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Taxation of U.S.-Korea Technology Transfer: A Developing Country's Point of View

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A country's foreign income taxation scheme fundamentally influences the import of foreign technology into that country. In a developing country such as Korea, which lacks the resources to unilaterally develop a technology base, the scheme can provide important incentives to aid in developing an independent technology.

Taxation of Korea's transfer of technology with the United States, its largest technology supplier, is governed by the Convention for Avoidance of Double Taxation between these two countries. The author argues that Korea should interpret this convention and formulate its tax laws with a view toward furthering the policy of technology development. The article analyzes Korean tax laws as they interact with this convention. The author then proposes changes to the Korean tax laws and interpretation of the tax treaty that will provide tax incentives consistent with the policy of Korean technology development.
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I.
INTRODUCTION

A. Technology and Economic Development

Technological progress is the cornerstone of economic development. "Many studies attribute between one-third and one-half of growth of real per capita income to technological change." According to the assumption of neutral disembodied technical change used by R.M. Solow, 2% out of 4.2% growth is attributed to technological change. Another study attributed thirty percent of Japanese economic growth during 1955-1980 to technical innovation. In Korea, one research report concludes that 11.8% of aggregate GNP growth during 1963-1982 was attributable to technological advances and another eighteen percent to closely related economies of scale.

In a developing country, self-development of independent technology is generally impossible or ruinously costly. Consequently, many developing countries have tried to buy foreign technology. Economic growth can then be based on the adaptation of the foreign technology.

Japan is one country that followed this strategy. As Ryuzo Sato and Gilbert Suzawa note:

Japan has imported basic knowledge and some technology and then proceeded to develop new technology or refinements of adopted technology. . . . [Japan] had the advantage of not having to expend a significant amount of resources on basic research. . . . Because of its access to new basic knowledge created in the United States and other advanced countries, Japan has been able to concentrate its research efforts on applied research and development. The productivity impact is much quicker with this kind of focus to research and development efforts.

B. Developing Countries and Import of Foreign Technology

The United Nations General Assembly Resolution 3201 (S-VI) of May 1, 1974 states that one basis of the New International Economic Order is "giving to the developing countries access to the achievements of modern science and technology, and promoting the transfer of technology and the creation of indigenous technology for the benefit of the developing coun-

1. RESEARCH AND POLICY COMMITTEE, COMMITTEE FOR ECONOMIC DEVELOPMENT, STIMULATING TECHNOLOGICAL PROGRESS 12 (1980).
5. CHRISTOPHER FREEMAN, THE ECONOMICS OF INDUSTRIAL INNOVATION 185 (2nd ed. 1982).
6. SATO & SUZAWA, supra note 3.
tries.” However, most technological knowledge in advanced countries is developed and possessed by multinational corporations (MNCs).

Are the MNCs willing to provide developing countries with technology? Yes and no. An MNC transfers technology only when the transfer benefits the MNC. For example, as MNCs profit from the cheaper labor and resources available in developing countries, the technology transferred will frequently be restricted to technology that can exploit this edge.

MNCs tend to confine their technology within the intra-company structure. From 1970 through 1985, more than eighty percent of the technology payments received by U.S. corporations was from their subsidiaries. A developing foreign firm operating exclusively as a contractor with MNCs will develop only dependent technologies.

"As long as an underdeveloped economy relies on dependent technologies, it is likely to remain poor and backward." Dependent technology and economic development are not compatible. A rising standard of living for the working masses in a developing country results in rising costs to the corporations, and a diminishing incentive to operate in that developing country. One study concluded that "[f]or economic development, at least some independent technological base is necessary, even if it is merely in an adaptive [research and development] capacity."

C. Regulation for Technology Import and the Role of the Tax System

Governmental intervention in the economy through technology import policies occurs in many countries, including Korea. One study argues that a major determinant of the ability of a developing country to absorb imported technology is the policy stance of its government. One of the primary vehicles for a government to influence technology transfer is through tax incentives or disincentives by establishing general or selective deterrents on technology import.

D. Methodology and Approach

This article provides a policy analysis of the income tax aspects of U.S.-Korea technology transfers. As demonstrated in the table in Appendix 1, the United States represents the largest supplier of technology to Korea as measured by royalties and other royalty-like payments. From 1967 through

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9. U.N. Centre on Transnat’l Corps., supra note 7, at 177.
10. Freeman, supra note 5, at 180.
11. Id. at 184.
12. Id. at 185.
13. For a list of countries controlling technology import and policy rationales, see Michael Blackney, Legal Aspects of the Transfer of Technology to Developing Countries 162-66 (1989).
1986, payments to the United States have constituted approximately forty-five percent of all Korean outlays for foreign technology.

This article analyzes both Korean foreign technology import taxes and U.S. technology export taxes to determine their effect on the flow of technology from the United States to Korea. These effects will then be utilized to propose Korean technology import tax policies that will better develop its economy. Under this analysis, the Korean tax system represents a controllable variable, because it is modifiable by unilateral Korean action. Interpretations of its law, administrative decrees, and even the tax laws themselves can be changed. In contrast, the U.S. tax system represents an exogenous parameter for Korea. It must be analyzed, however, to determine the influence of the Korean tax system on the behavior of the U.S. technology suppliers.

A redesign of the Korean tax system for U.S. technology suppliers is limited by the present tax treaty between the two countries. The Treaty represents another exogenous treaty condition, because it cannot be unilaterally changed by the Korean government. Interpretation of the Treaty, however, can be controlled by the Korean Government to the extent Korean taxes are involved. The Treaty has been in effect since 1979. Until 1988, technology transfer related provisions of the Treaty had been virtually nullified by Korean unilateral tax breaks. The Foreign Capital Inducement Act (F.C.I.A.) and its predecessors provided extensive tax holidays for foreign technology licensors.

The recent virtual elimination of F.C.I.A. tax holidays magnifies the importance of the Treaty. A few Korean rulings have interpreted the Treaty. Today, the Korean tax administration appears to base its decisions upon those interpretations, despite the fact that they were accumulated when the Treaty was not considered very important.

The interpretative discretion of the Korean Government is limited. In principle, the Treaty should be uniformly interpreted by and between both countries. Accordingly, analysis of the Treaty should be rendered in two tiers. First, the possible interpretations of the Treaty, supportable by a legal analysis of both the structure and the language of the Treaty, must be determined. Second, the bargaining power of the two countries must be analyzed to identify the practical limits in interpreting the Treaty.

Ideally, both tiers should involve an economic analysis of the relationship between the United States and Korea. In place of this unmanageable effort, this article will instead delve into U.S. tax concepts. For each issue of Treaty interpretation discussed in parts III through VI, the article discusses

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17. Treaty, supra note 15, art. 27(2), 30 U.S.T. at 5297; see also Klaus Vogel et al., United States Income Tax Treaties pt. 1 at 28 (May 1989).
how the U.S. tax system treats the same issue. The U.S. response is assumed to be based upon its established tax concepts. A Treaty interpretation consistent with established U.S. concepts will probably be acceptable to the United States, even if it is monetarily unfavorable. To summarize, this article will develop suggestions for the Korean tax system after analyzing the possible interpretations of the Treaty, subject to the limitations imposed by the Treaty and the U.S. domestic tax system.

Part II analyzes the international tax policy behind the Treaty and discusses the Korean Government policy for technology import in more detail. The policy points formulated in part II form the basis of the interpretation of the Treaty and proposals for redesign of the Korean tax system in subsequent parts. Part III addresses the Treaty’s characterization of a transaction as a technology transfer (which includes license and sale) and a service. Parts IV through VI review the various modes of technology transactions. Part IV discusses the technological service transaction. Parts V and VI address the license of technology, and the sale of technology respectively.

II.
TECHNOLOGY TRANSFER POLICY: THE TREATY AND KOREAN LAWS

A. International Tax Policy

A good starting point in discussing the Treaty concepts is the consideration of basic tax concepts and international tax policy principles that apply generally as well as to technological transfer. Five principles are formulated in the literature on U.S. taxation of international business transactions, four of which are relevant for the purposes of this article: 18

1. U.S. corporations are taxed on their net income wherever earned. This concept of global income is based on the equity argument that an entity should be taxed according to its ability to pay.

2. Source country governments have the first claim to tax income created within their own borders.

3. To alleviate double taxation, the United States allows its taxpayers to credit foreign income taxes paid against their U.S. tax liabilities. The credit is limited by U.S. tax rates in order to avoid reducing U.S. tax on U.S. income.

4. Certain payments to foreigners are subject to a withholding tax (on gross receipts) that mimics the tax that would be payable by a U.S. resident.

The two bases underlying the U.S. international tax policy are the taxation of worldwide income and the avoidance of double taxation. The former is an equity concept based on the ability to pay. The latter is conditioned by the priority of source jurisdiction over resident jurisdiction. Given the priority of source jurisdiction, the resident country must provide relief from double taxation. The foreign tax credit system is intended to achieve such neutrality.

The Corporate Income Tax Act of Korea (C.I.T.A.) also uses a system of worldwide taxation and foreign tax credit. Like the United States, source jurisdiction is adopted for taxing non-residents. As a result, the Treaty incorporates the four principles shared by the U.S. and Korean international tax law.

The fourth of the principles listed above is too narrowly formulated because it covers only a portion of the source jurisdiction. The permanent establishment principle or domestic trade or business concept is an alternative method of exercising the source jurisdiction. Conceptually the withholding tax is an approximation of the tax on net profits earned by non-residents. If a foreign entity's economic activity within the host country is not very significant, it is administratively inefficient to tax the net profit of the foreign corporation in exactly the same way as a domestic corporation and thus withholding tax is used. If a foreign entity’s economic activities in the host country reaches a designated threshold, it becomes more efficient to make the foreign entity pay the same amount of tax that would be paid by a domestic entity.

