

Taxation of Royalties

Cutting the cake — keeping your slice whole is easier in some countries than others, like Germany

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The development of new technologies and industrial innovation form the basic prerequisites for a long-term guarantee of the economic growth and international competitiveness.

All industrial countries that obtain from scientific research and development activities new products and new manufacturing techniques expect from the transfer of technology a return of the cost of their development efforts.

Such return is broadly called "royalties," a term that will have to be defined more exactly later in the language I am using, the language of tax law.

I shall start with the basic philosophy behind the claims of the two fiscs for their share of the cake. Let's begin with the country of origin of the technology, the country of the licensor: The most essential point for the licensor is to avoid double taxation of the profits derived from his development and research work.

The research work done for inventing and developing the technology has borne considerable expenses thus reducing the profits of the taxable entity in the country of origin of the patent, trademark or for manufacturing technique. This is the basic reason that later, when the fruits of such costly investments are maturing and being harvested, the claim for taxation should be principally with the fiscal authorities of such country of origin of the technology.

Another part of the basic philosophy is to let internal revenue of the country of the licensee have its fair share of taxation. That means, part of the profits resulting from the technology granted should be taxable within the country of the debtor of the royalty. There, at site, by implementation of such technology and by rendering technical services or granting technical assistance an economic activity is performed making use of the infrastructure of that country that justifies its tax claim.

Allocation

If this basic philosophy is accepted, the rest of the discussion is more or less a question of allocating,

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as mentioned above, the fair share of taxation to both fiscal authorities, in the country of origin and in the country of utilization of the technology.

With this theoretical and near-philosophical view I intruded already much too deeply into the matter, before giving an exact definition of what I am talking about. What do I mean by "technology"? How do I describe the taxable subject, the proceeds, the fees, the profits of the technology transfer?

To be precise about what I want to say, there is no better way than by making use of the definition given by international tax contracts, the so-called "Agreements for the Avoidance of Double Taxation." The Model Agreement of the Organization for Economic Cooperation and Development (OECD) or of the United Nations states:

The term "royalties" as used in such bilateral conventions means payment of any kind as a consideration for the use of, or the right to use—

(a) Any patent, trademark, design or model, plan, secret formula or process.

(b) Industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience.

(c) Any copyright of literary, artistic or scientific work, cinematographic film, and film or tapes for radio or television broadcasting.

There are two principal vehicles for conveying such technology between the parties. One is paper. Number two is human power—brain power or muscle power.

The transfer of rights by way of "paper" resulting in "royalties" has been dealt with in international tax law for a long time. The regulations are more or less accepted by both parties, the government of the debtor and that of the recipient of the amounts. We shall treat this subject extensively later on.

Internationally much more contended is the taxation of the flow of technology by "human power." The definition also given within the Model Convention for the Avoidance of Double Taxation is contained in the term "fees for technical services." This expression means payments of any kind to any person, other than payments to an employee of the person making the payments in consideration for services of a managerial, technical or consultancy nature, including the provision of services of technical or other personnel.

The problem exists in the fact that most often such fees are subject to a gross income taxation, although the profit element in such services rendered is much lower than with the transfer of rights.

Having now arrived at a consensus on the basis of our definitions I shall begin with the taxation in the country of the licensee owing the counter-value for the technology. First, the price for the transfer of rights,

namely the patent royalties and similar fees. As per the aforementioned philosophy, the country of the debtor claims the right to subject to taxation at least part of the profit derived from the technology transfer. To be on the safe side and to avoid having to run after its money the fiscal authorities of the debtor country levy a tax at source, the so-called "withholding tax."

International Agreement

This practice of taxation at source, by way of a withholding tax is internationally agreed upon. It is the only way of guaranteeing the fiscal authorities of the debtor country their share of taxation. Would they rely upon income taxation by way of an income tax return and an income tax assessment to follow, they very often would not be in a position to put through their claims for tax payments in lack of tangible assets of the licensor in the country of the licensee.

