The Double Irish, Dutch Sandwich and other delights

The significant potential benefits of special purpose IP holding company vehicles should be soberly assessed against their inherent risks and drawbacks

By **Harry Rubin**

An IP holding company (IPHC) operating through tax-advantageous jurisdictions may generate substantial tax savings, reduce and rationalise IP transaction costs, refocus IP management and enforcement strategies, help to monetise IP assets, and offer important liability insulation. The successful implementation and management of IPHCs involves the complex interplay of tax, IP, transactional, corporate, litigation, cost and management considerations.

The contemplated structure calls for establishing two Ireland-incorporated holding companies (the 'Double Irish') operating out of Bermuda (or another tax haven) and a third subsidiary in the Netherlands (the 'Dutch Sandwich'). This structure allows the parent company to shift international profit from IP assets to Ireland, which has a comparatively low corporate tax rate, and in turn to Bermuda, which has extremely low corporate tax rates. The Dutch subsidiary helps further by allowing the IPHC not to pay withholding tax on certain intra-EU royalties. In recent years, such structures have saved some of the largest IP-driven corporations many millions in taxes. Although the tax, IP, legal and business benefits offered by IPHCs are especially advantageous to companies with large IP portfolios with significant international business, even smaller companies stand to benefit from the IPHC under certain circumstances.

However, setting up IPHC structures is expensive, administratively burdensome and complex. Companies undertaking the formation of an IPHC must be cognisant, moreover, of several material potential problems, including the legal, accounting, administrative and expert costs of creating and running *bona fide* new companies, complications in IP asset enforcement and increased scrutiny from the Internal Revenue Service (IRS). Moreover, the winding down and post-termination aspects of an IPHC require careful planning, and the repatriation of profits from the IPHC to the parent company would vitiate the very tax advantages driving much of this structure in the first place.

Tax savings

A company earning significant sales revenue outside the United States would benefit from housing those sales and operations in a lower-tax jurisdiction. As IP assets are intangible, their development, manufacture and distribution may be comfortably relocated offshore. Ireland's tax system and low corporate tax rate of 12.5% have made it a popular destination for companies looking to form IPHCs. Ireland offers other tax benefits, such as the ability to claim capital expenditures on intangible assets and tax credits for R&D.

IP management

IPHCs improve management of IP assets and streamline administrative costs, thereby allowing for more efficient management, valuation and exploitation of IP assets.

The effective management of IP assets requires highly specialised and focused attention and market monitoring. An

IPHC is well situated to develop and enforce coherent defensive and offensive IP strategies and contend with these key questions: how should the IP be protected, legally, commercially and practically? Would the IP assets be best monetised through direct licensing or indirect sales through distributors or representatives? Is a strategic alliance of any sort the optimal approach?

Such centralised IP control also helps the parent company to identify and manage less profitable IP assets, potentially leading to the divestiture of IP classes to focus on more profitable ones. The divestment of unprofitable IP assets saves substantial legal fees and management time.

Without the centralised control afforded by an IPHC, it is difficult for large corporations to devote the consistent and expert attention necessary for a critical and internally unbiased evaluation of their IP assets. The objective and educated decision to abandon or sell unprofitable or redundant IP asset classes is an important strategic — potentially enterprise-transforming — decision. Both day-to-day management and strategic planning and expansion are aided by efficient control of IP assets through a separate holding company.

R&D, licensing and enforcement

An IPHC is ideally positioned to undertake and manage R&D, licensing and enforcement of IP assets and rights:

- First, an IPHC capitalises on the administrative value of centralised control to police the expiration of IP rights and, as such, is especially suitable to avert trademark 'genericide'.
- Second, IPHCs allow for close IP and technology market monitoring and implementation of market feedback to detect both salient IP developments in relevant fields of application and IP infringement, thereby leading to timely and appropriate business and legal IP enforcement. Such close market monitoring also informs the R&D effort and helps shape and sharpen IP strategy.

Monetisation of IP assets

An IPHC is particularly well positioned to undertake IP monetisation. Depending on the active and anticipated revenue stream generated by the intellectual property, portfolios could be monetised through either securitisation or collateralisation. Either strategy requires the creation of a separate IPHC.