In a treaty setting, however, the withholding tax rate is not necessarily an approximation of the normal tax on net profits. Advanced countries, including the United States, try to reverse the priority between resident and source jurisdiction. For example, the O.E.C.D. Model Double Taxation Convention specifies that no tax will be paid for royalties and several other categories of income received by a foreign corporation without a permanent establishment.
local establishment. The withholding tax in such a situation is not an approximation of tax on net profit, and the approximation concept sets only the maximum rate of the withholding tax.

When a treaty is involved, the withholding tax rate is determined by bargaining between the two parties to the treaty, not by economic logic. A capital or technology exporting country will try to reduce the withholding tax rate, while an importing country will pursue the opposite goal. This revenue aspect often overwhelms the concept of withholding tax as an approximation of tax on net income even in domestic tax law. "Many countries—including the United States—set rates of tax at source under their domestic law at unrealistically high levels, with the intention of reducing them through negotiations." The withholding tax rate is only an example. An essential function of a bilateral tax treaty is the allocation of revenue between the two countries. The revenue motive appears to be an implicit cornerstone of international tax policy, in addition to jurisdiction based on residence and capital export neutrality.

The U.S. approach toward treaty negotiation is well reflected in the U.S. Treasury Model Income Tax Treaty. The U.S. Model shows a strong preference for residence over source jurisdiction. For example, the O.E.C.D. Model provides for a ten percent withholding tax for interest income, but the U.S. Model requires no withholding tax in the source country. Further, a central characteristic of the U.S. treaty negotiation policy appears to be the securing of tax concessions from the source country. An important reason for the strong U.S. preference for using tax treaties to achieve tax concessions from a source country is that "at least since the First World War, the United States has been the premier capital-exporting country of the world." A theoretical justification for this policy does exist. It is easier for the resident country to avoid double taxation. The practical reason, however, appears to


27. See Vogel et al., supra note 17, at 30-32 for a summary of the competing interests between capital importing and exporting countries.


32. Rosenbloom, supra note 28, at 514; see also Ross, supra note 19, at 334 (arguing further that the United States cares less about reasonable treatment of foreign income than about maximizing its own revenue). For the analysis in this article, it is sufficient to assume that the United States tries to increase its revenue by reducing source country tax.

33. Rosenbloom, supra note 28, at 515-16.
TAXING U.S.-KOREA TECHNOLOGY TRANSFER

be in the strong economic interest of the United States as a capital exporting country.

B. Treaty Regime for Technology Transfer

As mentioned above, the United States and Korea share the same policies of worldwide taxation and avoidance of double taxation. Within the boundaries of these general principles, the Treaty provisions for technology transfer can be summarized as follows:

1. The Treaty distinguishes between the transfer of disembodied technology, technical service, and the transfer of technology embodied in capital goods. 34
2. A host country tax will be limited to the income sourced within the host country. 35
3. If a permanent establishment exists in the host country and the fee or royalty is effectively connected with it, the royalty or fee will be added and aggregated to the permanent establishment and thus taxed as net profit. 36
4. In the absence of a permanent establishment, the royalty clause imposes source country withholding tax, 37 while the capital gains clause exempts source country tax. 38
5. Absent a permanent establishment, a service contractor will not be taxed in the host country. 39
6. Taxes paid to the host country will be credited in the home country to avoid double taxation. 40

The Treaty regime is basically the same as the U.S. Model, except that the withholding tax applies to a royalty even if no permanent establishment can be found in the host country. 41

The Treaty includes three categories of income potentially applicable to a technology transaction: royalties, 42 capital gains, 43 and business profits. 44 This article will first address the initial issue of whether a transaction should fall under the business profits clause or another clause, that is, whether it should be regarded as a personal service or a technology transfer. Then,

35. Id. art. 6, 30 U.S.T. at 5267-71.
36. Id. art. 8, 30 U.S.T. at 5272-73.
37. Id. art. 14, 30 U.S.T. at 5284.
38. Id. art. 16(1), 30 U.S.T. at 5286-87. Profit from a contingency sale is subject to royalty treatment, as discussed in part V. See infra notes 305-15 and accompanying text.
40. Id. art. 5, 30 U.S.T. at 5265-67.
42. Treaty, supra note 15, art. 14, 30 U.S.T. at 5284-86.
43. Id. art. 16, 30 U.S.T. at 5286-87.
44. Id. art. 8, 30 U.S.T. at 5272-75.
transactions characterized as technology transfers will be further examined to
determine whether they constitute license or sales transactions.

The Treaty does not use the term "technology transfer." In this article
the term will cover a transfer of industrial property and know-how. Further,
it is defined from a technological perspective, without regard to legal
aspects such as exclusivity in use or form of payment. This definition of tech-
nology transfer includes both a license and a sale of technology. In contrast,
a personal service contract is governed by the business profits clause of the
Treaty.

This article adopts the above terms to avoid confusion caused by the
difference in statutory definitions of the terms "royalty," "business profit,"
and "capital gain," as used in the Treaty, the U.S. Internal Revenue Code
(I.R.C.), Korean domestic law, and other treaties. For example, the Korean
domestic law definition of royalty includes the proceeds or profits from the
sale of technology. Both the Treaty and the I.R.C. do not include them,
however, except for contingency basis sales proceeds. The royalty clause in
some treaties covers technological services as well.

For each of these categories (license, sale, and service), the implications
of the source rule, permanent establishment and effective connection, foreign
tax credit, and other issues involving both the host and home country will be
discussed.

C. Overview of Korean Technology Import Regime

Until recently, the international tax policies underlying the Treaty re-
garding technology flow from the United States to Korea had been almost
completely nullified by generous Korean domestic tax provisions. Most of
these tax incentives have been eliminated and tax holidays are rarely granted.
The former generous incentives warrant discussion for two reasons. First,
Korean tax incentives have significantly influenced the existing interpretation
and administration of the Treaty. Second, and more important, the evalua-
tion can lead to the identification of policy aspects which could be germane to
the interpretation of the Treaty. A detailed analysis of the few remaining tax
incentives appears in part V.

Given the general control of foreign exchange in Korea based on the
Foreign Exchange Control Act (F.E.C.A.), the import of foreign technol-
ogy or technological services is possible only after obtaining approval under

45. However, this term does not include copyright licenses.
46. C.I.T.A. art. 55(1)(9).
48. See, e.g., Convention for the Avoidance of Double Taxation, Sept. 12, 1989, U.S.-India,
art. 12(4), S. TREATY DOC. No. 5, 101st Cong., 1st Sess. (1989); Convention for the Avoidance
49. Waigukhwan Gwanri Beob [Foreign Exchange Control Act], Pub. L. No. 933,
amended by Pub. L. No. 4316 (Korea) [hereinafter F.E.C.A.].
the F.C.I.A.\textsuperscript{50} or the Technology Service Promotion Act (T.S.P.A.).\textsuperscript{51} The F.C.I.A. does provide for extensive tax reductions for technology transfer transactions. Such reductions have not been available under the T.S.P.A. Despite these fundamental differences, the exact borderline between the two laws is unclear.\textsuperscript{52} The borderline appears to exist between technology transfers and mere services not entailing tangible technology transfers.

The table in Appendix 1 demonstrates the statistics for technology-related overseas payments from 1962 through 1986, including licensing and consultancy. The table shows that licensing and consultancy, respectively, accounted for eighty percent and twenty percent of the payments up to 1986. Unfortunately, the author did not explain the standard used for distinguishing between licensing and consultancy. Based on the history of Korean regulations discussed below, licensing and consultancy probably correspond to the F.C.I.A. and T.S.P.A. approval procedures, respectively. If this assumption is correct, then most of the technology import transactions before 1986 enjoyed a tax break and these unilateral Korean measures voided the Treaty policies.

\section*{D. F.C.I.A. Tax Holidays: 1966-88}

Before 1966, Korea did not have a firmly established policy regarding foreign investment, technology transfer, and science and technology development.\textsuperscript{53} In 1966, the Korean Government responded to the meager level of foreign technology, demonstrated by the table in Appendix 1, by enacting a predecessor to the current F.C.I.A. and subjecting all foreign investment and technology to governmental approval.\textsuperscript{54} The role of the government involved much more than approval, especially in the early stages. One commentator noted that "[i]t took part in any negotiations involving large expenditures."\textsuperscript{55}

Once the government approved a technology import, an eight year tax holiday applied, providing a full exemption for five years and an additional

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{50} The approval authority is in the Ministry of Finance [hereinafter M.O.F.] but is delegated to the relevant ministry. \textit{See} F.C.I.A. art. 7.
\item \textsuperscript{51} Gisul Yongyeog Yuksesong Beob [Technology Service Promotion Act], Pub. L. No. 2474, \textit{amended by} Pub. L. No. 3691 (Korea) [hereinafter T.S.P.A.]. Another possibility of approval is under the F.E.C.A. itself, but such has rarely been available for industrial technology transactions. \textit{See} Jeffrey D. Jones, \textit{Licensing Operations in Korea, in AN INTRODUCTION TO LAW AND LEGAL SYSTEMS OF KOREA} 733, 736 (Sang Hyun Song ed., 1983).
\item \textsuperscript{52} \textit{Compare} T.S.P.A. art. 2(1) \textit{with} Waija Doib Beob [Foreign Capital Inducement Act], Pub. L. No. 3691 (F.C.I.A. original version).
\item \textsuperscript{54} Foreign Capital Inducement Act of 1966, Pub. L. No. 1802 (Korea) [hereinafter F.C.I.A. of 1966].
\item \textsuperscript{55} ENOS \& PARK, \textit{supra} note 4, at 37.
\end{itemize}
\end{footnotesize}
three year phase-out period. This eight year tax holiday effectively negated the impact of the Treaty. Effective July 1, 1984, the Korean Government switched to a “report” system. The F.C.I.A. established specific criteria “not to accept a report.” Significantly, the approval authorities could not accept an import of a “low-level or obsolete” technology. The authorities also widely exercised administrative guidance. A reduction in the tax holiday occurred contemporaneously with the switch to the report system. Abrogating the three year phase out, only the five year full exemption was available. Nonetheless, even five years was long enough to effectively deprive the Treaty of its impact.

