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Tax Aspects of International Licensing Agreements†

I. Introduction

A. License of "Industrial Property Rights"

One of the most important marketing devices used by American business in exploiting so-called "industrial property rights" abroad is licensing. For purposes of foreign licensing, "industrial property rights" can generally be grouped into three broad categories:

1) Foreign patents and copyrights
2) Foreign trademarks; and
3) Know-how

The last of these is a generic term to describe all non-statutory industrial property rights. "Know-how" may include tangible property such as inventions which are unpatented or unpatentable or technical data represented physically in the form of specifications, manuals, blueprints and the like; or "know-how" may represent intangibles such as techinical aid and assistance and person-to-person instruction to licensees.

B. Why Licensing?

Licensing to local enterprises in foreign countries is one of three ways by which an American enterprise owning foreign rights in industrial property may profitably exploit them. The others are: exporting and marketing in foreign countries the products protected by such rights and establishing the enterprise's own manufacturing abroad directly or through subsidiaries.

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For a variety of reasons, licensing is often preferred over these other marketing devices. The primary advantage of licensing is that it does not require the large outlay of capital and manpower that frequently characterize the other techniques. This factor has become increasingly important since the adoption of the Department of Commerce Foreign Direct Investment Regulations early last year restricting the transfer of capital abroad. Other considerations favoring licensing are foreign import restrictions, local currency fluctuations, the relative ease with which royalties may be transferred from most foreign countries as compared to the payment of dividends and the repatriation of capital, and practical difficulties in adapting a U.S. product for local markets.

C. Tax Considerations

As in every type of marketing arrangement, tax planning plays a crucial role in structuring licensing agreements. Payments received by an American licensor under a foreign license, whether constituting a sale or a non-exclusive license, are most often received in the form of royalties based on a percentage of net or gross sales, or may be received as stipulated fees or lump-sum payments. Since U.S. corporations and citizens are taxed on their world-wide income, domestic or foreign, all of this income received by the U.S. licensor is subject to U.S. taxes. Before entering into a license agreement, the licensor must consider the combined impact of U.S. and foreign taxes on these payments.

This discussion of these tax considerations will be limited to licensing by widely-held U.S. corporations rather than individuals, partnerships or close corporations. A review of tax aspects of foreign licensing of industrial property rights by American companies may be divided into three categories:

1) Direct licensing to an independent foreign licensee;
2) Indirect licensing through a domestic or foreign subsidiary; or
3) Cross-licensing, directly or indirectly.

II. Direct Licensing

A. U.S. Tax Considerations:

1. SALE

a) Favorable U.S. Tax Treatment:

In direct licensing, the first consideration of the American licensor is the nature of the property rights that it wishes to transfer. Favorable U.S. tax incentives may, when combined with other factors, cause the licensor to

decide to attempt a sale of these property rights, rather than a non-exclusive license or lease. If the property transferred qualifies as a capital asset[1] or a so-called "Section 1231 Asset,"[2] the property has been held by the licensor for at least six months and all substantial rights to the property are transferred, the transferor will be taxed on the income from the transfer of this property at capital gains rates, despite the fact that payments may be payable periodically measured by the assignor's production, use or disposition of the property transferred.[3] The payments will thus be subject to U.S. taxes of only 25% as opposed to 48%, the U.S. corporate rate on ordinary income.[4] (These rates are 27.5% and 52.8% with the full application of the 10% surtax.)[5]

b) Qualification of Property as Capital or Section 1231 Asset:

It is clear that patents, copyrights and trademarks qualify as either capital or Section 1231 assets, but know-how is not susceptible of this easy labeling.

A "Section 1231 Asset," as that term is defined in Section 1231 of the Internal Revenue Code of 1954, is property used in the trade or business of the taxpayer subject to an allowance for depreciation if such property is not inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of taxpayer's trade or business.[6] Patents and copyrights held by a corporation qualify as Section 1231 assets if they are not held primarily for sale to customers in the ordinary course of business.[7] Trademarks are capital assets, as that term is defined in Section 1221 of the Code, rather than Section 1231 assets, since they are not depreciable.

