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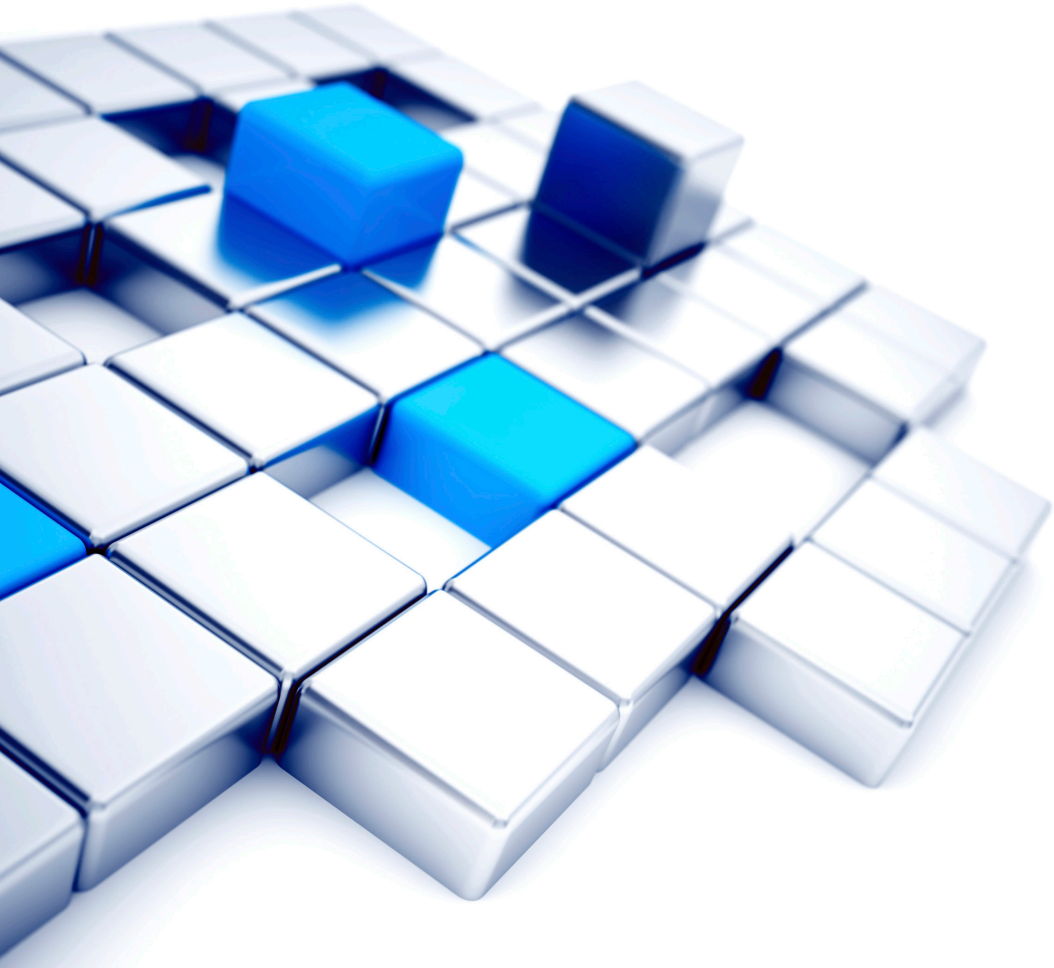
Situational awareness
Aligning business strategies and tax planning for intellectual property



If you have an apple and I have an apple and we exchange these apples then you and I will still each have one apple. But if you have an idea and I have an idea and we exchange these ideas, then each of us will have two ideas.

—George Bernard Shaw

Beyond patents, beyond tax

Few companies can create value without relying on intellectual property (IP)—the often invisible assets they can't weigh or lock in a safe, but which set them apart from their competitors.