Effective July 1, 1986, F.C.I.A. approval became available for the import of non-sophisticated technology, provided that the taxpayer waived the tax holiday. This amendment was necessary to enable the import of less sophisticated technology. Before the 1986 amendment, some non-sophisticated technologies were imported by taking advantage of the T.S.P.A. procedure. However, because the T.S.P.A. was originally designed to cover service transactions rather than non-sophisticated technologies, this procedure was largely ineffective.

The Korean government replaced the 1986 amendment with more drastic measures that became effective July 1, 1988. Commercial banks were vested with the power of prior approval unless the duration of the contract exceeded three years and the royalty amount exceeded a certain threshold level. Any agreement with a duration of three years or less became free from prior approval and no restrictions are imposed on extensions. An agreement subject to bank approval is no longer eligible for the F.C.I.A. tax break. More important, even an agreement subject to ministerial approval will seldom enjoy tax breaks. The F.C.I.A. tax benefits are granted only for such technology that is “imperative to the national economy and . . . difficult to independently develop domestically.” Few technologies satisfy this standard.
E. Impact of F.C.I.A. Tax Breaks Upon Treaty Interpretation

The F.C.I.A. tax holidays significantly impacted the Korean tax administration's interpretation of the Treaty. The distinction between a technology transfer and a service represents one example. As discussed previously, until July 1, 1986, the F.C.I.A. approval was not available for "low-level or obsolete" technology. The power of F.C.I.A. approval vested in the ministry in charge of the relevant business.65 This implied that the F.C.I.A. tax holiday was available only if the appropriate ministry, which typically was the Ministry of Trade and Industry, officially acknowledged the sophistication of the technology.

Given this mechanism, the National Tax Administration (the "N.T.A.")66 simply awarded royalty treatment to payments under F.C.I.A.-approved agreements, although no written policy was stated to that effect. Recognizing the professional judgment of the competent ministry, a separate review invoking the distinction between royalty and service fee treatments by the N.T.A. was deemed superfluous. Moreover, if any payments were to be made after the expiration of the tax holiday, royalty treatment would better serve revenue purposes.

In a typical technology transaction, expatriate engineers remain on the licensee's premises only for the initial stage of the transaction. While the F.C.I.A. still provided tax holidays, the expatriate engineers would have completed their work by the time of the expiration of the tax holiday for most transactions, so that no permanent establishment could be found. As a result, an F.C.I.A. approval almost automatically implied royalty treatment, because a service fee would normally be exempt from Korean tax unless the recipient had a permanent establishment in Korea.67 The Korean tax administration therefore did not view the characterization of the transactions as crucial. This practice of inferring royalty treatment was efficient before the liberalization of approval procedures and the virtual elimination of F.C.I.A. tax incentives, but it should be re-evaluated under the new system.

In contrast to the treatment of transactions approved under the F.C.I.A., the characterization of agreements approved under the T.S.P.A. were closely scrutinized, probably because non-sophisticated technologies were occasionally imported by taking advantage of the T.S.P.A. procedure. The existing Korean rulings on the issue of characterization were therefore issued in connection with the T.S.P.A.-approved transactions.

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65. F.C.I.A. E.D. art. 46(1)(2).
66. The N.T.A. is the main tax administration agency of Korea, comparable to the I.R.S in the United States.
67. Treaty, supra note 15, art. 8(1), (5), 30 U.S.T. at 5272, 5274. For further discussion, see infra text accompanying note 290.
The T.S.P.A. states that its goal is the "improvement of domestic technological capabilities." Consequently, the Korean regulations attempt to aid in the development of an independent domestic technological base. This goal should be regarded as the general policy purpose of the relevant regulations, including the F.C.I.A. The stated purpose of the F.C.I.A. does not address technology concerns, because the F.C.I.A. focuses primarily on foreign investment. Regarding technology import, the F.C.I.A. is not intended to restrict the import of foreign technology, but to monitor the tax incentives. The governmental review is not meant to restrict the import of foreign technology but to assure that the tax incentive is confined to those transactions that contribute to the build-up of a domestic technological tax base. The restrictive aspect of the F.C.I.A. and T.S.P.A. focuses on protecting domestic industries that have already accumulated some technology.

The above assertions can be supported by an analysis of the Technology Development Promotion Act (T.D.P.A.). The T.D.P.A. states its purpose, in part, as "self-development of industrial technology and absorption and improvement of imported technology." To further this purpose, the T.D.P.A. protects domestic enterprises that have developed their own technology by prohibiting the import of foreign technology in the same business. Under the auspices of the T.D.P.A., the Tax Exemption and Reduction Control Act (T.E.R.C.A.) provides a tax incentive for the absorption, application, and improvement of imported technology. The T.E.R.C.A. does not provide any tax incentive for the import of foreign technology, but does give incentives for its application and improvement.

This alleged policy purpose was overwhelmed by the use of F.C.I.A. tax benefits as incentives for foreign investment. A foreign investment incentive project typically involves a technology transfer transaction between the foreign investor (more often its affiliate owning technology) and the local subsidiary. An exemption of tax on royalty functions as an incentive for foreign investment. This foreign investment aspect overwhelmed the technology import aspects, because the majority of technology transactions occurred as part of a foreign investment. Technology transfer between unrelated parties has been less important. Consequently, the effectiveness of the F.C.I.A. tax incentive in building domestic technology cannot easily be assessed.

68. T.S.P.A. art. 1.
69. See Hyun, supra note 58, at 55-57.
71. Id. art. 1.
72. Id. art. 8(2) (before the Dec. 31, 1989 amendment).
74. Id. arts. 16-17.
Since 1988, however, the foreign investment tax incentives have been abrogated as well. Currently, the government grants the foreign investment tax incentive only when the foreign technology will likely increase the domestic technological base.\(^75\) Development of the domestic technological base remains virtually the sole policy consideration for any F.C.I.A. tax holiday.\(^76\) Unfortunately, the current system of tax incentives is not suitably designed to serve this policy purpose. This issue will be discussed in part V.

As a result of the F.C.I.A. tax holidays, the interpretation of the Treaty has not been deemed a significant issue to date. These interpretations surely will gain increasing importance in the future. What should be the guiding principles for interpretation?\(^77\) An earlier section discussed the basic international tax policies incorporated in the Treaty. The two guiding principles were world-wide taxation (ability to pay) and capital export neutrality (avoidance of double taxation). This article argued that a revenue perspective should be a third guiding principle. Once a policy decision is codified, revenue often becomes the leading consideration.\(^78\) However, an overreaching interpretation contravening the original policy purpose cannot be justified. In the interpretation of the Treaty, revenue maximization should be pursued within the limit of the policy purposes underlying it.

In a country that controls the import of foreign technologies, the tax system should neither vitiate nor contradict the purposes of the technology import regulations. Conversely, from an economic viewpoint, one could argue that conflict between a direct regulation and a tax law will increase economic efficiency through neutralization effects. This economic argument, however, logically leads to an endless chain of neutralizations. The governmental regulation itself could be designed to remedy a failure in the private market. Tax administration (including interpretation of law) should not contradict technology import policy even if the purposes of other regulations are not reinforced.\(^79\)

Regarding Korean taxation of technology suppliers, the design and administration of the system should ensure that tax effects do not impede the goal of domestic technology build-up. More specifically, a transaction involving supplying sophisticated technology should not be subject to more burden-

\(^{75}\) See F.C.I.A. art. 14 (1). The F.C.I.A. incentive for foreign investment is available in several other cases, but its effect on the national economy is insignificant.

\(^{76}\) For an account of current F.C.I.A. tax incentives for foreign investment, see infra text accompanying notes 216-20.

\(^{77}\) For an overall discussion of rules of treaty interpretation, see Vogel et al., supra note 17, pt. I at 24-28.

\(^{78}\) In the context of treaties between Canada and several Asian/Pacific countries (not covering Korea), it has been noted that doubts in interpretation are inevitably resolved in favor of taxation. Catherine A. Brown, Tax Aspects of the Transfer of Technology: The Pacific Rim 15 (1990).

\(^{79}\) For a view discrediting the role of developing country governments in tax preferences, see S.M.S. Shah & J.G.J. Toye, Fiscal Incentives for Firms in Some Developing Countries, in Taxation in Developing Countries 151, 151-64 (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).
some taxes than a service transaction. The tax system should not favor the employment of foreign service contractors (which could choke off domestic technology in an infant stage) over the import of machine-embodied or disembodied technology (which could be at the disposal of the Korean importer). In the following discussion, this proposition, along with the revenue maximization and neutrality concepts, represents a guiding principle in interpreting the Treaty.

A difficult tension exists between the Korean policy and the Treaty concept of neutrality. If the home country tax system completely submits to the priority of source country taxation, making all taxes paid to the host country creditable in the home country, any tax policies implemented by the host country to affect taxpayer behavior will be ineffective. The final tax burden will depend only upon the home country tax rate.