In a securitisation of IP assets, an IPHC issues securities based on licensing fees, royalties or other revenue streams anticipated from the intellectual property, in the form of debt or equity certificates, usually backed by the parent company. Securitisation is a good option for companies whose IP assets already produce a proven stream of revenue through licensing or other deals and credibly can project ongoing future revenues.

Collateralisation is another means of raising capital from IP assets. Unlike securitisation, collateralisation does not require an existing revenue stream. It is therefore a good option for companies whose IP assets do not currently produce revenue, but nonetheless are susceptible to credible valuation. Under the collateralisation model, lenders would extend credit to the parent company based on the value of the IP assets owned by the IPHC, as opposed to a revenue stream generated by the IP assets. The IP assets themselves are not transferred; the intellectual property is taken as collateral to minimise losses in case of default.

Notably, however, as the intangible nature of IP assets makes them inherently difficult to value, IP assets are treated by the market as more speculative and with a modicum of suspicion. This sometimes tends to depress the collateralised value of the IP assets.

Limitation of liability

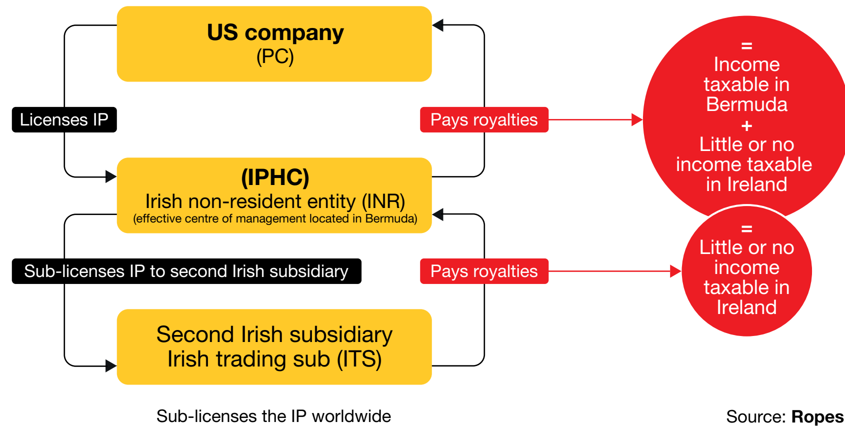
IPHCs insulate the parent company from potential liability and, conversely, protect the IP assets from the parent company's liability ambit. If a corporation owes damages in a lawsuit, or files for bankruptcy or otherwise becomes insolvent, its assets are vulnerable to seizure. IP assets held by the IPHC and licensed back to the parent company are generally protected from the parent company's insolvency, because they are not owned by the parent company. Limiting liability in this way can be invaluable to small businesses, since the ability to insulate valuable assets may mean the difference between total insolvency and the ability to salvage their most important assets — their intellectual property.

An IPHC does not, however, provide failsafe protection from all liability. An IPHC limits liability only for claims unrelated to the IP assets, such as the parent company's default on a contract, mortgage or lease, or tortious or other non-IP related conduct. Moreover, the IPHC cannot generally protect the parent company from all IP-related liability, such as infringement claims. Any infringement

Table 1. **IP holding companies – factor comparison**

Favourable	Unfavourable
• Tax savings	• Profit repatriation consequences
• IP management focus	• IRS scrutiny
• IP market back	• IP damage feed-limitations
• IP administration efficiencies	• IP enforcement problems
• Liability protection	• Organisational burdens
• IP monetisation options	• Expensive
	• Complex • Time consuming

Figure 1. **Double Irish structure**



Source: **Ropes & Gray**

action would likely be brought against both the parent company and the IPHC, since both companies would typically use the intellectual property and have either ownership or licence rights in it.

Formation of IP holding companies

An IPHC is any legal business entity (eg, limited liability company, limited liability partnership, corporation) that owns IP assets associated with its parent company, but does not engage in the parent company's activity. Depending on the parent company's goals, it may consider different ways of structuring its IPHC. Operational considerations, such as its international business strategy, are also important factors. A variety of IPHC structures exist, ranging from complex multi-subsidiary structures to simple ones.

