IP Migration in Relation to BEPS

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It is well known that life science and pharmaceutical companies incur a significant investment in performing research and development ("R&D") activities for a product that may not even succeed in the end. For many US-based pharmaceutical companies, on average, out of 5,000 to 10,000 compounds discovered, only five would end up going through the actual clinical trials, with one that ultimately gets approved by the US Food and Drug Administration ("FDA").[1] Due to this extensive effort, most of the pharmaceutical companies will plan to sell their products in multiple geographic markets. To align with their business objectives, many consider establishing a non-US principal company, which will oversee developmental and sales efforts outside of the US (the "Non-US Principal"). This Non-US Principal will be owned by a Non-US IP holding company ("Non-US IP HoldCo"), which uses certain IP developed by the US parent company ("US Parent") for the non-US operations. From an international tax and transfer pricing perspective, this is essentially an "IP migration" project, which typically involves the following steps:

- Assuming that US Parent has incurred all of the R&D expense to date, [CG1] [TZ2] develop a set of IP (including the compound or active pharmaceutical ingredient, trademark, trade name, technical data, chemical process, etc.), US Parent and Non-US IP HoldCo can consider dividing the economic right of the IP by territory. In a typical IP migration scenario, the US would own the right to the IP in the US territory, while the Non-US IP HoldCo would in-license the right to the IP in the Non-US territory (i.e. worldwide except for the US) from US Parent.

- In relation to the IP right covering the Non-US territory, since the US Parent has developed all of the IP to date, from a transfer pricing perspective, the Non-US IP HoldCo needs to compensate US Parent for this Non-US right at arm's length. This is often referred to as the "Platform Contribution Transaction ("PCT")." There are several specified transfer pricing methods to calculate this compensation.

- Going forward, US Parent and Non-US IP HoldCo can choose to enter into a qualified Cost Sharing Arrangement ("CSA") to share the risk associated with the future development of the IP.

- From an operational standpoint, US Parent will need to incorporate and create substance at Non-US HoldCo, as well as the Non-US Principal. This may include opening up bank accounts, setting up accounting ledgers to record the intercompany transaction(s), as well as hiring employees offshore for the Non-US Principal.

- Should the entities decide to enter into a CSA, there will be annual filing requirements in the US, including certain transfer pricing documentation to maintain.

Historically, a lot of the companies that adopt an IP migration strategy ended up choosing Non-US IP HoldCo to be located at a low-or zero-tax jurisdiction (such as Bermuda or the Cayman Islands). Although Non-US Principal will unlikely be located in the same jurisdiction, it will still be incorporated in a country that has a lower tax rate compared to the US (such as the Netherlands, Ireland, or Singapore). Since Non-US IP HoldCo becomes the economic rights owner of the IP for the Non-US territory and bears the associated entrepreneurial risk, the profits generated in the Non-US region will be kept at the Non-US IP HoldCo level. As a result, the company will face less tax burden in the US and pay less taxes on a global basis compared to the case with no IP migration. The company may end up having no employee at Non-US IP HoldCo and limited substance at Non-US Principal as well.

The G20 countries have observed planning strategies, including IP migration, developed by taxpayers that resulted in double non-taxation or a reduction in tax based in high tax countries, such as by shifting profits to low-or even no-tax jurisdictions. As a result, the G20 countries invited the OECD countries to initiate a project to target this "Base Erosion and Profit Shifting ("BEPS")" issue on a worldwide basis.

In February 2013, the OECD published a report that explicitly states 15 action plans to be developed in order to address the BEPS issue.[2] As the project progresses, certain developing countries were also included in this BEPS initiative. Together, the OECD, G20, and certain developing countries plan to establish an international tax framework under which profits will be taxed at the jurisdiction that conducted the actual value creation and economic activities.

Specifically, Actions 8 to 10 of the BEPS initiative focus on IP-related matters. Going forward, the tax authorities are expected to closely examine structures resulting from IP migration activities so that profits are aligned with functions that contribute to value creation for the company. For instance, if Non-US IP HoldCo does not have actual substance and is located in a low-or zero-tax jurisdiction, the tax authorities can challenge the return that Non-US IP HoldCo should earn. Instead of being entitled to profits generated in the Non-US region, Non-US IP HoldCo will only receive a risk-free return, while the profits are allocated to entities that actually generate value. That is, if there is no actual employee or key decision maker located at Non-US IP HoldCo to direct the Non-US operations, the tax authorities can argue that Non-US IP HoldCo exerts no control over the risks incurred. This means that Non-US IP HoldCo functions more like a "cash box" and therefore, should only be entitled to a market, or even risk-free, return. If all of the key activities are, in fact, performed by US Parent, the IRS may impose an adjustment that essentially counts all of the profits generated in the Non-US region as profits that US Parent should have earned.

Pursuant to Action 13 of BEPS, should certain conditions be met, a company may need to prepare a three-tier transfer pricing documentation, which discloses information such as income taxes paid in various jurisdiction, location of employees, and legal owner(s) of the company's IP. As a result, a company that adopted an IP migration strategy without proper substance may be subject to a significant adjustment during an audit examination, since the company would need to report more information to the tax authorities under this initiative.

Given the recent developments, it is strongly advised for multinational pharmaceutical companies to re-evaluate the functions performed and risks incurred by their parent and related companies and, if necessary, solidify the substance of their Non-US IP HoldCo under an IP migration scheme.

BPM for Life Science

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[1] *"Pharmaceutical Profile 2012," Pharmaceutical Research and Manufacturers of America 2012, page 30.*
[2] *OECD, "Report Addressing Base Erosion and Profit Shifting," February 12, 2013.*