1 Introduction

The laws of taxation are comparable to the rules of a complex game, such as poker.[1] Like poker, "playing" tax is about winning, or at least keeping, money. The seriousness of either game depends on the size of the stakes and whether the player can afford to lose. It is, after all, only money. But there remains one crucial difference: unlike poker, one cannot fold or opt out of the tax game. We are all obliged to play.

The players in the tax game are the government and the taxpayer. The government has one great advantage in that it writes the rules. However, the government must also (at least in democratic states) answer ultimately to the taxpayer, thus constraining its authoritarian tendencies. Moreover, it is very hard to write rules that contain no loopholes. Lawyers, accountants, and business people often display great ingenuity in exploiting this inherent difficulty. In the end, the game of tax is probably an even contest. Most taxpayers agree that the government is entitled to a reasonable share of financial support in exchange for the services that it provides. However, most taxpayers also agree that the government should obtain those revenues from someone else. Thus, the game is hard fought and never ending.[2]

The game of tax has never been more serious than it is today. Faced with structural budget deficits, many national (and sub-national) governments have become aware of tax minimization strategies that lead to an erosion of their tax revenue bases. Much of this undesirable taxpayer behavior can be linked to the lack of updated tax systems to deal with the rise of intellectual property's role in a rapidly changing global economy. Early systems of taxation did not specifically focus on intellectual

[1] *See* John A. Miller & Jeffrey A. Maine, *The Fundamentals of Federal Taxation* 4 (Durham, NC: Carolina Academic Press, 2017).

[2] The game was best described by Louis XIV's Finance Minister John-Baptiste Colbert: "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing." William Sharp McKechnie, *The State & the Individual: An Introduction to Political Science, with Special Reference to Socialistic and Individualistic Theories* (James MacLehose & Sons, 1896), 77.

property, which was of no particular consequence at a time when tangible, physical property was the driving engine of commerce. As intellectual property's role in the world economy has increased,[3] however, these antiquated tax systems (and their interactions with other tax systems) have created incentives for taxpayers with a lot of intellectual property to avoid taxes.[4]

In recent years, governments have struggled with how to write equitable and efficient tax rules governing emerging intellectual property assets – such as rules that will appropriately incentivize intellectual property development in their jurisdictions, or rules that will ensure their fair and appropriate share of tax revenues from intellectual property. Taxpayers, on the other hand, have attempted, within the letter of the law, to structure their intellectual property transactions to maximize tax benefits and create more value from their intellectual property.[5] For example, tax considerations can be important drivers in deciding how to structure an intellectual property license, or acquire intellectual property, or draft pleadings in an intellectual property lawsuit to achieve optimal results. Tax considerations are also often a key factor in deciding where to locate a firm's intellectual property assets.

Some of the most popular tax planning strategies involve "parking" intellectual property in holding subsidiaries located in tax-favored jurisdictions. In the United States, for example, many domestic companies operating in multiple states have reduced their overall *state tax burden* by moving their intellectual property assets to holding companies located in tax-favored states, such as Delaware or Nevada. Likewise, many US companies with foreign operations have reduced their *US and foreign*

[3] In 2012, the US Commerce Department released its comprehensive report on intellectual property. In the United States alone, intellectual property intensive industries support at least 40 million jobs. Intellectual property contributes more than $5 trillion to the US gross domestic product (GDP), or 34.8 percent of the GDP. "Intellectual Property and the U.S. Economy," U.S. Patent and Trademark Office, accessed November 3, 2016, www.uspto.gov/learning-and-resources/ip-motion/intellectual-property-and-us-economy.

[4] Joy Hail, "An Overview of the OECD Action Plan on BEPS," *Taxes: The Tax Magazine* 94 (2016): 47 (noting that the rise and increasing importance of intellectual property have highlighted how out of step traditional tax policies have become). "Apple Should Repay Ireland 13bn Euros, European Commission Rules," *BBC News*, August 30, 2016, www.bbc.com/news/business-37220799 ("Individual governments appear impotent in their attempts to apply their tax laws to multinationals like Apple. They have systems designed to deal with the movement and sale of physical goods, systems that are useless when companies derive their profits from the sale of services and the exploitation of intellectual property").