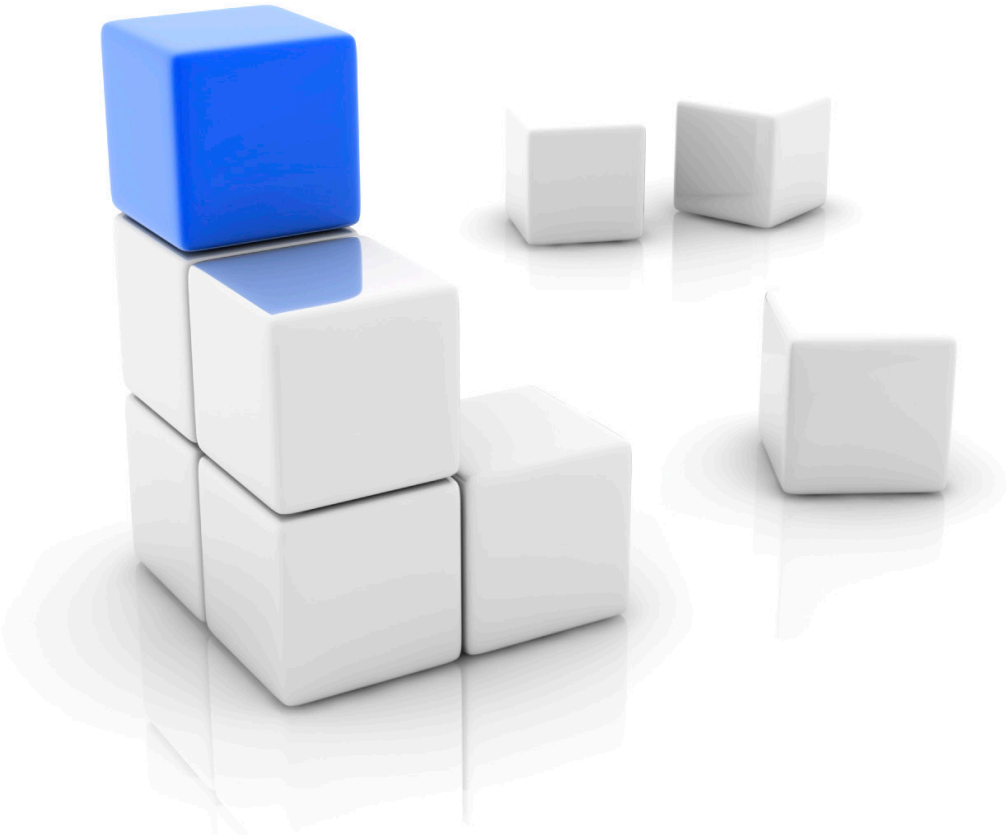
Business strategies that help build, protect, and monetize IP are a common focus for large organizations. Too often, however, these same organizations neglect to align the way they manage their IP with their global tax planning.

Failing to address the tax implications of intangible assets can lead to very palpable consequences.

- Poorly structured IP management may cause profits to build up in high-tax jurisdictions.
- Without careful planning, moving intangible assets across borders or among business entities may elevate transfer pricing risks and tax liabilities.
- Mergers and acquisitions can leave IP in places where owning it costs too much and it delivers too little value.
- Poor planning of IP management, or poor documentation of IP inventory and use, may invite regulatory challenges.
- Tax planning not attuned to the business may lead to costly government challenges.

The result can be not only a higher global tax burden, but also limited ability to make effective critical business decisions on an after-tax basis.

Few business leaders have the time to consider IP on its own as an important business issue. They're absorbed in the real-life scenarios that determine the success of the company. Alright, then: What about those scenarios? In these pages, we'll examine a few common examples and see how IP tax planning needs to be part of the calculus.



IP 101

Many people think of intellectual property (IP) in terms of "trade secrets"—but if they do, they're leaving a lot of other categories out of their plans to measure, protect, and profit from the intangibles within their organizations.

