

# Intellectual Property Holding Companies: A Strategic Analysis

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In the technology-driven environment, intellectual property (IP) is often the “crown jewel” asset of a company, both as an unrealized asset and, more importantly, in terms of the revenue that that IP could generate if properly and fully exploited over time. While this statement is true across the full spectrum of IP (e.g., patents, trademarks, copyrights, trade secrets and the like), it is particularly the case with regard to patents, arguably the most valuable kind of intellectual property in a company’s IP portfolio.

As a consequence, inventors and companies are becoming more concerned about protecting and exploiting their patent assets, and, to that end, many are moving toward a “two entity” legal structure. The first entity is the core company and typically the public face of the enterprise. This is where management sits, and where the business of the company is typically conducted (e.g. engineering, manufacturing, marketing and sales). The second entity is the legal repository of the intellectual property assets, and is singularly tasked with protecting, managing and exploiting the IP. This second entity is an intellectual property holding company (IPHC).

But is this two-entity IP strategy the best approach? It depends. There are several important aspects to the analysis, and it is absolutely essential that both inventors and companies evaluate all of these aspects before making a determination as to

whether this strategy makes sense for their specific situation.

## TAXATION

Historically, perhaps the most significant impetus to moving toward a two-entity structure has been driven by tax considerations. The strategy, at its essence, is designed to minimize tax liabilities by shifting licensing royalty income earned from IP assets to low/no tax states. The scenario typically works like this: 1.) The IP is placed within a stand-alone IPHC (as one might expect, there are exotic and arcane tax strategies for how, when, and under what circumstances this might be accomplished, but that discussion is well beyond the scope of this article); 2.) The core company then licenses from the IPHC the right to exploit the IP. By setting up the IPHC in a state that imposes no licensing royalty tax on a domestic entity whose sole business is the management of intangible assets used outside the state (such as Delaware), or, alternatively, in a state which has no corporate income tax at all (such as Nevada), the tax on that licensing royalty income is, at the very least, significantly reduced and perhaps eliminated completely. Moreover, the royalty payments would likely be deductible by the core company as a business expense.

However, this strategy is no longer a slam-dunk. Both federal and state taxing authorities have begun to look more closely at these two-entity structures, with an eye toward deconstructing them (and, not coincidentally, generating tax revenue), if their only meaningfully defensible reason for existence is tax reduction. If the IPHC is a mere operational shell, for example, with no real staff, no physical office (a P.O. Box/Virtual Office arrangement almost certainly won’t cut it) and no real operational responsibility other than to hold the IP, the IPHC might very well be determined by taxing authorities to be a sham. Additionally, if the nature of the licensing relationship between the entities is exclusive and long term, the IRS might well rule that the transaction was actually a disguised IP asset sale rather than a licensing arrangement, notwithstanding the contractual paperwork’s language to the contrary. Accordingly, prior to a decision to implement a two entity

strategy driven predominantly by a tax reduction motivation, a very serious review of the various structural, operational and contractual requirements for a successful two entity strategy should be undertaken to assure that it will survive a rigorous federal and state audit.

## MANAGEMENT

Aside from taxation, one of the other major reasons companies move to implement a two-entity strategy is to bring a more intense, professional and measurable focus to the management and exploitation of their IP assets. Important IP functions such as filings, assignments, marketing and licensing business opportunities would arguably be better managed in an environment set apart from the daily chaos of the executive suite. This, of course, would be the case in almost any size company, but is particularly true in environments where there are significant numbers of patents in, or moving through the corporate IP portfolio. In that scenario, the two-entity IPHC approach may be the right one, irrespective of almost any other consideration.

That said, it is important to gauge the cost and complexity of this strategy, up front. This is not an inexpensive route to take, and must be viewed in the context of the level of IP assets which would be addressed by this approach, and whether it makes sense to go this route if there is little or no anticipated licensing revenue involved in the equation. Moreover, to the degree that such an approach (for example, in a startup environment) is merely structural (e.g., there is an IPHC entity, but no real resources being applied within that IPHC to manage and support its purported mission), state and federal taxing authorities, as discussed above, might successfully deconstruct the entire strategy and eliminate any tax advantages which could otherwise pertain.

