What A Trademark Practitioner Should Know About Tax Law – And What You Can Say To Your Client About It

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- Patrick exclusively handles matters covering international taxation, frequently publishing articles and giving presentations on assorted areas of international tax law. Patrick works with advisors located throughout the United States and internationally on matters faced by their clients.

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Introduction

- Nonresident noncitizens face United States tax exposure only on income/assets directly associated with the United States
  - Special tax rules/regimes apply to nonresidents; familiarity with these rules is increasingly a necessity
- United States taxpayers are instead taxable on worldwide income
  - Where foreign corporate entities are used, foreign-sourced income can be subject to lower American tax rates
    - After the Tax Cuts and Jobs Act, trademarks generating income in multiple countries often benefits from incorporation of activities

Income Tax Basics

- Income-generating activities can be undertaken either in an individual capacity or through an entity
  - Individuals are taxable on all income earned by them directly
  - Entities – tax treatment depends on whether entity is a flow-through
    - Flowthrough entities – all tax attributes (income, deductions, etc.) flow through proportionately to the entity's underlying owners
      - Income treated as directly owned by the underlying stakeholder
    - Non-flowthrough entities (corporations, non-grantor trusts) taxable directly (i.e. carry their own tax attributes)

Income Tax Basics

- Entity – Regs. 1.1471-1(b)(39) defines an entity as "any non-individual taxpayer"
  - Organization – an entity separate from its owners
    - An undertaking by multiple parties is normally classified as an organization
      - Functionally, some type of formal structure/agreement will be needed for an entity to be found

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Income Tax Basics

- Two types of entities can generally exist under U.S. rules: (1) trusts and (2) business entities
  - "Trust" defined in the regulations – arrangement whereby trustees take title to property for the purpose of protecting or conserving it for beneficiaries, with the beneficiaries not sharing in the responsibility to protect/conserve the situs
- How are trusts taxed?
  - Grantor trust – income is taxable to the trust creator
  - Nongrantor trust – treated as an entity separate from its creator; subject to tax on its income directly

Income Tax Basics

- Business entity - any entity recognized for federal tax purposes that is not classified as a trust or otherwise subject to special treatment
  - Three types of business entities: (1) disregarded entities, (2) partnerships, and (3) associations taxable as corporations
    - Entities with single owners are either disregarded entities or corporations; when multiple owners exist, an entity can be classified as either a partnership or corporation

Income Tax Basics

- Under default U.S. rules, nonresident aliens/foreign business entities are subject to United States tax on:
  - (1) income effectively connected with a United States trade or business, and
  - (2) fixed or determinable annual or periodic income (“FDAP income”)
- Income tax treaties provide critical modifications to default rules for qualified residents of treaty party jurisdictions
  - “Effectively connected with a United States trade or business” standard elevated to “business profits attributable to a United States permanent establishment”
    - FDAP income tax rate can be lowered substantially

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Income Tax Basics

- Tax consequences – ordinary income earned by individuals/flowthrough entities/trusts subject to graduated rates of tax, up to 37%
  - Ordinary income – income not associated with disposition of a capital asset
  - Capital gains – income associated with capital asset disposition
    - Capital assets held less than a year taxed at ordinary income rates; capital assets held more than a year taxed at preferential long-term capital gains rates
      - LTCG tax rates capped at 20%
- Corporate taxpayers subject to a flat 21% tax rate on <u>all</u> income (ordinary or capital gains)

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Trademarks/Trade Names – Tax Rules

- Trademarks, trade names, and franchises subject to special tax rules
  - Trademarks/trade names: means of identifying a product, service or business
    - A means of identification rather than itself being a product, service or business
  - Franchises: the right to distribute, sell, or provide goods, services, or facilities, within a specified area
- Trademarks must actually be used to establish and maintain their status as trademarks, and the use must be associated with the goodwill of a business

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Trademarks/Trade Names – Tax Rules

- Costs of acquiring, creating and developing trademarks and trade names must be amortized and capitalized over a 15-year period
  - Amounts paid to acquire a trademark must be capitalized (rather than fully deducted immediately)
    - Amounts paid to a government to obtain, renew, renegotiate, or upgrade trademark/trade name rights must be capitalized
      - Costs “paid to facilitate the creation of a trademark” generally are capitalized
      - Costs to defend/perfect title also amortized
  - Sec. 1253(d): amounts paid or incurred on account of a transfer, sale or other disposition of a trademark are deductible immediately if they are contingent on the productivity of the trademark, paid as part of a series of payments payable no less frequently than annually, and substantially equal in amount (or payable under a fixed formula)

Trademarks/Trade Names – Tax Rules

- Disposition of a trademark/trade name: transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name
  - If no rights retained, transfer is a sale or exchange of property
    - Gains can be subject to long-term capital gains treatment where requirements met
      - Not available to trademark "dealers"/those who hold trademarks as inventory

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Intellectual Property - Tax Considerations

