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SUBJECT 1: TAXATION OF ROYALTIES FOR USE OF, AND GAINS FROM THE SALE OF, INTELLECTUAL PROPERTY/INTANGIBLES

OUTLINE

General Reporters

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INTRODUCTION

The topic was chosen because royalties, including payments for the use of and for the sale or other transfer of, intellectual property or intangibles (hereinafter "IP") is a rapidly growing sector of most economies.

According to the World Intellectual Property Organization (WIPO), the value of intangible assets held by firms worldwide was up 8 % in 2023 when compared with 2022 (after a severe hit due to Covid-19), reaching an overall amount of USD 62 trillion. In most high-income countries, intangibles account for the better part of firm value, reaching 90 % of intangible asset- intensity in the United States.

Intangibles can be used by a firm in two ways: The firm can use the intangibles in their businesses for production or distribution purposes, i.e. the value of the intangibles flows into the goods and services provided by that business in the market. Or the business can grant other firms the right to benefit from these intangibles – this is regularly achieved through license contracts and similar arrangements. The World Bank estimates that charges for the use of intellectual property – i.e. royalties – were at a record high of 580,25 USD billion in 2023; according to WIPO the numbers are even higher – exceeding USD 1 trillion.

In this context identifying when a payment is properly characterized as involving some form of transfer of IP and, once so characterized, how it is treated for tax purposes, has become a prominent issue on which governments and tax practitioners often disagree. In particular, the distinction between licenses/royalties on the one hand and services/service fees and other types of transactions can be hard to draw.

The characterization and treatment depend on numerous factors, including whether a particular transaction involves any substantive transfer of IP rights, whether any substantive transfer of IP rights is appropriately characterized as a transfer of the use of IP or the transfer of the IP itself, and whether the rights transferred are sufficiently interwoven with services or other activities to be ignored as separate income items. These characterizations and treatments are creatures of tax law, but often build on intellectual property law concepts. As a result, the General and Branch Reports will include some background on the intellectual property law concepts to the extent they inform the tax treatment of particular transactions.

In recent years, the topic of royalties has gained more and more prominence particularly in the international arena where the taxation of cross-border payments is at stake. According to WIPO numbers, the total amount of receipts from international trade in IP has risen from USD 3,5 bn in 1970 to USD 700 bn in 2015 and has risen substantially since then. The United States alone has seen its receipts from cross-border IP transactions increase by a multiple of 40 between 1982 and 2022, standing today at USD 130 bn. It is not surprising that these numbers attract the interest of tax legislators and tax authorities to claim jurisdiction over these items of income. On the other hand, this also explains why MNEs are said to have an interest in the strategic allocation of IP rights and the ensuing income to specific tax jurisdictions.

DESCRIPTION OF THE SUBJECT

Generally, the topic will cover the tax treatment of transactions involving the potential transfer of the types of IP that are capable of being transferred for value separately from the transfer of a broader trade or business. That includes patents, copyrights, trademarks, franchise rights, trade secrets and know how, for example, but does not include other intangibles like goodwill, going concern value, assembled workforce, customer relations or other potential forms of IP that are only transferred with a broader trade or business transfer transaction.

An introductory section will focus on the general non-tax law treatment of transactions that potentially involve the transfer of IP in some fashion. It will be based on U.S. and EU law, including some variations within the EU. Branch reporters will then be requested to identify areas where their laws differ in ways that are relevant to various aspects of local branch country tax treatment of IP transactions. Given the high degree of international coordination (e.g. for patents under the roof of the WIPO) or regional harmonization (e.g. for patents, trademarks etc. in the context of the European Union) it might make sense to invite a dedicated report on international standards for the protection and the transfer of IP rights. Against this background, national reporters will only have to describe to what extent their local law deviates substantially from international agreements.

The central element of the analysis is the characterization of a transaction under the relevant domestic and international tax law. The tax consequences can be quite dramatic and they will not only differ between countries but also between domestic rules and treaty provisions. The discussion will take into account from the start the fact that there is no uniform treatment of IP rights even at the “basic” domestic level. Therefore it is of high importance to take an analytical approach and discuss separately the tax treatment of IP-related domestic transactions for domestic tax purposes, the tax treatment of cross-border transactions under domestic legislation, and the tax treaty implications for cross-border transactions. The intricate issues involved include:

- license v. sale: license fees are regularly taxed as ordinary income, but depending on domestic tax law, the gain from a sale may be tax-free, subject to specific capital gains treatment or part of ordinary income;
- business assets v. privately-held (investment) assets. Royalties may be qualified and treated differently depending on the context in which the relevant IP has been acquired or held;
- service fee v. royalty: depending on domestic tax law and tax treaty law, this distinction may be relevant for withholding taxation. This is also an issue, that is heavily discussed from a policy point of view in the international arena.
- mixed situations, such as embedded royalties, “bundles” of IP rights being subject to an umbrella license agreement etc.