In reality, this proposition does not hold true. Host country taxes influence foreign taxpayers. The host country can try to affect the behavior of foreign taxpayers, because the double tax avoidance mechanism does not operate in an ideal way. Incentive or disincentive measures taken by a host country become effective only when the resulting final tax burden differs from the normal tax of the home country. Thus, the policy-oriented interpretation suggested above will work, but capital export neutrality (i.e., avoidance of double taxation) will be sacrificed. The influence of the host country tax can be measured only by analyzing the final tax burden to foreign corporations. This article provides such an analysis for Korean and U.S. taxes imposed on U.S.-Korea technology transfers.

III.

THE PROPERTY/SERVICE DICHOTOMY: THE PROBLEM OF KNOW-HOW

A. Tax Differences Between a Technology Transfer and a Service

A payment for technology transfer that does not involve a permanent establishment of the transferor is subject to a royalty withholding tax under the Treaty. 80 The Treaty defines royalty as a “payment . . . made as consideration for the use of, or the right to use, . . . patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how) . . . .” 81 Unlike a technology transfer, payment for a service is exempt from host country tax absent a per-

80. Treaty, supra note 15, art. 14, 30 U.S.T. at 5284. The capital gains clause of the Treaty may also apply to a technology transfer transaction in the form of a sale. Id. art. 16, 30 U.S.T. at 5286-87. This issue is discussed infra part VI.

81. Treaty, supra note 15, art. 14(4)(a), 30 U.S.T. at 5284. Contingency basis sales proceeds are additionally included in the scope of royalty. See infra part VI (discussing these in the context of the license versus sale dichotomy).
manent establishment. Instead, the business profits clause governs.\textsuperscript{82} Thus, the characterization of a transaction as a technology transfer or a technological service becomes a crucial issue.

\textbf{B. Definition of Know-How}

The Treaty's distinction between royalty and service fee is essentially similar to other laws or treaties.\textsuperscript{83} Under any definition, payments for intellectual property are royalties. Other payments present a difficult problem. In short, the characterization of these other payments depends upon whether the transaction involves a transfer of "know-how." In U.S. terminology, the royalty/service fee distinction is a part of the property/service distinction, in the sense that "know-how is a kind of property. Regarding this distinction, the commentary to the O.E.C.D. Model states that:

\begin{quote}
[Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition . . . states that "know-how" is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions: inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the process or technique. \textit{In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.} This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for . . . pure technical assistance do not constitute royalties.\textsuperscript{84}
\end{quote}

The essential distinction depends upon whether the licensee or project owner obtains access to technological information that is proprietary to the licensor or contractor. A technology ordinarily available in the industry ("customary skills of his calling") is not know-how. Consequently, payment for a service involving such technology represents service income.

Virtually all technology transactions involve the transfer of both know-how and services. For such mixed contracts, the commentary to the O.E.C.D. Model recommends disaggregating the payment on the basis of the information contained in the contract or another reasonable means.\textsuperscript{85} The commentary states, however, that:

\begin{footnotes}
\textsuperscript{82} Treaty, \textit{supra} note 15, art. 8(1), (5), 30 U.S.T. at 5272, 5274. This discussion is confined to corporate transactions, because transactions by individuals are insignificant in international technology transfer. Most of the discussions in this article apply to individual suppliers with slight modifications involving the concepts of physical stay and fixed facility in place of permanent establishment.

\textsuperscript{83} For a parallel presentation of the issue in the Canadian context, see \textsc{Brown}, \textit{supra} note 78, at 24.

\textsuperscript{84} O.E.C.D. \textsc{Model}, \textit{supra} note 26, at commentary on art. 12(2)(4).

\textsuperscript{85} \textit{Id.} at commentary on art. 12(2).
\end{footnotes}
If... one part of what is being provided constitutes by far the principal purpose of the contract and the other parts are only of an ancillary and largely unimportant character, then it is possible to apply to the whole amount of the consideration the treatment applicable to the principal part.\(^{86}\)

The commentary to the U.N. Model demonstrates the different understandings of the meaning and scope of know-how between developed and developing countries. This difference becomes especially apparent regarding the "payment... for information concerning industrial, commercial, or scientific experience," as distinguished from a technical service.\(^{87}\) Here, important issues not discussed when drafting the U.N. Model arise. As know-how is information that has not been divulged to the public, an ordinary technology in the industry is not know-how. First, how should the term "ordinary level" be defined? Second, does the term "industry" mean that of the transferor's country or of the transferee's country? Among developed countries, these are not serious problems because the technological gaps are not great. Between a developed and developing country, however, these questions present serious problems. Technological information generally known in the industry in a developed country will normally be new information to the same industry in the developing country. Should it be regarded as a royalty or as service income?

C. Conflicting Views Regarding the Concept of Know-How

Korean and U.S. rulings show conflicting views over the characterization issue. In the United States, payment to a technology transferor will be characterized as a service fee unless the transferred technology was the property of the transferor. A royalty characterization requires that the transferred technology be proprietary know-how of the transferor, even if it becomes know-how to the transferee in the transferee's country after the transfer of the technology.\(^{88}\) In contrast, Korea distinguishes the two by examining the ordinary industry level of technology in the transferee's country.\(^{89}\)

Which position represents the best interpretation of the Treaty? As argued above, capital export neutrality and revenue perspective should be two fundamental concepts guiding interpretation of the Treaty. A revenue perspective will lead to conflicting interpretations. Broadening the coverage of royalty will result in more revenue to Korea and less revenue to the United States. Capital export neutrality will not be harmed if the two countries share the same interpretation, regardless of the scope of the royalty term. Capital export neutrality will not be harmed if Korean taxes can be credited against the U.S. tax owed by the U.S. transferor, regardless of whether Korea taxes a

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\(^{86}\) *Id.* at commentary on art. 12(2)(9).

\(^{87}\) *U.N. MODEL, supra* note 25, at commentary on art. 12(3).

\(^{88}\) *See infra* text accompanying notes 91-110.

\(^{89}\) *See infra* text accompanying notes 111-20.
particular income. In essence, the issue contains the same elements as the unsolved dispute between developed and developing countries over inclusion of compensation for technological service in the scope of royalty. This dispute implies that neither Korea nor the United States can assert the universal validity of its position.

It should be noted that Korean technology import policy will demand that the concept of know-how be based on comparison with the Korean domestic level of technology. For Korea, revenue does not represent the only guiding principle. In part II, this article argued that the fundamental Korean policy of technology import has been to increase domestic technological capabilities. This has been accomplished by simultaneously deterring the use of foreign service contractors while providing technology import incentives.

This article argues that Korea should interpret the Treaty and redesign its tax system so that foreign service contractors have tax burdens at least equal to the burdens on technology transferors. This policy, which will favor the development of Korean technology, presupposes that a transaction involving an over-Korean level technology is regarded as a technology transfer and a transaction involving a Korean level technology is regarded as a service transaction. This requires that the concept of know-how be based on a comparison with Korean domestic level technology. If a service transaction is subject to no less tax than a license, the revenue interest of the United States will not prefer characterization as a service transaction. As seen in part II, the United States does not have general policies promoting or deterring particular technology or technology transfers. The United States only has a revenue interest in taxing technology exporting corporations, i.e., reducing source country taxes. If the Korean tax policy of not favoring services cannot pervade the U.S.-Korea technology flow, Korea should still pursue a policy-coordinated tax treatment through a competent authority procedure. Korea should develop a general principle reflecting Korean technology import policy and attempt to reach compromises with the United States based on this principle rather than resorting to a case by case approach. Given that the United States does not have a particular technology export policy, this Korean attempt will be acceptable to the United States. As a result Korea will be able to insert its technology import policy into the general agreement.

D. U.S. Distinction

The Treaty distinction between royalty and service fee is for source country tax purposes. For a U.S. licensor or contractor, however, the distinction between a technology transfer and a service transaction, or between royalty and service fee, is also important for U.S. tax purposes. The significance of the property/service dichotomy stems from the fact that royalty and service fees typically belong to different categories of income when determining

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90. See supra note 87 and accompanying text.
the foreign tax credit limitation. The limitation was initially adopted in 1921. After vacillating between overall and per-country limitations, the 1986 Tax Reform Act adopted the current basket limitation approach.\textsuperscript{91} In essence, this separate basket system places limitations on foreign tax credit for each of the nine categories of income.\textsuperscript{92} Royalty income will typically be included in the passive income category, while service fees will be placed in the residual category of other income. "The separate limitation for each basket in a taxable year should be the same proportion of the total U.S. income tax (before the credit) as the amount of foreign-source income within the basket bears to the total taxable income, although the language of the I.R.C. provisions are strangely vague."\textsuperscript{93} The policy behind the separate limitations involves the typical foreign taxation of the income in these categories. Since this income is often highly mobile and lightly taxed by foreign governments, U.S. taxpayers try to shift income to these categories of low-taxed foreign sourced income.\textsuperscript{94}

Source rules also involve a property/service distinction because different source rules exist for technology transfer and service in applying the foreign tax credit limitation formula. The source of personal services compensation depends upon the "place of performance," that is, whether the service is rendered inside or outside the United States.\textsuperscript{95} The source of royalties depends upon the place of use of the intellectual property, know-how, or royalty-bearing product.\textsuperscript{96} The Treaty provides that its source rule applies to the U.S. foreign tax credit,\textsuperscript{97} and the Treaty source rule is the same as the rule in the I.R.C.\textsuperscript{98} Given different source rules, a distinction between a royalty and a service fee or between technology transfer and services becomes necessary. The property/service dichotomy assumes even more importance for U.S. taxation of foreign taxpayers because the source rule represents the cornerstone of taxing international transactions inbound to the United States. Most cases that have addressed this issue involved the taxation of foreign taxpayers. The property/services dichotomy has primarily arisen in the context of payments for the creation or use of intellectual property.\textsuperscript{99} The classic case of \textit{Ingram v. Bowers}.\textsuperscript{100} laid the foundation for the property/service distinction. The case concerned the famous singer Enrico Caruso. Caruso recorded master discs at a U.S. studio. He was under contract to receive a certain

