HIDDEN RISKS IN EXPLOITING INTELLECTUAL PROPERTY TO AVOID CORPORATE TAXES

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INTRODUCTION

Google saved over $3 billion dollars in corporate income tax expenses between 2007 and 2010 through a transfer tax strategy known as the "Double Irish with a Dutch Sandwich."[1] But Google isn't the only offender, most companies with intellectual property engage in this strategy, and it is estimated that it costs the U.S. Treasury up to $90 billion a year.[2] So how do they get away with it? In brief, the key to the strategy is exploiting flexibility in determining the value of a company's intellectual property. Being intangible, there are many ways to value intellectual property; companies utilizing the Double Irish strategy claim that their IP is not very valuable for income tax purposes. This seems counterintuitive. Companies invest millions of dollars acquiring, litigating, and defending their intellectual property—in essence, asserting that it is very valuable. And indeed it is; in many cases, intellectual property accounts for more of the book value of a company than all other assets in the company combined.[3] Under the Double Irish strategy, companies minimize the value of their intellectual property for income tax

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1. Jesse Drucker, *The Tax Haven That's Saving Google Billions*, BLOOMBERG BUS. (Oct. 21, 2010), http://www.businessweek.com/magazine/content/10_44/b4201043146825.htm.

2. *See* Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 TAX NOTES 1580, 1585 (2011); *see also* MARK P. KEIGHTLEY, CONG. RES. SERV., R42927, AN ANALYSIS OF WHERE AMERICAN COMPANIES REPORT PROFITS: INDICATIONS OF PROFIT SHIFTING 1 (2013), https://www.fas.org/sgp/crs/misc/R42927.pdf; Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 402 (2013).

3. *See* KEVIN A. HASSETT & ROBERT J. SHAPIRO, WHAT IDEAS ARE WORTH: THE VALUE OF INTELLECTUAL CAPITAL AND INTANGIBLE ASSETS IN THE AMERICAN ECONOMY 3 (2011), http://www.sonecon.com/docs/studies/Value_of_Intellectual_Capital_in_American_Economy.pdf (stating that IP accounts for majority of market value in the following industries: software and services, pharmaceuticals and biotech, food beverage and tobacco, media, healthcare equipment and services, telecommunications services, household and personal products, consumer services, automobiles and components, commercials and professional services).

purposes, but seek to maximize its value for patent infringement damages. Companies should not be able to benefit in both facets by changing what they claim their assets are worth.

This article proposes a litigation strategy whereby a defendant in patent litigation could exploit plaintiff inter-company patent licenses to minimize damages. Inter-company licenses are used to minimize income taxes, but should also be used to minimize claimable damages. This note begins by introducing a basic understanding of the corporate entity and intellectual property licensing structure ("Tax Structure"). A basic understanding of how the Tax Structure functions is important to understanding why there is inherent risk in the way companies currently do business. Section I will also discuss patent litigation, how patent infringement damages are determined, and finally will briefly discuss whistleblower laws. Section II will discuss some of the currently known risks to the Tax Structure, such as standing, forfeiture of lost profits damages, and the discoverability of these corporate secrets. Section III will introduce novel patent litigation defense strategies that could be used against these companies; much to the benefit of defendants, and to the detriment of tech companies seeking to assert their patents. Finally, Section IV discusses some of the legal challenges that one would face when installing these strategies.

I. TRANSFER TAX, PATENT LITIGATION, AND WHISTLEBLOWER STATUES

This section will explain the Tax Structure, patent litigation laws, and portions of the whistleblower statutes. These laws come into play during the patent litigation defense strategies that this article recommends. A comprehensive overview of those laws is beyond the scope of this article, but a high elevation view of what they are, and how they function, is instructive for understanding the suggested litigation strategies.

A. Tax Structure

The Double Irish with Dutch Sandwich is an extremely complex tax structure.[4] Essentially, a U.S. corporation transfers the ownership of some intangible property, such as patents or other intellectual property ("IP") to a

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4. *See generally* Stephen C. Loomis, *Recent Developments: The Double Irish Sandwich: Reforming Overseas Tax Havens*, 43 ST. MARY'S L.J. 825 (2012) (containing a very in-depth and complete explanation of how the law allows this tax structure).

subsidiary that is an Irish corporation, but which has been elected as a Bermuda tax resident.[5] That IP is then sub-licensed to a series of other Irish and Dutch entities that, through a series of Irish and Dutch tax provisions, allows the U.S. corporation to avoid paying corporate income tax on sales generated by the IP following the transfer.[6] The main purpose of the structure is to shift all income related to this IP overseas, where it maintains a nominal tax rate.[7] Using the Double Irish and other tax strategies, many large U.S. corporations were able to pay average income taxes below ten percent, and even as low as 2.3 percent.[8] This is in stark contrast to the U.S. corporate income tax rate of thirty-five percent.[9]

This article will avoid the intricacies of the tax law involved, and simply refer to this interaction as a transaction between a U.S. corporation ("Parent"), and its wholly owned foreign subsidiary ("Subsidiary").[10]

The initial transaction between Parent and Subsidiary must be considered an arm's-length transaction.[11] For that reason, Subsidiary must pay the same price that an outside company would pay for the productivity, use, or disposition of such IP.[12] This is essentially a royalty,[13] a payment made by a licensee to the owner of intellectual property in return for rights of use.[14] Those payments made from Subsidiary to Parent are considered taxable income, subject to the U.S. corporate tax rate of thirty-five percent.[15] Since the purpose of this entire structure is to reduce income tax, there is a huge incentive to set the value of that intellectual property as low as possible.[16]

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5. *US: Double Irish/Dutch Sandwich*, INTELL. PROP. TAX, http://www.ip-tax.com/2010/11/us-double-irishdutch-sandwich/ (last visited Dec. 18, 2015).