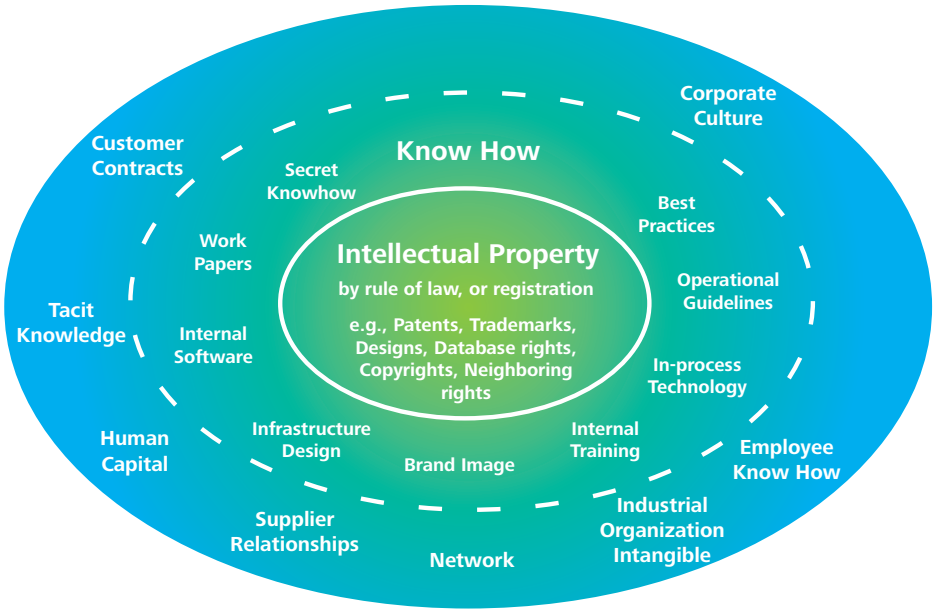
IP does include the kind of bona fide trade secrets you might lock in your safe. Everyone has heard stories about the "secret recipes" behind famous soft drink and fast food brands. But IP also includes trade intangibles like patents, and designs, as well as marketing assets like trademarks and brands. Workaday know-how—the experience an executive or a workforce has in getting the job done—can qualify as IP too.

IP is not a static commodity. The role it plays, the costs it imposes, the benefits it offers, and the associated risks—all change over its lifespan. IP may enter an organization at the moment of its creation, as a direct purchase, or when the company acquires an asset that includes ownership of the IP. Like other assets, IP can depreciate over time without appropriate investments, though the means of calculating that value erosion isn't always as clear as with a tangible investment. And in the end, an organization can retire an IP asset, much as it would a building or a piece of equipment. For example, IP can obsolesce, as technologies advance or change. The concept of the IP lifecycle is significant because it adds a time dimension to the way an organization considers and manages its intangible assets. This is not a decision you make once, but a long-term plan that requires both foresight and agility.

IP has value. There are numerous views that tax authorities will enumerate as their version of what that value is and what a company owes for owning, using, or transferring it. And the rules change frequently. The company that fails to identify, value, and protect its IP legally may be opening itself up to excess risk and leaving potential profit unrealized. To make IP work in the long-term, a company's IP strategy, its tax planning, its legal process and policies, and its business strategy must operate in alignment. Deploying the IP is an important consideration and a few options include granting the territorial ownership to an affiliate or third party, licensing, and sharing in the rights to it.

Know-how

IP is a broad category that includes elements that many people associate with the term—like patents and trade secrets—along with components that some organizations may neglect to consider, such as culture and relationships.



Now, let's look at some common IP scenarios—and how these principles may apply.

What if…

…You're engaged in M&A?

When your organization and another come together, many parts need to mesh. The longer that process of integration takes, the less efficient the deal will be. It's not surprising that at a time like this, many leaders focus attention on the tangible assets right before their eyes, such as working to integrate people efficiently.

But a merger or acquisition also has the effect of forcing two separate IP regimes to become one. If the resulting IP structure doesn't benefit from deliberate attention, it can be haphazard or worse. It might not support the tax planning and business strategies that brought the entities together in the first place. And you might find it locked into place.

Handled well, the integration of IP after an M&A deal may be a significant benefit. The new entity should have IP in the right places where it can help generate value, and everyone involved should have a clear understanding of the tax implications. The location and use of the IP should line up with the organization's operating and ERP structure. And due consideration should be given to not just beneficial ownership, but legal ownership as well. These sometimes, but not always, will or should be the same.