The tangible property which "know-how" encompasses may be considered a capital asset, but it is not clear whether that portion of know-how which cannot be reduced to physical form, such as technical information and skills which must be communicated through the rendering of technical assistance by the personnel who have accumulated the information and skills, can constitute a capital asset. Few cases have dealt specifically with whether any of the various forms of know-how constitutes a capital asset for purposes of capital gains licensing. Yet, there is authority for the

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[1]Internal Revenue Code of 1954 ("IRC") § 1221.
[2]IRC § 1231.
[3]IRC § 1235.
[4]IRC §§ 11, 1201(a).
[5]IRC § 51.
[6]IRC § 1231(b).
[7]*See* Treasury Regulations ("Regs.") § 1.167(a)-3 (Patents and copyrights subject to allowance for depreciation under IRC § 167); Mack & Co., Inc. v. Smith, 155 F.Supp. 843 (E.D. Pa 1957); National Bread Wrapping Machine Co., 30 TC 550 (1958).

proposition that unpatented inventions and secret processes constitute capital assets which may be licensed on a capital gains basis, and secret processes and secret formulae have been labeled "property" for tax purposes in a context other than capital gains licensing.[8] It would appear possible to argue that any tangible form of technical information, such as drawings, designs and specifications constitutes "property" and therefore a capital asset under Section 1221. Like trademarks, none of this property would qualify under Section 1231 because it is not depreciable.

c) What Constitutes a "Sale" of Industrial Property Rights?

There are two basic methods by which a transfer of rights to industrial property can be effected in order to qualify as a "sale": the rights can be assigned, or an exclusive license may be granted. In the case of patents, an assignment involves the transfer of legal title to the patent to the transferee, and steps must be taken to have the transferee registered as the patent owner in the foreign patent registry concerned. An exclusive license of a patent grants to the transferee an exclusive license to use, manufacture and sell within a particular geographical area the patented article for the life of the patent. In this case, the assignor retains title to the patent and may retain other controls without destroying the capital gain nature of the transaction, such as the right to recapture the patent rights upon the occurrence of certain events, *e.g.*, the transferee's failure to pay royalties or the transferee's bankruptcy.[9]

It is clear that a sale of a patent has occurred when the assignor has granted an exclusive license of the patent within one or more countries (either the U.S. or one or more foreign countries).[10] However, if such license is limited to an area within a particular country, the Treasury takes the position in regulations issued under Section 1235 of the Code that the transferor has not transferred "all substantial rights to the patent" so that the transfer is not a "sale" for purposes of obtaining capital gains treatment under Section 1235 (where the royalty payments are are payable periodically, measured by the productivity or use of the patent)."[11] The Tax Court has rejected the Treasury's position as set out in the regulations in a recent decision upholding capital gains treatment on an exclusive license of a patent only within the State of California.[12] Earlier case law decided

[8]*See* Samuel E. Diescher, 36 BTA 732 (1937), *aff'd* 110 F.2d 90 (3rd Cir. 1940), *cert. denied* 310 U.S. 650 (1940); Thompson v. Johnson, 50-2 USTC ¶ 9428 (S.D.N.Y. 1950); George S. Mepham, 3BTA 549 (1926); Wall Products, Inc., 11 TC 51 (1948).

[9]*See* Edward C. Myers 6 TC 258 (1946).

[10]*See* Rev. Rul. 64-56, 1964-ICB (Part 1) 133 and Rev. Rul. 69-155, IRB 1969-14, 12.

[11]Regs. 1.1235-2(b)(1).

[12]Vincent B. Rodgers 51 TC ____, 92, March 6, 1969 (CCH Dec. 29, 482).

under the 1939 Code prior to the enactment of Section 1235 had also upheld capital gains treatment on a transfer of patent rights within geographical limits inside a particular country.[13]

The basic principles relating to what constitutes a sale of a patent apply in the trademark and know-how area. However, an exclusive license of trademarks or tangible know-how must be perpetual, since this property has no fixed life as does a patent.

2. NON-EXCLUSIVE LICENSE:

Despite the favorable U.S. tax consequences which usually result from a transfer of all substantial rights to industrial property, other non-tax considerations may militate against this form of transfer. For a variety of reasons, the American owner of these rights may be unwilling to grant such substantial rights. For example, in order to obtain capital gains on the transfer of a trademark, the license must be perpetual, and trademark owners are normally unwilling to grant perpetual rights to transferees they do not control. Therefore, the American licensor may prefer granting a non-exclusive license to his industrial property rights. Under this method of licensing, the licensor retains the right to license the same rights to others in the same geographical area.

As pointed out above, all royalties or fees received by the American corporate licensor for the non-exclusive license of patents, copyrights, trademarks and know-how abroad are taxed to the licensor at ordinary income rates regardless of the source of payment. After the deduction of allocable expenses, this income is subject to the ordinary U.S. corporate tax rate of approximately 48% (or 52.8% assuming the full impact of the 10% surtax).[14]

B. Foreign Tax Considerations:

1. SALE V. LICENSE

Before entering into any type of licensing arrangement, whether exclusive or non-exclusive, the U.S. licensor should consider the effect of the source country's taxes on payments under the license. Generally, the foreign licensee must withhold these taxes from the gross payments to the non-resident licensor. The tax rates vary greatly from country to country. These taxes are normally income taxes but may also include other types of taxes, such as turnover or transactional taxes. The distinction is important

[13]*See* Vincent A. De Marco 25 TC 544 (1955).
[14]IRC §§ 11, 51.

because income taxes are creditable against U.S. taxes on the royalties and fees, whereas taxes other than income (for excess profits) taxes generally are not creditable.[15] This point will be discussed below.