6. *Id.*

7. *See* Alexander Eichler, *Apple, Google, Amazon Pay Corporate Income Tax Well Below Official Rate*, HUFFINGTON POST BUS. (April 17, 2012), http://www.huffingtonpost.com/2012/04/17/apple-corporate-income-tax-rate_n_1429955.html.

8. *Id.* In 2011, General Electric paid 2.3%, Amazon paid 3.5%, Xerox paid 7.3%, Apple paid 9.8%, Yahoo paid 11.6%, Google paid 11.9%, and Microsoft paid 18.9%. *Id.*

9. I.R.C. § 11(b)(1)(D) (2012).

10. In reality the transaction is occurring between the U.S. parent and then several subsidiaries overseas.

11. 26 C.F.R. § 1.482-1(b)(1) (2010).

12. I.R.C. § 367(d)(2)(A) (2012).

13. I.R.C. § 367(d)(2)(C) (2012).

14. Companies may also sell their patents to the overseas entity before the IP has any real value, which leads to many other interesting issues. *See* Andrew Blair-Stanek, *Intellectual Property Solutions to Tax Avoidance*, 62 UCLA L. REV. 2 (2015). This article deals only with IP licensed from Parent to overseas Subsidiaries.

15. I.R.C. § 11(b)(1) (2012) (listing the current marginal corporate tax rates ranging from 15% at the lowest margin to 35% at the highest).

16. *Id.* Setting the IP value low leads to smaller royalty payments.

This is where the magic of intellectual property comes in; because it is intangible, it is very difficult to prove its value.[17] For purposes of this transaction, it is in the best interest of tech companies to hire high-dollar tax and appraisal firms to appraise the IP. These tax companies, through experience, know what the IRS will allow for valuation, and as a result, they set the IP value as low as comfortably possible.[18] This minimizes the amount Subsidiary will pay to Parent, and minimizes the U.S. corporate tax that will be paid.

It is imperative to note two things at this point. First, this is treated as an arm's length transaction for purposes of the IRS, and second, the IP is valued as low as possible to avoid the Parent company having to pay income taxes. Payments made back to the U.S. Parent are typically structured as a license agreement for IP rights, with the Subsidiary serving as Licensee, and paying royalty payments back to the Parent for the productivity, use, or disposition of such IP.[19] The Parent company seeks to minimize taxable royalties paid, so the royalty rate is typically set very low.[20] The result is that the royalty rate is calculated based on depressed IP asset values, and the percentage paid as royalties is also minimized, leading to the lowest amount of sales being repatriated into the United States.

B. Patent Litigation Damages

Patent litigation is typically broken into two portions at trial.[21] The first portion of the trial interprets the claims of the patents in question, and determines whether the defendant has infringed those patent claims.[22] If those

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17. *See* Joseph B. Darby III & Kelsey Lemaster, *Double Irish More than Doubles the Tax Savings: Hybrid Structure Reduces Irish, U.S. and Worldwide Taxation*, PRACTICAL US/INT'L TAX STRATEGIES, May 15, 2007, at 2, 11 (pointing out that the regulations allowing this structure were set forth in the 1960s, the IRS has not updated them to reflect the current prevalence of intangible personal property, and that such inaction has created uncertainty in this area).

18. *See* Lee A. Sheppard, *Reflections on the Death of Transfer Pricing*, 120 TAX NOTES 1021, 1112 (2008) (citing William B. Taylor of Sullivan and Cromwell LLP).

19. I.R.C. § 367(d)(2)(A), (C) (2012).

20. *See* Mars, Inc. v. Coin Acceptors, Inc., 527 F.3d 1359 (Fed. Cir. 2008). In that case the inter-company royalty rate was four percent, but it sought a damages royalty rate of near ten percent. *Id.*

21. *See* Lucent Technologies, Inc. v. Gateway, Inc., 580 F.3d 1301, 1316–24 (Fed. Cir. 2009) (demonstrating a perfect example of complex patent litigation where many patents were litigated, some were infringed, some were not; ultimately damages were calculated and awarded, and then also appealed).

22. *Id.* at 1316–23.

claims are infringed, then damages are calculated and awarded.[23] Patent damages are calculated pursuant to 35 U.S.C. § 284 which states: "[u]pon finding for the claimant the court shall award damages adequate to compensate for the infringement but in no event less than a reasonable royalty for the use made of the invention by the infringer."[24] The statute sets a ceiling, "adequate compensation," or actual damages, and a floor, the "reasonable royalty."[25] Actual damages, which comprise lost profits or an established royalty, can be very speculative and difficult to calculate, and in many cases are not available.[26] A reasonable royalty calculation is thus the most common damages determiner, awarded in roughly eighty percent of patent infringement cases where damages are awarded.[27]

Reasonable royalty damages are typically determined based on a hypothetical arm's length pre-infringement licensing negotiation.[28] This is commonly referred to as the "willing licensor-willing licensee" approach.[29] *Georgia-Pacific* established a framework that continues to guide this inquiry, even over 40 years later.[30] In that case, Georgia-Pacific infringed patents that were held by U.S. Plywood, and following the appeal, the district court was charged with calculating a reasonable royalty.[31] The court established a

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23. *Id.* at 1324.

24. 35 U.S.C. § 284 (2012).

