reason denies treaty benefits and applies a high withholding tax that cannot be claimed as a credit for U.S. tax purposes, or denies deductions for the royalties, the cash tax and effective tax rate benefit from the structure would be eroded.

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[51] Section 862(a)(4).

House Blueprint

Under the House Blueprint, royalties paid by Foreign Principal may be excluded from US Parent's U.S. taxable income as export income because it is derived from IP that is licensed ("exported") offshore. In addition, US Parent would be subject to 20 percent corporate tax on its U.S. source income, after excluding export income and adding back the cost of imports.

Under the Licensing Model, Foreign Principal would not likely be subject to U.S. tax on its foreign earnings. However if Foreign Principal provides any goods or services to US Parent for the U.S. market, then the gross receipts for such items could be taxable as opposed to the net profits because the items may be considered "imports." To minimize the import BAT tax, US Parent would likely need to provide all services and goods to U.S. customers and limit imports.

The House Blueprint does not provide details on how R&D costs would be deductible. For example, potentially, a company can incur all R&D costs in the United States for IP that generates foreign royalties that are not subject to tax. Alternatively, the R&D costs incurred in the development of the foreign rights to the IP that give rise to the royalty may be an export expense that potentially would not be deductible in the U.S. However, the results may be effectively the same under a CSA. Under section 1.482-7(j)(3)(i), cost sharing payments are treated as reimbursements to the intangible development costs that are deductible by the payee. Assuming intangible development is performed by the U.S. controlled participant, the intangible development costs associated with the development of IP rights in the other participants' territory would be reimbursed through each participant's reasonable anticipated benefits ("RAB") share. Therefore, the U.S. controlled participants would receive a reimbursement of intangible development costs related to non-U.S. markets and therefore not be able to deduct them in any event.[52]

Similar to the Trump Administration Plan, if the Foreign Principal jurisdiction for any reason denies treaty benefits and applies a high withholding tax that cannot be claimed as a credit for U.S. tax purposes, or denies deductions for the royalties, the cash tax and effective tax rate benefit from the structure would be eroded.

Camp Proposal

Under the Camp Proposal, US Parent would be subject to a 25 percent corporate tax rate on its U.S. source income.

Only dividends paid by Foreign Principal to US Parent would be entitled to the 95 percent dividend received deduction. However, the royalties paid to US Parent by Foreign Principal may be eligible for the 40 percent deduction available for income from the foreign exploitation of intangibles owned by a U.S. entity. This would result in an effective U.S. tax rate on the foreign source royalty from Foreign Principal of only 15 percent.

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[52] Sections 1.482-7(a)(1), 1.482-7(d)(1)(iii). *See* sections 1.861-8(e)(3), 1.861-17(c)(3)(iv). *See also* Milone, Culp, Vance & Zavieh, *Whose Qualifying Research Expense Is It, Anyway?*, 238 DTR J-1 (Dec. 11, 2013).

To prevent base erosion, the Camp Proposal would create a new category of subpart F income, foreign base company intangible income or FBCII, which would require any foreign income to be taxed in the U.S. if it is subject to a foreign effective tax rate below 15 percent, potentially with a credit for foreign taxes paid. The net effect is that income from the foreign exploitation of intangibles is taxed currently at a minimum of 15 percent regardless of whether it is earned domestically or internationally.

Rather than allowing businesses to fully expense most research and experimentation (R&E) costs, the Camp Proposal would require businesses to capitalize and amortize these costs over five years. Expenditures attributable to R&E conducted outside the United States would be capitalized and amortized over 15 years. This would be a departure from current law which allows taxpayers to elect to deduct certain R&E expenditures paid or incurred in connection with a trade or business.[53] To the extent US Parent incurs R&E costs to develop the IP in the United States, it would be able to amortize the cost over five years. However, this would apply equally to US Parent under a Licensing Model as well as a CSA.

Licensing Model under BEPS

As mentioned above, the OECD transfer pricing guidelines released in October 2015 under the BEPS initiative propose to limit profits to a risk-free return for a related entity that solely funds the development of IP without assuming the functions and risks associated with DEMPE.[54] Thus, a controlled participant in a CSA that merely funds the development of IP may have difficulty in establishing DEMPE functions to justify its current profit or losses associated with its mere economic IP ownership.

Some of the difficulty in aligning the costs and profits associated with IP under DEMPE may be alleviated by the Licensing Model. The OECD's BEPS initiative seeks to add uniformity to the international policy of where profits should be taxed.[55] Under the BEPS initiative's DEMPE principles, profits are aligned with value creation, i.e., the location of people functions and the location where risks are controlled. A CSA under U.S. Treasury regulations may allow for higher IP profits to be allocated to a cost participant solely based on financial contributions to the IP development, which under DEMPE would only entitle the cost participant to a risk-free return on investment. The current framework for establishing DEMPE and economic nexus is difficult to apply, making the justification of IP returns more problematic. The difference between the values attributed to the mere economic ownership and funding of IP development by the U.S. tax authorities under a CSA and foreign tax authorities adhering to DEMPE principles creates a potential for double taxation on profits and a greater dependence on tax treaties and the mutual agreement procedure clauses.

