

Insight Into Andean Pact Licensing

Three chapters from new book explaining myth and reality of licensing in member nations

BY VICTOR BENTATA*

(The following article is extracted with permission from the book "Licensing in the Andean Pact: Myth and Reality" by Victor Bentata, edited by INPI.)

Royalty Assessment

It often happens in practice that the official zeal in pushing down the royalty rate causes the licensee to pay privately the agreed upon remainder without deducting it as a cost. This has the double effect of penalizing the local licensee while what was intended by the lawmaker was actually to penalize the foreign licensor, and of creating legal and statistical ambiguities. Forcing the natural law of supply and demand forces the unnatural. Perhaps the most practical and unbureaucratic system consists in only subjecting to examination and approval of royalties in excess of say 5%.

This would automatically remove from the government agency the bulk of its activity considering that the average royalty authorized on net sales in the Andean Pact countries is around 3% (including trademark rights) obviously depending on the branch of business involved, and for bare trademark licensing 1%. This is not a mere theory: the authority of the Peruvian CONITE Director may approve by himself up to 5% royalty, what in practice has become a quasi automatic 5% approval, whereas percentages additional to the one indicated must be approved by the Board of Directors and are usually granted when exports are involved. Furthermore, in Peru, royalties approved by the Central Reserve Bank are usually higher than those approved by CONITE. However, interesting variations are found in that country for example in granting hotel franchising 7% on profits plus 2.5% on gross sales.

Royalties accepted are higher in proportion as the product was a previously imported raw material, part or component, that is, when the industrial line starting from the end, namely assembly, escalates backward toward fuller manufacture. As know-how is progressively acquired, the tendency of the royalty allowance is to decrease.

Argentina has recently shown a clear way out on this point. Short of only a trademark without technology transfer and of the automobile industry, a 5% of local sales and an 8% on export sales becomes automatic and

does not require registration. However, since in the parent-subsidiary relation royalties are presumed to actually be an indirect dividend, contracts between related companies as indicated are subject to prior approval. India in turn gives preference to lump-sum arrangements as against royalties, but allows the latter up to 5% yearly of domestic sales and up to 7% when exports are involved. In cases of lump-sum payments 1/3 is paid at recordal, 1/3 when the documentation is transferred and the last 1/3 when production begins. Korea uses a traditional 3% on net sales whereas Brazil does not allow royalties on licensing of trademarks consisting of variations of previously registered marks. Here, however, royalties do not have to run from the date of government approval but could run from the future date of commencement of the production.

In the "approval and registration countries" such as those of the Andean Pact, royalty remittances abroad do not generally require prior approval since an overall approval is already secured at the start. At most it only requires *ex post facto* notifications to the government agency. But the law provides otherwise. Furthermore, royalty payments agreed upon in foreign currency may be given a fixed parity rate of exchange regardless of actual exchange rates, so that the licensor's and licensee's expectations remain constant in line with the principle of free initiative of the parties concerned.

Royalties are sometimes subject to exchange controls, and worse, mostly in the Third World, to the actual availability of the foreign currency. These limitations prompted major international trading companies to step in, introducing the complex formulas of barter, buy-back, etc., the latter being a combination of turn-key engineering with payment in kind consisting in the product of the manufacturing. Other mechanisms of countertrade are counter purchase (whereby the seller undertakes the obligation to buy back a percentage of the contract in goods or services), compensation buy-back (whereby the cost of the investment is repaid through production output), foreign exchange generating programs (assuring exports for the buyer to pay), swap (of fungible products saving transportation costs), clearing/switch (converting soft into hard currency within bilateral trade agreements) or blocked funds conversion. As we may thus observe, official royalty fixing by formal mathematical or profitability calculations or by mere intuitions as is often the case, may easily become unrealistic.

Official bodies have also sometimes introduced the principle of the most-favored nation forgetting that one should also pay heed to local particularities. Mexico, for example, stipulates as a guideline that the technology hired be of "the lowest available worldwide price," that

*Victor Bentata & Asociados, Caracas, Venezuela.

is, the application of the most-favored country clause even when the other countries include China, Japan, Germany, India or Brazil. It is not difficult to perceive that the conditions sought by a continent like India may become fatal for medium to small markets as the members of the Andean Pact are. At most, the most-favored licensee clause is only meaningful in nonexclusive licensing within a particular country (despite difficulties in providing evidence thereof), but never intentionally.