[5] *See* Alina Macovei & Marc Rasch, "Tax and the Strategic Management of Intangibles," *Intellectual Asset Management* (March/April 2011): 23–28, available at www.iam-media.com/Magazine/Issue/46/Features/Taxand-the-strategic-management-of-intangibles.

tax burdens by transferring their intellectual property assets and operations to controlled foreign subsidiaries in low- (or zero-) tax countries, such as Ireland, Singapore, Switzerland, and the Netherlands, as well as sandy tax havens like Bermuda and the Cayman Islands. This book closely examines these tax minimization strategies – specifically the use of *domestic* and *foreign* IP Holding Companies. Interestingly, the two companies – Apple and Victoria's Secret – that are in the title of this book and subject to further examination in later chapters, formed their key IP Holding Companies in the same year decades ago.

Use of Domestic Intellectual Property Holding Companies

Corporations are utilized for a variety of reasons. Corporations can, for example, protect owners from legal liabilities and provide businesses greater access to financing through capital markets. But corporations can also be used for more questionable purposes – most notably the avoidance of taxes. Leaked documents from a Panamanian law firm reveal how corporate entities in certain US states have been used by some of the world's richest individuals to hide cash and avoid taxes.[6]

The use of corporate entities in certain US states to hold intellectual property is particularly pervasive. Victoria's Secret, Dow, Honeywell, Limited Stores, Lane Bryant, Express, Sherwin Williams, Toys-R-Us, and Abercrombie & Fitch are all examples of US corporations that shift intellectual property assets to wholly owned subsidiary companies located in tax-favored states, but that turnaround and license back the right to use that same intellectual property.[7]

Delaware is a particularly attractive jurisdiction for domestic US subsidiaries. In fact, different companies form an astonishing 600 to 800 subsidiaries annually in Delaware. And the practice is not confined to a specific sector of the economy. In the retail and apparel industry, the notables include Victoria's Secret, Gap, Limited Stores, Lane Bryant, Express, Abercrombie & Fitch, Talbots, H.D. Lee Company, Wrangler Clothing, Spring Industries, and Nordstrom NIHC – all companies that transfer valuable trademarks to Delaware holding subsidiaries. Countless

6 "What Are the Panama Papers?," *The New York Times*, April 4, 2016, www.nytimes.com/2016/04/05/world/panama-papers-explainer.html?_r=0.

7 Dow Chemical Company, for example, executed an agreement between Dow and its wholly owned Delaware subsidiary, Dow Global Technologies, wherein all of Dow's patents were contributed to its subsidiary for tax shelter purposes, according to Edward Valenzuela, Dow's former Manager of Tax Economics, who was responsible for the finances of the tax shelter and calculation of royalties paid by Dow to its subsidiary.

others, in industries ranging from home improvements to department stores, transfer their intellectual property assets to wholly owned subsidiaries in Delaware. And Fortune 500 Companies, ranging from Stanley Black & Decker to Home Depot to Walmart to Chevron, are organized under the laws of Delaware and have formed IP Holding Companies in the same state.

This begs the question, why are companies attracted to Delaware? After all, it is a small state not known for its natural resources, a technical workforce of Silicon Valley caliber, or sales force. Certainly, Victoria's Secret does not need to set up its subsidiary in Delaware to hold its valuable brand in order to market and sell lingerie. Not only does Delaware have a limited population, it has within its borders only four out of the total 1,060 Victoria's Secret stores in the United States. Likewise, technologically, Honeywell does not need to locate its patents in Delaware in order to manufacture aerospace products, control technologies, turbo chargers, and performance materials. Neither do Sherwin-Williams nor Dow Chemical need their patents to be held in Delaware for manufacturing, marketing, and distribution of their products. These companies, and the vast IP Holding Companies formed in Delaware, are there primarily for the benefit of saving taxes.

