SENTIENT

A GUIDE TO

INTELLECTUAL PROPERTY HOLDING STRUCTURES

OUR SENSE. YOUR FUTURE.

What is Intellectual Property ('IP')?

IP represents a range of intangible assets derived from human intellect. It encompasses inventions, literary and artistic works, designs, symbols, names, and images used in commerce. IP is legally recognised, allowing its creators or owners exclusive rights to use and derive benefits from their creations.

Why is it important to protect IP?

Protecting IP is critical for several reasons. It not only secures the creator's rights but also encourages innovation by providing a return on investment. Moreover, IP protection prevents competitors from exploiting your creations, thus maintaining a business's unique value proposition and market position.

What are the benefits of putting IP into a holding company?

Transferring intellectual property (IP) to a holding company presents several key advantages:

Asset Protection: By keeping IP assets separate from the day-to-day operational activities of the company, they are shielded from business liabilities, including potential claims from creditors in the event of legal actions or insolvency.

Tax Efficiency: Utilising jurisdictions known for favourable IP tax regimes can greatly improve financial outcomes by optimising tax responsibilities, thereby boosting overall profitability.

Simplified Management: Managing IP from a central holding entity allows for more streamlined processes in the administration, licensing, and commercialisation of IP rights, facilitating easier enforcement.

Notable Jurisdictions for IP Holding Companies

There are a few globally recognised jurisdictions favoured for their strong IP protection laws and beneficial tax structures, however the Isle of Man, Malta, Hong Kong and Gibraltar are among some that offer robust frameworks that promote efficient IP management and utilisation. Let's explore some of these further:

Isle of Man

The Isle of Man presents a unique proposition for managing and structuring IP and royalty rights, particularly relevant for international figures such as athletes, entertainers, and public personalities.

The focus is on crafting solutions that enhance revenue streams from various sources such as personal image rights, appearance fees, and licensing deals while ensuring the protection of accumulated wealth for maintaining a certain lifestyle.

Regarding patents, the Isle of Man aligns with the UK's system under the UK Patents Act 1977, thereby eliminating the need for re-registration if patents are transferred to the Isle of Man.

Similarly, trademarks are registered through the UK Trade Mark Registry as per the UK Trade Marks Act 1994, simplifying the process and ensuring consistency in protection standards.

Furthermore, even though the Isle of Man is not an EU member, it recognises the Community Trade Mark, allowing for a consolidated registration that extends across the EU if approved. The Island is also part of the Madrid Protocol, which streamlines the brand registration process throughout the EU.

Importantly, no withholding tax is imposed on royalty payments in the Isle of Man.

Malta

Malta offers an advantageous tax structure for IP Holding Companies, making it a highly desirable location for the management and monetisation of IP assets.

This structure benefits from Malta's appealing tax regime, which supports the development, purchase, and exploitation of IP.

It is particularly suitable for businesses in sectors like investment services, e-commerce, and online gaming, as well as any entity that earns revenue through the licensing of patents, copyrights, trademarks, and other intangible assets.

The Maltese IP system distinguishes between active and passive royalties, providing significant tax refunds that can lower the tax burden on revenue from patent licensing to as little as 5%, and sometimes up to 10% for passive royalties. Furthermore, from January 2010 onwards, certain types of royalties and related income from patents and copyrights have been exempt from income tax, adding to Malta’s attractiveness as a jurisdiction.

This fiscal approach, combined with Malta's comprehensive double tax treaty network and adherence to EU directives that eliminate withholding taxes on royalties, makes Malta a strategic choice for IP holding companies aiming to reduce their tax liabilities while enjoying a strong legal and regulatory IP environment.

Hong Kong

Hong Kong presents numerous advantages as a location for establishing IP holding companies, attracting businesses seeking to maximise their IP strategy.

One of the primary attractions of Hong Kong is its favourable tax system, which includes no taxes on dividends or royalties and a low corporate tax rate.

This setup provides significant financial incentives for companies by minimising tax liabilities on income derived from IP.

Additionally, Hong Kong offers a strong legal framework that is especially supportive of IP rights. The region’s adherence to international IP treaties and its comprehensive IP laws facilitates the effective protection and commercial exploitation of intellectual assets.

Hong Kong's strategic geographic location also provides unparalleled access to Mainland China and other Asian markets, making it an ideal gateway for businesses looking to expand in Asia.

Moreover, Hong Kong's reputation as a global business hub, ensures a reliable and dynamic environment for IP holding companies.

These attributes make Hong Kong a compelling choice for businesses aiming to enhance their IP management and exploitation while securing their assets in a globally respected financial centre.

Gibraltar

Gibraltar offers a range of strategic advantages for setting up IP holding companies, making it an appealing jurisdiction for businesses focused on optimising IP management and revenue generation.

Key among these advantages is Gibraltar's favourable tax regime, which includes a competitive corporate tax rate and potential reductions or exemptions on IP royalties.

This financial benefit is further bolstered by exemptions from capital gains and inheritance taxes, providing additional fiscal incentives for companies.

Moreover, Gibraltar's robust legal environment, based on English Common Law, ensures strong protection and enforcement of IP rights.