Internationally, the clause intends to rule the game in abstracto regardless of such essential factors as population, government policies and imports, technical capabilities, distances and others. It may accordingly in practice provoke a loss of opportunities of investment and employment for our countries. The point is not a clear cut one, besides the difficult question to tackle as to information concerning licensing agreements. The clause may also bounce back against the licensee should subsequent royalty agreements with third parties show higher royalties and the clause be maintained forward — both parties thereby taking their risks on it. The mere obligation for the licensor to disclose, is accordingly never a final answer.

One may lawfully state in a contract the obligation of the licensor not to grant a later license in any part of the world under more favorable terms than the one agreed upon. But such a clause may prove unrealistic in view of the quite different size and nature of the markets to be involved, so that certain qualifications would have to be included likely to make it practically inoperative.

158 When the royalty rate approved is extremely low, rather than ascertaining that the country thereby has "saved" money in the balance of payments, we may assert that the country is probably acquiring a second-rate technology as is the case with Brazil in the area of microcomputers. There is actually no "real price" of technology. The latter results, just like any other real price, from the tension of offer and demand.

Taxation and Currency Controls

We certainly have too much neglected within the Andean Pact the incentives required for proper licensing, especially taxation, in favor of a fever to regulate restrictive practices. Non-double taxation agreements on earnings and royalties can become on this point a significant tool if one does not look to licensing as a defense hedge but as a channel of development.

The Andean Pact regulates technology imports but does not regulate the contracting abroad of services to be also performed abroad. Obviously, the cost of such external services will not be tax deductible either in view of the basic principle of territoriality whereby profits made abroad are tax-exempt. If technology transfers take place abroad for an Andean country and even though the transferee imports it into Venezuela, no involvement of the local government agency is required.

Contrariwise, the countries of the Andean Pact do not generally tax profits made abroad when the economic activities are carried outside of the territory. Colombia, however, in the case of services lent abroad but included in the technical assistance agreement, declares such profits taxable as inland-revenue (Ruling Decree 187/1975) but conversely, technical assistance lent abroad is tax exempt provided the lender has no domicile in Co-

lombia and the services are declared to be unavailable in the country. Furthermore, Colombia considers as territorial taxable income any service payment effected by the Colombian State independently of the place where such service is lent.

It is clear that the "connection" with the national territory making the income taxable can, if stretched to the extreme, become practically anything depending on the whims of the government officer in charge. The tendency is accordingly to ideally divide any deal into two portions: one involving a totally extraterritorial action, and the other involving clearly territorial or territorially connected actions. The link between the two, consisting of traveling agents or the existence of offices in the country concerned, either rented or owned, is generally legally absorbed into the territorial operation, so as to maintain the nonterritorial portion fully insulated.

The different weights of taxation applied by the several Andean countries bear a negative effect as regards the declared intention to uniform the legislation applicable to the import of capital and technology into the region. Thus, Colombia applies to fees and royalties a 40% tax on the gross income plus a 12% remittance tax; Peru applies 55% on same but has a possible cost deduction of up to 15% thereof depending on disbursements effected in Peru, plus an additional 5% deduction if the foreign beneficiary proves to have carried out research destined to Peru, the indicated 55% being applicable to the balance after all deductions; Ecuador applies 40% plus 4.4% as withholding tax; Venezuela is an exception, applying differential tax rates depending on the category of technology involved.

The evolution of these tax brackets is of interest. For example, Peru has raised taxes as regards private parties but maintained the old 25% tax rate on net sales for state-owned enterprises. Colombia, like Ecuador and Chile, does not differentiate the two categories, and in Bolivia a 30% royalty tax must be paid at remittance. If we compare this with other areas of greater importance, the situation is far more eloquent. In Argentina income tax on royalties is of 18% plus a remittance tax of 45% of same. In India, a 50% income tax on royalties is levied.