\textsuperscript{91} See generally 1 \textit{ISENBERGH, supra} note 29, §§ 16.1-.6 (1990) (discussing the history of the adoption of the basket limitation approach).
\textsuperscript{92} I.R.C. § 904(a), (d)(1).
\textsuperscript{93} 1 \textit{ISENBERGH, supra} note 29, § 19.5.2.
\textsuperscript{94} See 1 \textit{ISENBERGH, supra} note 29, § 19.6; see also Ault & Bradford, \textit{supra} note 18, at 18-19.
\textsuperscript{95} I.R.C. §§ 861(a)(3), 862(a)(3); see also discussion infra part IV.
\textsuperscript{96} I.R.C. §§ 861(a)(4), 862(a)(4); see also discussion infra part V.
\textsuperscript{97} Treaty, \textit{supra} note 15, art. 5, 30 U.S.T. at 5266-67.
\textsuperscript{98} Treaty, \textit{supra} note 15, art. 6, 30 U.S.T. at 5267-72.
\textsuperscript{100} 47 F.2d 925, \textit{aff'd}, 57 F.2d 65 (2d Cir. 1932).
amount of the selling price of records sold. The court ruled that Caruso’s income was personal service income, since he never obtained an interest in the master record.101

Karrer v. United States102 reached a similar result in a case involving a patent. A Swiss scientist conducted patentable research for Hoffman-La Roche of Switzerland. Hoffman-La Roche assigned the U.S. patent applications to a U.S. company, and the U.S. assignee paid a certain sum to the scientist. The court held that the payment was for personal services (and thus exempt from U.S. tax based upon the source rule), because Karrer “never had a right” which could be licensed, and “had nothing to sell.”103 The distinction between services and transfers of intangible property turned on whether or not the supplier had rights in an asset separately identifiable under local law,104 although the more recent cases have eroded this principle.105 In Karrer, although the transferee had acquired a patent, the payment to the transferor represented a service fee because the transferor did not own a patent before the transfer.

Regarding non-intellectual property payments, the I.R.C. bases the distinction between a technology transfer and a service on the concept of know-how. The Code uses the more distinct terms “secret processes and formula” to define royalty.106 Neither the Code nor U.S. case law directly addresses the issue of the technological gap between the United States and the technology importing country. An extrapolation of the reasoning in Ingram v. Bowers and Karrer, however, involves a comparison of the transferred technology with the level of technology in the licensor’s country. Characterization of income derived by a U.S. licensor or contractor from a Korean payor will thus depend upon whether the transferor is regarded as the owner of intangible property. U.S. courts will not treat a transfer of what is considered ordinary level technology in the United States as know-how property and will characterize it as service income.

A mixed contract involving know-how is addressed by Revenue Ruling 64-56.107 Previously, under Revenue Ruling 55-17,108 the I.R.S. had treated the value of personal services accompanying a transfer of know-how as having only nominal value. This position was later changed by Revenue Ruling 64-56, which required a separate valuation of services, unless they were

101. Id.; see also WILLIAMS, supra note 99, at A-19; ISENBERGH, supra note 29, § 4.44-.45.2.
103. Id.; see also WILLIAMS, supra note 99, at A-19.
104. 1 ISENBERGH, supra note 29, § 4.44.
107. 1964-1 C.B. 133.
merely ancillary and subsidiary to the transfer of know-how. This treatment is consistent with the commentary to the O.E.C.D. Model. Under this view, a typical technology transfer transaction normally involves both a transfer of property and a provision of services. The ruling does not specify when services will be considered subsidiary, but it sets forth several safe harbor rules, which need not be detailed here.

**E. Korean Distinction**

Approximately a dozen Korean tax rulings address the characterization of a technology agreement. Although only a few of the rulings directly relate to the Treaty, the standard for distinction under other treaties (except the treaty with India) is virtually identical. Thus, these other rulings can also be applied to the interpretation of the Treaty. Korean tax authorities and courts accept the general distinction between royalty and service fee based on the concept of know-how, which stems from a comparison with the domestic level of technology.

The Korean Supreme Court has ruled that a fee under a service agreement not involving undivulged know-how and ordinarily performed in the industry should be characterized as personal service income. In that case, the plaintiff was a Korean contractor hired by the Ministry of Transportation to investigate potential locations for a new airport. After obtaining approval under the T.S.P.A., the plaintiff entered into a five month contract with the U.S. consulting firm PMM. In accordance with the contract, PMM analyzed the demand and capacity of the existing airport, facilities, manpower, and auxiliary facilities for the new airport, as well as facility layout planning. The plaintiff paid the specified fee and did not withhold any Korean income taxes.

The Court found that the services of PMM did not involve a transfer of know-how. The court defined know-how as an undivulged special knowledge or expertise. The court decided that an enterprise in the same industry could ordinarily perform the same service, and the investigation could have been rendered solely by domestic technicians. As PMM was hired because of its accumulated experience in selecting airport sites, the court ruled that PMM's service constituted a personal service rather than a royalty. Under this holding, since PMM's service was less than six months, and therefore did not involve undivulged know-how and ordinarily performed in the industry should be characterized as personal service income. 112 In that case, the plaintiff was a Korean contractor hired by the Ministry of Transportation to investigate potential locations for a new airport. After obtaining approval under the T.S.P.A., the plaintiff entered into a five month contract with the U.S. consulting firm PMM. In accordance with the contract, PMM analyzed the demand and capacity of the existing airport, facilities, manpower, and auxiliary facilities for the new airport, as well as facility layout planning. The plaintiff paid the specified fee and did not withhold any Korean income taxes.

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109. 1 Isenbergh, supra note 29, § 4.48.
110. JON E. BISCHL, EXPORTATION OF INTANGIBLE INDUSTRIAL PROPERTY AND TECHNICAL ASSISTANCE A-4 (BNA Tax Mgmt. Portfolio No. 44-5th, 1984) ("it appears that services will be considered subsidiary if the value of the property component exceeds the value of the services").
112. Id.
113. The case does not clearly disclose how the fee was calculated.
constitute a permanent establishment under Article 8 (business profits) of the Treaty, PMM was exempted from Korean income tax.\footnote{114} The essential point of this ruling is that a payment will be characterized as a royalty if paid as consideration for know-how. While never expressly discussing the technological gap issue, the ruling was based on comparing the technological level of the service at issue with the domestic level of technology. The N.T.A. issued several rulings declaring that a payment will be subject to royalty treatment if it involves a supply of undisclosed technical information or know-how.\footnote{115} The N.T.A. rulings remain silent about the technological gap.

When addressing mixed contracts, Korean rulings also require a breakdown into the personal service portion and the royalty portion. If the contract itself disaggregates the portions involved in the contract, the tax authorities typically respect the contract, unless it is a related party transaction.\footnote{116}

Similar to the commentary to the O.E.C.D. Model and Revenue Ruling 64-56 in the United States, a Korean Supreme Court case\footnote{117} held that an ancillary factor will be controlled by the character of the main factor and separate valuation will not be required. A Korean military contractor engaged a U.S. corporation for "technology transfer education and training" in connection with remote-controlled model aircraft. The court found that the level of transferred technology was that ordinarily possessed by the enterprises in the industry, and did not significantly surpass the model aircraft used in Korea. The court held the payment to the U.S. transferor should be regarded as a service fee despite the transfer of ancillary know-how. Thus, the payment was not subject to Korean income taxes.

If no provision in the contract provides for a breakdown, the Korean tax authorities will look to the relative level of compensation for the services. In a recent letter, the N.T.A. ruled that "a payment far in excess over the cost of

\footnote{114}{Judgment of July 23, 1991, Daibeobwon [Supreme Court], 904 Beobwon Gongbo 71 (Korea). The Korean Supreme Court rendered a similar ruling in a case involving a corporate resident of Italy, which does not have a tax treaty with Korea. The Italian corporation prepared a technical design and delivered it to a Korean buyer. All the works were performed outside Korea. The design incorporated undisclosed, sophisticated industrial and scientific knowledge and information. The Court ruled that the source of income from such activity was inside Korea. This presupposed that the income was characterized as royalty.}

\footnote{115}{See Waein [N.T.A. Priv. Ltr. Rul.] 1264.37-2313 (July 10, 1982, Korea); see also C.I.T.A. Interpretation 6-1-12, 6-55 (C.I.T.A. Interpretation is a collection of the N.T.A.'s private letter rulings systematically edited by the N.T.A., often translated as "C.I.T.A. Basic General Rules" or "Corporate Tax Basic Guidelines." The legal effect of the C.I.T.A. Interpretation is the same as private letter rulings, which is similar to the effect of private letter rulings in the United States. See GUJJE CHOSE SILMU PYONRAM [INTERNATIONAL TAX PRACTICE MANUAL] (Hyung Soo Lee ed., 1989), for all of the private letter rulings of the N.T.A. cited herein.}

\footnote{116}{For a discussion of the U.S. treatment of this issue, see supra text accompanying notes 107-10.}

\footnote{117}{Judgment of May 9, 1989, Daibeobwon, 851 Beobwon Gongbo 71.}
service plus normal profit" will be deemed a royalty.\textsuperscript{118} This ruling appears to have been mainly revenue motivated.\textsuperscript{119}

The above approach greatly simplifies the characterization issue. Any payment within the range of cost plus reasonable profit will be treated as a service fee. Any payment beyond this level will be regarded as a royalty. Despite its simplicity, however, this approach appears misguided. The conceptual distinction between a royalty and service fee hinges on the technological nature of what the transferor provides to the transferee. If the transfer involves undivulged information, a technology transfer exists. Otherwise, a service transaction exists. Apparently, the purpose underlying the excess profit approach is to prevent a possessor of undivulged know-how from garnering much larger profits than its competitors who do not possess similarly informative technological know-how.