It should be noted that, just as for U.S. tax purposes, a sale of property rights may be accorded different foreign tax consequences from a non-exclusive license. Also, the method of payment, whether in a lump sum or periodic and contingent upon the productivity of the property, may affect foreign taxes. Many double taxation treaties in which the United States is a party cover specifically the taxation of capital gains and royalties from the transfer of industrial property rights. However, in cases in which treaties do not exist or when they are silent on the treatment of a sale or license of industrial property rights, local counsel in the source country should be consulted as to the local tax consequences of a sale or license.

2. EFFECT OF TREATIES:

At the present time the United States is a party to 25 treaties for the avoidance of double taxation. The foreign tax saving afforded by many of these treaties on payments to American licensors is dramatic. A treaty may reduce or completely eliminate foreign taxes. Therefore, in planning foreign licensing operations, the existence of a double taxation treaty between the U.S. and a particular foreign country may be the critical factor in the American owner's decision to sell or license industrial property rights in that country as opposed to another country which does not have a tax treaty with the United States. Since not every income tax treaty to which the U.S. is a party specifically covers payments received from the sale or license of industrial property rights, a careful review of each treaty must be made.

In order for the special treaty rates to apply to capital gains and license royalties, the common requirement is that the U.S. recipient have no "permanent establishment" in the source country.[16] This term is generally defined as an office or other fixed place of business or the existence of an agent with wide discretionary authority to act for the U.S. principal.[17]

To demonstrate the effect of double taxation treaties on the source country's taxes, the following is a comparison of treaty and non-treaty

[15]IRC § 901.

[16]*See, e.g.,* Income Tax Treaty with the United Kingdom, April 16, 1945, Article III, 60 Stat. 1377, TIAS 1546 (*as modified* by Supplementary Protocol signed May 25, 1954, 6 UST 37, TIAS 3165; Supplementary Protocol signed August 19, 1957, 9 UST 1329, TIAS 4124; and Supplementary Protocol signed March 17, 1966, 17 UST 1254, TIAS 6089).

[17]*Id.,* Article II(1)(1).

rates on royalties and other fees from the license of industrial property rights in five countries in different parts of the world, each of which has concluded a double taxation treaty with the United States. (The Brazialian treaty has been signed and ratified by the U.S. Senate, but the treaty will not come into force until instruments of ratification are exchanged between the United States and Brazil.)

a) Japan:[18]

In Japan, the regular non-treaty rate on royalties received by a non-resident foreign licensor from the license in Japan of patents, trademarks, secret processes and other scientific works is 20%, whereas under the income tax treaty between Japan and the United States, a U.S. licensor with no permanent establishment in Japan is subject to only a 10% withholding rate.

b) Brazil:[19]

In Brazil, the rate of withholding on royalties and fees for licenses by non-residents of patents and technical assistance in Brazil is 25% (or 30% if certain formal requirements are not observed), and the rate is 25% to 30% on trademark royalties. For non-resident U.S. licensors, the treaty rate (when the treaty becomes effective) on such royalties and fees is a flat 15%.

c) Belgium:[20]

The normal withholding rate on amounts paid to non-residents for the license of industrial property rights in Belgium is 20%. The U.S.-Belgium Income Tax Treaty exempts completely from Belgian taxes royalties paid to non-resident U.S. licensors.

d) France:[21]

France withholds an income tax of about 20% on royalties paid to non-residents which are not protected by a treaty, whereas the U.S.-French Treaty provides that in the case of all royalties except on copyrights, payments to U.S. residents with no permanent establishment in

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[18]Income Tax Treaty with Japan, April 16, 1954, Article VII, 6 UST 149, TIAS 3176 (*as modified* by Protocol signed May 7, 1960, 15 UST 1538, TIAS 5637; and Protocol signed August 14, 1962, 16 UST 697, TIAS 5798).

[19]Income Tax Treaty with Brazil, March 13, 1967, Article 14 (Treaty will not go into effect until instruments of ratification are exchanged. *See* Commerce Clearing House Topical Law Reports, TAX TREATIES, ¶ 802).

[20]Income Tax Treaty with Belgium, October 28, 1948, Article IX(2), 4 UST 1647, TIAS 2833 (*as modified* by Convention signed September 9, 1952, 4 UST 1672, TIAS 2833: Convention signed August 22, 1957, 10 UST 1358, TIAS 4280; and Protocol signed May 21, 1965, 17 UST 1142, TIAS 6073).