25. *Id.; see* Bandag, Inc. v. Gen. Tire Co., 704 F.2d 1578, 1583 (Fed. Cir. 1983) (stating that a "reasonable royalty . . . is . . . the floor below which damages shall not fall.").

26. *See* Mars Inc. v. Coin Collectors Inc., 527 F.3d 1359, 1367 (Fed. Cir. 2008) (holding that a parent corporation—having a wholly owned subsidiary that handles the manufacturing and sales, and pays royalties back to the parent—may not recover lost profits); Seal-Flex, Inc. v. W.R. Dougherty & Assocs., 254 F.Supp.2d 647, 656 (E.D. Mich. 2003) (for a royalty to be "established" it must be paid or secured before the infringement began; must be paid by a sufficient number of persons to indicate the reasonableness of the rate; must be uniform in amount; must not have been paid under threat of suit or in settlement of litigation; and must be for comparable rights or activity under the patent).

27. Chris Barry et al., 2*011 Patent Litigation Study: Patent Litigation Trends as the "America Invents Act" Becomes Law*, PRICE WATERHOUSE COOPERS 14–15 (2011), http://www.pwc.com/us/en/forensic-services/publications/assets/2011-patent-litigation-study.pdf (stating that "reasonable royalties are the most frequent kind of damages awards in patent cases and comprise a greater share with each passing year.").

28. Georgia-Pacific Corp. v. U.S. Plywood Corp., 318 F. Supp. 1116, 1121 (S.D.N.Y. 1970).

29. Lucent Tech., Inc. v. Gateway, Inc., 580 F.3d 1301, 1324 (Fed. Cir. 2009); *Georgia-Pacific*, 318 F. Supp. at 1121.

30. *See* Univ. of Pittsburgh of Commonwealth Sys. of Higher Educ. v. Varian Med. Sys., Inc., 561 F. App'x 934, 946 (Fed. Cir. 2014) (analyzing infringement damages based on the *Georgia-Pacific* factors); Whitserve, LLC v. Comp. Packages, Inc., 694 F.3d 10, 27 (Fed. Cir. 2012) (stating that damages may be calculated using some or all of the *Georgia-Pacific* factors).

31. *Georgia-Pacific*, 318 F. Supp. at 1117.

fifteen-factor test to determine what amount a willing licensee would hypothetically pay for a license.[32] The three factors most pertinent to this article are factors one, two, and fifteen, as follows:

> 1. The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty.
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> 2. The rates paid by the licensee for the use of other patents comparable to the patent in suit.
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> 15. The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed upon (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; that is, the amount which a prudent licensee—who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention—would have been willing to pay as a royalty and yet be able to make a reasonable profit and which amount would have been acceptable by a prudent patentee who was willing to grant a license.[33]

These factors are merely meant to provide a reasoned economic framework for this hypothetical negotiation that determines the reasonable royalty rate.[34]

These factors have been used in hundreds, if not thousands of cases, yielding reasonable royalty rates ranging from four percent to thirteen percent.[35] This means patent infringers are to pay damages equivalent to that percentage of the profits generated by the sales of products infringing those patents. Plaintiffs seek to maximize the value of their IP, and demand the highest royalty rate that they can possibly justify based on those factors.[36]

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32. *Id.* at 1120.

33. *Id.*

34. *Lucent Tech.*, 580 F.3d at 1324–25.

35. Jonathan E. Kemmerer & Jiaqing Lu, *Profitability and Royalty Rates Across Industries: Some Preliminary Evidence*, KPMG 8 (2012), http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/gvi-profitability-v6.pdf.

36. *See* John C. Jarosz & Michael J. Chapman, *The Hypothetical Negotiation and Reasonable Royalty Damages: The Tail Wagging the Dog*, 16 STAN. TECH. L. REV. 769, 830 (2013) (documenting 49 cases wherein plaintiffs' calculated royalty rates differed from defendants' calculations ranging from 2.2 times higher, to 344.8 times higher; also wherein every case the plaintiffs claimed much higher reasonable royalty rates than the defendants). Note it would be interesting to see what royalty rates many of these companies are paying to license their IP to their overseas entities for purposes of transfer tax. Unfortunately that information is usually confidential.

C. Whistleblower Statutes

"Blowing the whistle" in this context means notifying the IRS that an individual or company may not be complying with the Internal Revenue Code.[37] Since a company participating in the Double Irish might be claiming different values for its IP (low for tax purposes, high for damages purposes), there may be cause to blow the whistle. That act may serve as additional leverage for the defendant during the strategies that will be proposed in Section III. Many articles have been published analyzing and defining what the whistleblower statutes are and how they function.[38] The litigation strategies proposed in this note will only require a very basic understanding of what the whistleblower statues are, and how they function.

A party holding credible information, and wishing to blow the whistle, may notify the IRS by mailing a form 211 to the IRS directly.[39] Pursuant to 26 U.S.C. § 7623: "[t]he Secretary, under regulations prescribed by the Secretary, is authorized to pay such sums as he deems necessary for . . . detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving the same."[40]

The informant may receive an award of "at least 15 percent, but no more than 30 percent" of the proceeds collected in successful audit.[41] The amount of the award is fully within the discretion of the IRS, and depends on the extent to which the informant's information was helpful.[42] Substantial awards can be paid to whistleblowers; over $125 million was awarded to whistleblowers in 2012, and over $53 million was awarded in 2013.[43] In 2012,

37. *Whistleblowers—Informant Award*, IRS, http://www.irs.gov/uac/Whistleblower-Informant-Award (last updated Oct. 23, 2015) ("The IRS may pay awards to people who provide specific and credible information to the IRS if the information results in the collection of taxes, penalties, interest or other amounts from the noncompliant taxpayer.").