The rate of such withholding tax on the gross amount of the sum to be transferred varies very much and is lowest in the industrialized countries and is highest in the so-called "developing countries." The standard average rate can be fixed at around 25%. There are countries imposing up to 40% and more, like Mexico, Columbia, India and others. Such rates are bilaterally reduced within the framework of the so-called "Agreements for the Avoidance of Double Taxation." Here the standard rate for royalties, oscillates around 10-15%. That means the two parties, the governments of the contracting countries agree to reduce their normal rate of withholding tax correspondingly. We have been talking of gross withholding tax. Only very few countries apply a net withholding tax by giving room for a lump-sum deduction of expenses. An example is Spain, which subjects only 50% of the nominal invoice amount to a 33% withholding tax resulting in an effective rate of 16% of royalties.

In this context, a side aspect of taxation in the debtor country has to be mentioned. If there is a parent/affiliate company relation—if at least 50% of the shares of the licensee company are in the hands of the licensor company—many developing countries think the rights vested in the license agreement should not be seen as autonomous or independent rights. Instead, they should be regarded as some sort of a dower of the parent company to its affiliate. This "starting capital" is supposed to put the foreign affiliate company in a position to render self-supporting and profit-yielding activities abroad. The philosophy behind it means that the return of the affiliate to its parent company is represented by the profit and dividend distributed. Such countries, for an example Brazil, are not allowing royalty payments as a deductible expense for income tax purposes of the company owing such license fees. On top of this discrimination there is a withholding tax at the rate of 25% on gross amount.

As mentioned before, taxation at source of technical services rendered is much more problematic and doubtful if performed on a gross-income basis. The implementation of technology requires highest skilled technical personnel, engineers, fitters, erectors and supervisors to be sent to the country of the licensee.

A whole lot of direct costs, like salaries, allowances, social and medical charges, traveling expenses and

many things more should be attributed to these technical assistance fees, leaving a rather small profit for taxation in comparison with the taxable margin resulting from patent royalties. Assume that such a net-yield of the technical assistance fee would realize a profit of 15%. A withholding tax of only 15% would result in a taxation of 100% of the profits earned. This is not a theoretical example. Such cases occur everyday. It stands to reason that the licensor strives for selling its technology over the counter or on a "f.o.b.-basis" and tries to avoid such costly implementation at no profit after taxes. Suffering from this practice will in the end be the licensee. He does not get the full knowledge of the manufacturing technique that cannot be put entirely on paper. That technique can only be transmitted by "human beings" by word-of-mouth with explanations about the functioning of the machine in certain situations, by demonstrations disclosing a trick how to manipulate the equipment, and by training the ear to listen to the sound of the motor to discover its functioning at an optimum.

Absurdity

Another example that shows the absurdity of such withholding tax in certain cases is the claim of the Ministry of Finance of India to tax at source at the rate of 20%, fees, paid to a foreign country for the training of Indian personnel abroad. Normally such invoices are calculated to cover board and lodging, tuition and pocket expenses of such Indian technical students or engineers in the country of the licensor. In my long tax experience I would not know a computation of such sums to be reimbursed by the licensee to contain even a fraction of a percent profit element. Imposing withholding tax by a government therefore is a bad reward for the generosity of the licensor offering his help to make the best use out of the technology sold.

Changing sides, I shall now give you an impression of the mechanism and problems in context with the taxation of the return of the technology in the country of origin.

Basically, it is a matter of the tax system in the country of the licensor. We generally discern between two modes on which the tax law is based. One method is called the "tax-credit" conception. It is represented, for example, by the United States and the Commonwealth Countries. The second kind of tax law is based on the so-called "tax-exemption" method. It is represented, for example, by the Federal Republic of Germany. Starting with the U.S. method, one can plainly say that practically every dollar earned inside or outside of the country—dividend, interest, royalty, wages, sales profits, etc.—is taxable within the United States.

Consequently, taxes paid to a foreign government will be credited to the tax debt due within the United States. Of course there are certain limits provided for within the U.S. tax law, curtailing such credit for foreign taxes to the amount of U.S. tax payable upon the foreign income. So the problem exists in the definition of foreign income.