- The Tax Cuts and Jobs Act in 2017 made significant modifications to American taxation
  - Special rules were created to capture tax associated with intangibles used in multinational activities
    - Rules regarding global intangible low-tax income (GILTI) provided to “punish” multinational business enterprises for storing IP offshore
      - Deductions for foreign-derived intangible income (FDII) designed to reward multinationals for storing intangibles in the United States

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Foreign Corporations - GILTI

- Under Sec. 951A, U.S shareholders of a controlled foreign corporation must include their share of global intangible low-taxed income in US tax
  - U.S. shareholder and controlled foreign corporation concepts mirror Subpart F
    - GILTI inclusion treated similarly to Subpart F in many ways, but not technically a component of Subpart F
  - **50% deduction available for GILTI, but ONLY for C-Corporations!**
    - Makes the effective tax rate for corporate shareholders 10.5%
    - For non-corporate U.S. shareholders, rate can be 37%

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Foreign Corporations - GILTI

- GILTI Application
  - Functionally, GILTI essentially is tax imposed on U.S. shareholders of a CFC on the excess of an assumed 10% rate of return on tangible business assets of the CFC
    - GILTI imposes a minimum tax on foreign earnings that exceed a standard rate of return amount
  - GILTI: Excess of the shareholder’s net CFC tested income over the shareholder’s net deemed tangible income return
    - Need to determine (1) net CFC tested income and (2) net deemed tangible income return

Foreign Corporations - GILTI

- GILTI Application
  - Net CFC Tested Income: aggregate of U.S. SH's pro rata share of the tested income of each of their CFCs over the aggregate of the U.S. SH’s pro rata share of the tested loss of each CFC
    - Tested income – excess of gross income from the CFC (subject to exclusions) over deductions properly allocable to that income
      - Income excluded includes effectively connected income and Subpart F income
      - Tested loss: excess of deductions properly allocable to a CFC’s income over gross income
  - No direct reference to intangibles is made in Sec. 951A
    - Aim may have been intangible income, but application will be significantly more far-reaching, and not limited to one type of income (i.e. movable income)

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Foreign Corporations - GILTI

- GILTI Application
  - Net Deemed Tangible Income Return: excess of 10% of the aggregate of U.S. SH's pro rata share of qualified business asset investment (QBAI) of each CFC
    - QBAI - average of the CFC's aggregate adjusted bases in specified tangible property used in a trade or business of the corporation and of a type with respect to which a deduction under Sec. 167 is allowable
      - Computed quarterly; adjusted basis determined using the alternative depreciation system

Foreign Corporations - GILTI

- GILTI Application
  - Application of GILTI leads to significant change in immediate inclusion scope for U.S. shareholders of foreign corporations
    - For foreign corporations with limited tangible business assets, GILTI is largely unavoidable, and creates current U.S. tax inclusion for CFC income for U.S. SHs
      - GILTI can be mitigated through C-corporation deduction; individuals/non-corporate entities not eligible, however
        - Sec. 962 election can be beneficial, but not a complete elixir

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Domestic Corporations - FDII

Foreign-Derived Intangible Income ("FDII")

- **A deduction is allowed to *domestic corporations* in an amount equal to 37.5% of the FDII of the domestic corporation for the tax year**
  - Deduction ONLY available to C-corporations!
- FDII equals deemed intangible income multiplied by a fraction: foreign-derived deduction eligible income over deduction eligible income.
  - FDII is the portion of intangible income derived from serving foreign markets; like GILTI, it assumes a 10% rate of return on tangible assets
    - FDII concept offers a special reduced effective tax rate on income from US-held intangibles; concept does not explicitly look at intangibles but assumes a fixed rate of return on business assets with the balance of income being from intangibles

Tax Advice – Best Practices

- Within tax realm, assorted issues can arise when giving advice
  - Applicable standards for tax advice generally dictated by the Internal Revenue Service (as do state Bars)
    - Circular 230: establishes rules for tax practitioners generally (attorneys, accountants, etc.) representing taxpayers in matters with the Department of the Treasury
      - General statutory authority for Circular 230 provided by 31 U.S.C. § 330

Tax Advice – Best Practices

- Circular 230: general requirements of due diligence and best practices within the tax realm
  - Written tax advice must incorporate all relevant facts, and not rely on unreasonable representations made by the client
  - Rules applicable to written communications, whether made in memorandum, email, etc.
  - 2014 revisions – general reasonable practitioner standard largely applicable
    - Tax positions generally must have a reasonable basis
- Critically, where tax impact occurs in multiple jurisdictions, advisors are required in <u>each</u> jurisdiction!

Tax Advice – Best Practices

- Additional considerations:
  - ABA Model Rule 1.1 – "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation"
    - *For non-tax attorneys, usually the best option is serving as issue spotter – and deferring on substantive advice to tax professionals*
  - Circular 230 language on competence (Sec. 10.35): A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

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