The Double Irish

The Double Irish takes advantage of low Irish corporate tax rates and the interplay between certain characteristics of US and Irish tax laws to form a structure of two related Irish subsidiaries that allows companies legally to avoid higher US corporate tax liability. It requires the creation of two Irish subsidiaries, with one effectively managed in Bermuda or another similar tax haven (see Figure 1). The parent company thereby benefits from the differences in Irish and US tax laws.

The Double Irish envisages two related Irish holding companies:

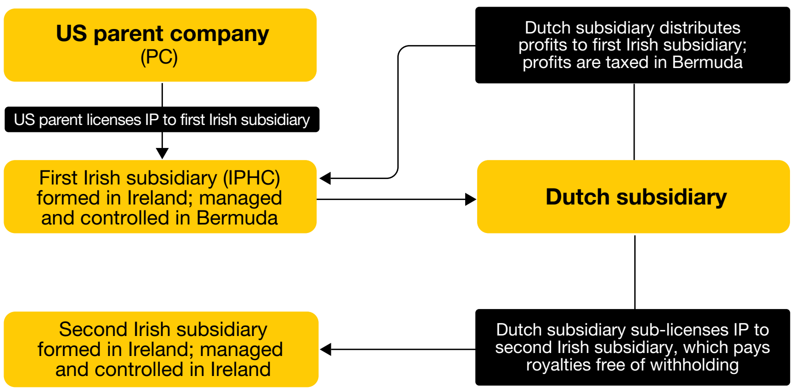
- The first is a subsidiary of the parent company (the IPHC) incorporated in Ireland, frequently known as an 'Irish non-resident entity' (INR). The INR has its effective centre of management and operation in a tax haven (eg, Bermuda). For Irish tax purposes, the INR is tax resident in Bermuda instead of Ireland. Irish tax law permits a company to pay taxes in the country of its operations, rather than its place of incorporation. From a US perspective, the parent company licenses its IP assets to the INR, which pays low royalties to the parent company. The INR's income from the licences is then taxed in Bermuda, resulting in little or no taxable income in Ireland.
- The second Irish company, frequently known as an 'Irish trading subsidiary' (ITS), is set up as a subsidiary of the INR. The ITS sub-licenses the intellectual property from the parent company through the INR and, in turn, exploits the IP assets in countries outside the United States. The royalties paid by the ITS to the INR are deductible against the ITS's profits. While Ireland recognises the INR as tax resident in Bermuda, for US tax purposes the ITS and INR can 'check the box' to elect to be recognised as the same entity; and because both are incorporated in Ireland, US law treats them as tax resident in Ireland.

Ultimately, the structure allows the parent company to exploit its intellectual property internationally while substantially reducing its US tax liability, because the royalty payments to the INR are deductible while any remaining income to the ITS is taxed at Ireland's low 12.5% rate. A company with substantial international IP-related revenue is likely to realise significant tax savings through the Double Irish corporate structure.

Double Irish with Dutch Sandwich

Other Ireland-based subsidiary structures

Figure 2. **Double Irish with a Dutch Sandwich – simple**



Source: **Ropes & Gray**

can also be beneficial. Adding a so-called 'Dutch Sandwich' to the Double Irish averts withholding payment on royalties under EU law, because Irish law exempts certain royalties paid to companies in other EU member states from Irish withholding tax. The resulting structure is more complex, but is potentially even more tax efficient (see Figures 2 and 3).

Simpler IPHC structures

To avoid these complicated structures, a parent company may choose simply to create one IPHC in a country with a favourable corporate tax rate or other favourable tax incentives. Ireland offers a corporate tax rate of 12.5% and a number of other incentives, including tax credits for R&D and the ability to claim capital expenditures on intangible assets. It is an attractive location for a simple wholly owned subsidiary, even for parent companies electing not to set up the more complicated Double Irish system. Some US states can also be convenient locations for cost-saving corporate structures simply by forming a wholly owned subsidiary in such a state for holding the IP assets.