Normally, patent royalties are regarded totally as income. No expenses have to be attributed to such

return. Such provisions mean that the foreign tax can be fully credited against U.S. income taxes as long as it does not surpass the rate of U.S. income or corporation tax.

In the case of taxation of services rendered, the U.S. tax law provides for a deduction of expenses from the fees received. But such reduction in most instances does not lead to a taxable income for which the credit of foreign taxes would not be fully applicable. In other words, in all major countries of origin of technology possessing such kind of tax system there is no problem of getting credit for the foreign withholding taxes in their national tax assessments. This situation is a considerable—and very often—a decisive factor in the competition on the sales market of technology.

There are variations in the broad scale of tax credit in the different countries. The United States is at the one end with the best tax credit facilities. Japan, France and Great Britain are in the center, and Germany is the worst country for making use of such foreign tax because of its aforementioned different tax system.

German Example

Contrary to the United States, Germany does not include foreign income principally in the assessment basis for German taxes. There are, for example, dividends from a foreign company of which at least 25% are in the possession of the German firm which are totally tax exempted in Germany. Also, the profits of a permanent establishment abroad are fully free of tax if there exists a convention for the avoidance of double taxation between the two countries. In such a system, credit for foreign taxes can only be obtained under certain circumstances.

First, the foreign tax has to correspond to a German income or corporation tax. This means that foreign withholding taxes on the return from technology—royalties or fees for technical assistance—must bear the character of a tax levied on profits and must not show the character of a turnover-, sales- or value added tax. There is a guideline published by the German Ministry of Finance listing all the taxes of the world for which a tax credit in Germany is applicable.

Second, there has to be income or profit in the sense of the German tax law against which such foreign withholding tax can be credited. There is no carry-forward of such tax credit for foreign withholding taxes.

Third, only so much of the foreign tax can be credited as would be payable in Germany for such income.

For royalties as a counter value for patent trademarks and other rights there is a very common practice by the government tax auditors to apply a

lump-sum deduction of 50% of the invoice amount as cost, reducing the basis for the comparable German income to half.

In view of German corporation tax rate of 56%, the maximum tax credit in context with royalties is 28%.

Looking upon the extreme example discussed before in the field of technical assistance fees for services rendered where the profit of 15% according to German computation provisions encounters a 15% foreign withholding tax, there is only room for a tax credit equal to 8,4 points of the taxes levies abroad.

There is still another reason why the foreign withholding taxes cannot be credited effectively against the German income tax. The reason has its origin in the basic function of the German corporation tax system which finally eliminates all tax advantages at the moment of distribution of profits. In order to make this statement understandable, some further explanation of the German corporation tax system is necessary.

On January 1, 1977, Germany introduced an imputation system with two corporate tax rates. The law provides that the tax rate payable on distributions of profit is 36%, while 56% tax is imposed on the balance of the taxable income.

The imputation system provides that resident shareholders are entitled to offset the 36% tax paid by the company when distributing profits as dividends.

Corporate Dividend

The lawful order that the corporate dividend has to bear always 36% corporation tax results in the fact that no foreign tax credit is effective once it would reduce the tax load below this basic 36% limit.

The credit for foreign taxes is superseded or made totally ineffective by distributing all part of income taxed at 56% and parts of income taxed at 36%.

Two years ago the well-known German paper "Frankfurter Allgemeine" started its economic section with an article with the sentence, "A world-unique special tax burden for German enterprises." The article deals with this unbearable tax charge originating from the fact that German firms are not allowed to add the credit for foreign withholding taxes to the reduction of German corporation tax when distributing dividends. In comparison, the Italian Government that almost copied the German tax law in 1978 eliminated this injustice within the German law by allowing to deduct the foreign withholding tax from the lower Italian corporation tax rate corresponding to the German rate of 36%. Efforts of the German industry approaching the Ministry of Finance in Bonn for a change of the German tax law have failed up to now. That means that we have to live with this special tax punishment for German licensors.