It is well known that a large part of cross-border IP transfers are performed between affiliated firms. For the United States it has been estimated that more than 70 % of IP transfers (in terms of overall value transferred) take place within corporate groups. This makes transfer pricing a central issue of royalty taxation. OECD has addressed these challenges under Actions 8-10 of the BEPS Action Plan which resulted in the DEMPE concept, but country practice is not yet fully aligned and there are always new contentious issues coming up. Thus, transfer pricing deserves a special chapter in this report.

Last but not least one might think about normative consequences from the findings coming from the country reports. These findings might feed into the current debate on international allocation of taxing rights where one of the focal points in the eternal conflict between residence countries and source countries is – among other topics – the justification of withholding taxes on royalties, capital gains and service fees against the background of Art.7 and 12 of the OECD Model Tax Convention and the broadening of these provisions under the UN Model Tax Convention. Thus, a wider policy outlook could and would round off the panorama of the national reports and the analytical part of the general report.

ANNEX 1 - TABLE OF CONTENTS OF THE BRANCH REPORTS

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2. Economic Background: Basic Economic Data about the Level and Type of Technology in a Country (Most relevant Sectors of Technology; Extent of Export and Import of Technology)
3. Introduction: Legal Background

How Different Types of Transferable IP/Intangibles are Protected under IP and other Non-Tax Law (Patents, Copyrights, Trademarks, Franchise rights, Trade secrets, Know how, Indigenous Knowledge)

Types of transactions Involving the Transfer of IP

Transfers of the use of IP where the transferor retains some meaningful right to use the IP ("License Transactions")

- Transfers of exclusive or non-exclusive geographic rights
- Transfers of exclusive or non-exclusive "field of use" rights
- Transfers of rights for a limited period of time

Transfers of the ownership of IP, where the transferor gives up all rights for future use of IP ("Sale Transactions')

- Impact of contingent consideration
- Impact of contractual rights of reversion
- Impact of rights of transferor to sue for infringement

Determining Whether Transactions Involve Transfers of IP Rights or Something Else

Transfers of tangible property/inventory with rights to retransfer or other use of embedded IP rights (e.g. patent, copyright or trademark)

- Give examples

Transfers of software with limited rights to copy but no re-sale rights

- Give examples

Transfers of know-how provided in the form of technical services

- Give examples

Use of name, image, and likeness rights ("NIL") as part of performing services

- Give examples

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 - a. Characterizing transactions:
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 - ii. Types of IP transfers that give rise to royalty income/expense
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 - b. Timing of income recognition
 - i. Lump sum payments
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 - iii. Periodic contingent and noncontingent payments
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 - i. Special regimes for taxing royalties (e.g. patent boxes)
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 - d. Treatment of payments by transferee of IP
 - i. Deduction or amortization for lump sum and advance and periodic contingent payments for use of IP
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 - i. Transfers of patented, etc. inventory with rights to resell
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 - a. Source of income from payments in IP transfer transactions
 - i. Contingent and non-contingent royalty income
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 - b. Nexus for taxation of income from cross-border IP transfer transactions
 - i. General rules on nexus for IP rights (place of development of the IP right, place of use and/or exploitation, place of registration etc.)

- ii. Payments to resident taxpayers and permanent establishments of non-resident taxpayers
 - 1. Royalty income
 - 2. Gain on sale income
 - iii. Payments to other non-resident taxpayers
 - 1. Royalty income, including applicable withholding tax rates
 - 2. Gain on sale income, including applicable withholding tax rates
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- 6. Part Three: Application of Treaty Principles
 - a. Income earned abroad by local residents and permanent establishments
 - i. Qualification of income under treaty allocation rules
 - ii. Substance requirements for residence country taxation (Beneficial Ownership, LOB etc.)
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 - i. Qualification of income under treaty allocation rules
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 - b. Country-specific deviations from these international principles
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- 8. Part Five: Case Studies
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 - b. License of accounting software to be customized and used in licensee's business accounting systems
 - c. License of trademark to use on manufactured products distributed around the world
 - d. License of right to use pro athlete's name, image and likeness on products sold globally
 - e. License of cloud computing capacity for data storage and analysis with licensee ability to download analysis on its own servers