38. *See* Peter D. Banick, Note, *The "In-House" Whistleblower: Walking the Line Between "Good Cop, Bad Cop"*, 37 WM. MITCHELL L. REV. 1898 (2011); Frank J. Cavico, *Private Sector Whistleblowing and the Employment-at-Will Doctrine: A Comparative Legal, Ethical, and Pragmatic Analysis*, 45 S. TEX. L. REV. 543 (2004); Gerard Sinzdak, *An Analysis of Current Whistleblower Laws: Defending a More Flexible Approach to Reporting Requirements*, 96 CALIF. L. REV. 1633 (2008). Also note that there are many different types of whistleblower laws, including Federal IRS, employment, and SEC actions.

39. *How Do You File a Whistleblower Award Claim Under Section 7623 (a) or (b)*, IRS, http://www.irs.gov/uac/How-Do-You-File-a-Whistleblower-Award-Claim-Under-Section-7623-(a)-or-(b) (last updated Feb. 20, 2015) (noting that whistleblower claims are submitted under penalty of perjury).

40. 26 U.S.C. § 7623(a)(2) (2006).

41. *Id.* § 7623(b)(1).

42. *See id.*; 26 C.F.R. § 301.7623-1(a), (c) (2008).

43. Laura Sanders, *IRS Pays Awards to Whistleblowers*, WALL ST. J. (Apr. 18, 2014), http://online.wsj.com/news/articles/SB10001424052702304626304579507501731992142.

one whistleblower alone was paid $104 million.[44] While this reward program serves as a carrot for tipsters, it also serves as a stick to keep corporations from pushing the tax laws too far, which is especially an issue where off-shore entities are engaging in questionable transfer tax schemes with their intellectual property.

As a final matter, the whistleblower must disclose his or her identity to the IRS, but, due to recently adopted tax rules, may remain anonymous to the public.[45] This promise of anonymity, in addition to the potentially enormous awards serve as powerful incentives for would-be whistleblowers.

II. DEVELOPED LEGAL RISKS TO THE DOUBLE IRISH

The legal risks of offshore entity licensing are developed by case law. This section describes the well-known legal risks to the Tax Structure. There are already substantial risks that tech companies must consider when using the Double Irish.

A. Standing to Enforce IP

The first issue to consider is standing to bring suit for patent infringement. Only a patent owner or an exclusive licensee has constitutional standing to bring an infringement suit; a non-exclusive licensee does not have standing.[46] This rule commands that only the owner of all IP rights has standing to enforce patent rights worldwide. The licensing and sublicensing agreements between many U.S., Dutch, and Swiss entities are most likely non-exclusive.[47] In order to enforce IP rights, the patent owner (Parent) would have to be the named plaintiff in a suit.

The Parent must be named as a party in order to have standing in an IP enforcement lawsuit; however, if the Parent has no recorded sales, the Parent cannot seek lost profits damages.[48] The purpose of the Tax Structure is for

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44. *Id.*

45. *See* TAX CT. REP. 345(a).

46. *See* Sicom Sys., Ltd. v. Agilent Techs., Inc., 427 F.3d 971, 976 (Fed. Cir. 2005).

47. *See* Mars, Inc. v. Coin Acceptors, Inc., 527 F.3d 1359, 1367 (Fed. Cir. 2008) (holding that Mars's subsidiary lacked standing to sue because it was a non-exclusive licensee). It makes sense that inter-company licenses would be non-exclusive because companies would not want to preclude themselves from being able to profit from licensing the IP to other companies, or infringing companies.

48. Lost profits damages are a form of actual damages that can be sought, and are considered the ceiling, or higher damages that may be sought. *See id.* That is, they are the most desirable type of damages, as they can result in the highest rewards. Plaintiffs do not want to lose the ability to seek lost profits.

overseas entities to be able to set up manufacturing, marketing, sales, and receive revenues for exploitation of the company IP portfolio that has been licensed to those foreign entities. The purpose, more precisely, of this structure, is to shift sales from the Parent to the Subsidiary. The problem is that if U.S. Parent must be the named party in any IP enforcement lawsuit, and if it is structured in a way to show no sales, then it cannot seek lost profits damages from revenues that were lost due to infringement. In theory, the Dutch or Swiss subsidiaries would need to sue for lost profits, because it is their revenue that is damaged by lost profits due to infringer activity. However, those entities are merely non-exclusive licensees of IP, and they have no standing to sue.

B. Lost Lost Profits?

If a patentee is able to show that but for the infringement, it would have made the sales that the infringer made, the patentee is entitled to an award of lost profits.[49] Four elements are required to prove lost profits: "(1) demand for the patented product, (2) absence of acceptable noninfringing substitutes, (3) manufacturing and marketing capability to exploit the demand, and (4) the amount of the profit that he would have made."[50] These factors can be very difficult to prove in any situation, but they are especially difficult to prove when using the Tax Structure.[51] Whether a Parent may recover lost profits on behalf of its non-exclusive licensee/Subsidiary (the Tax Structure) was at issue in *Mars, Inc. v. Coin Acceptors, Inc.*[52]

In that case, Mars owned two coin machine patents, which it licensed to MEI, a wholly owned subsidiary, to make and sell coin machines.[53] MEI paid royalties to Mars based on "gross revenue sales value" of MEI's products that used Mars's patented technology, and MEI was required to make those payments whether or not it made any profit.[54] Coin Acceptors, a competitor, produced and sold its own coin machines.[55] Mars believed that Coin Acceptors' machines used its patents and, thus, brought suit against Coin Acceptors.[56] The district court heard the case and determined that Coin