Handled poorly, post-M&A IP strategy can become a muddle that enhances risk, decreases efficiency, contains redundancies, and elevates the global tax burden. There are decisions in integration that you get to make only once—and if an inefficient IP strategy is baked into the deal, it can be hard to fix later.

In M&A, IP planning needs to be front and center—not only in integration, but as part of the due diligence process. IP should be a factor in why the deal is happening and how.

Key disciplines

M&A

Mergers and acquisitions can challenge a company's strategy by throwing new IP and structures into the mix—at various points in their lifecycles, and in a way that's seldom aligned with the strategic decisions that already govern other intangibles. That means analyzing the value of the IP, assessing its risks, and quantifying the potential opportunities it represents. There will likely always be plenty of work remaining during post-merger integration. But ideally, the big IP decisions will happen during due diligence and contribute to large-scale decisions about the deal itself.

…You're changing your ERP environment?

Whether it's an update or an overhaul, a revamped ERP system will fundamentally alter the way a supply chain moves through an organization. Is your IP strategy aligned with that new supply chain? Or are you going to find out months from now that for tax purposes, you're earning all your income in a high tax foreign country?

Where supply chains are concerned, businesses need to apply a tremendous amount of transfer pricing logic to the design of their business processes. That means knowing the rules of the road in and between the jurisdictions where you operate. Who owns the IP? How does it drive value? Who posts the profits when it does? How aggressive are the relevant taxing jurisdictions at play?

When an ERP project takes IP into account, people ask these questions early in the process and build the answers into the logic of the new system. At a minimum, that adds clarity that can help address excess taxation and manage risk. But the potential benefits don't stop there: A sound IP component to ERP change can identify areas of opportunity as well.

Remember the old 'Garbage in Garbage Out' principle of information systems? An ERP structure that doesn't have IP strategy baked in may end up generating results that aren't consistent with effective IP practices. Your risk will most likely go up, as different governments compete for your tax dollars and if you don't have the documentation to sort out the liability.

To maintain your profits properly and to allow your IP to generate value instead of costing you money, your information systems shouldn't treat intangibles as an afterthought.

Key disciplines

Transfer pricing

When related parts of a business use each other's resources, tax authorities expect them to charge each other as if they were separate companies operating "at arm's length." Failure to effectively plan can lead to significant tax liabilities and risks of double taxation. Anticipating and easing the burden of transfer pricing starts with the way different parts of a business legally relate to one another and the ways in which ownership of the relevant IP is parceled out.

For example, a business unit in one country may perform manufacturing functions for a business unit in another country that imports the goods and sells them. The plans and specifications, technical secrets, and know-how that go into the manufacturing process all represent IP. Who owns it—the parent company or the manufacturing arm? Does the manufacturing unit owe the other unit a royalty for using the IP? Or do they own it jointly under a cost-sharing agreement?

Today, the ability to transfer and apply IP instantly around the globe using the internet adds complexity to these issues. Because this high-speed, high-volume information flow exists in the digital "cloud" rather than in a distinct physical location, it invites questions about where the IP actually resides and whether or not it has actually traveled across a border.

Obeying the law starts with knowing the law. And it's changing, fast, in every jurisdiction where you do business, prompted by recent projects on Intagibles and Base Erosion and Profit Shifting (BEPS) currently being addressed by the OECD.

…You're recasting your business model?

Sometimes it's evolution: A computer hardware company might find itself emerging as a software leader or as a cloud service provider. Sometimes it's revolution: For example, health care reform has many hospitals and insurers re-examining whether they're even in the same business anymore.

Whatever the pace, a shift in business model changes everything. If you don't account for IP as part of the process, the tax implications can go from dramatic to traumatic in a hurry.

Once again, the answer is to include IP tax planning from the outset. Take an inventory of your IP portfolio and business model from scratch, as if you were starting a new business—because in many ways, you are. What is it? Where is it? What am I delivering, and from where?

Inconsistency means risk. If your business contracts support one truth about IP and your IP strategy supports another, you may be at a disadvantage asserting your position to tax authorities.