[21]Income Tax Treaty with France, July 28, 1967, Article 11, TIAS 6518 (entered into force August 11, 1968).

France are subject to a maximum withholding tax of only 5%. Copyright royalties received by a non-resident U.S. licensor are exempt from French taxes.

e) United Kingdom:[22]

In the absence of a treaty, royalty payments to non-resident corporations for the license of most intangible property rights in the U.K. are subject to U.K. withholding tax at the normal U.K. standard tax rate of 41¼%. Payments to U.S. licensors are exempted by treaty from U.K. tax, a savings of 41¼% of the gross payments.

Both the French and U.K. treaties specifically cover the tax treatment in the source country of payments from the sale of industrial property rights. The U.K. treaty treats such payments exactly the same as payments from non-exclusive licenses, whether the payments are fixed or are contingent on the productivity of the property, whereas the French treaty subjects contingent payments to the same five per cent French tax as is imposed on license royalties and exempts non-contingent payments from tax.[23]

As the above examples indicate, the treaties with the industrialized countries of Western Europe generally provide more favorable tax treatment than do other treaties.

C. U.S. Tax Credit

1. GENERAL

The effect of any foreign taxes on payments to American licensors is considerably lessened by the U.S. tax credit allowance. Under Section 901 of the Code, subject to certain limitations, U.S. individuals and corporations as well as certain aliens and foreign corporations, may elect to credit against their U.S. taxes "the amount of any income, war profits and excess profits taxes paid, or accrued during the taxable year to any foreign country or possession of the United States."[24] If the U.S. taxpayer does not elect to credit these taxes, they may be deducted as an expense.[25]

a) Limited to U.S. Taxes

The credit for foreign taxes imposed on a U.S. licensor during a particular taxable year is limited to the licensor's U.S. taxes for that year. If, because of substantial deductions allowed to the licensor during a year, its total U.S. tax liability (computed on its net income) is less than the foreign taxes withheld by the foreign licensee on gross payments, the excess

[22]Income Tax Treaty with the United Kingdom, Article VIII.
[23]*See* footnotes 21 and 22, *supra;* Income Tax Treaty with France, Article 12.
[24]IRC§ 901.
[25]IRC § 164.

foreign taxes withheld will be lost as a credit forever. Such excess may never be used as a credit against the licensor's U.S. taxes for any other year.

b) Limited to Income Taxes

Also, since the credit is limited basically to foreign income taxes, any foreign turnover or gross receipts taxes on the royalties and fees will not be creditable. For example, the French turnover tax and the Mexican mercantile receipts taxes on royalties and technical service fees both have specifically been held not to be creditable taxes.[26] Because of this limitation on the tax credit, the license agreement may provide that all taxes of the source country, other than income taxes, are to be borne by the licensee.

c) Section 904 Limitation

A further limit on the U.S. foreign tax credit allowance is the so-called "Section 904 Limitation," which generally limits the credit to the proportion foreign-source income bears to total income on a "per country" or "over-all" basis.[27] Under the "per country limitation," during a particular year the credit for taxes paid to a foreign country cannot exceed the same proportion of total U.S. taxes payable during that year which the taxpayer's taxable income from sources within the foreign country bears to its total taxable income.[28] Under the "over-all limitation," the total credit for taxes paid to all foreign countries during a year cannot exceed the proportion of U.S. taxes which the taxpayer's total foreign-source taxable income bears to its taxable income from all sources.[29] The taxpayer may elect either of these limitations but may not switch back and forth from year to year.[30]

To the extent that creditable foreign taxes exceed the 904 limitation, the excess may be carried back two years and forward five or until used up. The excess is credited against U.S. taxes in the other years to the extent that the creditable foreign taxes are less than the 904 limitations for those years.[31]

2. PROOF OF PAYMENT OF FOREIGN TAXES AND OTHER REQUIRED INFORMATION

In order to be entitled to the foreign tax credit, the American licensor

[26]Eitington—Schild Co., Inc. & Subsidiaries, 21 BTA 1163 (1931); Rev. Rul. 58-3, 1958-1 CB 263.
[27]IRC § 904.
[28]IRC § 904(a)(1).
[29]IRC § 904(a)(2).
[30]IRC § 904(b).
[31]IRC § 904(d).

must be able to prove that the foreign taxes were paid, and to produce information as to the amount of the licensor's U.S. and foreign-source income for the year in question.[32] Therefore, in drafting license agreements, the licensor should be careful to include a provision that the foreign licensee is required to produce a proper receipt of payment of foreign taxes.