While not a member of the European Union, Gibraltar maintains unique access provisions that facilitate trade and market access within the EU. Coupled with the territory's political stability, these factors create a secure and advantageous setting for businesses.

Companies often choose Gibraltar for their IP holdings to leverage these benefits, along with its well-established financial services sector and professional infrastructure, which supports sophisticated corporate structures and enhances the profitability and security of their intellectual assets.

IP, the Isle of Man & Economic Substance

In 2017, the Crown Dependencies gave commitments to the EU to introduce rules on Economic Substance. The legislation, which came into effect on 01 January 2019, is designed to protect the reputation of offshore jurisdictions like the Isle of Man by ensuring that income streams from certain activities are based on actual local activity to substantiate the use of low-tax jurisdictions.

Substance legislation doesn't apply to all entities; it applies to certain 'relevant entities' carrying out income-generating activities within certain 'relevant sectors', one of which is IP companies - those with intellectual property.

What is considered an IP asset?

The key IP assets are:

1. patents and assets that share the same features of a patent including copyrighted software, technical know-how and other similar novel, useful and protected assets.
2. trademarks, brands, customer lists and similar marketing intangible assets.

Accountants may aggregate various intangible assets together under the heading 'Goodwill', where on analysis this includes IP assets, as above, the company will be considered an IP company.

An IP company may hold and receive income from an IP asset in several different scenarios.

Income from IP assets includes royalties, licence fees, franchise fees and any other payments arising from allowing another party to use an IP asset.

Where a company purchases or develops an IP asset with the intention of selling it on at more than cost, the proceeds from the sale will be gross income in line with general taxation principles.

Core Income Generating Activities (CIGA) for IP Companies

The legislation sets out a list of CIGA for an IP Company. The CIGA required to be undertaken will ultimately depend on the nature of the asset being exploited and how that asset is being used to generate income for the company.

1. 'Research and development' - for patents and similar assets. These activities include advancing the understanding of scientific relations or technologies, addressing known scientific or technological obstacles, increasing knowledge or developing new applications, etc.
2. 'Marketing, branding and distribution' - for marketing intangibles, such as trademarks, brands and similar. These activities should be directly linked to the specific marketing intangible.

Marketing and branding could include marketing, advertising, seeking endorsements, artistic design, developing consumer awareness and developing customer loyalty.

Distribution could include securing market access to allow the intellectual property to be exploited efficiently, this includes allowing on demand services, such as video demand, and in business-to-business sectors, integrating into complex IT systems.

In exceptional circumstances an IP company may be able to demonstrate that it is undertaking the following alternate CIGA in order to meet the economic substance requirement:

- taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income,
- taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset,
- iarrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of revenue from third parties.

A company is not required to undertake all the CIGA listed in the legislation in each accounting period. However, the company will be required to demonstrate that it was undertaking in the Island the CIGA relevant to the type(s) of IP asset(s) it held throughout the accounting period.

Due credit will be given for research and development, or marketing, branding and distribution undertaken in the Island by the company in earlier periods, the value of which is being realised by the exploitation of the IP asset in the current period.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets, will not be capable of demonstrating CIGA for IP.

High-risk IP Companies

Where a company receives income from IP, it will also have to consider if it is a "high risk IP company", which is defined in the legislation.

There is a rebuttable presumption that a high-risk IP company has failed the substance requirement as the risks of artificial profit shifting are greater. As a result, the competent authority will exchange all the information, provided by the company, with the relevant EU Member State competent authority where the immediate parent company, ultimate parent company and/or ultimate beneficial owner is resident. Such exchange of information will be in accordance with the existing international tax exchange agreements.

To rebut the presumption and not incur further sanctions (see below), a high-risk IP company will have to produce materials which will explain how the DEMPE (Development, enhancement, maintenance, protection and exploitation) functions have been under its control, and that this has involved people who are highly skilled and perform their core activities in the Island.

The high evidential threshold requires

- Detailed business plans which clearly lay out the commercial rationale for holding the Intellectual Property asset(s) in the Island;
- Concrete evidence that the decision making is taking place in the Island, and not elsewhere; and
- Information on employees in the Island, their experience, the contractual terms, their qualifications, and their length of service.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets, cannot rebut the presumption.

What is Adequate Substance?

Tax resident companies undertaking relevant activities are required to be directed and managed in the Island in addition to undertaking CIGA in the Island.

What is the directed and managed requirement? The requirement to be directed and managed in the Island ("the directed and managed test") is a separate test to the case law "central management and control" test used in determining the tax residence of a company.

Companies which meet the 'management and control' test for tax residence will still need to ensure that they also meet the directed and managed requirement in order to have adequate substance.

This requirement consists of the following parts, all of which must be complied with for each accounting period:

a) the Board of Directors must meet in the Island at an adequate frequency given the level of decision making required;

b) during the meetings in the Island, there must be a quorum of the Board of Directors physically present in the Island;

c) strategic decisions of the company must be set at meetings of the Board of Directors and the minutes must reflect those decisions; If a company has one director, then they should evidence those written resolutions were passed by that director when he is physically present in the Island;

d) the Board of Directors must have the necessary knowledge and expertise to discharge their duties as a board; and

e) all minutes and company records must be kept in the Island.