As we can see, a number of differences in taxing policies exist in the splitting of royalties applicable to state-owned enterprises (such as in Peru and Venezuela, the latter as regards exchange rates applicable) or in the splitting between income tax and remittance tax or even, as is the case in Venezuela, the splitting of tax categories between technical services and royalty income. The former is taxed at 30% of an estimated flat 90% gross income and the latter at 50% on the same basis. As for Venezuela, the correct interpretation is to conclude that the state is interested in having substantially low-grade technology imports paid for instead of the newest technology covered by patents: taxation on patent royalties is substantially higher. The net result is that in the licensing contracts of Venezuela a continuous effort is found to avoid mention of patents despite the fact that process may be covered, as they usually are, by such patents, the patent right remaining in the background in reserve as a means of pressure and a legal guarantee of exclusivity. The contracts tend to read as imported proprietary know-how in order to benefit the considerable differential in tax rates. The penalization of royalties on patents does not contribute to

keep the country alive to export possibilities through the latest technology, and forces the enticement of continuous imports of comparable goods of higher quality. This is in addition to the problems thereby raised by the legal requirement of working links of registered patents exacting an official recordal of the licensee.

Non-double taxation agreements exempting royalties from income tax in the royalty recipient country are extremely scant if not nonexistent in the area. Outside of the Andean Pact non-double taxation agreements have become a consistent and fairly productive technology transfer medium. For example, Argentine licenses pay 18% tax on royalties, but the country has signed several non-double taxation treaties encouraging technology flow into that country by not taxing the royalty income of the licensor at least in its home country. The morale of the matter is that too greedy or "nationalistic" an approach backfires on the country and deprives it of the main asset sought.

Basically, the U.S.A. and Germany grant unilateral tax credits to their nationals for tax payments effected abroad. There should be accordingly an interest in considering the feasibility of operating through them as an alternative to tax haven countries. Holland in this respect offers as well a palette of combinations.

When tax burden is added to the burden of exchange controls, even when benefiting from differences of exchange, the situation may tend to become impracticable. In Venezuela recent monetary measures offer government corporations a preferential rate of exchange while the private sector pays royalties abroad at the open floating rate at least twice higher. But since the public sector in that country represents 75% of all royalty payments to be effected abroad, the effect is that the private royalty paying sector has no leverage to obtain a readjustment of the royalties to meet the original expectation of the licensor in terms of hard currency. The technology flow to the private sector then tends to slim. This in turn may defeat the complete design of technology transfer and discourage licensors from making a real effort. Despite the fact that royalties are levied on net sales in local currency, sometimes a fixed parity of exchange is forced by the foreign licensor as a condition, thus discouraging the licensee and also the consumer's expectation as regards the end price.

In countries without full exchange controls, such as Mexico, Venezuela, Ecuador or Peru, there is no way of controlling a royalty remittance whenever the payor does not withhold the tax, such remittances becoming non-tax deductible. One is wont of repeating "you should not pay unapproved royalties abroad," but the control would be pointless unless such payments were otherwise officially qualified. After exchange controls were abolished in Peru, foreign investments themselves began to flee the country accordingly as "royalties," calling for additional regulations defeating the whole purpose of technology transfer.

Parent/Subsidiary Relations

The Andean Pact concept forecloses any intracorporate royalty or fee payment. These restrictions possibly derive from the actual or feared use of technology transfer agreements among related companies aiming at securing artificial tax advantages. Generally speaking, intracorporate payments other than commer-

cial or dividends, are considered indirect dividends and dividends are limited by the legislation when dealing with foreign enterprises operating in the country. This logical view, however, probably defeats new technology inflow. When local companies are contractually bound by a payment, a technical counterpart *must* be the case and this no doubt stimulates and guarantees actual technical inflow to the recipient country.

A summary overview of the situation prevailing in some other countries may illuminate the point. In Brazil intracorporate payments *may* be approved for technical assistance although not for patents or trademarks; in Argentina, an intracorporate payment of 5% or less on the licensee's net sales is automatically acceptable. A cursory overview of the situation in highly-developed countries is still more telling. The U.S. Internal Revenue Service is entitled to attribute a reasonable royalty income from wholly-owned subsidiaries of domestic parent corporations established abroad whether or not royalties are provided, and German law taxes *ex officio* an assumed royalty income from fully-owned subsidiaries abroad. Thus the parent/subsidiary relation is revealed to be far more complex than originally considered.