49. Del Mar Avionics, Inc. v. Quinton Instrument Co., 836 F.2d 1320, 1326 (Fed. Cir. 1987).
50. Panduit Corp. v. Stahlin Bros. Fibre Works, Inc., 575 F.2d 1152, 1156 (6th Cir. 1978).
51. *See Mars*, 527 F.3d at 1363.
52. *Id.* at 1365.
53. *Id.* at 1362.
54. *Id.* at 1365.
55. *Id.* at 1363.
56. *Id.*

Acceptors had indeed infringed Mars' patents.[57] This determination was only the beginning, however; several additional issues presented themselves after finding infringement.[58] One of the main issues was whether MEI could sue Coin Acceptors directly for lost profits.[59] The district court and Federal Circuit found that MEI could not sue for lost profits because as a non-exclusive licensee, it had no rights to exclude others from practicing the patents.[60] Mars was the proper party to request lost profits, but Mars did not make or sell anything using the infringed patents.[61]

On review, Mars argued that, by virtue of the parent-subsidiary relationship and its consolidated financial statements, "all MEI's lost profits were inherently lost profits of Mars."[62] Mars claimed that MEI's profits flowed *inexorably* to Mars, and therefore Mars should be able to recover on a lost profits theory.[63] The facts of the case however did not support their claim.[64] The royalty payments received never varied based on profits.[65] Mars was never able to identify in the record any time where it had received profits above the normal royalties paid.[66] Since the profits did not actually flow inexorably from the Subsidiary to the Parent, the court chose not to decide whether a Parent could recover lost profits where the Tax Structure was present.[67] Cases following *Mars* explored facts where the profits did flow to the parent, but the court again did not allow the parent to collect on a lost profits theory.[68]

One of those cases was *St. Jude v. Access Closure*,[69] where a novel lost profits theory was introduced. St. Jude owned two patents relating to a

57. *Id.*
58. *Id.*
59. *Id.* at 1365.
60. *Id.*
61. *Id.*
62. *Id.* (quoting Brief for Appellant at 18, Mars, Inc. v. Coin Acceptors, Inc., 527 F.3d 1359 (Fed. Cir. 2008) (Nos. 07-1409, 07-1436)).
63. *Id.* at 1367.
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. *See* Herbert v. Lisle Corp., 99 F.3d 1109, 1120 (Fed. Cir. 1996) (stating that the only exception is where the patentee has the ability to manufacture and market a product, but for some legitimate reason does not; even then the "burden is . . . commensurately heavy"); Rite-Hite Corp. v. Kelley Co., Inc., 56 F.3d 1538, 1548 (Fed. Cir. 1995) (finding that "[n]ormally, if the patentee is not selling a product, by definition there can be no lost profits").
69. St. Jude Med., Inc. v. Access Closure, Inc., No. 08-CV-4101, 2010 WL 4968147 (W.D. Ark. Dec. 1, 2010).

medical device.[70] It did not make or sell any products in relation to these patents, but instead set up wholly owned manufacturing subsidiaries, which made and sold those products.[71] Access Closure, a competitor, infringed those patents, and once again the court was faced with the question of whether a parent should be able to pursue lost profits on behalf of its licensee-subsidiaries.[72]

Aware of prior unsuccessful attempts to be awarded lost profits, St. Jude creatively sought to recover the decrease in its own market value due to the decrease in sales of its wholly owned subsidiaries, rather than seeking "lost profits."[73] The court agreed with this theory, as a completely separate theory from lost profits, and examined it independent of the existing recovery theories.[74] Ultimately, the court concluded that 35 U.S.C. § 284 was broad enough to allow many acceptable recovery theories, and allowed St. Jude to present its claim for damages based on a reduction in income theory to the jury.[75] Unfortunately for St. Jude, the Federal Circuit found the patents invalid, and so St. Jude could not recover based on its new theory.[76]

Because this decision applies to most U.S. companies, it has several interesting ramifications. First, under this recovery theory, a corporation could pursue something similar to lost profits if it could prove that its value had been injured due to losses in sales of subsidiaries. Pursuing damages under this theory would allow the corporation to calculate damages independent of the reasonable royalty rate. Avoiding the reasonable royalty rate would allow the corporation to keep its existing inter-company licenses out of the litigation. This could be a huge benefit to patent litigation plaintiffs as they could then avoid issues arising because of their Tax Structures.

C. Discoverability of Licenses and the Tax Structure

As reasonable royalty damages are most common, discovering past licenses is extremely important. There are two types of licenses that may be discovered when calculating reasonable royalty damages, existing licenses, and past settlement licenses. The Federal Rules of Civil Procedure allow for

70. *Id.* at *1.
71. *Id.* at *5.
72. *Id.*
73. *Id.* at *6.
74. *Id.*
75. *Id.*
76. *See* St. Jude Med., Inc. v. Access Closure, Inc., 729 F.3d 1369, 1376–80 (Fed. Cir. 2013).

the discovery of information that is reasonably calculated to lead to the discovery of admissible evidence.[77] Licenses existing on patents-in-suit are discoverable.[78] Licenses on patents *similar* to those in suit are discoverable if there are no licenses on the patents-in-suit.[79] The Federal Circuit has established that there is no "settlement negotiation privilege" that would make settlement license agreements undiscoverable.[80] Most existing licenses, as well as settlement licenses may be discovered during patent litigation.

