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Intercompany Arrangements Following a Flip Transaction

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Many overseas companies reorganize or “flip” to create a US parent company or to access US venture financing and customers. Following a flip, there is a US “parent” company with one or more overseas “subsidiary” companies, that often hold most – if not all – of the employees, along with the original business and technology/intellectual property assets.

- As the parent holds the funds from the venture financing, it needs to consider:
- The separate tax treatment of each subsidiary.
- Any intercompany licensing arrangements required for each subsidiary’s operations.
- Documentation of intercompany arrangements between the parent and each subsidiary.
- How to fund the subsidiaries to cover local employment and operating expenses.

It’s important to remember that the parent and each of its subsidiaries are separate companies that must maintain separate accounting, tax and corporate records and ensure appropriate corporate governance procedures are followed. This involves managing each company’s business and their respective assets in accordance with local legal requirements and establishing systems for local tax and accounting compliance.

What’s the best way to do this?

Several factors will determine the appropriate intercompany arrangements between a parent and each foreign subsidiary. The companies’ accounting or tax advisers will need to be involved in this analysis to ensure compliance with applicable tax and transfer pricing requirements. There’s no one-size-fits-all arrangement, but some key factors to consider include the following:

Role of the subsidiary

If the subsidiary employs engineers and other technical resources – often at salaries significantly lower than in the US – you may want to keep the engineering function in the subsidiary. If sales or business development employees have already been hired overseas, some sales activity may also take place out of the subsidiary.

Tax position of the subsidiary

If the subsidiary has accumulated tax losses from its operations before the flip, it may make sense to have the subsidiary conduct sales of products or services – so long as profits from those sales can be offset by available tax losses. This might mean the parent acts as a holding company, providing financing by way of capital contributions (equity) or loans, to cover the subsidiary’s operational costs that are not met by the fledgling sales activity.

Intellectual property (IP) ownership

Where the business began overseas in what is now a “subsidiary” of a parent, IP rights, such as those around the technology platform, products or services, are likely owned by the overseas subsidiary. Initial funding and grants made to the subsidiary, sometimes by government agencies, may impose ongoing requirements – such as, IP assets must remain in the subsidiary, minimum employee numbers in the subsidiary, etc. – to avoid triggering repayment of grants or loss of other benefits. Moving the IP from the subsidiary to the parent may not be possible because of these restrictions, or it may require careful analysis of the tax consequences of transferring IP assets out of the overseas country (if treated by the country’s tax authorities as a ‘sale’ of an IP asset to the parent, subject to tax on any increase in value of the IP since its creation).

What are some typical intercompany arrangements?

While each situation is different – and is often based on the company’s history, prior funding or personnel resources – some typical alternatives include:

Parent as ‘holding company’ with subsidiary carrying out operations and sales

The parent provides capital to the subsidiary through capital and/or loans, and the subsidiary handles operations and sales (where it has the benefit of tax losses and owns the IP/technology, for example). Both the parent loans and the utilization of tax losses require careful tax and accounting analysis.

Parent as reseller or distributor (in US or more broadly)

The parent provides sales, management and administrative functions, funds the engineering operations of the subsidiary and receives a “license” to the technology from the subsidiary to allow the parent to make sales and receive customer revenues. The parent acts as a reseller or distributor for the subsidiary, which owns the IP/technology in the products or services.

Parent owns future-developed IP

The subsidiary continues engineering and development work, which is assigned to the parent under a research and development services agreement in return for payment to cover the subsidiary’s operating costs. So, while it may not be possible to transfer pre-flip IP to the US parent without a tax cost, this approach could be considered if the initial technology will become obsolete as new products or services are developed. The parent then sells or licenses to customers and receives revenues. The parent also might appoint a subsidiary as a limited risk distributor to sell products or services in specific territories.

IP cost-sharing

In this model, the parent and the subsidiaries agree to split the cost of developing future IP, which each then owns, often based on geography (for example, the US owns rights to sell in North America, and the subsidiary has rights in the rest of the world). This is obviously a more complicated structure requiring significant tax planning and implementation. These kinds of arrangements have become far less common since the Tax Cuts and Jobs Act was passed in 2017 and may not be appropriate for early-stage companies.

Intercompany arrangements are documented in one or more “intercompany agreements.” Agreements between subsidiaries also may be required, as well as agreements covering administrative or other services around the group.

Intercompany agreements document the transfer of funds, IP or other assets between different companies in the same group. They

require regular review to ensure compliance with the tax regimes and transfer pricing requirements of the US and overseas tax authorities.

Key Contacts

Julie Wicklund Palo Alto	jwicklund@cooley.com +1 650 843 5093

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