The excess profits approach may suffice as an approximation for determining the existence of know-how where a perfectly competitive equilibrium exists in the general economy. Where this rare condition does not exist, however, excess profit does not necessarily match technological innovation. The cost plus profit approach can play only a limited role as corroborating evidence in finding the existence of know-how. How far the N.T.A. will pursue this ruling remains uncertain.

Contingency basis fees present another difficult issue. One N.T.A. ruling addresses this point. The ruling stated that if the foreign licensor or contractor bases its compensation on the aggregate sales price, the quantity of the products incorporating the technology, or the frequency of the use of the technology, the compensation will be characterized as a royalty.\textsuperscript{120} This ruling appears to be proper. If payment is based on the use of the technology, the technology itself represents the value of the technology to the transferee, rather than the initial work rendered by the transferor.

\section*{IV. Taxation of Service Contracts}

Absent industrial property or know-how, the business profits clause governs technological transactions involving corporations. The Treaty also contains a personal services clause, but this applies only to individuals.\textsuperscript{121} The business profits clause, which covers the "furnishing of services,"\textsuperscript{122} also ap-

\begin{thebibliography}{99}
\item 120. C.I.T.A. Interpretation, \textit{supra} note 115, at 6-1-13. . .55. This issue is not the same as the contingency basis sale of technology which is discussed in part V. Here, our concern is with the distinction between service fee and royalty and not between capital gain and royalty.
\item 121. Treaty, \textit{supra} note 15, art. 18, 30 U.S.T. at 5288-89.
\item 122. \textit{Id.} art. 8(5), 30 U.S.T. at 5274. The Treaty incorporated the U.S. policy of expressly confining the scope of the applicability of the personal service clause to individuals. Applicability of the personal service clause, absent an express provision, is an important issue. See U.N.
\end{thebibliography}
plies to technological services or other personal service fees received by a corporation. Accordingly, Korean taxability of corporation-performed technological services depends upon the permanent establishment principle. Therefore, the key concepts involved in service contract taxation analysis include the source rule, permanent establishment, and effective connection.

In part II, this article argued that the Korean policy behind technology import involved increasing its indigenous domestic technology. Under such a policy, the tax system should not favor the employment of foreign service contractors over the import of disembodied technology that could be accumulated in Korea, because foreign service contractors could choke off domestic technology in an infant stage. Korea's primary interest in taxing foreign service contractors will be in revenue. Revenue, then, should be the guiding principle when interpreting the Treaty provisions for service income.

A. Source Rule for Service Income

Under the Treaty, a host country must limit its tax to the income sourced within the host country. The Treaty provides for a "place of performance" source rule for "income received by a corporation for furnishing the personal services of its employees or others." Accordingly, it may be argued that Korean taxability of service income will be limited to services performed in Korea. Korean taxability, however, can be extended far beyond the place of performance rule, because this source rule is in conflict with both the business profits re-sourcing rule and the permanent establishment rule.

Under the business profits re-sourcing rule, "industrial or commercial profits which are attributable to a permanent establishment... shall be treated as income from sources within that other Contracting State," and such attributable income remains taxable in the host country. Conversely, if not attributable to a permanent establishment, business profit (including personal service income of a corporation) becomes non-taxable in the host country. As a result, the place of performance source rule loses its significance and the host country taxability of corporate personal service income depends exclusively on the permanent establishment and attribution concepts. This circumvention of the source rule forms the basis for expanding the source jurisdiction of Korea as at-

Model, supra note 25, at commentary on art. 14 (demonstrating that a majority of the participants in the drafting of the model treaty were of the opinion that the personal service clause applies only to individuals); see also O.E.C.D. Model, supra note 26, at commentary on arts. 7, 14. But see Kukjo [M.O.F. Ruling] 1260-1-640 (June 15, 1983, Korea).

124. Id. art. 6(6), 30 U.S.T. at 5269.
125. Id. art. 6(8), 30 U.S.T. at 5270.
126. Id. art. 8(1), 30 U.S.T. at 5272.
127. Id.
128. The place of performance rule survives for home country tax purposes. For the purpose of the foreign tax credit, a service income may be sourced as foreign income even though it has not been taxed in the host country. Treaty, supra note 15, art. 5, 30 U.S.T. at 5265-67.
tempted in this article. Otherwise, the boundary of Korean taxability will be limited, both by the place of performance and by the concept of attribution to permanent establishments. Moreover, neutralizing the source rule should not be entirely repugnant to the United States, because the re-sourcing concept in the Treaty originates from the U.S. tax regime. The I.R.C. re-sources some types of foreign source income to their U.S. source if they are attributable to a fixed place of business in the United States. 129

Nevertheless, the C.I.T.A. reinstated the source rule to tax a foreign corporation only on Korean sourced income. 130 The C.I.T.A. uses the place of performance rule for technological services provided by corporate employees. Subjecting “income arising from performing or making available a personal service in Korea” 131 to Korean taxes, the C.I.T.A. uses the place of performance rule for technological service provided by corporate employees. Under the I.R.C., the source of income from personal services also represents the place where the services are performed. 132 Significantly, the personal service source rule covers not only individuals but corporations. 133 The main difficulty with the service income source rule involves matching compensation with services performed in different places, especially if the services are performed by corporate employees engaged in different tasks and receiving widely varying compensation. An allocation standard could be based upon either man-hours or salary. 134

In Korea, a number of letter rulings have been issued regarding the personal services source rule. Involving different treaties, many of these rulings conflict with each other and confuse the Treaty source rule, the C.I.T.A. source rule, and the permanent establishment concept. None of these rulings address the allocation between Korean sourced and foreign sourced income. 135 Several recent rulings implicitly presuppose that the full amount paid to the foreign contractor is sourced within Korea, even though only a part of the services were actually performed in Korea. 136 The facts in these rulings involve services provided partly in Korea and partly outside Korea.

129. I.R.C. § 864(c)(4)(B); see 1 ISENBERGH, supra note 29, §§ 10.7-10.8.3.
130. C.I.T.A. art. 1(3).
131. C.I.T.A. art. 55(1)(6).
133. For a discussion of Hawaiian Philippine Co. v. Commissioner, 100 F.2d 988, 991 (9th Cir. 1939), see WILLIAMS, supra note 99, at A-18. Note that this issue is different from the applicability of a personal service income clause of a treaty to a corporation.
134. See also WILLIAMS, supra note 99, at A-29. See generally 1 ISENBERGH, supra note 29, § 4.18, (discussing, inter alia, Tipton & Kalmbach, Inc. v. United States, 480 F.2d 1118 (10th Cir. 1973)).
135. A detailed discussion of these rulings is not given because they involve a complex issue concerning the applicability of the personal service income clause to a corporation under treaties that do not expressly provide for such applicability. See supra note 122 and accompanying text.
Yet these rulings specify that the amount of payment will be subject to Korean taxes. Other rulings use the language “services made available in Korea” to further broaden the scope of Korean sourced income to include the payment for personal services, the product of which was made available in Korea. The logical extension of the above ruling will impose Korean tax on a service performed entirely outside Korea if the result of the service is used in Korea. For example, if a professional or engineer prepares a document or report outside Korea for use in Korea, payment for such document or report would be Korean sourced income. This result is contrary to other rulings specifying that a payment for a service performed entirely outside Korea does not represent sourced income within Korea.

Application of these far-reaching Korean rulings cannot be prevented by the Treaty source rule of place of performance, because only the C.I.T.A. source rule is applicable to U.S. contractors. Existing C.I.T.A. language suggests that taxing the full amount of payment is not acceptable, because only “income from personal services performed or made available within Korea” is Korean sourced. However, the concern in this article is in designing the tax system. For policy purposes, given that both the Treaty conditions (permanent establishment and effective connection) and the C.I.T.A. source rules must be satisfied before the Korean Government can impose a tax on a foreign corporation, the C.I.T.A. concept of Korean sourced income should be extended, and the reduction of the Korean tax burden should be achieved through the Treaty conditions. Apparently, the Korean tax authorities tried to achieve this objective through interpretation of existing law. This appears doomed by the C.I.T.A. language, which clearly limits Korean sourced income to income from “performing or making available a personal service in Korea.” This expression clearly covers payment only for the on-shore services and expressly excludes services performed offshore. The C.I.T.A. language, “income from making a personal service available in Korea,” is similar to that in the Treaty’s place of performance rule, which defines income as “furnishing the personal servi-

140. Further, the above rulings concerning U.K. corporations are not acceptable under the independent service clause of the U.K. Treaty which subjects “remuneration derived” from “services rendered in” the host country to host country taxation. Convention for the Avoidance of Double Taxation, Apr. 21, 1977, U.K.-Korea, art. 14(1), 1978 Gr. Brit. T.S. No. 65 (Cmnd. 7257) [hereinafter U.K.-Korea Convention].
141. For an analysis of the relationship between C.I.T.A. source rules and treaty rules, see Kim, supra note 138, at 105-08.
142. C.I.T.A. art. 55(1)(6).
143. Id.
ices of its employees or others." At best, the C.I.T.A. language may be interpreted to cover a payment to a contractor that hired a subcontractor to provide a service in Korea. Even if the result of the service is made available in Korea, a service performed outside Korea remains uncovered by the C.I.T.A. language. Existing language in the C.I.T.A. will not justify the extension of the Korean rulings.