Indeed, state tax savings can be great. Victoria's Secret, which had previously transferred its trademarks to its IP Holding Company, turned around and paid to its subsidiary $698,500,000 in 2015 in royalties for the right to use the trademarks. The subsidiary pays no state taxes on the royalty income received while the parent company enjoys a tax deduction for the royalty payments paid to the subsidiary. Nordstrom's IP Holding Company received $197,802,386 in 2002 and $212,284,273 in 2003 from royalty income for the licensing of its parked trademarks in Delaware back to the parent and affiliate companies. Gore, the maker of Gore-Tex products, assigned patents to its subsidiary and then licensed the right to use the patents from the same subsidiary; the subsidiary received $231,000,000 in 2015 in royalty payments from Gore but paid no state income tax on the royalty income because it is a Delaware holding company. And that's not all. As Gore is the subsidiary's sole shareholder, it also receives dividends and gains access to cheap loans from the subsidiary. These are merely three examples among the countless US corporations avoiding state taxes by parking their valuable intellectual property in Delaware. The total sum each year in state taxation escaped through this web-like scheme is in the hundreds of billions of dollars. And because companies are avoiding state income taxes by shifting their intellectual property assets to Delaware, other states are negatively impacted.

How is it possible for corporations to escape paying state income taxes, so easily, on billions of dollars of intellectual property-related income? At least two possible explanations are available. First, despite the fact that the United States is a homogenous country with one federal government and an integrated economy, it functions at the state level as if it were fifty different nations. Each state can do whatever it wants with respect to taxation as long as it does not offend the US Constitution. Delaware is known as the epicenter for incorporation. It has boasted for years about its friendly corporate laws and the sophistication of its judiciary system for corporations. While no one was paying attention in the early 1980s, Delaware took an unprecedented step toward *acquiring* intellectual property assets. The State crafted a gift to corporations of all sizes to encourage the relocation of their intellectual property assets to Delaware. The nickname, "The First State," is apt for Delaware as it leads other states in capturing intellectual property assets and related income. Nevada and Michigan are also attempting to acquire a piece of the intellectual-property-relocation pie. However, they are nowhere near Delaware in terms of sophistication, tradition, and history of corporation friendliness.

Second, intellectual property has become significantly important to both large and small corporations. The major revisions of laws relating to patents, copyrights, and trademarks provide corporations the legal basis for creation, protection, enforcement, and commercialization. As exploding technological developments coincide with major revisions to expand the scope of intellectual property law, corporations are acquiring more intellectual property than ever before through in-house creation and acquisitions. Along with these major revisions leading to the time when Delaware began to capture the relocation of intellectual property, corporations embraced licensing as the new mode of commercialization. The licensing intellectual property model allows corporations to not only use the intellectual property in the operation of business, but also avoid paying taxes on the income generated from that use. Significantly, the assignment to and license back of intellectual property can be implemented with ease as no physical or visible activities occur due to the intangible nature of intellectual property assets that would otherwise attract unwarranted attention. The transfer of ownership of intellectual property can be done easily, allowing the shifting of intellectual property from one state with an income tax to a different state without income tax with great ease.

Moreover, intellectual property income shifting to Delaware occurs without attracting much attention. Delaware quietly continues to keep corporations happy as its laws do not allow the public to investigate, review, examine, inspect, or merely look at any filings or activities of IP Holding Companies.[8] Similarly, Delaware laws protect companies by requiring little public disclosure. As *Bloomberg* reported, Delaware lures corporations to set up shell companies to escape tax, and it stands out for its "emphasis on privacy" to become the birthplace of "corporate secrecy" and the "world's most secretive jurisdiction."[9] In fact, Delaware has, in using these methods, created a template for use by offshore tax havens, from Singapore to Luxembourg and the Cayman Islands to Panama!

