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Has BEPS Signaled the Death Knell for U.S. Pharmaceutical IP Migration to Ireland?

Marc Alms, Kieran Taylor and Cliona Donnelly
Alvarez & Marsal Taxand LLC, New York, U.S. and William Fry, Dublin, Ireland

Mergers and acquisitions continue to flourish within the pharmaceutical industry. Are multinational pharmaceutical enterprises still able to generate tax savings through IP migration to Ireland, in light of the OECD action plan to combat base erosion and profit shifting?

Marc Alms is Managing Director and Kieran Taylor is Director at Alvarez & Marsal Taxand LLC, New York, U.S. and Cliona Donnelly is Partner, William Fry, Dublin, Ireland

I. Introduction

In recent months, the U.S. has shown overt aggression towards tax-motivated planning schemes, with a particular focus on U.S. multinational enterprises ("MNEs") attempting to move profits offshore, often to low-tax territories, such as Ireland. 2014 and 2015 saw a spate of corporate inversions[1]—particularly focused within the pharmaceutical industry—whereby U.S. groups merged with foreign competitors, and in the process changed their tax residency to a more favorable tax jurisdiction. Similarly, if less public, a common business planning technique is to transfer the location of intangible property ("IP"). While businesses frequently have commercially strategic reasons for moving IP, relocating IP to low-tax jurisdictions (and theoretically reallocating profits in the process) is often used as an alternative mechanism of reducing a group's effective tax rate.

As is widely known within the tax universe, the Organization for Economic Development ("OECD") has tasked itself with combatting base erosion and profit shifting ("BEPS"). BEPS includes shifting profits from a high-tax territory to a low-tax territory without appropriate substance, and relocations of IP are firmly within the BEPS scope. While the U.S. (although an OECD member and active participant in BEPS discussions) has in general kept the interests of businesses and protection of certain American ideals prioritized above immediate adoption of many of the BEPS recommendations, other nations (particularly some of the key destinations for U.S. IP, e.g., Ireland) have been more welcoming towards these initiatives.

As merger and acquisition activity continues to flourish within the pharmaceutical industry,[2] and the executive suite remains under pressure to deliver higher investor returns and earnings per share, this article addresses the question: can pharmaceutical MNEs still generate significant tax savings through IP migration to Ireland?

II. U.S. Regulations

Typically, when undertaking an IP migration, a U.S. MNE will migrate either its global or rest-of-world exploitation rights to a foreign entity in a low-tax loca-

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tion. This relocation is intended to justify a decrease in profits attributable to and taxable in the U.S., as the low-tax IP owner is now entitled to a significant portion of the reward attributable to the transferred IP. As part of the relocation, either a one-time lump sum payment or a regular royalty flow will likely be due to the U.S. entity. Whatever the form of the payment, there will be initial transfer pricing and corporate tax implications both in the U.S. and in the foreign destination of the IP.

The current U.S. transfer pricing regulations describe means for valuing the initial transfer and any resultant revenue streams from moving IP into a foreign jurisdiction. Historically, these rules have not presented taxpayers with any major roadblocks to transferring IP and have described several options for valuing IP transferred abroad.

There are three typical means of transferring IP (particularly "rest-of-world" distribution rights, as is the most common) outside of the U.S., with tax outcomes varying depending upon the method of transfer. These are:

- full transfer of all substantial rights through a sale;
- license of the IP, with all substantial rights transferred; and
- cost-sharing arrangement where an asset is jointly developed by two or more cross-border affiliates.

Depending upon the chosen method, both the transfer of the IP itself and any resultant revenue stream may be subject to different applications of the U.S. corporate tax law and transfer pricing regulations. Outright taxable transfers and licenses of IP would be subject to the transfer pricing rules and taxed in accordance with the ultimate valuation method chosen.

Historically, U.S. taxpayers could use the applicable transfer pricing regulations to transfer the full economic rights to the IP to a low-tax jurisdiction where the IP would be accompanied by more limited supporting business processes (or "substance" in tax parlance), and still reap significant rewards in tax savings. Tax would be paid on the value of the transfer; however, the future "profits" attributable to such IP would no longer be allocated to the U.S. (and would thus no longer be taxed in the U.S.), instead falling within the new, low-tax jurisdiction. The focus in these transactions was on the ownership rights resulting from the funding of IP development and a broad assumption of risk related to such development efforts. Now, however, the BEPS initiative, led by the OECD and supported by the major European economies, may raise the bar and require more "substance" to justify profits earned overseas by relocated intangibles.

III. Irish Regulations

In line with the U.S. rules, the method of transferring IP and the resultant revenue streams are also subject to different applications of the Irish tax law and transfer pricing rules. Ireland is a member of the OECD and therefore endorses the OECD Transfer Pricing Guidelines. The Irish code states that it shall be construed to ensure practical consistency between the Irish code and Article 9 of the OECD Model Tax Convention as well as the OECD Transfer Pricing Guidelines.

As Irish transfer pricing legislation has only been in place since 2010, it remains to be seen whether the Irish Office of the Revenue Commissioners has a priority for particular methods or whether it will indicate any underlying principles regarding the choice of method. However, a common theme in the OECD Transfer Pricing Guidelines is that there is no "best method" approach and that transfer pricing is not an exact science.