Expansion of the Korean sourced income concept requires amending the restrictive expressions of the C.I.T.A. One possible approach would involve incorporating the residence of payor rule as has been done for the source of royalty. Such a provision would label as Korean-sourced a payment for services that are performed outside Korea but produce results used in Korea, as intended by one of the above-mentioned rulings. One serious taxation problem does exist with this approach. It will cover the import of virtually all industrial products. In the modern industrialized world, seemingly no industrial products exist that do not incorporate engineering or technical services. Thus, virtually all payments for the import of industrial products will be sourced within Korea. Although this approach appears extreme, it can work. Even if Korea broadens the scope of sourced income, the tax will be reasonably restricted by the Treaty provision. For a non-treaty country supplier, however, such a scheme could result in a withholding tax on the payment of import sales prices.

Another less polemic approach would provide that any income which Korea can tax under an applicable treaty will be deemed to satisfy the Korean source requirement, without regard to the C.I.T.A. source rule which would otherwise apply. In effect, this approach subjects a treaty country corporation only to the applicable treaty. Under the Treaty, this approach enables Korea to tax a service income derived by a U.S. contractor regardless of the C.I.T.A. source rule, if the income is attributed to a permanent establishment in Korea.

B. Permanent Establishment and Attribution

Service income as a part of business profit is taxable in the host country only when the contractor has a permanent establishment in the host country. The Treaty defines the term "permanent establishment" as a "fixed place of business through which [a foreign corporation] engages in industrial or com-

144. Treaty, supra note 15, art. 6(6), 30 U.S.T. at 5269.
145. See infra note 190 and accompanying text.
146. Specifically, the N.T.A. ruling cited supra note 136.
147. For example, U.S. export sales companies normally can give foreign source to their income by virtue of the title passage rule. Conceptually this implies concession by the U.S. of the importing countries' source jurisdiction. See C.I.T.A. art. 59(1)(1), providing for a two percent withholding tax for profits from a local business without a permanent establishment. Currently, this provision is not enforced at all.
148. See Kim, supra note 138, at 102.
149. Id.
150. See supra text accompanying note 128.
mmercial activity. Similar to the O.E.C.D. or other model treaties, the Treaty expressly enumerates items included in or excluded from the scope of a permanent establishment.

The Treaty does not, however, specify any minimum duration requirement for finding a "fixed" place of business for corporate personal service activities. For a construction or installation project, the Treaty definition of permanent establishment specifies a six month duration as the critical borderline but remains silent on engineering or other technological service projects. The O.E.C.D. Model and the U.S. Model are also silent on such projects. The U.N. Model provides for a six month threshold for consultancy and other services. The C.I.T.A. enumerates a service activity as an example of the permanent establishment while not specifying any minimum duration requirement.

Regarding this issue, several inconsistent Korean rulings exist. One ruling specifies that a sojourn of expatriate engineers dispatched from a foreign corporation for technical assistance, engineering, supervision, or other services regarding a construction project constitutes a permanent establishment irrespective of the duration of their stay in Korea. Apparently, this holding applies only to a non-treaty corporation. For a U.S. or other treaty country corporation, several rulings adopted the six month test. The Supreme Court also implicitly adopted the six month test in the PMM case. The rationale for the six month test is apparently analogous to the six month test applicable to construction, assembly, or an installation project under the applicable treaties.

No U.S. ruling exists regarding the Treaty definition of permanent establishment. Even under other treaties, few rulings address the concept of permanent establishment for a technological service. An I.R.S. ruling issued under the old U.S.-Canada Treaty (effective up to 1984) appears to be the

152. Id. art. 9(2)-(3), 30 U.S.T. at 5275-77.
153. Id. art. 9(2)(h), (3)(f), 30 U.S.T. at 5276-77.
154. U.N. MODEL, supra note 25, art. 5(3)(b).
155. C.I.T.A. art. 56(2)(4).
156. C.I.T.A. Interpretation, supra note 115, at 6-1-27-..56.
159. Almost all of the Korean treaties adopted the six month test rather than the twelve month test for such projects. See e.g., Treaty, supra note 15, art. 9(2)(h), 30 U.S.T. at 5276.
only ruling involving technological service.\textsuperscript{161} A Canadian corporation performed engineering services in the United States for the planning and design of manufacturing plants. The taxpayer had only one project in the United States and the duration of the project did not exceed one year. The U.S.-Canada Tax Treaty did not have any express provision on consultancy or other service activities. The ruling, however, did not mechanically apply the minimum duration requirement. Even a construction project was not the subject of a minimum duration requirement under the then prevailing U.S.-Canada Treaty. The I.R.S. reviewed the role of the engineers dispatched to the United States, the fee structure and the duration of the local activities and ruled that the Canadian engineering company did not have a permanent establishment in the United States.\textsuperscript{162}

Again, as discussed in part II, tax on a foreign contractor should not be less burdensome than on a technology transferor. This policy stance implies that revenue should be the guiding principle for interpreting the Treaty provisions for service income. The threshold for finding a permanent establishment of a foreign service contractor, therefore, should be reduced, because a licensor remains subject to withholding tax. It is not desirable for Korea to set a six month minimum duration for a permanent establishment for service contractors. No minimum duration of local activities is implied by the general concept of a permanent establishment, and no logical necessity mandates an analogy to the construction projects. The commentary to the U.N. Model specifies that a minimum three month test may be adopted for a construction or service project.\textsuperscript{163} An even lower threshold would be needed to achieve the Korean policy of technological development.

As a matter of policy, this position can be substantiated by a comparison with the U.S. system. As the watershed for dividing gross income based and net income based taxation, the I.R.C. uses the concept of "a trade or business within the U.S."\textsuperscript{164} in place of the permanent establishment. Under the I.R.C., a personal service performed in the United States constitutes a U.S. trade or business\textsuperscript{165} and becomes subject to net profit taxation. No minimum duration requirement exists to impose this treatment. In sum, this article argues that any minimum duration requirement should be abrogated as a matter of principle, and transactions should be treated on a case by case basis.

Given the lower threshold, how much of the profits from service activities can be taxed in Korea? The Treaty provides that Korea can tax "such profits as are attributable to the permanent establishment."\textsuperscript{166} If Korea low-

\textsuperscript{162} Id.
\textsuperscript{163} U.N. MODEL, supra note 25, at commentary on art. 5(3).
\textsuperscript{164} I.R.C. § 882.
\textsuperscript{165} I.R.C. § 864(b); see 1 ISENBERGH, supra note 29, § 9.13. The commercial traveler exception is negligible for our purposes.
\textsuperscript{166} Treaty, supra note 15, art. 8(1), 30 U.S.T. 5273.
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ers the threshold for finding a permanent establishment, the attribution rule should serve to limit Korean taxes. It is possible, using the attribution concept, to apportion the profits from the entire project according to the relative importance of local activity to the entire project. Such an apportionment would effectively play the role of the source allocation rule under the I.R.C. that apportions profits based on the man-hours or compensation to the relevant personnel. To prevent manipulation of the data, a time based allocation would be preferable, although the possibility of a compensation based allocation also exists. 167

The attribution rule so interpreted produces the same result as the I.R.C. source rule. A non-treaty country corporation will not benefit from the treaty protection and will be subject to the C.I.T.A. tax liability on the entire amount of Korean sourced income as broadly expanded by the C.I.T.A. A withholding tax can be imposed in the absence of a permanent establishment as defined by the C.I.T.A. 168 Many treaty country corporations could be subject to the same treatment, if the source rule, business profits, or other clause of the applicable Treaty fails to give the necessary protection.

C. Services Related to Import of Foreign Capital Goods

Nonetheless, the lower threshold should not apply to services related to the import of foreign machinery or equipment. Typically, the import of sophisticated machinery or equipment necessitates installation and assembly services by the foreign supplier. The Treaty explicitly specifies that an installation service will not constitute a permanent establishment unless it exceeds six months. 169 The Treaty, however, does not mention the assembly or supervisory service. Thus, the threshold problem could also be raised for these activities. A six month threshold should apply to these activities to the extent they relate to the import of foreign machinery or equipment.

Given the policy purpose of building an independent technology base, the import of foreign machinery or equipment that are at the full disposal of Korean enterprises represents one essential means of accessing foreign technology. As described in the table in Appendix 1, foreign machinery and equipment has played a significant role in furthering the import of foreign technology.

Creating a threshold for finding a permanent establishment for an installation or assembly service that is higher than the threshold for other services is consistent with the F.C.I.A. policy. The purpose of the F.C.I.A. is the inducement of foreign capital. 170 The term "foreign capital" in this sense

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167. Profit apportionment, however, is only a subset of the attribution rule. It is also possible to use a separate accounts method or presume an arm's length profit under the attribution rule. O.E.C.D. MODEL, supra note 26, at commentary on art. 7(2), (4). The non-mechanical aspect of the attribution rule gives broad latitude to Korean tax administration.