Under the Licensing Model, US Parent recognizes a portion of the profits attributable to the IP in the form of arm's length royalties, which likely will satisfy the DEMPE requirements, as US Parent has the people functions and assumes risks to earn the return. As previously mentioned, the royalty would need

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53 *See* section 174.

54 OECD BEPS, Actions 8-10.

55 As opposed to the various base erosion and diverted profit approaches (e.g. UK diverted profits tax, Australian MAAL, Japan CFC, etc.) employed by countries that may create gaps or double taxation where the various regimes intersect and overlap.

to be arm's length under methods set forth in the U.S. transfer pricing regulations. Depending on whether Foreign Principal is a routine, limited risk distributor or full risk distributor, the royalty may be structured as a deductive royalty that target's a fixed operating margin for Foreign Principal or a percentage of Foreign Principal's sales.

Another issue that may be avoided through the Licensing Model is the potential of determining the intangible development costs in a CSA. Under the revised OECD transfer pricing guidelines, the value of a controlled participant's contribution in the development of the IP will no longer be based on costs incurred, but rather the value of the functions performed under the specific contribution.[56] This change in how to determine the value of contributions could potentially lead to additional balancing payments being owed by the foreign cost participant to the U.S. cost participant, further eroding any tax benefit of a CSA. The Licensing Model may eliminate this extra burden so long as the parties determine the arm's length royalties for the license.

In addition, the Licensing Model may be subject to less risk of controversy with foreign tax authorities. As high profile tax controversy cases have made headlines in the media, it has caused public outcry for multinational companies to pay their fair share of tax.[57] U.S. multinational companies face a reputational risk that social media and news networks will accuse them of not paying their fair share of taxes.[58] A Licensing Model may help mitigate these controversies as arm's length royalties are paid to US Parent that developed and owns the worldwide rights to the IP and should have substantial activities and people functions to justify the profits or losses generated in the United States. Also the U.S. federal income tax rate is one of the highest among G20 countries,[59] so there is less concern that profits are stripped away to a low tax jurisdiction. Should U.S. tax reform lower the corporate tax rate to 20 or 15 percent, other countries may assert that profits are being diverted to the United States (as the new "tax haven"). However, provided US Parent has sufficient DEMPE functions in the United States, foreign tax authorities may be satisfied that the arrangement does not result in profit shifting.

Effective Tax Rate

As a result of the update to ASC 810-10-45-8 (formerly ARB 51), intercompany transfers of property (with the exception of inventory) will no longer be deferred until the transferred asset is sold outside the group. The selling entity would recognize a current tax expense for the full amount of gain, which may be offset by a deferred tax asset recorded by the buyer for the book-to-tax difference on the asset.

This new guidance on accounting for intercompany asset transfers could have a negative impact for financial statement purposes on a U.S. multinational company that structures its PCT as a sale of IP

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[56] OECD BEPS, Action 8-10, at ¶ 8.26.

[57] Stefano Morri & Steffano Guarino, *A Battle for the Revenue between Giants: The Apple Case*, 85 Tax Notes Int'l 1163 (Mar. 27, 2017); *see also* Edward Kleinbard, *Through a Latte Darkly: Starbucks's Stateless Income Planning*, 139 Tax Notes 1515 (June 24, 2013).

[58] Michael Skapinker, *Starbucks Backlash was not just Froth*, Financial Times (May 14, 2014).

[59] Congressional Budget Office, International Comparisons of Corporate Income Tax Rates, at 9 (Mar. 2017).

under a CSA, because the tax expense would be currently recognized for financial statement purposes, resulting in a higher effective tax rate.

Because ARB 51 only applies to intercompany sales of assets and not licenses, it should not have an effect on the Licensing Model.

Withholding Tax

Many jurisdictions impose a withholding tax on royalties paid to U.S. taxpayers.[60] As such, it must always be considered whether the jurisdiction where Foreign Principal will be located has an income tax treaty with the United States that can lower or eliminate the withholding tax imposed on royalties.[61] US Parent would need to satisfy certain requirements such as residency and limitation on benefits to obtain the benefit of a reduced withholding rate under the terms of the treaty.[62]

Conclusion

U.S. multinational companies that have not transferred IP rights offshore under R&D cost sharing arrangements, but still desire the benefits of U.S. tax deferral, could consider a Licensing Model. The structure still has the potential to provide cash tax or effective tax rate benefits under current U.S. tax law if structured properly without the potential up front, U.S. tax of a PCT. It also appears that the Licensing Model may continue to be viable and generate benefits under the various U.S. tax reform proposals, should they come to fruition. Finally, it may address BEPS concerns related to challenges regarding IP returns and lack of DEMPE.

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60 *See, e.g.,* sections 881(a)(1), 1441, 1442 (U.S. federal income tax imposes a 30 percent withholding tax rate on royalties not connected with a U.S. business paid to nonresidents).

61 United States Model Income Tax Convention of November 15, 2006, art. 12.

62 United States Model Income Tax Convention of November 15, 2006, arts. 4, 22.