3. SUMMARY OF FOREIGN TAX CREDIT PROVISIONS

In summary, the foreign tax credit may serve to cancel foreign taxes totally on payments for industrial property rights. On the other hand, the limitations on the credit may render it largely ineffective in certain situations.

III. Indirect Licensing

A. Introduction

The second principal licensing device is indirect licensing through subsidiary companies. In any discussion of the tax consequences of this form of licensing as they differ from the tax consequences of direct licensing, it must first be pointed out that prior to the enactment by Congress of the Revenue Act of 1962,[33] licensing through foreign subsidiaries could achieve substantial tax savings over the direct license route. However, the Revenue Act of 1962 sharply reduced the effectiveness of setting up foreign subsidiaries for licensing abroad. This is particularly true with regard to the establishment of straight licensing subsidiaries having no other activities.

B. Prior to 1962 Revenue Act

1. ESTABLISHMENT OF FOREIGN "BASE COMPANIES"

Prior to 1962, it was common practice for U.S. companies to establish foreign subsidiaries to handle all of their foreign licensing operations. These "base companies" could be established in tax-haven jurisdictions such as Panama or the Bahamas, which impose no corporate income taxes on foreign-source income, or more often, in Western European countries, such as Belgium and Switzerland, with relatively low corporate tax rates and with substantial networks of double taxation treaties ensuring low rates of tax in the source country.

a) Straight Licensing Subsidiaries

These subsidiary companies could be completely inactive, performing no

[32] IRC § 905(b).

[33] Pub. L. 87-834 (Oct. 16, 1962), 76 Stat. 960.

other function than licensing the industrial property rights received from their U.S. parent, and collecting the income therefrom. In other words, these companies would not develop or create this property themselves nor add any substantial value to the property after its acquisition from the parent, which would perform all of these activities.

b) Method of Transfer of Property to Subsidiary

Prior to 1962, as now, industrial property rights could not be assigned to a foreign subsidiary without tax unless the parent obtained a prior "Section 367 ruling" from the Internal Revenue Service that the transfer was not in "pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes."[34] It is possible that the transaction would not be considered a taxable exchange requiring a ruling if the transfer is made as a contribution to capital after the subsidiary has issued its stock, but recent authority indicates that a ruling under Section 367 may be required whether the property is transferred in exchange for the subsidiary's stock or is couched as a contribution to capital for which no additional stock is received in exchange.[35]

(The Treasury has recently adopted guidelines setting out objective standards for issuing favorable Section 367 rulings in various transactions involving foreign corporations.[36] The guidelines state that a transfer to a foreign corporation controlled by the transferor of machinery and foreign patents essential to and intended to be devoted to manufacturing and selling within a foreign country ordinarily will be granted a favorable Section 367 ruling that the transfer is exempt from tax under Section 351.[37] The guidelines also state, however, that a favorable ruling on the transfer of patents, trademarks and other intangible property will be denied in certain situations. A favorable ruling will not be granted when the property to be transferred consists of U.S. patents, trademarks and similar intangibles to be used in connection with [1] the conduct of a trade or business in the United States or [2] the manufacture in the United States or a foreign country of goods for sale or consumption in the United States. Favorable rulings also will be denied for the transfer of foreign patents and other intangibles to be used in connection with the sale of goods manufactured in the United States.)

Even if a Section 367 ruling could not be obtained, prior to 1962 the

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[34]IRC § 351, 367.

[35]Rev. Rul. 64-155, 1964-1 (Part 1) CB 138; *Cf.* Morgan v. Commissioner, 288 F.2d 676 (3rd Cir. 1961); Davant v. Commissioner, 366 F.2d 676 (5th Cir. 1966); Werner Abegg et. al., 50 TC 145 (1968).

[36]Rev. Proc. 68-23, I.R.B. 1968-22, 33.

[37]IRC § 351.

property rights could be sold by the U.S. parent to a foreign subsidiary under an assignment or exclusive license with the income being taxed to the parent at capital gains rates. The stated consideration could be kept to a minimum subject to the power of the Commissioner to require that such payments be at "arm's length" under Section 482.[38] At any rate, all of the royalty income derived from third-party licensees in foreign countries could be accumulated free of U.S. tax subject only to relatively low foreign taxes. After an accumulation of income in the foreign subsidiary, it could be liquidated, with the income passing up to the parent at capital gains rates.

