U.S. TAX ASPECTS OF INTERNATIONAL LICENSING AGREEMENTS

CHARLES A. RAMUNNO*

I. INTRODUCTION

The licensing of industrial property rights is a significant aspect of international business. It has been estimated that the value of products manufactured abroad using United States patents and know-how has more than twice the value of exported United States manufactured products.

The licensing of industrial property rights includes licensing of patents, copyrights, trade names, trade-marks, and know-how consisting of secret processes, designs, plans, formulas and other technological data.

Licensing arrangements generally are structured in two forms. The rights may be licensed directly to an unrelated foreign licensee either on an exclusive or non-exclusive basis; or the rights may be transferred to a foreign subsidiary or affiliate of a United States corporation which then licenses the rights in the foreign country. The purpose of this article is to acquaint the reader with the broad outlines of the United States tax problems that may be encountered when industrial property rights are licensed in foreign countries.

II. DIRECT LICENSING TO UNAFFILIATED COMPANIES

The United States income tax consequences of income derived from the transfer of industrial property rights to unaffiliated companies is dependent upon the type and nature of the rights transferred. Generally, income received from a transfer of industrial property rights is ordinary income unless the transfer can qualify as a sale of a capital asset held for more than six months. If the transfer qualifies, any gain derived on the transfer will be treated as a long-term capital gain.[1]

Under the provisions of section 1235, qualified individuals who transfer all of the substantial rights to a patent are entitled to long-term capital gain treatment for any gain realized from the transfer.[2] A qualified individual is an individual whose efforts created such property, or any other individual who has acquired his interest in such property in exchange for consideration paid to the creator of the invention prior to the actual reduction to practice of the invention

* B.A., Regis College, J.D. University of Denver, Associate, Holme, Roberts and Owen, Denver.

1. INT. REV. CODE OF 1954, § 1201.
2. INT. REV. CODE OF 1954, § 1235(a).

covered by the patent, if such individual is not the employer of the creator or related to such individual.[3]

All other taxpayers, and individuals transferring property rights other than patents, are entitled to long-term capital gain treatment only if: (1) the transferred right is a capital asset as that term is defined by section 1221 or if it is an asset used in a trade or business as defined in section 1231; (2) the transaction is a sale or exchange; and (3) the right was held for more than six months.

Generally, section 1221 defines a capital asset as all assets except inventories and assets used in the trade or business of a taxpayer which are subject to the allowance for depreciation. Section 1231 defines "property used in the trade or business" as property used in a trade or business which is subject to the allowance for depreciation, has been held for more than six months, and is not property which would be included in the inventory of the taxpayer. In order for the transfer to qualify as a sale or exchange, the transferor must transfer substantially all of his rights to the property to the transferee.

A. *Patent Transfers*

When discussing the income taxation of patent transfers it is proper to speak of "assignments" and "licenses". A transfer of all the substantial rights in a patent is deemed an assignment or sale or exchange and may qualify the transferor for capital gain treatment. A transfer of anything less is called a license with the proceeds of such transfer being taxed at ordinary rates.[4] The issue of whether "all substantial rights" in a patent have been transferred is difficult to determine. It is the most common question in cases involving capital gain treatment for patent transfers.

In general terms a transfer of "all substantial rights" is a grant of an *exclusive* license to manufacture, use and sell the invention.[5] A transfer of patent rights will be deemed a sale if it appears from the agreement and surrounding circumstances that the transferor intended to surrender all his substantial rights to the invention.[6] A grantor may fail to transfer to his grantee "all substantial rights" in a patent either by retaining a substantial right in himself,[7] or by restricting the grantee so as to prevent him from receiving all substantial rights.[8]

> The 'substantial right' in a patent the retention of which by the

3. INT. REV. CODE OF 1954, § 1235(b).
4. Merck & Co. v. Smith, 261 F.2d 162 (3rd Cir. 1958).
5. Waterman v. Mackenzie, 138 U.S. 252 (1891).
6. Bell Intercontinental Corp. v. United States, 381 F.2d 1004 (Ct. Cl. 1967).
7. Allied Chem. Corp. v. United States, 370 F.2d 697 (2d Cir. 1967).
8. Fawick v. Comm'r, 436 F.2d 655 (6th Cir. 1971).

> grantor will conclude a sale, has reference . . . to the substantial *property right* in a patent . . . and not the grantor's contractual right to obtain future payments in return for his conveyance of that property right.[9]

The *Bell* court defines the property right in terms of a patent owner's monopoly right to exclude all others from practicing the invention.