Much of Congress's scrutiny and public outcry has not been directed at Delaware. It instead pours toward faraway, distant shores as described below. Perhaps it is easier to express anger and distaste toward other nations and exotic locales rather than toward the small, quiet state located next door to the nation's capital. But we cannot ignore that intellectual property income shifting occurs on a very large scale here in the United States, and that Delaware is at the center of the domestic intellectual property tax minimization strategies. So, as nations struggle to deal with intellectual property income shifting by multinational companies, US states must address intellectual property income shifting by multistate entities. Granted there are no Panama Papers to provide a peek into Delaware's corporate secrecy, but that does not mean Delaware should be ignored. Chapter 2 puts a focus on Delaware to examine how that state has become the "domestic" tax haven. Chapter 3 explores how corporations, over the last several decades, have structured their intellectual property ownership to avoid paying state income taxes.

Years before Congress held its hearings on international tax havens and how certain US multinational corporations relocate intellectual property offshore to avoid paying federal taxes, some states attempted to rectify the problems caused by domestic tax havens. They made efforts to assert that they had jurisdiction to tax the out-of-state IP Holding Company. They encountered strong resistance from the out-of-state IP Holding Company claiming that it had no property or payroll within the jurisdiction for tax purposes and that state taxation of such company's income was unconstitutional.

The constitutional challenges forced some states to seek different solutions. They went after the parent companies within their own state by refusing to allow these companies to deduct royalty payments and other related expenses made to controlled out-of-state subsidiaries. They also

[8] Delaware declined, after numerous requests, to provide the authors with information on its IP Holding Companies.
[9] David Kocieniewski, "Delaware's $1 Billion Incorporation Machine," *Bloomberg*, April 27, 2016, available at www.bloomberg.com/news/articles/2016–04-27/delaware-s-1-billion-opacity-industry-gives-u-s-onshore-haven.

declined to recognize the legitimacy of the transfer-and-license-back transactions between the parent company and its wholly owned subsidiary under judicially crafted, common law doctrines, such as the sham transaction doctrine. Some states amended their laws to impose mandatory combined reporting of related companies. Other states insisted on "add-back" of the royalty payments increasing taxation of the parent company. None of these approaches offered a perfect solution as each has its own associated problems.

All in all, very few states have aggressively gone after out-of-state IP Holding Companies or their in-state affiliates. Not only do the costs and enormous time commitment of prolonged litigation serve as additional deterrents, uncertainty itself prevents some states from mounting their challenges against IP Holding Companies.

Despite the efforts employed by these few states, popular media glosses over the issue and the public shows no interest. No outrage, disgust, or cry of unfairness across the populace has materialized. Attention is aroused, of course, by tax lawyers and tax consultants regarding crafting new strategies for their clients. One jurist in a tax case involving an IP Holding Company aptly described the game of tax:

> Once upon a time, before the advent of the shot clock, some basketball teams employed a maneuver known as the "four corners offense." This strategy involved a series of passes among team members that seemingly did not advance the ultimate purpose of putting the ball in the hoop, but had the separate purpose of depriving the opposing team of possession of the ball. In a somewhat analogous enterprise, corporate tax consultants devised a strategy that involved a series of transactions passing licensing rights between related corporations and that was motivated by a desire, not to directly enhance corporate profits, but to keep a portion of those profits out of the hands of state tax collectors.[10]

The massive amount of income generated from the licensing of intellectual property cannot be ignored, and some states are determined to obtain their fair share of the apportioned sum for state tax purposes. Maryland made headline news when it was embroiled in a battle with Gore Enterprise Holdings, Inc., the IP Holding Company of all things Gore-Tex. Litigation lasted for eight years after the state issued an assessment of almost $27 million in tax, interest, and penalties against the company. Massachusetts, New Jersey, and New York are in active pursuit of their fair share of IP Holding Company licensing income through legislative and judicial means. Chapter 4 details different approaches states have adopted to push back against taxpayers involved in the scheme. Chapter 5 considers alternative solutions to the problem.

