



Effective IP Migration Strategies for  
Hi-Tech Companies  
in  
M&A Framework



INTERNATIONAL

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## Overview

- Transfer Pricing Regulations Recap
  - Arm's Length Standard: OECD, Art. 9 and IRC §482
  - IP Migration: Existing and IPRD
  - Cost Sharing: Current and Proposed Regulations
- Potential M&A "Deal" Structures with IP Migration
  - Pre "Deal": NOL Utilization
  - Pre and Post "Deal": By-passing Buy-in/PCT payments
- Summary - Key M&A / Cost Sharing Deal Factors

### Transfer Pricing Regulations Recap

- Arm’s Length Standard: IRC 482 and OECD, Article 9, I.
- Purpose of Section 482: *to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such [controlled] transactions. [1.482-1(a)(1)]*
- Applicable only to “controlled transactions.”
- Limitations in Jurisdiction

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### Transfer Pricing Regulations Recap

- IP Migration
  - Licensing: Existing (‘Make/Sell’)
  - Buy-in: Existing (‘Make/Sell’) + In-Process IP
  - PCT: In-Process IP only, (482-4 for existing IP)

	482-4	Buy-in	PCT
Existing IP	X	X	
In-Process R&D (IPRD)		X	X

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### What Is Cost Sharing?

- Joint funding of research and development of intangible property (IP) resulting in joint economic ownership of that IP.
- The parties to the cost sharing arrangement (CSA) agree to share the costs of development in exchange for a proportional share of the anticipated benefits.
- In most cases, one or more of the participants contributes pre-existing intangibles to the arrangement. (Such technology or intangible assets are termed “external contributions” in the proposed regulations.)

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### What Is Cost Sharing? (Continued)

- CSAs seek to determine not only the appropriate share of ongoing intangible development costs (IDCs) to be borne by each participant, but also to properly value the pre-existing intangibles each party contributes to the arrangement.
- Under the current regulations, these “buy-in payments” (or preliminary and contemporaneous transaction (PCT) payments under the proposed regulations) are subject to the commensurate with income standard.
- In general, CSAs are used by companies to manage the development of their IP in a tax-efficient manner.

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### Impetus for Change

- The Treasury and IRS have become increasingly concerned that U.S. taxpayers use CSAs to transfer IP offshore without appropriate arm's length remuneration.
- Specifically, the IRS believes that U.S. taxpayers have historically undervalued their external contributions to CSAs.
- Thus, the government issued the proposed cost sharing regulations which:
  - Provide taxpayers with additional guidance on the types of external contributions for which arm's-length consideration must be paid; and
  - Present "specified" methods for valuing those contributions.

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### Cost Sharing Today and Tomorrow

<u>Current</u>	<u>Key Changes</u>	<u>Proposed</u>
<ul style="list-style-type: none"><li>• <b>Buy in Payments</b><ul style="list-style-type: none"><li>– Separation between existing and new IP value.</li><li>– Declining royalties.</li><li>– Commensurate with income requirement.</li><li>– Adjustment to achieve arm's length result.</li><li>– Focused on specific technologies with specific uses.</li></ul></li></ul>		<ul style="list-style-type: none"><li>• <b>PCTs/RTs</b><ul style="list-style-type: none"><li>– Do not separate existing and new IP value.</li><li>– No declining royalties.</li><li>– IRS-only initiated adjustments and potential cap on income shift.</li><li>– Adjustments punitive, but safe harbor wide.</li><li>– Reference Transaction allows for full exploitation of IP and broadens definition of IP to be cost-shared (e.g. workforce in place).</li></ul></li></ul>

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### Pre “Deal” NOL Utilization

- The exit strategy for many high-tech’s is to be acquired.
- A common characteristic of high-tech acquisition targets is an existing pool of NOL carryforwards.
- The issue at hand is that a change in control leads to §382 limitations that in turn decrease the value of the target.
- To plan for acquisition, migrate IP off-shore through §482-4 or cost sharing prior to “deal” (before limitations occur).

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### Example of Pre “Deal” NOL Utilization

- US company holds all existing and in-process IP.
- US company has significant NOLs subject to §382 limitations post “deal”.
- US company shifts IP off-shore all/or in part.
  - All technology (§482-4).
  - Certain technology (§482-4).
  - Non-US rights to all or certain technologies (cost sharing regulations).
- Approach depends on NOL pool relative to IP value, among other factors.