Whether an exclusive license limited to a particular geographical area or particular field-of-use, *e. g.* mining industry, will constitute a transfer of all substantial rights is unclear. The Seventh Circuit Court of Appeals in a recent decision stated that a geographical limitation to certain eastern states did not constitute a transfer of all substantial rights for purposes of section 1235.[10] However, it should be noted that the *Klein* case deals with the validity of the regulations under section 1235 which state that limitation within the country of issuance is not a transfer of all substantial rights. This case is distinguishable from the situation in which a patent is limited geographically to the foreign country which issued the patent. In such case it would seem that the transfer would be considered a transfer of all substantial rights.

The Sixth and Ninth Circuit Courts of Appeal have made rulings similar to *Klein* with regard to field-of-use limitations in transfers to which section 1235 applies.[11] However, in *Fawick* and *Mros*, and in other cases prohibiting capital gain treatment where the transfer contained a field-of-use limitation, specific note was made of the fact that the field-of-use to which the transfers were limited was not the only industry in which the patents had value. In *Carruthers v. United States*[12] and cases following that decision, capital gain treatment was permitted. The courts found no value for the patent in any other field outside the particular industry to which the transfer was limited. The compatibility of the cases not allowing capital gain treatment with the *Carruthers* decision is expressly noted in *Fawick*[13] wherein the court stated:

> [A] field-of-use restriction in a license may not prevent the transfer from being one of property consisting of all substantial rights to a patent, where the field-of-use to which the licensee is restricted is the only field in which the invention has value. See *e.g. United States v. Carruthers* . . . .

Therefore all the field-of-use cases can be reconciled by using a transfer of all substantial rights standard.

If the grantee of a patent does not receive all of the monetarily

9. Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1014 (Ct. Cl. 1967).

10. Estate of Klein v. Comm'r, 507 F.2d 617 (7th Cir. 1974).

11. Fawick v. Comm'r, 436 F.2d 655 (6th Cir. 1971); Mros v. Comm'r, 493 F.2d 813 (9th Cir. 1974).

12. 219 F.2d 21 (9th Cir. 1955).

13. Fawick v. Comm'r, 436 F.2d 655, 662 (6th Cir. 1971).

valuable property rights in the patent which the transferor had, there has not been granted an assignment that qualifies for capital gain treatment because of a failure to transfer "all substantial rights". However, the courts will permit the grantor to restrict the grantee's rights to protect the grantor against loss of future income where the consideration for the transfer is to be paid in installments or on a royalty basis. Thus, the retention of legal title to a patent is looked upon as a harmless security device which does not negate a transfer of all substantial rights to the grantee.[14]

For all taxpayers other than individuals coming within the purview of section 1235 the grantor must show that he is not a dealer in patents to obtain capital gain treatment. Section 1235 removes the requirement that the transferor of a patent not be a dealer in order to receive capital gain treatment on any gain realized on the sale of the patent. In *Allied Chem. Corp. v. United States*[15] the court listed the following factors used in determining whether one is a dealer in certain property:

> [T]he purpose for which the property was acquired, sales activities of the taxpayer and those acting in his behalf, the continuity and frequency of sales as distinguished in isolated transactions, the substantiality of the sales when compared to other sources of the taxpayer's income, and the details of the taxpayer's business.

In *Allied* the court found that the taxpayer was in the business of developing salable products rather than salable patents and therefore was not a dealer in patents. Generally, the courts have not imposed dealer status on inventors, except where the inventor is clearly shown to have continually developed inventions and obtained patents thereon, with the intention to sell the patents for profit.[16]

With the exception of transfers covered by section 1235, to which no holding period applies, a transferor of a patent must hold the propert more than six months. The holding period of an invention begins when it is first reduced to practical application.[17] Thus the gain from the sale of an invention can be a long-term capital gain even though a patent has not been issued.[18]

The fact that payment for the use of a patent is paid periodically over the life of the patent, as opposed to a lump sum, is not indicative that a sale has not occurred.[19] However, a payment in the form of a

14. Treas. Reg. § 1.235-2(b)(i) (1957).
15. 66-1 U.S.T.C. 9212 (S.D.N.Y. 1966), *aff'd*, 370 F.2d 697 (2d Cir. 1967).
16. Lockhart v. Comm'r, 258 F.2d 343 (3rd Cir. 1958).
17. Kronner v. United States, 110 F. Supp. 730 (Ct. Cl. 1953).
18. Edward C. Myers, 6 T.C. 258 (1946).
19. Lockhart v. Comm'r, 258 F.2d 343 (3rd Cir. 1958); Rose Marie Reid, 26 T.C. 622 (1956); Edward C. Myers, 6 T.C. 258 (1946).

lump sum does indicate a sale.[20] For individuals coming within the purview of section 1235, that section provides that capital gain treatment is available regardless of the method of payment.