The transfer pricing legislation is silent on whether or not foreign comparables can be used as a basis for establishing transfer prices. Until the Office of the Revenue Commissioners provides guidance on this, the principles of the OECD Transfer Pricing Guidelines surrounding "sufficient comparability" should determine whether the use of foreign comparables is appropriate. The Irish transfer pricing legislation is regarded as a "one-way" system, in that adjustments to taxable profits will only be made when there is an understatement of profits as a result of an arrangement between connected parties. In reality, due to the low corporate tax rate in Ireland, the likelihood of an understatement of profits in Ireland is low regardless of the method chosen.

IV. BEPS Measures

Foreign tax authorities were only too willing to accept IP transferred out of the U.S., with some (including the U.K.[3]) designing tax regimes with very low tax rates specifically with pharmaceuticals in mind. While the U.S. tax will be calculated as referred to above, the other side of the IP transfer would have to generate significant savings in order to justify the migration at all. As mentioned, historically, pure transfer of ownership was enough to warrant these ongoing tax savings; however, the times are changing.

As part of the BEPS project, the OECD has transformed the internationally accepted framework of IP transfer pricing, and in so doing has challenged the ability of territories to offer such favorable rates of tax purely through migrating the location of IP ownership. In OECD-following nations, an entity owning IP will no longer be entitled to keep all the profits from exploitation of this IP (e.g., sales revenue) purely by virtue of IP ownership. Specifically:

> For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible. . . the return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members. . .[4]

The specific functions, assets and risks the OECD references when considering entitlement to profits borne from IP are those relating to development, enhancement, maintenance, protection and exploitation of the intangibles ("DEMPE functions").[5] Substance is now required to manage the DEMPE functions, and only with this substance (e.g., staff) can profits be attributable to an IP-owning territory.

V. BEPS Impact

Considering the U.S.'s apparent lukewarm response to BEPS, why should U.S. pharmaceutical firms care? From a U.S. perspective, the rules have yet to change. Relocating the ownership of U.S.-based IP allows a U.S. entity to reduce its profits. A foreign nation, receiving the uptick in profits and associated tax revenue, is highly unlikely to challenge a structure based on receiving too much income, hence the taxpayer and foreign nation are both automatic winners, right? Wrong.

As outlined, while the U.S. may not be rushing to adopt BEPS initiatives, it is looking to challenge U.S. tax "avoidance" wherever possible. As such, there is an increasing likelihood the U.S. may use other nations' adoption of BEPS as an argument against them—reminding territories such as Ireland that in order to justify retention of IP-related profits, their own domestic rules will soon require these DEMPE functions to be located in their jurisdiction. The U.K., for example, can no longer claim that simple ownership of IP entitles it to a large share of related profits (and, indeed, the OECD has specifically challenged the U.K.'s overly generous tax regime).

The impact on BEPS relating to such transfers into Ireland is typically discussed in light of the much publicized "double Irish" tax regime. This regime was, however, not per se a part of Ireland's tax code. However, in light of negative connotations made by the OECD in respect of this tax regime, Ireland's reaction was to unilaterally change its Irish tax residency rules to effectively end the "double Irish" structure. This means that beginning in 2015, any companies incorporated in Ireland would be tax residents in Ireland (subject to double tax treaty overwrite). A grandfathering period for existing companies will exist until January 1, 2020.

In light of the fact that Ireland's offshore regime is being phased out by 2020, additional unilateral action was taken by Ireland in recently introducing further enhancements to its existing and often overlooked onshore IP regime by the introduction of a knowledge development box ("KDB"). Interestingly, the KDB introduced by Ireland was the first such KDB to comply with the OECD's "modified nexus" standards as set out in the final reports of the OECD's BEPS project. These provisions apply to reduce the corporate tax rate in Ireland by 50%, to 6.25% on any qualifying profits. Overall, the impact of BEPs in Ireland has led to a bolstering of Ireland's competitive tax regime but only where appropriate substance is located in Ireland. Being mindful of its pharmaceutical sector, Ireland can also provide a favorable rate of taxation via migration of IP, provided the substance referred to above is present.

VI. Can a Pharmaceutical Company Still Achieve Tax Savings?

As outlined, relocation of IP to Ireland can still generate significant tax savings for U.S. pharmaceutical companies, even in our "post-BEPS" world. In light of these recent changes, both from the Irish perspective and the wider BEPS environment, it is now clear that a corporation will need to employ defined functions to be eligible for the onshore regime in addition to the historically acceptable ownership in the new tax jurisdiction. The functions required are clear; hence, in addition to relocating the ownership of the IP, a corporation will now need certain senior staff in the new, low-tax jurisdiction managing the key DEMPE functions. While this additional "substance" is a larger requirement than pre-BEPS, relocating these functions and IP ownership will allow companies to truly maximize tax savings while remaining compliant from both an IRS and local OECD territory BEPS perspective.

Marc Alms is Managing Director and Kieran Taylor is Director, Alvarez & Marsal Taxand LLC, New York, U.S., and Cliona Donnelly is Partner, William Fry, Dublin, Ireland. They may be contacted at: malms@alvarezandmarsal.com; ktaylor@alvarezandmarsal.com; cliona.donnelly@williamfry.com

Notes

[1] http://www.theglobeandmail.com/report-on-business/big-deals/tax-inversions-down-but-not-out/article23308643/.

[2] http://www.ft.com/fastft/288242/healthcare-deals.

[3] http://www.telegraph.co.uk/finance/budget/9159673/Budget-2012-GlaxoSmithKline-to-invest-500m-in-UK-and-create-1000-jobs-after-cut-in-patent-profits-tax.html.

[4] Actions 8–10: 2015 Final Reports , p. 80.

[5] Actions 8–10: 2015 Final Reports, p. 88 [Amended OECD Transfer Pricing Guidelines, Chapter VI].

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