With licenses on patents-in-suit being generally discoverable, it follows that the Tax Structure would also be discoverable.[81] The Tax Structure engages in license agreements and development agreements between the Parent and Subsidiary. Those agreements may include the entire patent portfolio, and, therefore, include the patents-in-suit, making the inter-company license agreements discoverable. Those agreements set out what the company thinks its IP is worth, at least for tax purposes. Furthermore, tax information is published in proxy statements by publicly traded companies, where they declare their effective corporate tax rate.[82]

In *Mars*, the defendants were even able to discover negotiations and communications that Mars had with the British government during a tax audit regarding its Double Irish.[83] The defendant was able to quote passages taken directly from that correspondence.[84] The same information could be extremely helpful to future defendants facing corporations that have been audited. That information would include the royalties that Subsidiary is

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77. FED. R. CIV. P. 26(b)(1).

78. Mars, Inc. v. Coin Acceptors, Inc., 527 F.3d 1359, 1373 (Fed. Cir. 2008) (showing discovered licenses on the patents-in-suit); Bally Technologies, Inc. v. Bus. Intelligence Sys. Solutions, Inc., No. 2:10-cv-00440-PMP-GWF, 2011 WL 3892221, at *2 (D. Nev. Aug. 30, 2011) (showing that license agreements on the patent-in-suit are absolutely discoverable, and should be largely favored over licenses covering similar technologies). It is generally understood that licenses covering the patents-in-suit are discoverable; the above are just a few practical examples.

79. *See* American Original Corp. v. Jenkins Food Corp., 774 F.2d 459, 462 (Fed. Cir. 1985) (allowing the discovery of royalties paid "for use of a comparable patent in the industry."); *Bally Technologies*, 2011 WL 3892221, at *3 (clarifying that when a license exists on the patents-in-suit, other licenses on similar patents should not be discoverable).

80. *See In re* MSTG, Inc., 675 F.3d 1337, 1348 (Fed. Cir. 2012). *But see* LaserDynamics, Inc. v. Quanta Comput., Inc., 694 F.3d 51, 77–78 (Fed. Cir. 2012) (limiting the circumstances when settlement license agreements may be discovered to those instances when the probative value outweighs the risk of unfair prejudice per Rule 403).

81. *See, e.g.*, *supra* note 74 and accompanying text.

82. Proxy statements are available on most tech company websites under investor information tabs. *See, e.g.*, *Annual Reports and Proxy Statements*, UNITED TECHS., http://www.utc.com/Investors/Pages/Annual-Reports-and-Proxy-Statements.aspx (last visited Jan. 16, 2016); *Notice of 2015 Annual Meeting & Proxy Statement*, GEN. ELECTRIC (Apr. 22, 2015), http://www.ge.com/ar2014/assets/pdf/GE_2015_Proxy_Statement.pdf.

83. *See Mars*, 527 F.3d at 1373.

84. *Id.*

paying Parent for the right to exploit IP, which may be used to establish a reasonable royalty rate.

III. NOVEL LITIGATION STRATEGIES—THE "DOUBLE DIP WITH WHISTLEBLOWER SANDWICH"

As established, the IRS requires that Parents engaging in the Tax Structure pay a reasonable royalty rate to license IP to Subsidiaries. That license demands an arm's length transaction between Parent and Subsidiary. The royalty rate should technically be the same rate that the company would expect others to pay to license the same IP. It is thus disturbing to see companies enforce their IP against competition, and then ask for a much higher royalty rate for the same patents. This "double dip" is a clear conflict of interest where companies are minimizing IP value for tax purposes, but then saying it is extremely valuable for damages purposes. They are seeking to double dip, by saving millions and billions on income taxes, and then trying to recover as much as possible for patent damages. They should not be able to do this. The value of their IP for tax purposes should be enforced in patent litigation as the established reasonable royalty rate.

To illustrate how this information could be used as a litigation defense strategy, assume a hypothetical patent litigation where the defendant is found to have infringed the plaintiff's valid patents. The next step is to determine patent damages. At some point during trial, the defendant should request discovery of all existing patent licenses involving the patents-in-suit, specifically those that the Parent corporation holds with its Subsidiaries. Being that most tech companies use the Tax Structure in one form or another, there are undoubtedly licenses covering the patent-in-suit. The defendant should find and analyze what royalty rate the plaintiff is paying itself, for purposes of income taxes. If there have been any audits, statements made by plaintiffs to the IRS regarding licensing rates may be very helpful. Most likely, plaintiff Subsidiaries have paid a minimal royalty rate to the Parent, minimizing income tax liability.

The plaintiff's probable next step would be to attempt to prove actual damages via lost profits. To counter this, the defendant should raise issues of standing. The Subsidiary would be merely a non-exclusive licensee, and so would have no standing to enforce the IP. The Parent corporation would have to be the named plaintiff and, as such, would need to prove "(1) demand for the patented product, (2) absence of acceptable noninfringing substitutes, (3) his manufacturing and marketing capability to exploit the demand, and (4) the amount of the profit he would have made."[85] Parent most likely would not have the manufacturing and marketing infrastructure to exploit that IP. Accordingly, it would be simple for defendant to show that lost profits damages are not available to the plaintiff.

Plaintiff would be left with reasonable royalty damages as the floor to damages. The Tax Structure licenses that would be discovered speak to factors one, two, and fifteen from *Georgia-Pacific*.[86] The Tax Structure licenses would show royalties received by the patentee for the licensing of the patent in suit, per factor 1. They would show the rate paid by the licensee for the use of other patents comparable to the patent in suit, per factor 2. And finally, they would show the amount that a hypothetical negotiation would have resulted, per factor 15 (IRS presumes the licenses to be arm's length transactions between Parent and Subsidiary).