C. Since 1962 Revenue Act

1. SUBPART F

a) Foreign Personal Holding Company Income

The 1962 Revenue Act introduced new provisions into the tax law dealing with loopholes created by the use of foreign subsidiaries. Some of these provisions are found in the addition of Sections 951-964 to the Code, otherwise known as the Subpart F provisions.[39]

i) Royalties

Under these provisions, royalty income received by foreign subsidiaries from the licensing of industrial property rights, which is not connected with an active business carried on by the subsidiary, may be treated as so-called "Subpart F" income, and taxed currently to the U.S. parent as a dividend.[40] Royalties from the license of industrial property rights are defined as "foreign personal holding company income" unless such royalties are derived in the active conduct of a trade or business.[41]

Foreign personal holding company income is considered to be "foreign-base company income," which is taxable currently to the U.S. parent as Subpart F income unless the total foreign base company income of the subsidiary is less than 30% of its total gross income, in which case no foreign-base company income will be taxed to the U.S. parent.[42] If foreign-base company income constitutes more than 70% of gross income in a particular year, all of the income of the subsidiary will be taxed to the parent in that year.[43]

[38]IRC § 482.
[39]IRC §§ 951-964.
[40]IRC §§ 954 (a)(1), 952(a)(2), 951(a)(1)(A).
[41]IRC §§ 954(c)(1), 954(c)(3)(A); Regs. § 1.954-2.
[42]IRC § 954(b)(3)(A).
[43]IRC § 954(b)(3)(B).

Thus, since 1962, if a foreign subsidiary performs no other activities than passively to license abroad industrial property rights created by its parent and receive royalties therefrom, incurring only certain expenses of administration incident to the receipt of the income, all of its income is taxed currently to the U.S. parent, thus completely eliminating a former tax shield. If the subsidiary carries on an active business, passive royalty income not connected with the business also will be taxed to the parent if the royalties constitute more than 30% of gross income. Tax deferral is, of course, still possible when royalties are less than 30% of gross income, as in the case of a foreign subsidiary engaged primarily in manufacturing abroad.

ii) Royalties Derived from the Active Conduct of Trade or Business

The regulations under Section 954 define the situations in which royalties are considered to be derived in the active conduct of a trade or business by a controlled foreign corporation.[44] Generally, the regulations state that royalties derived from the licensing of the following property will be considered to be derived from an active trade or business: (1) property which the licensor has acquired and to which he has added substantial value, but only if the licensor is regularly engaged in such activities and in licensing the property; (2) property licensed as a result of marketing functions by the licensor which, through its own staff of employees located in a foreign country, maintains and operates a substantial organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property.[45] If royalty income received by a foreign subsidiary meets these tests, it will not be foreign personal holding company income, and receipt of such income will not be subject to Subpart F treatment unless it fits one of the other categories of "foreign base company income." One of these other categories is "foreign-base company services income."

b) Foreign Base Company Services Income

Income of a subsidiary attributable to the performance by the subsidiary of technical services, whether such income is part of gross royalty payments or in the form of separate fees, may be subject to treatment as foreign base company services income under Section 954(e) if the services are performed outside the country in which the subsidiary is incorporated and are considered as being performed for or on behalf of the U.S. parent or other "related party."[46] Such income is taxed currently to the parent as

[44]Regs. § 1.954-2(d)(1)(iii).
[45]Regs. 1.954-2(d)(1)(iii)(a).
[46]IRC § 954(e).

Subpart F income (again, however, only if the total foreign base company income of the subsidiary, including foreign personal holding company income and foreign base company services income, constitutes more than 30% of gross income of the subsidiary).[47] Technical services would be considered to be performed by the foreign subsidiary for or on behalf of the U.S. parent if: (i) the subsidiary performs such services with respect to industrial property sold by the parent which the parent is, or has been, obligated to perform; (ii) the subsidiary performs services with respect to property sold by the parent; or (iii) the subsidiary is not capable of performing the services without assistance from the parent in the form of know-how, services of personnel, or equipment.[48] Most undercapitalized foreign subsidiaries performing services abroad are particularly vulnerable to attack under the "assistance" theory [(iii) above]. However, the Treasury has softened its position in this area by adopting new regulations which require assistance to be "substantial" before income from services is Subpart F income.[49]

2. SECTIONS 1248[50] AND 1249[51]

In addition to the problem of current taxation to the U.S. parent of a foreign subsidiary's income under Subpart F, since 1962 a U.S. shareholder (owning more than 10% of the voting stock of the foreign company) has been taxed under Section 1248 of the Code at ordinary income rates, to the extent of the foreign subsidiary's earnings and profits, accumulated since 1962, on the gain on the liquidation or sale of the stock of a foreign company.[52] An exception to this treatment is provided for earnings accumulated in years during which the subsidiary qualified as a "less developed country corporation" if the parent has held the subsidiary's stock at least 10 years before disposition.[53] Also, earnings already taxed in the U.S. (including earnings taxed under Subpart F) are not taxed under this Section.[54] The enactment of Section 1248 eliminates one of the major pre-1962 tax advantages of using foreign subsidiaries for licensing: the accumulation of earnings in the subsidiary at low foreign tax cost and, at