Finally, there is the issue of ongoing product development by the core company. Assuring the flow of new IP assets into the IPHC, where such IP assets derive from the work done in the engineering group typically owned by the core company (but which may or may not be technically tied to IP assets already owned by the IPHC), can be daunting in any number of respects, not the least of which would be the issue of asset transfer valuation.

## PROTECTION

The whole point of patent filings, of course, is to create a comprehensively-

protected playing field for the intellectual property—to protect both the IP asset itself as well the financial rewards that might someday derive from that asset. One of the major benefits of the two-entity solution is that the IPHC serves to shield the patent asset from various unpleasant litigation or financial scenarios which might befall the core company; neither lawsuits nor bankruptcy, typically, could reach the IP held within the IPHC. This idea remains valid, and is often an important consideration for prudently cautious inventors, particularly in the startup environment.

However, as the result of *Poly-America, L.P. v. GSE Lining Technology, Inc.*, this two-entity protection strategy now has to be balanced against important restrictions placed upon the IPHC. *Poly-America, L.P. v. GSE Lining Technology, Inc.*, 383 F.3d 1303, 1310-12 (Fed. Cir. 2004). Essentially, what this ruling says is that because the IPHC is the sole owner of the patents, the core company (which is merely a licensee, and almost always a non-exclusive licensee) has no standing to sue for its lost revenues or to ask a court to issue an injunction to stop a patent infringer. Only the IPHC has standing, and, largely, its only standing is to sue for what it has or will lose, which is only its licensing revenue. The result of this can be particularly unsatisfactory if the serious revenue losses, due to infringement, derive predominantly from the product sales of the core company, rather than from licensing royalties of the IPHC.

## MERGERS, ACQUISITIONS, FUNDING AND VALUATION

An often-overlooked area of consideration is the interplay between various possible financial events on the company horizon and the management and ownership of the IP assets. Obviously this is a very complex area, and the details are well beyond the reach of this article. That said, there are certainly some key considerations, depending upon the circumstance.

For example, will the core company be engaged in significant and ongoing M&A activity? If so, it may well make sense to isolate all IP within an IPHC entity right up front, both for taxation and managerial IP focus reasons. This is particularly true if the activity has an international component. There is, to cite simply one situation, virtually no viable technique to effect a tax-free patent transfer from domestic to off-shore ownership. Setting up an offshore IPHC, prior to the actual international M&A transaction, therefore, could be an important strategic planning consideration in an inter-

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national transaction where important IP assets are involved.

Is the core company likely to seek equity funding, or will it need to obtain debt financing? If so, a two-entity IPHC strategy will be more complex and, more than likely, run directly counter to the typical desire of an inventor/patent holder to isolate its IP ownership from the core company. What savvy investor, for example, would inject serious funding into a core company startup entity if that investor wasn't also going to own a commensurate portion of the IP assets upon which the company's future success is predicated? Likewise, what banker, in reviewing a loan request, would grant a loan to a core company startup unless the underlying IP assets were reachable as security for that loan?

One plausible advantage for the two-entity IPHC approach, it should be noted, is that valuation can sometimes be higher for the two separate entities, taken together. Given their separate areas of focus, it is not unreasonable to assume that they each, as fully responsible custodians of their respective business realms, would do a better job of growing their respective businesses and creating value.

Yet another possible advantage in the two-entity IPHC approach is flexibility in licensing the IP assets and pursuing different products and services related to the IP assets. Additional core companies may be created to pursue different markets, products or services. Any of these core companies may later be easily sold or divested without impacting the operations or finances of the others. In that way, a profitable niche market related to the IP assets of the IPHC may be developed (either through a new core company, a licensed third party or a joint venture) and then sold off, all the while insulating the IPHC and any other core companies from risk, ownership issues and interference.

## CONCLUDING REMARKS

There are many and varied aspects that inventors and company managers should consider in determining whether a two-entity IPHC strategy makes sense, and, because each circumstance is unique, the analysis and ultimate decision will often involve a balancing test of the various components described above. One thing is for certain, however—anyone who says that the choice is simple has obviously not been paying attention. IPT