INTIPSA

International IP Strategists Association

This is one of a series of Briefing Notes published by the International IP Strategists Association (INTIPSA), a not for profit group dedicated to advancing awareness of best practice in IP strategy and management. For more Briefing Notes, and to find out the benefits of joining INTIPSA, visit www.intipsa.com

Strategic intellectual property offshoring through outsourcing

Traditionally intellectual property (**IP**) offshoring has been used by multinational corporations as a way to reduce their global effective tax rates by holding their IP in low tax offshore jurisdictions. The 2009 relocation by McDonalds of its European head office to Geneva was reportedly motivated by the desire to take advantage of Switzerland's relatively beneficial tax regime for profits derived from IP. McDonalds joins a growing list of companies including Procter & Gamble, Colgate – Palmolive, Google and Yahoo! that have moved the management and exploitation of IP to jurisdictions such as Switzerland, Holland and Ireland for tax reasons.

While the world's largest corporations have always had the resources and the global reach to restructure their IP in this way, the emergence of IP as the central asset of many companies means that a global approach to holding and exploiting IP is something that companies with global ambitions can no longer afford to ignore irrespective of size and stage of development.

In this paper we explore how companies can apply financial services thinking in their IP strategy in order to structure their IP holdings to deliver operational and tax efficiencies on an international scale.

Why consider offshoring?

Offshoring has been one of the key elements of globalisation and a driver of economic growth over the last three decades. Deregulation of financial markets and elimination of capital controls saw the emergence of a network of dominant financial centres around the world including the City of London, the International Financial Centre in Dublin and Singapore's financial centre to finance the new wave of multinational globalisation.

Between the early 1990s and the turn of the century many companies recognized the benefits of offshoring certain functions for strategic as well as tax reasons. The 1990s witnessed the establishment of many manufacturing operations in Western Europe and South East Asia by US companies looking to establish a global manufacturing and supply-chain capability, access European and developing markets and benefit from a lower cost and more flexible labour force. A second wave brought manufacturing into Eastern Europe and mainland China.

In our view, the next big global trend is the emergence of IP as the central asset of the most successful companies. This trend manifests itself in the many high profile patent disputes surrounding mobile handset technology, the emergence of non-practicing entities (**NPE**) and a variety of IP centric business models in both operating and non-operating companies. In our opinion this trend will drive the formation of global centres for IP services in Europe and Asia.

IP, once the preserve of the legal department in head office, is now operationally important, demands new and varied skills to optimise its exploitation and is subject to regional variation. Furthermore IP represents a real element of a company's value and is responsible for significant revenues from licensing or from the sales of goods and services that are supported by IP.

Taking all of this into account it seems natural, therefore, that for a company to use its IP to the fullest extent possible it needs an optimised structure to hold and exploit it. Given that IP is often sourced globally through such diverse channels as direct acquisition, open innovation, joint ventures and university collaboration; a holistic global approach to the holding and use of IP is needed for today's modern enterprise. This is as true for large established multinationals as it is for international SMEs and high value scaling start-ups.

Where tax is concerned there are opportunities and risks. On the one hand authorities are fighting to keep taxing rights to existing IP in their jurisdictions while at the same time offering incentives such as patent boxes or capital allowances to attract new IP.

For example the new UK patent box offers an incentive that takes the UK some way towards being comparable to the Benelux countries. It is hard to be specific about how it will play out but it shows that there is strong competition globally to attract and maintain mobile IP investment.

While the incentives offer opportunities, there are some pitfalls involved in offshoring that can be avoided by early decisions around global IP strategy. Allowing IP rights to build up in the wrong place can be costly in terms of inhibiting future tax planning and international development.

Firstly tax authorities are keen to prevent IP being used as a way to illegitimately move profits offshore so that they may be booked in a low tax jurisdiction. Exit charges are often levied on transfers of IP out of a jurisdiction. And where IP is held in an overseas jurisdiction authorities can look beyond the legal ownership to the economic ownership when evaluating the appropriate tax laws to apply. For example, countries such as UK and USA are examining rules which would allow them to tax excess overseas profits including those arising from IP offshoring.

In practice this means that a company must demonstrate that its offshore IP subsidiary not only has legal IP ownership but also assumes some of the costs and risks associated with the IP that it holds and is entitled to share in the benefits associated with its exploitation.

An offshore subsidiary can do this by actively managing, developing and exploiting IP rather than merely passively collecting royalties through an insubstantial company. Therefore an offshore IP subsidiary should engage suitably qualified individuals to operate and manage the day to day activity of IP exploitation and monetization so that the economic and legal ownership of the offshored IP are aligned.

Putting it all together means that, even at an early stage, tax and global IP structure is an important consideration for many companies that are trading or planning to trade internationally.

However offshoring is no longer simply a matter of picking a particularly favourable offshore jurisdiction and assigning the rights to an insubstantial subsidiary. Real thought needs to be given to which IP rights support the business, what their value is and how those rights can best be managed offshore from both an operational and a tax perspective.

Outsourcing as a means of offshoring

As we have noted, offshoring to a low tax jurisdiction without substance risks the home tax jurisdiction claiming taxation rights on those profits. Therefore an offshore subsidiary needs to have its own substance and activity to avoid this risk.

Normally the establishment of a standalone operation is the only option for a company wishing to provide substance in an offshore IP subsidiary. In this case the company must rent an office, engage directors and employ staff locally. Alternatively staff can be transferred into the subsidiary. Both options are costly and slow to set up, particularly so for smaller companies or those with inadequate resources. Furthermore, in the case of IP management which requires particular skills and experience there are increased operational risks associated with the delegation of important responsibilities to remote isolated teams.