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### Benefits to Acquiring Company

- Maximize NOL carryforward benefit by reducing rate hit associated with buy-in payments.
- Cash tax savings.
- Establishes or is consistent with structures ready for global business expansion.
- May align with many larger corporate (i.e. acquirers) structures in the high-tech space.

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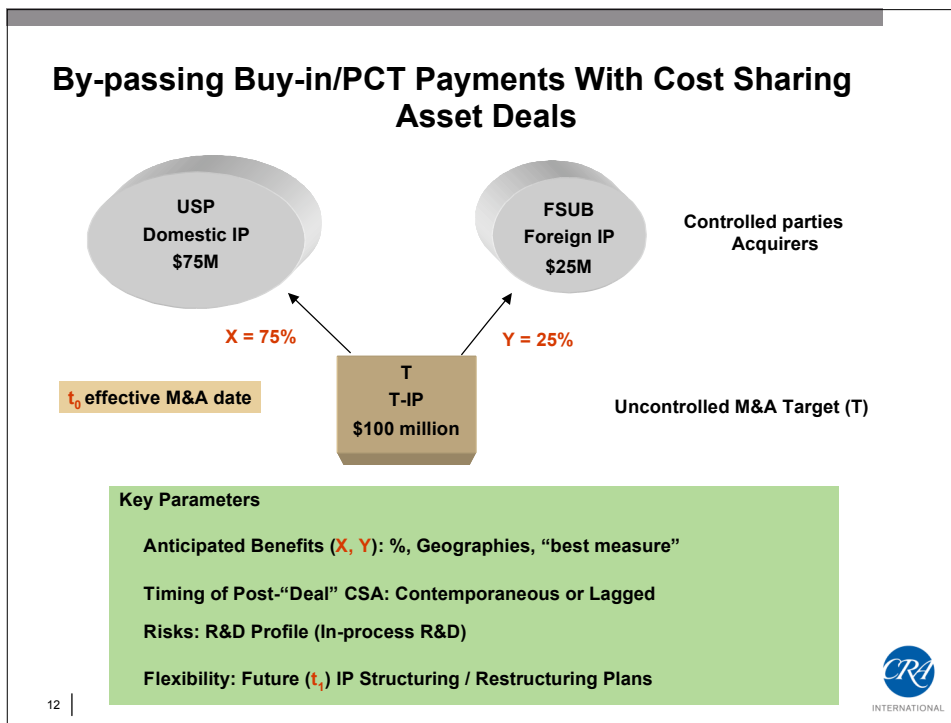


### By-passing Buy-in/PCT Payments With Cost Sharing

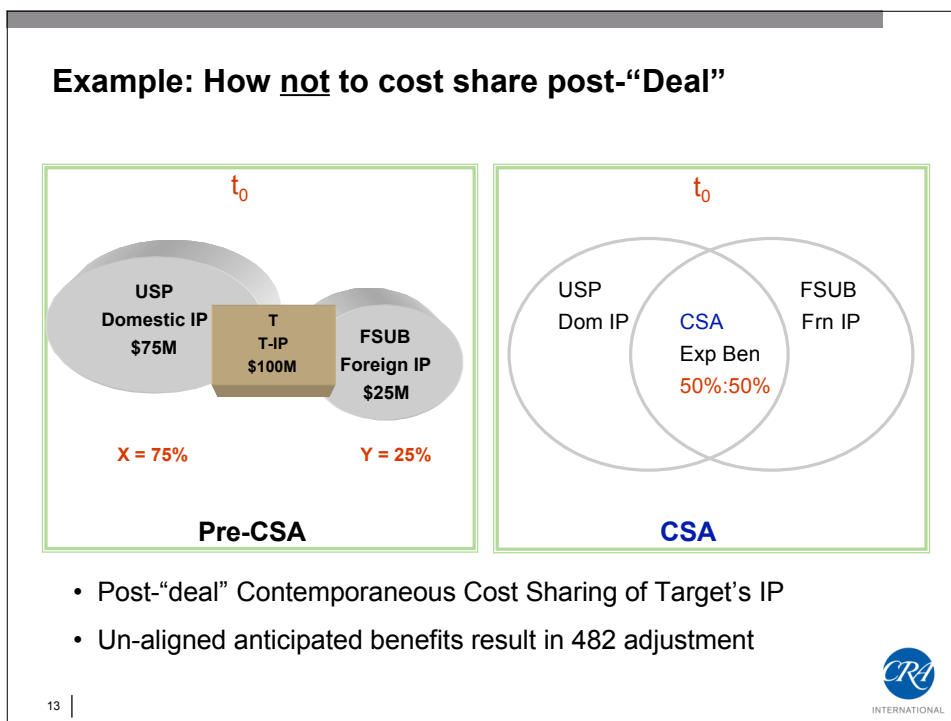
- Established US hi-techs regularly engage in predatory or expansionary M&A deals.
- US hi-tech Acquirers hold substantial portion of global profits / revenues offshore in low-tax CFCs. (i.e. existing cost sharing arrangements, off-shoring ops.)
- Issue: M&A “deal” itself, combined with US Acquirer’s offshore profits, provide a unique cover opportunity to migrate acquired Target IP offshore at arm’s length, limiting §482 jurisdiction.
- To maximize post-“deal” cost sharing options with respect to Target’s IP, resolve and align certain cost sharing parameters during pre-“deal” planning.

