# Tax Issues in Technology Transfers

*Recent treaties, new IRS rules change tax situations; case studies are discussed*

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The recent U.S. tax treaties with both Canada and Australia lower the withholding rates on technology royalties. For both these countries this is a trend followed in other recent treaties.

The Canada/U.S. treaty, ratified in 1984, provides 10% withholding on technology royalties, while the former treaty applied a 15% rate. The new Australia/U.S. treaty, ratified in 1984, also provides 10% withholding on technology royalties, but the change is more dramatic because the former treaty provided no relief at all. Technology royalties were subject to statutory rates of 51% in Australia and 30% in the U.S. While the new 10% treaty rate is an improvement for the U.S. investors in these countries, it still exceeds the zero rate of both the U.S. and the OECD model treaties.

On the other hand, the U.S. has tightened the tax rules on transfers of technology abroad by U.S. taxpayers. Until the Tax Reform Act of 1984, the Internal Revenue Service generally let U.S. companies transfer technology to foreign affiliates tax free if the recipient used the technology in a trade or business. Additionally, if a "toll charge" on the transfer was imposed by the IRS, it was a one-time lump-sum payment of tax on the difference between the technology's cost basis (usually zero) and its fair market value (usually large and often difficult to determine).

The new rules provide, in effect, that technology transfers to foreign affiliates must be (1) by licenses that provide for arm's-length royalties or (2) by sales that provide for an arm's-length purchase price. the latter route is being little used because of (1) valuation problems, (2) the reluctance of transferors to accelerate the recognition of income, and (3) the reluctance of transferees to commit funds up front. Most U.S. technology transfers to foreign affiliates will be via royalty arrangements intended to be arm's length.

Price Waterhouse partners and managers recently met to discuss the impact of these tax issues, and the discussions considered six technology-transfer case studies. The purpose was to stimulate discussion rather than to reach "right" answers, as the facts involved borderline situations, and the "answers" were based primarily on Canadian, U.K., and U.S. court decisions and controversies. Two are discussed below.

The first considers the definition of a "royalty," demonstrating that definitions vary from jurisdiction to jurisdiction and can change materially within one jurisdiction.

The second case study considers the thin line that may divide a licensing arrangement and a partnership. The participants discerned that Canadian law is well developed in this area, perhaps because Canada imports a great deal of technology, and the transactions therefore get close scrutiny.

One case deals with a Canadian shipbuilder who contracted with a U.S. corporation to get computer tapes (and user's manuals) containing technical data for use in constructing ships. The shipbuilder did not get ownership of the material, but did receive a nonexclusive license to use the data. The contract did not state the circumstances under which the U.S. corporation could require that the tapes be returned. There was no restriction on the extent of use of the information nor a time limit on its use, and it was clear that the amount paid, a lump sum paid in three installments, was not related to the extent of use or to revenues or profits attributable to the use.

The questions for discussion were (1) whether the payments would be subject to withholding if the shipbuilder were resident in the participant's country, and (2) would that country's tax treaty (if any) with the U.S. affect the withholding tax liability.

### Three Levels

This situation was considered by three levels of Canadian courts. The Tax Review Board found that the payments were not "rents or royalties" under Canadian law. They were not rents because there was no "use for a certain time," and were not royalties because the "use" referred to in the contract did not relate to "degree of use" or "duration of use." "Royalties" normally would refer (1) to a share of the profits or (2) to a share or percentage of profits based on use or on the number of units, copies, or articles sold, rented, or used. Thus, being neither "rents" nor "royalties," the payments were *not* subject to Canadian withholding.

On appeal, the next court generally agreed with the lower decision. It would stretch the term "royalties" to encompass a lump-sum payment (even though made in three installments) that in no way attached to the extent of use or to resulting profits. The taxpayer acquired "informa-

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tion concerning industrial, commercial or scientific experience," but there should be no withholding tax since the payments were not dependent on (1) the use made of the information, (2) the benefit derived, (3) the production or sales of goods or services, or (4) profits.

The decision was appealed to the next level. The appeals court held that, under the U.S. tax treaty, the U.S. company was not taxable in Canada on industrial and commercial profits because it did not have a permanent establishment in Canada, and therefore the question was whether the payments were "rentals and royalties," defined in the old (pre-1984) treaty as including those "...arising from leasing real or immoveable, or personal or moveable property or from any interest in such property, including rentals or royalties for the use of, or the privilege of using, patents, copyrights, secret processes and formulae, good will, trademarks, trade brands and other like property."

### Court Holdings

The court held that this language did not expand the meaning of "rents and royalties" to include payments that did not have the characteristics ordinarily associated with rentals or royalties, and that the ordinary connotation of these words does not include a lump-sum payment for the use of or the privilege of using property *indefinitely.* Thus, the payments were industrial and commercial profits, and not subject to tax in the absence of a permanent establishment.

In the final decision, there was a strong hint that the court disagreed with the lower courts' decisions that the payments were not taxable under Canadian law, but did not elaborate and found the payments exempt under the tax treaty.

The new U.S.-Canada treaty, however, seems broad enough to include payments like those in the case. Article XII(4) defines royalties as "*...payments of any kind* received as consideration for the use of, or right to use, any copyright of literary, artistic or scientific work...any patent, trademark, design or model, plan, secret formulae or process, or for the use of or the right to use, tangible personal property or for information concerning industrial, commercial or scientific experience..." (Emphasis added.) This language appears to catch any payment made for information, regardless of how it is computed (which is close to the royalty definition of current Canadian domestic law). Now that the new U.S. treaty is in force, Canada's right to tax various payments for industrial, commercial, or scientific information should be expanded.

The "payments of any kind" language also is in the "royalty" definition of both the OECD and the U.S. model treaties, so the trend is to make it irrelevant how payment is made.

### "Licensee" or "Partner"?

In a second case, a foreign company granted a Canadian company the exclusive right to manufacture and distribute a patented product in Canada. Under the agreement, the formulae, technical procedures, and product know-how were made available. The agreement could be terminated by either party, in which case the Canadian company would cease manufacture and return all the information. Under the agreement, the Canadian company issued an annual report to the foreign company showing net product sales less the costs of production, advertising, administration, financing, and distribution, arriving at a net profit or loss. One-half the profit was remitted as a royalty; if there was a loss, the foreign company would remit one-half the amount to the Canadian company. It was agreed that the companies would approve the annual advertising budget in advance.

The question for discussion was whether this arrangement would be treated as a license in the participant's home country.

On these facts, Canadian tax authorities initially took the position that the foreign company was a limited partner of the Canadian company. The actual arrangement had been in effect many years and withholding tax had been paid annually on the royalty. The tax authorities contended the foreign company was carrying on business in Canada via the partnership, which itself constituted a permanent establishment, and thus the company should have been filing Canadian tax returns and reporting its share of the profits. All years were open because the foreign company had never filed tax returns.

The situation ultimately was resolved in favor of the foreign company without going to court, but it should be noted that the only argument Revenue Canada considered compelling was that the arrangement did not meet the common law tests of what is a partnership in Canada.