Plaintiff and defendant would both be likely to hire experts to maximize, and minimize the royalty rate, respectively. At this point, defendant should produce the Tax Structure licenses that were procured during discovery. Defendant would point out that the IRS demands an arm's length transaction, and that the plaintiff has represented to the IRS, under penalty of perjury, that the royalty rates Subsidiary is paying to Parent are the reasonable royalty rates. Objections to plaintiff's making this argument would force the plaintiff to contradict himself. If plaintiff tries to prove the IP is worth more, it potentially invalidates its Tax Structure, showing that it underpaid in income taxes. Taking Google as an example, it is extremely unlikely that it would wish to repay the billions saved using the Tax Structure.[87] At this junction, it seems more probable that it would settle for more favorable terms than defendant would have gotten otherwise. This portion of the litigation strategy is the "double dip" portion. The plaintiff cannot double dip without raising serious questions about its Tax Structure.

This approach, at the very least, should improve settlement terms for the defendant. But defendants are simply not raising it as a defense. Either they are not aware of the intercompany licenses,[88] or on the other hand, it is too difficult to assert because of the challenges that will be discussed in Section

85. Panduit Corp. v. Stahlin Bros. Fibre Works, 575 F.2d 1152, 1156 (6th Cir. 1978).

86. *See* Georgia-Pacific Corp. v. United State Plywood Corp., 318 F.Supp. 1116, 1121 (S.D.N.Y. 1970).

87. Drucker, *supra* note 1.

88. This could completely be the case based on the limited number of patent attorneys that know anything about tax law. Also based on the fact that most patent attorneys are probably oblivious to the fact that this structure exists, and those that know about it most likely have no idea how it functions.

IV. The only example of raising this defense is *Mars, Inc. v. Coin Acceptors, Inc*.[89]

In *Mars*, Mars had previously traversed a tax dispute with the British Internal Revenue Service for its licensing structure with its subsidiary manufacturing entities.[90] During that dispute, it had justified the low royalties it was paying back into its British entity, stating that paying anything over four percent royalties for the patents-in-suit would be "excessive."[91]

During its litigation with Coin Acceptors, communications between Mars and the British Internal Revenue Service during the tax dispute were used in the damages defense that Coin Acceptors raised in opposition to the reasonable royalty damages of seven percent that were awarded at the district court level.[92] Coin Acceptors argued that if Mars told the British Government that anything over four percent was excessive, then clearly a seven percent damages royalty award was also excessive, and clearly above the value these patents would have received in a real license negotiation.[93]

The district court simply stated that an intra-company license, and a license between competitors are not the same thing.[94] It further stated that the intra-company license was not a true arm's length negotiation, and that it is expected that a parent would charge its subsidiary a smaller licensing royalty than it would charge a competitor.[95] The Federal Circuit affirmed the district court, stating in relevant part:

> the terms in an intra-company license agreement made to satisfy the requirements of the United Kingdom taxing authorities are likely to be very different from those resulting from a hypothetical negotiation between competitors. While Coinco may be correct that the United Kingdom taxing authorities requested that the license rate be one that simulates the rate that would have been reached in an arm's-length negotiation between independent enterprises, there is no evidence that suggested that the 4% rate would have been the rate at which Mars would have licensed a competitor.[96]

The district court and Federal Circuit rationale precisely outlines the problem. To be sure, Mars *told* the UK taxing authorities that four percent was a reasonable royalty rate, but they would never give that rate to a

89. Mars, Inc. v. Coin Acceptors, Inc., 527 F.3d 1359 (Fed. Cir. 2008).
90. *Id.* at 1373.
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*

competitor.[97] Basically Mars had the benefit of lowering its tax liabilities, while at the same time increasing its damages by taking two different positions on its royalty structures. Incredibly, the Federal Circuit allowed this without batting an eye.

This outcome is perplexing. Perhaps the Federal Circuit would have enforced the tax royalty rate if the audit had been dealing with the IRS, a U.S. government entity, rather than the UK. If the Federal Circuit were to make the same conclusion following an IRS audit of those licenses, the IRS would be pretty interested in that decision. One would imagine that a lawsuit would immediately follow where the IRS would seek to enforce the new patent damages royalty rate for tax purposes.

This is where the "whistleblower" portion comes into play. In order to gain even more leverage, the defendant could threaten to file a form 211 with the IRS. The defendant would have legitimate evidence in the form of the intra-company license agreements. Those agreements would show what the company is claiming its IP is worth to the IRS. The defendant would most likely also have access to the plaintiff's expert reports and damages calculations where the plaintiff tried to prove that its IP is worth much more than what they represented to the IRS. This self-serving fabrication could lead to many whistleblower investigations by the IRS.

However, the whistleblower portion of the abovementioned strategy has some pitfalls. The statute requires that an individual bring the suit, not a corporation.[98] It might be difficult where the client is a company, to determine who should bring the whistleblower action. Even with this difficulty, it seems that the threat of "blowing the whistle" itself brings even greater leverage to the defendant in the settlement context. The plaintiff corporation most likely stands to lose a lot more money from tax penalties, than from settling for smaller patent damages.[99]

IV. CHALLENGES TO ENFORCING THIS STRATEGY

Although past licenses are discoverable and admissible, that does not mean that they must have any influence over patent damages calculations.

97. *Id.*

98. IRS, *supra* note 37.

99. The largest patent damages award of 2014 was $393 million. Ryan Davis, *Top IP Verdicts of 2014—And the Firms that Won Them*, LAW 360 (July 8, 2014, 8:45 PM), http://www.law360.com/articles/555435/top-ip-verdicts-of-2014-and-the-firms-that-won-them. This is much smaller as compared to the $3.1 billion that Google has saved over the past seven years on income taxes. Drucker, *supra* note 1.