In order for a transfer of a patent to constitute a sale, the transfer must be for the remaining life of the patent.[21] Therefore, a transfer which is terminable at the discretion of the grantor prior to the expiration of the patent is a license and not a sale.[22]

B. *Transfers of Know-How*

Gains realized from the transfer of know-how are generally subject to many of the same rules that are used to determine the character of the gain derived from the transfer of patents.[23] The major difference is that before any gain realized on the transfer of know-how can receive capital gain treatment the know-how must first be considered property for purposes of section 1221 or section 1231, since sales and exchanges of property only qualify for capital gain treatment under section 1201. The Internal Revenue Service has determined what qualifications know-how must have to be considered property in the context of section 351 in Rev. Rul. 64-56.[24] Generally that ruling states that the term property includes secret processes and formulas and any other secret information as to a device or process, in the general nature of a patentable invention without regard to whether the patent has actually been applied for, and without regard to whether it is patentable in the patent law sense. The fact that information was recorded on paper or some other physical material is not itself an indication that the information is property.[25] The ruling also requires the country in which the transferee is to operate to afford to the transferor substantial legal protection against the unauthorized disclosure and use of the know-how in order for the know-how to be considered property.[26]

To qualify for capital gain treatment the transfer of know-how must be granted in perpetuity.[27] Any time limitation placed upon the transfer will be deemed a transfer of less than all substantial rights

20. Kavanagh v. Evans, 188 F.2d 234 (6th Cir. 1951).

21. Oak Mfg. Co. v. United States, 301 F.2d 259 (7th Cir. 1962); Kavanagh v. Evans, 188 F.2d 234 (6th Cir. 1951); Thomas D. Amour, 22 T.C. 181 (1954); Lynne Gregg, 18 T.C. 291 (1952), *aff'd*, 203 F.2d 954 (3rd Cir. 1953).

22. Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1020-21 (Ct. Cl. 1967).

23. Pickren v. United States, 249 F. Supp. 560 (M.D. Fla. 1965), *aff'd*, 378 F.2d 595 (5th Cir. 1967).

24. 1964-1 CUM. BULL. 133, *amplified by* Rev. Rul. 71-564, 1971-2 CUM. BULL. 179.

25. *Id.*

26. *Id.*

27. Pickren v. United States, 249 F. Supp. 560 (M.D. Fla. 1965), *aff'd*, 378 F.2d 595 (5th Cir. 1967).

and therefore will not constitute a sale.

C. *Trade-marks and Trade Names*

The taxation of trade-marks and trade names parallels very closely the taxation of income derived from the sale of patents and know-how. However, it should be noted that any gain realized by the creator of a copyright will be taxed as ordinary income because a copyright is not a section 1221 or section 1231 asset.

III. FOREIGN TAX CREDIT

Section 901 allows United States citizens and domestic corporations and certain other qualified persons to take as a credit against United States income taxes the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States. The credit is allowed for income taxes imposed by any foreign country or United States possession. Taxes imposed by political subdivisions of foreign countries are also eligible for the credit.[28] The taxes must be imposed on income as that concept is used in United States income taxation. Section 903 provides that the tax imposed "in lieu of" income taxes will qualify. Regulations under section 903 state that to qualify as an "in lieu of" tax the foreign taxing jurisdiction must (1) have a general income tax law; (2) the taxpayer must be subject to such law; and (3) the general income tax must not be imposed upon the taxpayer.

Section 904 limits the amount of foreign tax credit a taxpayer is allowed to a proportion of the total United States tax based upon the ratio that the foreign taxable income bears to total taxable income from all sources.[29] Section 904 provides two methods for computing the limitation. The first method is the per-country limitation provided by section 904(a)(1). Under this limitation the limiting fraction is calculated separately for each country. Thus the amount of credit for a particular country is limited to the ratio of taxable income from that country to total taxable income from all sources. Under the overall limitation as provided by section 904(a)(2) taxes paid to all countries are aggregated and the limitation is applied on the basis of the ratio of total foreign taxable income to total United States income from all sources.