If your model going forward involves mobile or virtual services, it can be unclear where the assets that support those services are located for tax purposes, or where the value-driving transactions took place. The physical location of servers and other elements of your IT infrastructure can be key considerations, but not the only ones. Contracts and customer relationships matter too. Shared service centers that support operations in multiple jurisdictions can make the picture more complex.

Key disciplines

Business Model Optimization

Creating value through business transformation

The alignment of a company's operating model and its global tax planning enhances the opportunity for value creation. Each must adapt to satisfy the demands of the other. BMO is the process of pursuing this balance and integrates the operating model with global tax planning into the way a business operates.

Tax planning that is not based on operations can dramatically increase the risk profile of a company. And a business model that does not take tax planning into account may end up surrendering some or all of the profit it creates to higher taxes.

The way an organization structures and locates the components of its business, and the way it sets relationships among them, can influence the way the IP contributes to value and the way in which taxing authorities view that contribution. Often, a process that seems completely internal can actually "carry" IP across jurisdictional borders, incurring transfer pricing or other risks along the way.

Some of the basic IP structures are:

- **Dispersed:** The organization's IP resides in a number of different locations
- **Overlapping:** Similar or identical functions implicating IP are taking place in multiple locations
- **Regional:** The IP resides in more than one location, but is limited to a few
- **Centralized:** The IP resides in a single location and units "use" it from there

Income characterization

When an element of IP contributes to creating value, what kind of value is it? Is it capital gain, business income, or something else? Were the IP rights acquired by means of sale or license (e.g., is the transaction recorded as an upfront payment or a long term license stream?) The distinction can have a significant effect on the way the sum in question is taxed not limited to countries, yet state taxing jurisdictions as well.

…You're developing new IP?

Even the simplest IP tax scenario—developing brand-new IP, outside the context of a merger or system change—isn't necessarily simple. Whether it's a new pharmaceutical patent, a new software application or some other freshly minted intangible asset, you theoretically have a clear path to making all the right decisions. But will you?

Traditionally, the party that takes the risks and incurs the expense of developing IP is credited with the returns it generates, and is responsible for the taxes on those returns. However, there's a growing global trend to also consider where the IP is managed, directed, or controlled.

For example, India may seek to tax the profits associated with R&D activity within its borders even if the IP involved is owned by investors in the United States who funded its creation. Other countries may alter their tax codes with the explicit aim of reducing IP tax burdens and encouraging innovation within their borders, as with the many "Patent Box" regimes coming on line in Europe.

What this means for companies that develop IP is that it's more important than in the past to coordinate the human side of IP and tax planning. Where are your people? Where does the IP "go" to make R&D happen? Who is participating in which phases of the process?

Even if your approach doesn't involve pursuing deliberate incentives like the Patent Box, it's still vital to align your organization's internal IP ownership structure with a distribution of personnel and functions that places taxable activities in more desirable jurisdictions.