Several district and appellate court decisions have shaped the requirements that must be met in order for past licenses to bear any weight on the reasonable royalty calculation.

The licenses being used to prove a reasonable royalty must be based on the exact patents in question, or must be based on the same technology as the patents in question.[100] In *ResQNet.com, Inc. v. Lansa, Inc.*,[101] the damages award was vacated because the damages expert presented no evidence that the licenses used to calculate the reasonable royalty involved similar technology to the patented technology.[102] The expert relied on an existing license that included a bundle of patents that did not even include the patent-in-suit.[103]

Under *ResQNet.com*, there is a valid argument likely to be raised by a plaintiff, namely that a defendant cannot rely on a bundle of patents covering many different technologies to establish a reasonable royalty. In most cases, the IP licensed is hundreds of patents, including the patents-in-suit. It is difficult to pinpoint how much one patent is worth relative to another in the portfolio. There is a deeper argument as well: that the royalty paid is for the *international* value of the patents. That is, that whatever royalty was paid differs from the value of the patents in the United States. It would be an "apples to oranges" comparison.

Another challenge is that the economic circumstances of the contracting parties in the licenses under consideration must be the same as the economic circumstances of the parties in litigation.[104] In *Finjan, Inc. v. Secure Computing Corp.*, the infringer attempted to raise an argument about an existing license that allowed for a lower rate than the district court determined.[105] The Federal Circuit rejected that request because the infringing party had failed to account for the economic circumstances of the parties in the existing license, namely that those economic circumstances were substantially different than the circumstances of the parties in litigation.[106]

Considering *Finjan*, the economic positions of the parties in the inter-company license are most likely going to be very different than the economic positions of the parties in litigation. Courts may find that arm's-length dealing between Parent and Subsidiary is not the same negotiation as arm's-length

100. *See* ResQNet.com, Inc. v. Lansa, Inc., 594 F.3d 860, 881 (Fed. Cir. 2010).
101. *Id.*
102. *Id.* at 882.
103. *Id.* at 876.
104. *See* Finjan, Inc. v. Secure Computing Corp., 626 F.3d 1197, 1211 (Fed. Cir. 2010).
105. *Id.*
106. *Id.* at 1211–12.

dealing with a competitor. Further, there could be a disparity in bargaining power if the defendant is a very small or very large company leading to a different royalty rate than was accomplished on the inter-company license.

Past licenses are only useful when they were issued near the time of the existing litigation. Licenses relied upon must not be a result of cross-licensing, and the date of the license must not significantly predate the date of the hypothetical negotiation used to determine reasonable royalties.[107] In *ePlus, Inc. v. Lawson Software, Inc.*, the expert opinion on damages was excluded because it was based on an existing license that was for multiple patents including cross licenses, and the licenses relied on predated the hypothetical negotiation by four to five years.[108]

Under *ePlus*, there would be a timing issue if a defending party tried to assert existing licenses against a Parent. Most current Tax Structures were formed years ago. The overseas entities paid a multi-year royalty for a license to all of the Parent's patent portfolio; the value of that royalty being determined at the time of license formation. Plaintiff could argue that with the rapid change of technology, the values of those patents in 2000 are very different than what they would be in 2015 and forward. The hypothetical negotiation must be based on what the value would have been when the infringement began, and most likely these past licenses are going to be valued in a different time and year. In some cases, the royalties are paid up, with no ongoing royalties, making current valuation more complicated.

The license in question must be of the same format as the license royalty damages being sought; that is, the license must be a lump sum or running royalty to match what is being sought in damages.[109] In *LaserDynamics, Inc. v. Quanta Computer, Inc.*, the expert sought to testify on a damages calculation based on running royalty theory.[110] That testimony was excluded where the damages pursued in suit were based on a lump sum.[111] This situation may become an issue where a company used a lump sum payment for its Tax Structure, and is now seeking a running royalty as damages.

CONCLUSION

Notwithstanding all of these difficulties in fully enforcing the strategies set forth, the strategies themselves are useful as settlement leverage and in negotiations. Although a defendant may not be able to win on every legal

107. *See* ePlus, Inc. v. Lawson Software, Inc., 700 F.3d 509, 523 (Fed. Cir. 2012).
108. *Id.*
109. *See* LaserDynamics, Inc. v. Quanta Computer, Inc., 694 F.3d 51, 80 (Fed. Cir. 2012).
110. *Id.*
111. *Id.*

issue raised by these existing Tax Structures, winning every issue is probably not necessary. No plaintiff is going to be excited at the threat that its corporate tax structure may: (1) become public knowledge; (2) be invalidated; or (3) be the subject of a whistleblower proceeding. Such proceedings have the potential to cost the company a large amount of money in back-taxes and penalties, but even more than that, any publicity generated by these proceedings is likely to greatly impair the goodwill of the company. U.S. citizens do not like the words "outsourcing," "tax loopholes," or hearing how corporate America is paying a much lower effective income tax rate than the average citizen due to these Tax Structures.[112] As damages come into question, the use of the "Double Dip with Whistleblower Sandwich" is likely to lead to a more favorable settlement than the defendant would have faced otherwise.

112. This is evidenced by the recent Occupy Wall Street and other similar movements. *See* Charles M. Blow, *Occupy Wall Street Legacy*, N.Y. TIMES (Sept. 13, 2013), http://www.nytimes.com/2013/09/14/opinion/blow-occupy-wall-street-legacy.html.