



BDO Seidman, LLP
Accountants and Consultants

Subject:
**Qualified Patent
Cross Licensing
Arrangements**

February 2007

International Tax Alert

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Issue

Treasury issues guidance on tax withholding requirements for Qualified Patent Cross Licensing Arrangements

Date/Timing

Qualified Patent Cross Licensing Arrangements (QPCLAs) entered into on or after February 14, 2007.

Affecting

Participants in QPCLAs as defined by Revenue Procedure 2007-23.

Background

In order to both protect valuable patents and avoid patent infringement suits, developers of intellectual property have entered into cross licensing arrangements defining terms of use for their respective patents. As the number of these arrangements has increased, tax advisors have approached the Internal Revenue Service with questions regarding withholding requirements on royalties paid by U.S. taxpayers to foreign licensors for patents used in the United States.

In Notice 2006-34, the Treasury described both the questions it was receiving and its initial thoughts on how cross licensing arrangements should be taxed. Additionally, the Treasury requested input from taxpayers and advisors on the details of typical cross licensing arrangements as well as recommendations on their U.S. tax treatment. The Treasury followed up with Rev. Proc. 2007-23, in which it summarized the responses it had received and in which it described the method that should be used for withholding taxes and capitalization.

Net Consideration Method Available for QPCLAs

In Rev. Proc. 2007-23, the Treasury defines a QPCLA as “a nonexclusive, nontransferable patent cross licensing agreement among uncontrolled parties, the subject matter of which is limited to the parties’ present or future patent rights, as specified in the

arrangement.” Regarding the issue of “control,” Rev. Proc. 2007-23 adopts the control definition found in Treas. Reg. § 1.482-1(i)(4). The Treasury further states that the transfers under the arrangement should not exceed a de minimis amount based on the facts and circumstances surrounding the arrangement.

Assuming a cross licensing arrangement qualifies as a QPCLA, a taxpayer can use the Net Consideration Method for determining its U.S. withholding tax obligation and any capitalization required under IRC sections 263(a) or 263A. The Rev. Proc. defines “Net Consideration” as the net amount of consideration paid and received by the respective parties to the QPCLA. Additionally there is a conformity requirement. Use of the Net Consideration Method is contingent upon the taxpayer’s reflecting the net consideration in its audited financial statements for those years ending after February 14, 2007 in which the method is used for tax purposes.

Finally, a taxpayer’s election to use the Net Consideration Method is a change in method of accounting under IRC sections 446 and 481. Accordingly, a taxpayer electing the Net Consideration Method is required to obtain the consent of the Commissioner under IRC sections 446(e) and 1.446-1(e)(3).

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