[47]IRC §§ 954(a)(3), 952(a)(2), 951(a)(1)(A).
[48]Regs. § 1.954-4(b)(1).
[49]Regs. §§ 1.954-4(b)1)(iv), 1.954-4(b)(2).
[50]IRC § 1248.
[51]IRC § 1249.
[52]IRC§ 1248(a)(1).
[53]IRC § 1248(d)(3).
[54]IRC §§ 1248(d)(2), 1248(d)(4).

the parent's election, the transfer of these profits to the parent at capital gains rates.

b) 1249

Also, with the addition of Section 1249 of the Code by the 1962 Act, it is no longer possible for a parent to sell industrial property rights to a more than 50%-owned subsidiary at capital gains rates. Section 1249 specifically provides for the taxation of the gains from such a sale as ordinary income.[55] Unless a Section 367 ruling can be obtained from the Internal Revenue Service that the transfer of such property qualifies for tax-free treatment under Section 351, a substantial tax may be incurred on the transfer. As indicated above, the transfer of property to a wholly-owned subsidiary, although couched as a contribution to capital with no additional stock being received in return, may be treated as an exchange requiring a Section 367 ruling.[56]

D. Foreign Investors Tax Act of 1966

1. PRIOR TO 1966 ACT

As we have seen, even after the 1962 Act, it has been possible to shield from U.S. taxes, royalty income of a wholly-owned foreign subsidiary when the royalties are derived from the active conduct of a trade or business by the subsidiary, or, when royalties if not so derived constitute less than 30% of gross income. However, even this haven has been eliminated if the foreign company carries out all of its licensing activities through a U.S. office.

Prior to the enactment of the Foreign Investors Tax Act of 1966,[57] it was possible for a foreign corporation to establish a U.S. office and through such office develop itself, or acquire from its parent and add substantial value to, industrial property to be licensed at that office and avoid U.S. tax on the income from the license of the property abroad. Income from the license or intangible property outside the U.S. is considered foreign-source,[58] and prior to 1966, foreign-source income of a foreign corporation wholly-owned by a publicly-owned parent was not subject to U.S. tax except under Subpart F. The Subpart F provisions would not apply to this royalty income since the subsidiary was performing active business

[55]IRC § 1249(a).

[56]*See* footnote 35, *supra*.

[57]Pub. L. 89-809 (Nov. 13, 1966), 80 Stat. 1541.

[58]IRC § 862(a)(4).

functions with respect to the royalty income, and it would thus be considered to be derived from the conduct of an active business within the meaning of the Subpart F foreign personal holding company regulations.[59]

2. EFFECT OF 1966 ACT

With the enactment of the Foreign Investors Tax Act, however, the tax saving achieved by this practice has been virtually eliminated. Section 864(c)(4), added by the Act, provides that royalty income received by a foreign taxpayer from the license of industrial property rights abroad, although such income is foreign source, will be subject to U.S. taxes if effectively connected with the conduct by the taxpayer of a trade or business in the United States.[60] In order to be so connected, an office or other fixed place of business of the foreign taxpayer in the United States must participate materially in the production of the income, and such office must regularly carry on such income producing activities.[61] This effectively connected foreign-source income is subject to U.S. tax at the normal U.S. corporate rate of approximately 48% (or 52.8% assuming the full 10% surtax applies), with a credit being allowed for any foreign income taxes on the income.[62]

E. Western Hemisphere Trade Corporations and Possessions Corporations

Indirect licensing also can be carried out by the American owner through U.S. subsidiaries. Normally, no U.S. tax saving will result from the use of such companies. However, licensing through a subsidiary which qualifies as a Western Hemisphere Trade Corporation[63] or possessions corporation[64] can achieve substantial tax savings for limited licensing activities.

1. WESTERN HEMISPHERE TRADE CORPORATIONS

As the name implies, a Western Hemisphere Trade Corporation (WHTC) is a corporation all of whose activities are carried on in the Western Hemisphere. A U.S. corporation qualifying as a WHTC is allowed a 14% reduction in the computation of its taxes.[65] Thus, the

[59]*See* footnotes 44 and 45, *supra*.
[60]IRC § 864(c)(4)(B)(i).
[61]IRC § 864(c)(5).
[62]IRC §§ 882, 906.
[63]IRC §§ 921, 922.
[64]IRC § 931.
[65]IRC § 922.

present effective U.S. rate on corporations so qualifying is approximately 34% (or 38.8% again assuming the full 10% surtax applies).