In cases where there are corporate directors, these will be looked through, to the individuals (officers of the corporate director) performing the duties of the director.

On this basis, IP companies established in applicable jurisdictions will need to consider whether they have 'adequate substance' in their tax jurisdiction.

A relevant sector entity (except for a pure equity holding company) will be considered to have adequate substance in the Isle of Man if it:

1. is directed and managed in its jurisdiction;
2. has an adequate number of (qualified) employees proportionate to the level of activity carried on in its jurisdiction;
3. has adequate expenditure proportionate to the level of activity carried on in its jurisdiction;
4. has an adequate physical presence in its jurisdiction; and
5. conducts core income-generating activity ('CIGA') in its jurisdiction.

IP companies' income comes from the holding or exploitation of intellectual property (“IP assets”) and are within the scope of this sector. If there is any indication that a company is seeking to manipulate its income to avoid being subject to substance requirements, for example by disguising royalties as part of the sales income, the respective Tax Administrations will take appropriate action.

Once substance is established, the entity must file an economic substance report each year, which, in the case of the Isle of Man, forms part of the annual tax return.

Penalties for failure to comply with the new substance regulations vary from one jurisdiction to another – but range from increasing fines, removal from the register through to imprisonment.

The Isle of Man legislation includes specific powers to request additional information in relation to any substance information provided on or with the income tax return.

This also includes specific sanctions to address circumstances where companies have acted to avoid or seek to avoid the application of the economic substance requirements.

If an entity in a relevant sector does not meet the economic substance requirement in an accounting period, it will be subject to sanctions which include exchange of information, increasing financial penalties ranging between £10,000 to £100,000, removal from the register through to imprisonment.

What other legislation should you be aware of?

Awareness of international treaties and national laws is crucial. The World Intellectual Property Organization (WIPO) conventions, TRIPS Agreement, and specific jurisdictional laws governing IP rights, tax, and corporate structures must be considered to ensure compliance and optimise benefits.

The Role of a Corporate Service Provider in Setting Up an IP Holding Structure

Corporate service providers ('CSP') play a crucial role when setting up an IP holding structure due to the specialised knowledge and comprehensive support services they provide, such as:

Expertise in legal and regulatory compliance – CSPs possess in-depth understanding of the legal and regulatory environments across various jurisdictions. They can ensure that the IP holding structure complies with all local laws and international regulations, which is crucial in avoiding legal pitfalls and ensuring the validity of the structure.

Facilitation of incorporation and structuring – CSPs assist with the entire incorporation process, from choosing the right jurisdiction based on specific IP strategies to the actual filing and registration of the company. This can include advising on the most advantageous legal form and structure to maximise IP protection and fiscal benefits.

Ongoing management and governance – Beyond setup, CSPs manage administrative tasks such as the preparation of annual reports, compliance filings, and renewal of licenses. This ongoing management helps maintain the legal standing of the IP holding company, ensuring that it continues to operate within the legal framework prescribed by the jurisdiction.

Tax optimisation – Working with your chosen advisors, CSPs can provide guidance on structuring the company to benefit from favourable tax regimes and treaties, which is essential for reducing tax liabilities on income from intellectual properties like patents and trademarks. This can significantly enhance profitability from IP assets.

Asset protection – By structuring assets effectively, CSPs help shield IP assets from potential risks associated with operational liabilities. This segregation helps in safeguarding IP from creditors or litigations directed at the operational side of a business.

Connection with local and international networks: CSPs often have established relationships with local authorities and international legal and financial experts. This network can be invaluable in facilitating smooth operations and resolving any issues that may arise during the lifetime of the IP holding structure.

Customisation according to business needs: CSPs can tailor the IP holding structure to align perfectly with the specific needs and goals of your business. This customisation involves understanding the nuances of the company's IP assets and designing a structure that optimises control, efficiency, and revenue generation.

Having the knowledge and expertise of a CSP ensures that your structure aligns with both business goals and international standards.

Conclusion

Intellectual Property is an invaluable asset in today's competitive landscape. Effectively protecting and managing IP through a holding company not only secures these assets but also leverages strategic advantages in terms of asset protection, tax efficiency, and simplified management.

Selecting a respected jurisdiction and partnering with an experienced corporate service provider are pivotal steps in establishing a robust IP holding structure.

Corporate service providers are vital in navigating the complex landscape of IP management. They not only ensure legal and regulatory compliance but also contribute to strategic planning and the ongoing success of the IP holding structure. Their role is fundamental in transforming intellectual property into a secure and profitable asset for the business.

Companies should remain vigilant about relevant legislation to maximise their IP's potential, thereby fostering innovation and securing long-term success. The journey towards intellectual asset optimisation begins with the strategic step of establishing an IP holding company—a move towards safeguarding innovation and driving business growth.

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The information contained in this eBook is for guidance purposes only and should not be considered nor construed as any form of professional legal, tax or VAT advice. We strongly recommend that the appropriate professional advice always be sought before setting up any kind of structure.

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