In addition, some of the more tax-friendly jurisdictions such as Ireland, Malta and Luxembourg lack a ready supply of potential employees with the core skills that are needed to staff an IP management subsidiary.

While large multinationals often have the capacity to fund and staff an overseas IP management office, smaller companies or those that have high value assets but low headcount often find that the burden of establishing and maintaining a remote office is a significant barrier to unlocking the benefits of managing IP offshore.

We suggest an alternative, cost effective and lower risk approach.

In this case the operation of the offshore subsidiary is provided by an outsourcing partner who becomes responsible for day-to-day IP management operations delivering services according to a service level agreement. Thus the operational risk is reduced by passing responsibility for sourcing trained staff onto a service provider who is better placed to do so with its local knowledge and network.

Additionally a higher level of service at lower cost can be achieved by engaging a specialist contractor who serves a wider range of domestic and foreign clients.

Outsourcing is becoming more and more acceptable for IP operations. The engagement of specialist contractors to pay renewal fees is now well established. The use of offshore back-office operations for document review and other legal processes is also gaining ground. Contracted IP and technology development is commonplace. Recently, specialist firms have emerged which provide highly specialised services relating to patent licensing and assertion sometimes on a contingency basis.

IP outsourcing is no longer about cost saving by delegating commoditized work to low cost providers. Companies are now identifying internal skills gaps at all levels that are difficult to fill either by hiring or by organic growth from within. Outsourcing is now an acceptable way to fill these gaps and to reduce the associated risks.

In our view the attractions and challenges of offshoring IP in tax-friendly jurisdictions will also drive managers to consider outsourced managed solution as an alternative to building remote standalone operations, either as an interim or long term solution to achieving alignment of economic and legal ownership of IP assets. They will do this to take advantage of the cost and risk benefits that come from engaging a trusted experienced specialist as opposed to attempting to source local staff with appropriate skills and experience.

Financial Services thinking

The idea of outsourcing corporate functions to a specialist in a low-tax jurisdiction is not a new model.

In the 1980s the Irish government established an International Financial Services Centre which provided attractive tax incentives to firms, primarily banks and insurance companies who established operations in the Dublin docklands area.

Corporate treasurers soon recognized that they could centralise regional or global treasury operations in Dublin to unlock those tax incentives for their corporations' financing activity. However they were presented with the challenge of attracting and hiring competent treasury professionals in what was then a backwater as far as financial services were concerned.

To solve this problem several banks and independent specialists began offering an outsourced managed treasury service designed to provide the needed services in a way that was acceptable to the relevant tax authorities.

In the same way today, corporate IP offices are attracted by tax incentives to move IP into certain jurisdictions and are confronted with the challenge of putting substance into these subsidiaries.

We believe that companies should investigate all options including the option of engaging a specialist service provider to deliver day-to-day IP management services to the subsidiary.

Some Scenarios

To see how outsourcing might be used in practice it is worth considering some hypothetical examples:

A US technology start-up is building a significant US and international IP portfolio. It anticipates generating large profits sourced domestically and internationally. As an alternative to developing all its IP in the US it can establish an offshore subsidiary and enter into a cost-sharing arrangement (perhaps including R&D tax benefits) with it. The subsidiary holds a portion of the IP rights and shares in the revenues generated reducing the effective tax rate on profits from commercialisation. The start-up is not yet ready to open an overseas office and so engages an outsourcing partner to establish and run the offshore operation until such time as it is ready to support its own office with an operation built around this IP core.

An NPE domiciled in a high-tax jurisdiction has raised capital in order to fund the acquisition of patents from global companies. It foresees licensing these patents to both domestic and foreign companies. It sets up a subsidiary in a low-tax jurisdiction which co-invests in the IP acquisition and assumes some responsibility for licensing and business development. Cross-border transfers of IP are avoided to minimize tax-leakage, capital allowances are generated and the effective tax rate on patent licensing revenues is reduced significantly. The retained profits can be used to invest in further overseas acquisitions. The NPE, although valued at over €1 billion has less than 50 highly skilled staff and cannot justify employing lower skilled staff in a remote location. It turns to a specialist service provider to add substance to its offshore operation while ensuring that the service contract is closely managed by one of its executives.

An established multinational uses some of its own legacy IP together with IP acquired from mergers and acquisitions to develop new more valuable IP. It first licenses the legacy IP to an existing manufacturing subsidiary in a low-tax jurisdiction which invests time and money in assembling and integrating various IP rights through R&D thereby creating new, more valuable IP. The subsidiary then licenses all group companies to the new IP providing a tax saving. Although the subsidiary has significant employment in its manufacturing plant, it has no skilled IP resources and due to its business model, the addition of extra headcount is unacceptable. The multinational outsources the IP strategy development and management to a specialist in order to deliver the financial benefits without increasing headcount.

Conclusion

With the growing awareness of IP as one of the central assets and profit drivers in a business, companies of all sizes and stages of development are gradually adopting IP strategies that support their business. Such strategies should include examining how IP can be held and managed in low-tax jurisdictions to deliver tax savings. Traditionally only big companies had the resources and reach to engage in this type of activity but outsourced IP management propositions now enable small and growing companies to lock in tax benefits at low cost at an early stage. . We forecast major growth for outsourced IP management services, in line with analogous experiences in specialist financial services.

Fred Logue and Tony Owens
New Morning IP