[10] *NIHC, Inc. v. Comptroller of the Treasury*, 439 Md. 668, 669–70 (Md. App. Ct. 2014).

The Multistate Tax Commission has advocated adopting a common approach, and a number of states have joined efforts to accomplish this. But, unsurprisingly, Delaware views this joint effort as a direct threat to its sovereign interests. Delaware's favorable tax treatment for IP Holding Companies is the product of its own policy choice to become super competitive in the national marketplace. The *New York Times* reported that in 2011 alone Delaware had collected $860 million in taxes and fees from absentee corporate residents. Delaware's tax policy, however, allows corporations to escape the taxes paid to other states, resulting in the staggering amount of $9.5 billion tax savings over the past decade.

While some states criticize Delaware, others take the "if you can't beat 'em, join 'em" approach. Nevada, Wyoming, Michigan, and Oregon have embraced and imitated Delaware by remaking their states to become the new friendly jurisdictions for corporations. These states want IP Holding Companies to be easily formed without much disclosure, and they will exempt income from the investment and licensing of intellectual property from state taxation. Both Nevada and Wyoming do not impose a corporation income tax. And Oregon has attempted to fashion itself as the "Delaware of the West."

We can certainly debate the soundness of state responses to IP Holding Companies – which have been either to fight the practice of multistate firms or to adopt the Delaware-type tax model. But any debate must consider "fairness" issues that stem from the domestic IP Holding Company structure. Is the current system fair to companies that operate in only one state? Is the system fair to companies that operate in multiple states but that rely solely on brick-and-mortar operations? Is the system fair for states that have been short-changed of revenues, but that could certainly use those revenues for essential government services? Similar issues of fairness are echoed in connection with the use of foreign IP Holding Companies by multinational firms.

Use of Foreign Intellectual Property Holding Companies

Recent studies reveal that the vast majority of the largest, publicly traded corporations in the United States maintain an astonishing number of subsidiary companies in tax haven jurisdictions.[11] The use of foreign subsidiaries is particularly pervasive among large multinational

[11] According to a recent study by a tax advocacy group, at least 358 companies (almost 72 percent of the Fortune 500) maintained at least 7,622 subsidiaries in tax haven jurisdictions. *See* "Offshore Shell Games 2015: The Use of Offshore Tax Havens by Fortune 500 Companies," *Citizens for Tax Justice*, 2, October 5, 2015, http://ctj.org/pdf/offshoreshell2015.pdf [hereinafter Offshore Shell Games 2015] (looking at 2013 10-K

companies that rely on intellectual property. Large established public companies, such as Apple, Microsoft, Google, and Facebook, have carefully set up complicated webs of offshore subsidiaries. The same goes for smaller and younger private companies. It was reported that Uber, for example, which was founded only six years ago, has already set up seventy-five subsidiaries around the world.[12]

Why do US multinational companies set up elaborate foreign subsidiary structures? Apple, for example, does not really need its principle foreign subsidiaries in Ireland to sell iPhones and iPads to non-US customers. Similarly, Microsoft technically does not need its main foreign subsidiary companies in Ireland, Puerto Rico, and Singapore to sell Windows around the world. Statistical, as well as anecdotal, evidence reveals the most likely motivation: The use of foreign subsidiaries in low-tax or no-tax jurisdictions is saving these US multinationals a staggering amount of taxes.[13]

Foreign subsidiaries allow US multinationals to avoid US taxes on foreign income (and sometimes US-source income). *The New York Times* reported that Apple has been able to sidestep billions of dollars in taxes with its intellectual property income-shifting techniques.[14] *Bloomberg* reported that Google too has been able to save billions in taxes to achieve an overall tax rate of 2.4 percent.[15] The use of foreign subsidiaries also permits

reports filed with the Securities and Exchange Commission and using the list of tax havens from the Government Accountability Office). For an earlier study, *see* U.S. Government Accountability Office, *Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09–157 (December 2008), 4, *available at* www.gao.gov/assets/290/284522.pdf.