US transfer pricing rules

One potential hurdle in setting up an IPHC is presented by the transfer pricing rules of Section 367 of the Internal Revenue Code. Under Section 367(d), a US company that transfers intangible property to a foreign corporation is deemed to have sold that property for an amount "commensurate with the income attributable to the intangible" (26 USC § 367(d). See also 26 USC § 482 (authorising the IRS to allocate income among related business entities to reflect actual income)). The company is then further deemed to receive an ongoing stream of royalties from the assets. In other words, the US government imputes an amount consistent with the IP assets' market value onto the transaction and its ensuing revenues. The IRS thus precludes the transfer of IP assets to IP holding companies at artificially low prices.

It is possible to mitigate this problem by making an initial transfer of IP assets and conducting subsequent development within the IPHC. As the transfer pricing rules of Section 367(d) apply to the initial transfer of IP assets, subsequent developments of the intellectual property are treated as created in the jurisdiction of the IPHC (eg, Ireland). Royalties and other revenue from newer versions or redevelopments of the IPHC's assets are treated for IRS purposes as belonging to the IPHC. Businesses can plan around Section 367(d) transfer pricing rules by making post-transfer developments of IP assets from within the IPHC. Notably, the tension from a transfer pricing perspective is that while the parent company seeks the lowest possible IP price, the transfer price must be significantly higher to satisfy the IRS. Unsurprisingly, in the clash between those two, the IRS invariably prevails.

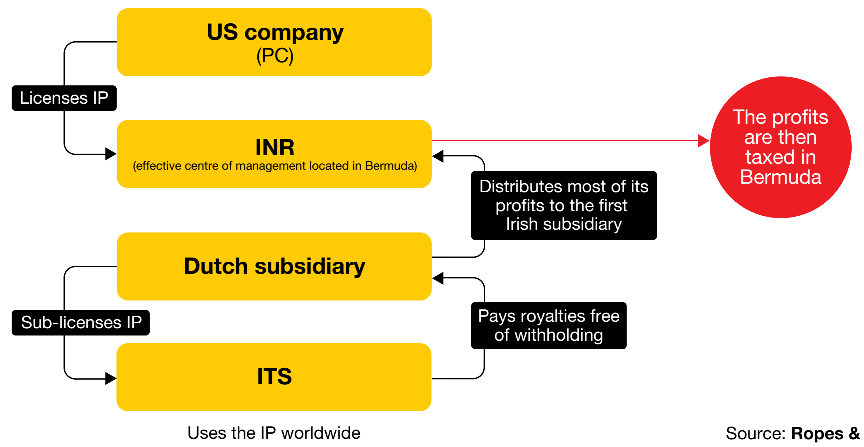
Drawbacks of IPHC structure

Although there are many attractions to setting up IPHCs, their potential pitfalls must be given serious consideration.

Administrative and transaction costs

An IPHC requires the creation of new offshore corporate entities, with significant attendant legal, accounting and expert fees. An office must be established in the applicable jurisdictions; employees must be managed and their salaries paid; and forms must be filed in accordance with governing

Figure 3. **Dutch Sandwich and Double Irish**



Source: **Ropes & Gray**

law. All respective corporate formalities must be satisfied. Transfer pricing requires careful analysis to establish a fair transfer price that will withstand IRS scrutiny. To establish this price, expert accountants and economists are required. All of this requires extensive management focus, time and expenditures.

Inter-company agreements

Substantial legal and executive time must be devoted to devising, planning and structuring all appropriate legal documentation and, especially, the inter-company and licence arrangements between the US parent and the various Irish subsidiaries and related entities, as well as their customers. The importance of these agreements cannot be overstated. They should never be approached as 'canned' or *pro forma* documents:

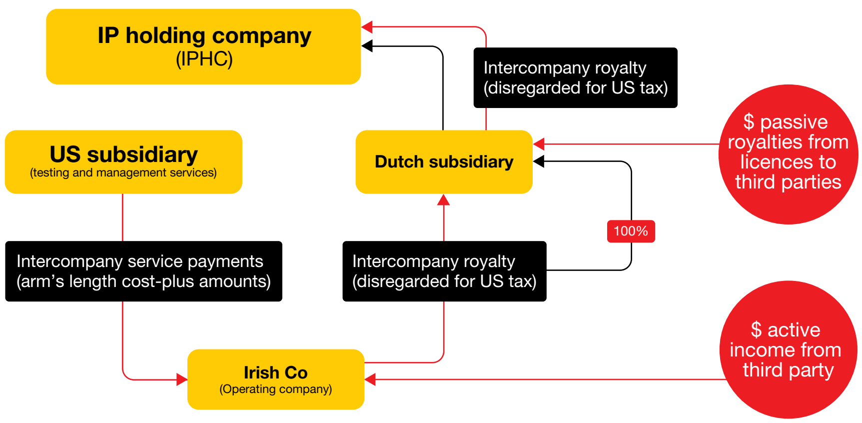
- First, they have to be commercially reasonable arm's-length agreements to withstand scrutiny from regulatory authorities and interested third parties, including investors, which might challenge the arrangements.
- Second, the agreements must foster a productive and seamless working relationship between the various corporate entities.
- Third, the agreements must not impede or encumber the IPHC's ability to enter into commercially necessary arrangements with third parties, even while safeguarding for the parent company all IP rights necessary for the parent company's proper functioning and business success.
- Fourth, the documents must deal expressly and strategically with the winding down, termination and post-termination complexities of the IPHC arrangements.

Enforcement of IP rights

An IPHC requires careful strategic balancing of the imperative to protect IP assets with the legal right and standing to enforce them. Structuring the IPHC arrangement can significantly affect litigation options in IP infringement cases. The IPHC may claim only its own damages, not those of the parent company. Now, an IPHC that does not actually make sales may most significantly limit the parent company's tax liability and exposure in the event of insolvency, but it also may be precluded from suing potential infringers for lack of standing. Additionally, the jurisdiction in which the IPHC is located will affect its ability to enforce and develop its IP assets. For instance, a jurisdiction with beneficial tax treatment may not be a member of international IP treaty regimes required to develop and manage the IP portfolio.

The IPHC structure influences how courts calculate damages. Generally, a parent company will not have standing to sue for potential infringement of IP assets held by an IPHC, unless the parent company can show that it has exclusive and substantial licensing rights or control of the IP assets. Courts have held that in some cases, the parent company may join its subsidiary – the technical patent owner – as co-plaintiff, if the parent company is an exclusive licensee of the patent. Additionally, the parent company may sue in its own name if it can show that it holds all substantial rights in the intellectual property by, for example, being a virtual assignee.

Figure 4. **Irish/Dutch – detailed**



IPHC
- Organised under Irish law
- Managed & tax resident in Bermuda
- Own all intellectual property

DUTCH SUBSIDIARY
- Organised and resident in the Netherlands
- Elects "disregarded entity" status for US tax
- Sub-licenses all IP to Irish opco or third parties
- Taxable royalty spread agreed with Dutch tax authorities

IRISH SUBSIDIARY
- Organised and resident in Ireland
- Elects "disregarded entity" status for US tax
- Sub-licenses use all IP from Dutch subsidiary
- Conducts or manages manufacturing of product in Ireland
- Sells product to third parties

Source: **Ropes & Gray**

Significantly, courts have also limited damages in infringement cases where rights in IP assets are essentially shared by a parent company and its subsidiaries. If, for example, the parent company is a non-exclusive patent licensee, and therefore does not have standing to sue for infringement, an infringement suit brought by the IPHC will be limited to reasonable royalty damages because the IPHC cannot recover the parent company's lost profits. The resulting damages will likely be significantly less than had the parent company's damages been part of the calculation. Granting the parent company exclusive IP rights should preserve its right to sue for lost profits, but may prove commercially fatal for the implementation of an optimal IP portfolio monetisation or strategic alliance. Another possible solution to this problem is the reassignment of patent rights to the parent company (or other manufacturing company); however, the lost profits calculation would then apply only to the period following the date of the reassignment.