Key disciplines

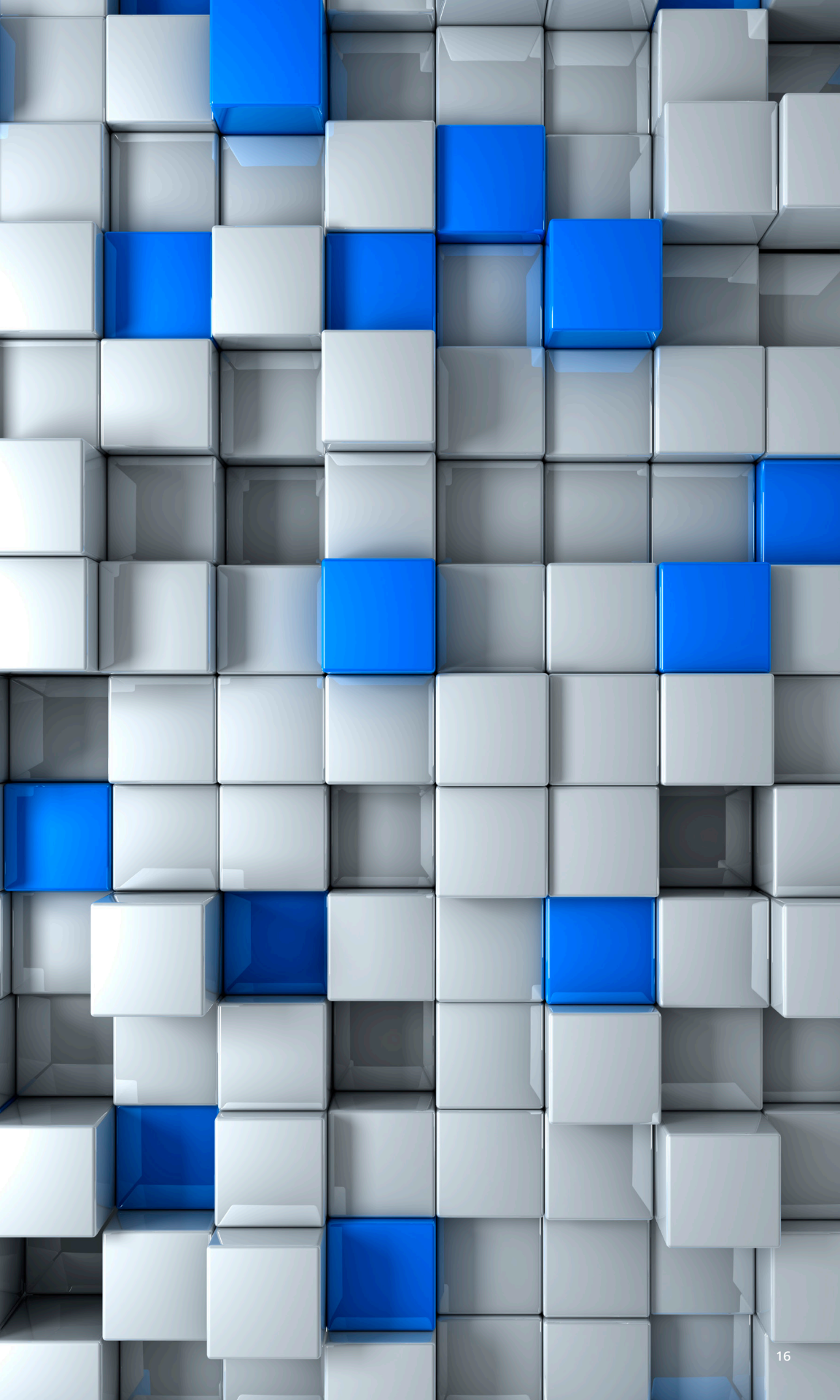
People strategy

The first group many think of when they think of IP is innovators. But in many cases they have the least to do with the property's place in the business plan or its effect on tax status. The investors and executives who work with the IP are usually more central to both business strategy and tax planning, because they are the ones required to manage the risks. But as certain countries increase their focus based on where the people and locations where IP is managed, organizations may benefit by shifting some of the calculus to other organizations—for example contractors—and into other tax jurisdictions where some operations are located. It means the placement of individual people and business units may have more impact on both tax planning and business strategy than in the past.

Analytics

IP taxation is a fertile field for analytical methods because it involves multiple rules and tax rates that exist at the same time across different jurisdictions, complex ways to calculate IPs current and future value, and an almost endless array of "what-ifs" that make it hard to quantify the potential outcomes of strategy decisions.

For example, using conventional means it can be difficult to estimate the market value of an IP asset being transferred, the expected return an investor will be owed arising from operations that use IP or the tax liability on that profit.



Now what?