As is readily apparent from the foregoing, the determination of the country in which the taxable income is derived is necessary to compute the limitation on the amount of foreign tax credit allowable.

28. Treas. Reg. § 1.901-2(b) (1973).

29. This formula can be expressed as follows:
foreign taxable income/total taxable income x total United States tax equals allowable credit.

Section 862(a)(4) states that rentals or royalties from property located without the United States, including rentals or royalties for the use or for the privilege of using without the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties is income derived from sources without the United States. A proposed amendment to the regulations under section 862[30] states that gains derived from the sale of patents, copyrights and other like property shall be treated in the same manner as if the gain were a rental or royalty. Therefore, if a patent or other like property is sold or licensed to a user outside the United States, any gain derived from the sale will be treated as foreign source income.

IV. DIRECT LICENSING TO AFFILIATED FOREIGN CORPORATIONS

Instead of selling or licensing to an unaffiliated foreign company the United States holder of industrial property rights may choose to transfer rights to an affiliated foreign corporation, who in turn will sell or license the rights. The major tax advantage gained by using a foreign affiliate is that the foreign earnings may not be taxed currently by the United States. However, several significant hurdles must be overcome before any advantage is achieved.

Unless the transfer of the industrial property rights is made pursuant to a tax free organization of a foreign affiliate under section 351 the transfer will be taxable and any gain realized will be taxed as ordinary income under section 1249. Section 1249 provides that any gain recognized from the sale or exchange of a patent, an invention, model, design, copyright, secret formula or process, or any other similar property by a United States person to a 50 percent controlled foreign corporation shall be taxed as ordinary income. However, section 1249 does not apply if the transfer is non-taxable under section 351.

In order for a transfer to a foreign corporation under section 351 to be nontaxable, section 367 requires prior approval by the Internal Revenue Service that the principal purpose of the transfer is not the avoidance of United States income taxes.[31] The Internal Revenue Service has issued guidelines in Rev. Proc. 68-23[32] which indicate that a favorable ruling will be issued if the property to be transferred to the foreign corporation is to be devoted by the transferee corporation to the active conduct, in any foreign country, of a trade or business; and if the trade or business will have need for substantial investment and fixed assets or will be engaged in the purchase and sale abroad

30. Proposed Treas. Reg. § 1.862-1, 39 Fed. Reg. 26743 (July 23, 1974).
31. INT. REV. CODE of 1954, § 367(a).
32. Rev. Proc. 68-23, 1968-1 CUM. BULL. 821.

of manufactured goods. Rev. Proc. 68-23 states that a favorable ruling under section 367 will not be issued if the property to be transferred is transferred under circumstances which make it reasonable to believe that such property will be licensed by the transferee. Rev. Proc. 68-23 also provides that a favorable ruling will not be issued if the property to be transferred is United States patents, trade-marks and similar intangibles to be used in connection with the United States trade or business or the manufacture in the United States or a foreign country of goods for sale or consumption in the United States.

After the transfer of the industrial property rights to the foreign corporation it is likely that the United States corporation will control more than 50 percent of the foreign corporation. In 1962 Congress amended the Internal Revenue Code to add Subpart F, sections 951 to 964, to deal with the taxation of controlled foreign corporations. Under section 951 all Subpart F income is taxed pro rata to the United States shareholders of the foreign corporation whether or not such income is distributed to the shareholders by the foreign corporation.

Briefly stated, Subpart F income includes interest, dividends, rents, royalties and other investment income including income from the licensing of patents, copyrights, trade-marks, know-how and other industrial property rights. In addition Subpart F income includes income from United States insurance risks and foreign base companies' sales and service income. The provisions of Subpart F can be avoided if the foreign corporation engages in the active conduct of a trade or business.

V. FOREIGN TAXES

A discussion of foreign taxes that may be imposed upon the licensing of industrial property rights by foreign taxing authorities is beyond the scope of this article. However, there are two principles which apply to most foreign jurisdictions.

Most industrialized countries have signed treaties with the United States to prevent the taxation of the same income by both the United States and the foreign country. Generally, the treaties provide that businesses of one treaty country shall not be subject to taxation by the treaty country on its profits if it is not engaged in a trade or business in the latter country through a permanent establishment in such country.

Secondly, most foreign countries impose a withholding tax on the royalties paid to the United States licensors. These rates of withholding vary from country to country, and the manner and the royalties taxed are dependent upon the country involved.