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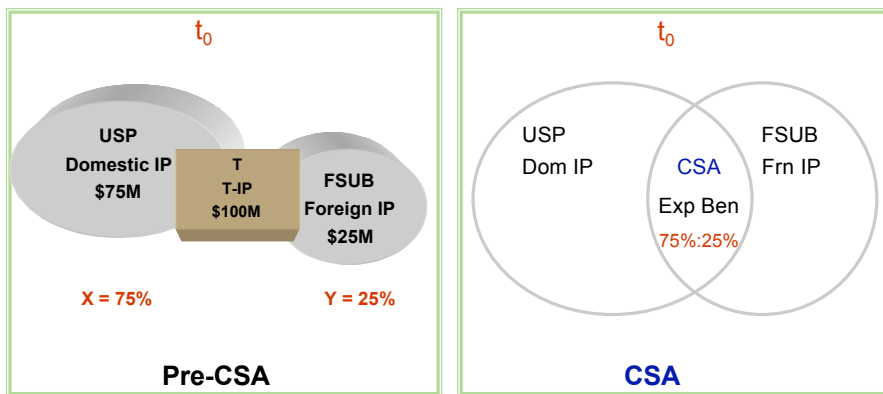


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**Example: Post “Deal” Contemporaneous Cost Sharing**

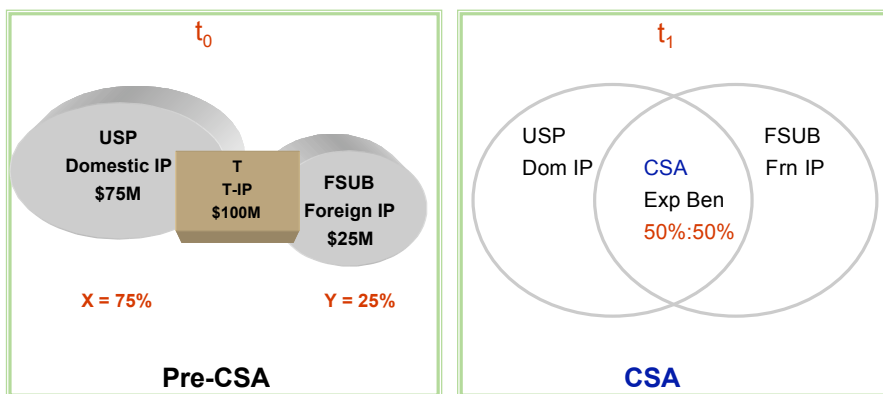


- Aligned “deal” and cost shared anticipated benefits (X, Y)
- Acquirer’s Benefits: No additional PCT / Buy-in required, immediate CSA benefits, no IRS adjustment

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**Example: Post “Deal” -- Lagged Cost Sharing**



- Unaligned or Aligned “deal” and cost shared anticipated benefits
- Benefits to Acquirer: Buy-in/PCT options; flexible management of risky new (in-process) IP; Separable transactions

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### Summary – Main Points

- Consider IP Migration strategies (i.e. CSAs) before and during M&A deal, not after.
- IRC 482 has limited jurisdiction: If no controlled transaction, no transfer pricing, no IRS jurisdiction.
- Proposed CSA (482) regs reduce options for I/C transfers of existing IP
- Cost sharing M&A Target's IP contemporaneous with M&A deal may reduce USP's future tax planning and audit defense options
- Waiting to Cost Share T's IP increases USP's future flexibility in tax planning and audit defense strategies
- Integrate IP strategy within M&A strategy.
- Plan on-going IP migration in light of proposed changes to cost sharing rules.