Royalty or fee payments effected by subsidiaries to their parent companies are only penalized by depriving the subsidiary of tax deductibility when no exchange regulations exist. Such payments are, technically speaking, legally nonexistent and are tax-wise considered dividends.

The legislation has thus fallen short of reality. For example, cases involving the pooling of international experience in data banks and comparable arrangements, remain in the dark. As a result of such situations, Venezuelan Decree 2442 of 1977 provides as previously indicated for a special type of "technology transfer," namely a parent/subsidiary remuneration previously approved by the government agency. This last case constitutes a borderline case between stable arms-length licensing and occasional services. It is regretful, however, that the authority has always refused to approve any specific request under this heading, alleging that when the local company is essentially commercial it should not apply, and otherwise turning down the request as being "wrongly filed," i.e. to be channelled as ordinary licensing.

It is arguable whether or not "licensing" between a fully-owned subsidiary and its parent company constitutes a genuine transfer of techniques. On one side everything remains within the single capital fold owning the two parties so that, lacking an arms-length relation, no actual "transfer" may be the case. On the other side it is obvious that the fully-owned subsidiary, in order to better compete, introduces in the country new technical skills and, as an entity, is actually acquiring from the parent company, which is a separate legal entity, valuable know-how and other rights. Clearly, one may tie technology transfer with investment and here nullify any possibility of payment. This theoretical approach may defeat the targets of companies aiming at the maximization of their return when actual assets are given out to other countries. Accordingly, some balance must be found.

A probable result of this consideration is the very limited technology transfer existing between parent

company and its local subsidiary. The "licensing" relation is in practice then limited to writing a registered user agreement so that the compulsory use of trademarks and the compulsory working of patent inures in the sole legal benefit of the parent company as registrant of industrial property rights. This also ensures, in the case of nationalization of the subsidiary, the disengagement of the licensor's intellectual properties. This indicates well that a certain kind of "transfer" has taken place whereby certain other assets should remain "reserved" to the parent company. The legal construction prompts accordingly the subsidiary/parent company licensing relation to be limited to a "permission" of use of certain rights without compensation, thus falling short of a full-fledged licensing entailing legal obligations.

The fear of intracompany manipulation has caused the Brazilian INPI to exact the presentation of *all* existing contracts between subsidiary and parent company. Taking the *a priori* position that the subsidiary company should sit on the bench of the accused instead of presuming its good faith and establishing penalties when unresponsive, is an eloquent indication of the general attitude toward foreign licensing, placing the government agency in a fairly aggressive rather than in a stimulating attitude.

A generalized confusion exists accordingly between the concept of a registered user agreement as consolidating the use link in industrial property, and licensing proper. Both are designated under the same term of "technology transfer" and both, inexplicably require government approval even when no compensation at all

is the case.

It is difficult to understand why a registered user agreement is necessary to have the licensee's use inure to the benefit of the registrant when dealing in a subsidiary/parent company relations, i.e. when the registrant controls the quality and use of the goods.

But it is still more difficult to understand why official approvals must be sought when "free permissions" of use of industrial property rights are granted by a parent company to its local fully-owned subsidiary. Here no balance of payments or employment problems arise, and what the parent company is doing is merely filling a requirement stemming from the Industrial Property Law. It is the confusion of the two that encumbers the situation. My contention is that such registered user agreements without payments attached should be freed from any requirement of government approval and be directly registered at the Patent Office. I would further involve in the procedure proposed the relations other than parent/subsidiary companies and include sublicensing and cross-licensing of all sorts. None of these legal categories affect in any way the country's priorities and requirements for which controls and red tape are introduced.

Again, the question of the "double registration" at the government agency and the Patent Office arises. Such doubling of formalities is inexplicably indispensable in order to consolidate the rights of licensing by protecting the ownership of such rights to the parent companies. No doubt, some simplification should be introduced here to make it more realistic and practical.