12 Brian O'Keefe and Marty Jones, "How Uber Plays the Tax Shell Game," *Fortune*, October 22, 2015, http://fortune.com/2015/10/22/uber-tax-shell/.

13 Harry Grubert, "Foreign Taxes and the Growing Share of US Multinational Company Income Abroad: Profits, Not Sales Are Being Globalized," *National Tax Journal* 65 (2012): 247–81, *available at* www.ntanet.org/NTJ/65/2/ntj-v65n02p247-81-foreign-taxes-growing-share.pdf?v=%CE%B1&r=032797049889688346 (providing evidence that US multinationals are avoiding corporate income tax by shifting reported income to low-tax jurisdictions).

14 *See* Landon Thomas Jr. and Eric Pfanner, "Even Before Apple Tax Breaks, Ireland's Policy Had Its Critics," *The New York Times*, May 21, 2013, www.nytimes.com/2013/05/22/business/global/ireland-defends-attractive-tax-rates.html; Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times*, April 28, 2012, www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html.

15 *See* Jesse Druker, "'Dutch Sandwich' Saves Google Billions in Taxes: Internet Giant Uses Complex Structure to Keep Its Overseas Tax Rate at 2.4 percent," *Bloomberg Businessweek*, October 22, 2010, www.nbcnews.com/id/39784907/ns/business-us_business/t/dutch-sandwich-saves-google-billions-taxes/; Jesse Drucker, "Google 2.4 percent Rate Shows How $60 Billion Is Lost to Tax Loopholes," *Bloomberg News*, October 21, 2010, www.bloomberg.com/news/2010–10-21/google-2–4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

US multinationals to avoid foreign taxes on foreign income. The BBC reported that Facebook (a US multinational) paid only 4,327 pounds in corporate tax in the United Kingdom in 2014, despite Britain being one of the company's largest markets outside the United States.[16]

These results are achievable for many reasons, as explored more fully in Chapter 6. For starters, despite the fact that the world economy has become more interconnected, nations' tax policies differ greatly. As examples, countries impose different corporate income tax rates and offer different incentives for the development and exploitation of intellectual property assets. And some countries have aggressively utilized tax policies to encourage multinationals to relocate their intellectual property assets and related income (and sometimes their residency) to their jurisdictions.

Further, the mobility and intangibility of intellectual property make it relatively easy for multinationals with huge portfolios of intellectual property (e.g., technology and pharmaceutical companies) to shift intellectual property assets and the profits they generate to tax-favored jurisdictions. In some cases, multinationals transfer outright ownership of intellectual property to their controlled subsidiaries. In other cases, they transfer only the economic rights through license arrangements and joint research and development agreements.[17] Regardless, through the manipulation of intercompany prices, multinationals can easily shift intellectual property income from high-tax to low-tax countries saving billions in taxes – a luxury not available to those firms whose value lies mostly in their tangible, physical assets, and whose profits are more linked to brick-and-mortar operations.

Increasingly, nations are using tax policies to draw technological innovation into their borders – not for any global cause, such as increased worldwide welfare, but for self-interests, such as the increased well-being of their own citizens. Research and development activity, with its own positive spillover effects, can lead to technological advances. These advances then can lead to economic growth, meaning increased tax revenues for a country. And, as intellectual property increasingly becomes the dominant source of value in the world economy, more and more multinationals are taking advantage of nations' favorable tax policies to

[16] Kamal Ahmed, "Facebook to Pay Millions of Pounds More in UK Tax," *BBC News*, March 4, 2016, www.bbc.com/news/business-35724308.

[17] A transfer need not be made to each country where it conducts business; a transfer can be of economic rights to one country only, one that offers a very low rate. As seen in Chapter 7, this is often achieved through a cost sharing agreement between a multinational and a foreign subsidiary. Lee Sheppard, "How Does Apple Avoid Taxes?," *Forbes*, May 28, 2013, www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes/#34f845a2d6f7.