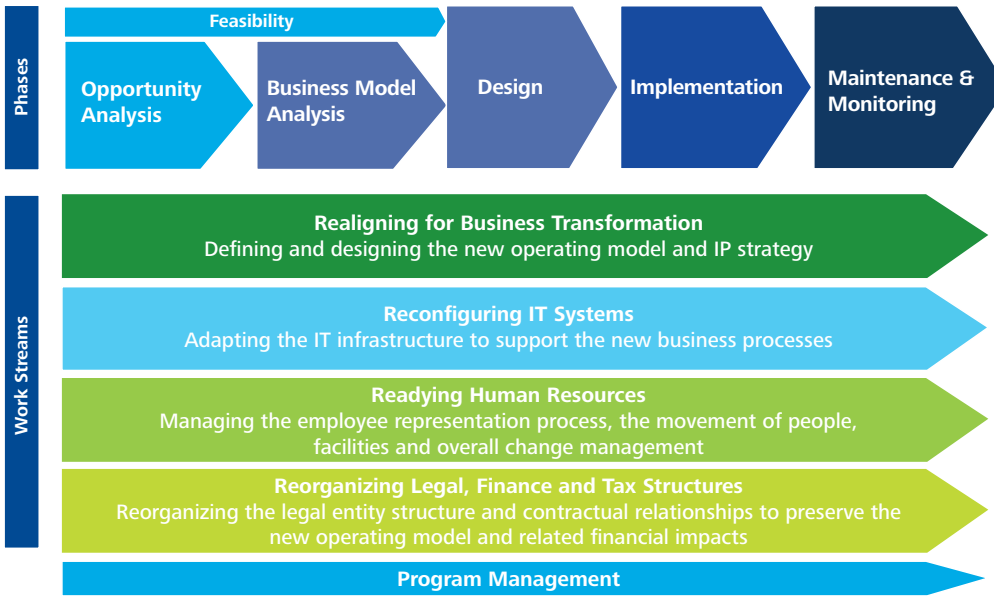
Process: Start at the beginning

Deloitte's business model optimization methodology can help guide the realignment of IP planning so that business strategy and tax planning are in sync.

Four simultaneous work streams—the "4Rs"—guide an organization through realignment of the business model, reconfiguring of IT systems, readying the human resources, and reorganizing the structures that govern the relationships among legal, finance, and tax regimes.

These efforts progress through four phases—feasibility, design, implementation, maintenance and monitoring—to provide a rigorous overall framework for integrated transformation of business, systems and tax.

Not every IP planning project involves every facet of the 4R methodology. It is a map, not a checklist. Using it, organization leaders and their advisors can determine that the right processes are in place as the business moves to design and implement consistent business and tax strategies.



The 4R methodology

Realigning for business transformation
Aligning IP tax planning and business strategies may or may not be part of a larger business model transformation. But every organization should make sure its business model is capable of efficiently developing and deploying IP in the right ways. This is the groundwork for everything that follows so it is critical that the organization's management, operations, and tax professionals (whether internal, external, or both) partner in this assessment and design process.

Reconfiguring IT systems
IT systems must be able to support governance structures, supply chains, and every other part of a business in harmony. IP is an essential part of this puzzle. Building this capability will touch upon access to financial data, tax policies, transfer pricing, approval processes, and other issues.

Readying human resources
Aligning strategies means changing functions, locations, and risks. That can mean moving people, which has the potential to trigger attrition, disruption, and leadership confusion. The talent implications of IP strategy can't be ignored.

Reorganizing for legal, finance, and tax structures
Changing the way valued assets move within and through a company can lead to unforeseen changes in customs, taxes (both direct and indirect), and calculations about ownership and profit. Organizations can't leave these elements to chance.

Conclusion: Don't go it alone

As businesses seek new ways to drive revenue and profits while effectively managing cash flow and costs, effective IP tax planning is a smart idea. It can help companies create substantial value while helping them address and manage tax-related risks.

But companies cannot consider IP strategy, tax planning, and business strategy as separate items. They all work together. The way an organization arranges its internal structure can have far-reaching effects on the tax liabilities that come with developing and using intangible assets.

Interactive tools like Deloitte's Digital Global ST^{2}EPS uses descriptive analytics to help businesses identify focus areas in tax planning and estimate the tax impact that can result from different scenarios—based on IP or on other considerations.

The tax laws of the parent organization's home country are one place to start. It's also vital to know the tax laws of countries in which subsidiaries operate or have a presence, and the transfer pricing activities that transpire between parent and subsidiaries. Similarly, it may be important to understand in what jurisdictions tax incentives may be available in the global business landscape.

More than anything, it's vital to have the right support. A sustainable, profitable, coherent approach to IP tax planning is too complex for almost anyone to tackle alone.

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