A straight licensing subsidiary which does not conduct an active trade or business cannot qualify as either a Western Hemisphere Trade Corporation or a possessions corporation. In order to qualify as a WHTC, a corporation must conduct all of its business in the Western Hemisphere, receive at least 95% of its gross income from sources outside the U.S. for the three-year period immediately preceding the taxable year in question (or for the period during which the corporation has been in existence, if less than three years), and for such period receive 90% or more of its gross income from the active conduct of a trade or business.[66]

A U.S. subsidiary set up for licensing its parent's industrial property in the Western Hemisphere would not meet the active business test unless it performed such substantial functions with regard to the property licensed as to make the royalty income active business income. The active business requirement may be satisfied by a subsidiary which produces and develops its own property and regularly licenses this property through its own marketing staff. License royalties also may be treated as active business income if incidential to active sales of goods produced through the use of the industrial property licensed. Finally, it is possible to get favorable WHTC treatment on limited passive Western Hemisphere licensing functions by placing them in a U.S. subsidiary, which primarily carries on manufacturing or export sales activities in the Western Hemisphere and otherwise qualifies as a WHTC, if the passive license income is less than 10% of gross income.

2. POSSESSIONS CORPORATIONS

Possessions corporations are exempt from U.S. tax. In order to qualify, a corporation must be organized in the U.S., receive at least 80% of its gross income from sources within a possession of the U.S. (most often, Puerto Rico) for the three-year period immediately preceding the close of the taxable year in question (or for the period during which the corporation has been in existence, if less than three years), and at least 50% of its income for such period must be received from the active conduct of a trade or business within such possession.[67] This special tax provision has limited application for licensing operations because of the geographical limitation

[66]IRC § 921.

[67]*See* footnote 64, *supra*.

on a possessions corporation's activities and the active business requirements which would rule out a passive licensing subsidiary.

F. Summary

Recent enactments of Congress have eliminated many former U.S. tax benefits of licensing a U.S. parent's industrial property through subsidiary companies. In view of these sharply reduced tax savings, American licensors should carefully consider the problems of administration and expense of setting up licensing subsidiaries before deciding on this method of licensing.

IV. Cross Licensing

A. Introduction

Cross licensing is the third principal category of licensing. Foreign cross licensing involves a license by an American owner of patents, copyrights, trademarks or know-how and a reciprocal license of similar property rights owned by a foreign entity. Fees are payable by both the American and foreign owners under the licenses. Cross licenses may be in one agreement or in separate agreements. The tax problems to the American licensor or income received from the foreign licensee have been discussed under direct and indirect licensing above. Cross licensing, however, involves not only the tax treatment of the American company, but also of the foreign owner.

B. U.S. Tax Consequences to Foreign Owner

1. WITHHOLDING OF U.S. TAX

If the foreign owner is a corporation and has no office or fixed place of business in the U.S., in the absence of a treaty between the U.S. and the country of domicile of the foreign company, the U.S. payor must withhold U.S. income tax of 30% on the gross fees and royalties paid to the foreign owner.[68]

This treatment applies not only to royalties from a non-exclusive license but also gains from the sale of industrial property rights in the U.S. when the payments are contingent on the productivity or use of the property.[69] When payments from the sale of such rights are not contingent, they may escape U.S. taxes.

Income tax treaties may substantially reduce or eliminate any U.S. tax. In most treaties, this is done on a reciprocal basis. For example, royalties

[68]IRC §§ 881, 1441; Regs. § 1.1441-2(a).
[69]ICR § 881(a)(4).

received by a British company from the license of industrial property rights in the United States are exempt from U.S. tax if the British licensor does not have a permanent establishment in the United States. This is exactly the same treatment as is given a non-resident American licensor in the United Kingdom.[70]

When the foreign licensor carries on business in the U.S. through a permanent establishment, payments to it in respect of industrial property rights used in the United States are taxed at ordinary U.S. corporate rates after the deduction of expenses, and a credit may be allowed for foreign taxes on the same income.[71] In this situation, the payor does not have to withhold U.S. taxes on the gross payments.

The impact of American taxes on payments made to the foreign licensor may materially affect any agreement which the American owner can make. If the foreign company can take home almost all of the gross payments, obviously the American can make a better deal. Of course, this works the same way when the American is licensing in another country.

V. Summary

This article has attempted to outline only briefly the important role of tax planning in organizing foreign licensing operations. Each problem area requires a study in depth before deciding on a structure for a foreign licensing arrangement. Of course, tax questions are only one of a myriad of factors the American owner must consider before embarking on any foreign license of industrial property rights, and each of these other factors, taken separately, might be the subject of other treatises.

[70]*See* footnote 22, *supra*.
[71] IRC §§ 882, 906.