Trademarks are particularly difficult to enforce when held by a separate holding company. US trademark law requires trademark owners to control the quality of the goods or services with which the trademark is used. Thus, it is crucial to ensure that the IPHC has in place vigorous policies, procedures and protections for trademarks, to avoid a loss of control over the use of a mark and a consequential finding of abandonment.

Increased risk of scrutiny from IRS

In light of the considerable tax savings afforded by IPHCs and their inherent transfer pricing sensitivity, the IRS quite understandably has shown a prurient interest in the Double Irish and similar structures. When legitimately implemented, such structures should comply with US tax law. But transfer pricing deals between US companies and foreign subsidiaries are certainly given more than typical IRS scrutiny. IRS requests of information must be expected in offshore IPHC deals relating to patent or technology valuation.

Winding down and repatriation of profits

Experience shows that because the IPHC structure tends to be heavily tax driven, IPHC strategies frequently centre on tax planning to the detriment, and even gross neglect, of other competing considerations that are cumulatively of equal or even greater importance. Probably the two most significant drawbacks associated with remote IPHC structures – termination of the enterprise and repatriation of profits – are also most frequently overlooked.

No IPHC structure should be undertaken without a serious contemplation of the eventualities, triggers, mechanics and consequences of winding down the enterprise. The winding-down process needs to be clearly spelled out. Who will own the intellectual property and what licence rights will remain with which entity on termination? What will the wind-down consequences be as a practical matter for licensees and customers? Who will own the equity of which entity on termination? How will disputes relating to termination be resolved? What mechanisms should be built into the agreements to ensure an orderly and non-contentious winding down?

It should go without saying, but is frequently left unsaid, that the tax benefits of IP holding companies hold only for so long as there is no necessity or reason to

Action plan

There are many advantages for both large companies and SMEs in setting up an IPHC:
- The tax savings can be significant.
- An IPHC is ideally positioned to undertake and manage R&D, licensing and enforcement of IP assets and rights.
- Both securitisation and collateralisation of intellectual property are available to IPHCs.
- IPHCs insulate the parent company from potential liability, protecting the IP assets from the parent company's liability ambit.

However, before creating an IPHC, the drawbacks must be considered:
- It is an expensive operation, bearing in mind the legal, accounting and expert fees requited to set up an IPHC, and the ongoing costs of running offshore offices.
- Substantial time must be devoted to devising, planning and structuring all appropriate legal documentation.
- Under certain circumstances the creation of an IPHC makes IP enforcement more problematic.
- The creation of an IPHC often invites close scrutiny from the tax authorities.
- Too much focus can be placed on the tax-planning aspects of an IPHC to the detriment of other important issues, such as termination of the enterprise and repatriation of profits.

repatriate profits or revenues back to the United States. Upon such repatriation, the profits, of course, will be taxed by the United States, thereby substantially vitiating a key rationale for undertaking the huge cost and expense associated with forming the remote IP structures. At best, if there is a need to repatriate profits at some stage, the Double Irish/Dutch Sandwich structure is a means to defer US tax, not to reduce or avoid it. Therefore, as a general rule, if there is a reasonable likelihood that profits may have to be repatriated to the United States, the contemplated benefits associated with the IPHC structures must be comprehensively rethought, and certainly cannot be undertaken based primarily on the tax-saving rationale.

Benefits worth considering

Forming a holding company for IP assets helps to insulate intellectual property from potential parent company liability and may generate valuable tax, business and administrative efficiencies. Double Irish and similar structures potentially offer the greatest tax savings for companies with robust international sales and significant IP asset portfolios.

Smaller companies may prefer simply to form just one subsidiary in a lower corporate tax rate jurisdiction, such as Ireland or Switzerland, or in a low-tax US state. Whichever structure a company ultimately elects, the benefits of locating IP assets in separate IP holding companies are worthy of serious consideration, even while the potential drawbacks of IPHCs (see the factor comparison) are closely contemplated.

Although tax considerations may be central – perhaps even dominant – tax savings should by no means be the controlling, let alone dispositive, factor determining whether to implement IPHCs. *iam*

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