168. See supra note 147.


170. F.C.I.A. art. 1.
includes foreign capital goods. 171 The F.C.I.A. provides several preferential measures to facilitate the import of sophisticated machinery and equipment. 172 The F.E.C.A. provides for this preference for the import of foreign machinery by exempting the installation service from the prior approval requirement. 173 These preferences for the import of capital goods support the six month threshold for assembly and supervisory services. A governmental objective of promoting the import of foreign capital goods will be contradicted by the imposition of a lower threshold. Indeed, the U.N. Model provides for a uniform six month test to assembly, installation, and supervisory services. 174

An installation, assembly, or supervisory activity continuing for more than six months constitutes a permanent establishment under the Treaty. 175 The Korean tax base of a permanent establishment will be the amount of income “attributable to” the permanent establishment. One N.T.A. ruling addresses this issue. 176 The Korean tax base will include i) net profit arising from the service activities performed in Korea, and ii) a portion of the equipment of sales profit as attributable to the onshore activities, that is, such portion of sales profit as allocated in proportion to the onshore and offshore revenues. 177

No U.S. ruling has been rendered on this point. Under the Belgium-Germany Treaty, 178 the two countries ruled that the profits from the local assembly works would be taxed in the host country, while the profits from the delivery of the machinery would not be. 179 France and Morocco reached a similar agreement. 180

Despite these contrary rulings, the Korean tax treatment still remains preferable. If the imported machinery cannot be installed by local engineers, the foreign exporter will be unable to sell it to the Korean buyer. In this sense, a part of the sales profit is attributable to the local activities which constitute a permanent establishment. The above mentioned N.T.A. ruling does not discuss treatment of an agreement providing for lump sum payments and not distinguishing between the equipment sales price and the onshore service charge. The N.T.A. would probably calculate the hours actually

171. Id. art. 2(9).
172. F.C.I.A. arts. 36, 41.
173. F.E.C.R. arts. 11-34(1)(3).
174. U.N. MODEL, supra note 25, art. 5(3)(a).
175. Treaty, supra note 15, art. 9(2)(h), (3)(f), 30 U.S.T. at 5276-77.
177. Id.
spent, assess a customary per diem or other charges, and allocate the equipment sales profit.

D. Foreign Tax Credit in the United States as Home Country

According to the Treaty, the United States should allow a credit against the U.S. tax for an appropriate amount of Korean taxes paid by a U.S. corporation subject to the foreign tax credit limitation system.\textsuperscript{181} Foreign tax credits present the following four issues: (i) creditability, (ii) source rule, (iii) classification under the nine basket system, and (iv) carryover of excess credit.

A detailed analysis of these four issues will not be necessary for the purpose of this article, but one observation is noteworthy. Different interpretations of the Treaty can result in double taxation. The source rule is one example. If Korea taxes income as Korean source income while the United States regards it as a U.S. source income, the Korean tax will not be credited against the U.S. tax liability. The 1986 Tax Reform Act worsened this situation for U.S. corporations by reducing the U.S. tax rate and imposing tighter restrictions on foreign tax credit. For the particular category of U.S. contractors discussed in this part, however, the suggested attribution rule will normally achieve the same result of the U.S. interpretation of the place of performance rule. There would be no serious conflicts between the Korean tax treatment under the suggested interpretation and the U.S. interpretation of the Treaty.

Korean taxation of a part of the equipment sales profit requires some analysis. If the United States does not accept that a part of the sales profit is attributable to a permanent establishment in Korea, the Treaty re-sourcing rule will not apply for foreign tax credit purposes. Instead, the Treaty source rule before re-sourcing will bind the United States in granting the foreign tax credit. The Treaty source rule for the sale of machinery or equipment is the place of sale.\textsuperscript{182} Accordingly, depending on the contract, the title passage rule may result in U.S. or Korean sourced income. It can be expected that the U.S. seller and Korean buyer will arrange that the title pass outside the United States so that the profits taxed in Korea will be treated as a foreign sourced income for the purpose of foreign tax credit. As a result, Korean taxes on a part of the sales profits will not deter the inflow of U.S. capital goods.

\textsuperscript{182} For a discussion of the place of sale rule applicable to personal property, see \textit{supra} text accompanying notes 268-71.
Part III discussed the conceptual distinction between royalty and service fee or the property/service dichotomy. A technology transfer transaction that involves property (industrial property or know-how) will be governed by the royalty clause unless the capital gains clause applies. This part will analyze the royalty clause. Additionally, the remaining F.C.I.A. exemption from royalty withholding tax is discussed here.

Under the Treaty, royalties are subject to withholding tax in the source country. If, however, the right or property giving rise to the royalty is effectively connected with the licensor's permanent establishment in the source country, the withholding tax will not apply and the net profit from the royalty will be aggregated with other business profits attributable to the permanent establishment. Taxes paid in the host country will be credited in the licensor's home country. Here, the key concepts are the source rule, permanent establishment, effective connection, and the foreign tax credit.

A. Source Rule For Royalty

The Treaty adopted the place of use standard in defining the source of a royalty. The Treaty provision specifies that "royalties . . . shall be treated as income from sources within one of the Contracting States only if paid for the use of, or the right to use, such property within that Contracting State." The I.R.C. adopts the place of use rule. The C.I.T.A. was also the place of use rule, and the Treaty adopted this concept. Effective January 1, 1990, the C.I.T.A. broadened the scope of Korean-source royalties by incorporating the residence of payor rule. The literal language of the amended C.I.T.A. includes "compensation paid in Korea" as Korean-sourced royalty. Arguably, this phrase should be interpreted to mean payments from Korean corporations or from permanent establishments of foreign corporations in Korea. In relations between the United States and Korea, however, the Treaty overrides the C.I.T.A. and only the place of use rule will apply.

184. Id. art. 16, 30 U.S.T. at 5286-87.
185. Id. art. 14, 30 U.S.T. at 5884.
186. Id. art. 14(1)-(2), 30 U.S.T. at 5284.
188. Id. art. 6(3), 30 U.S.T. at 5268.
190. C.I.T.A. art. 55(1)(9). The C.I.T.A. amendment is meaningful in connection with non-treaty country corporations and a number of treaties which adopt the residence of payor rule. See, e.g., Convention for the Avoidance of Double Taxation, June 19, 1979, Korea-Fr., art. 12(5), 1217 U.N.T.S. 329, 385 [hereinafter Korea-Fr. Convention]. Before the amendment, if a treaty provided for the residence rule, Korean-sourced income of a corporation resident in that treaty country was reduced to such income as satisfied both the C.I.T.A. place of use rule and the treaty rule of residence of payer. See Kim, supra note 138, at 105-08.
The location or place of use of an intangible property is not always obvious. The place of use of a patent or a know-how is the place of manufacture of the related products.\textsuperscript{191} The place of use of a trademark represents a more complex problem. In Revenue Ruling 68-443, the owner of a foreign trademark granted an exclusive license to a U.S. manufacturer, which affixed the mark to goods for shipment to foreign customers.\textsuperscript{192} Rights to use the mark in the United States were owned by an unrelated company.\textsuperscript{193} The ruling held that the place of use of the trademark was the place of use or consumption of the products to which the mark was affixed.\textsuperscript{194} Further, this place was the foreign countries in which the products were used or consumed, i.e., where the use of the foreign trademark was legally permitted, rather than the place of affixation (which was the United States). As a result, the royalties were ruled to be foreign sourced income.\textsuperscript{195} In contrast, the expression “privilege of using” can create U.S. source income even if the intangible property is not actually used in the United States.\textsuperscript{196} The same should hold true under the Treaty expression of the “right to use” a property in Korea.

The conclusion of Revenue ruling 68-443 cannot be incorporated into the Korean tax rules. Under the restated Trademark Act of Korea,\textsuperscript{197} affixation also represents a use of a trademark and can be subject to an infringement action. If the licensee sells its product to a dozen countries in different proportions, prorating royalty income commensurately with the sales revenue is almost impossible. From a macro-aspect, the reciprocal adoption of Revenue Ruling 68-443 would result in revenue loss to Korea, because Korea is a technology importer.

\section*{B. Permanent Establishment and Effective Connection}

If the U.S. transferor creates a permanent establishment in Korea and effectively connects a royalty received with that permanent establishment, the royalty income will be attributed to the permanent establishment and taxed on a net income basis.\textsuperscript{198} If a foreign corporation maintains a branch in Korea, and the branch engages in a licensing business or develops technology and licenses it to a Korean corporation, the license fee will clearly be attributed to the branch.\textsuperscript{199} In reality, however, such foreign corporation branch
cases are rare in Korea, because manufacturing activities exist only in the subsidiary form.\footnote{See Chang Hee Lee & Byoung Kook Min, Legal Aspects of Establishing a Business Presence in the Republic of Korea, 3 TRANSNAT'L LAW. 49 (1990).}

This portion of the article focuses on whether the human activities related to a technology transaction conducted in the host country can constitute a permanent establishment. The face-to-face training of the application of technology represents a typical example. In the context of a service contract, some Korean rulings have held that even a single local activity can constitute a permanent establishment.\footnote{This issue was discussed in part IV. See supra text accompanying note 156.} Assuming a bottom limit threshold for permanent establishments as proposed in this article,\footnote{See supra text accompanying notes 163-65.} should local activities performed by the engineers or technicians dispatched by the licensor constitute a permanent establishment of the licensor?\footnote{In the context of treaties between Canada and several Asian Pacific Rim countries, it has been noted that mere ongoing assistance or personal training in a technology transfer agreement may trigger a permanent establishment. See BROWN, supra note 78, at 17.}

In Korea, one N.T.A. ruling held that a service conducted as a means of transferring technology will be deemed a part of the technology. Conversely, a service that is not connected to the technology will be deemed a separate service.\footnote{C.I.T.A. Interpretation, supra note 115, at 6-1-28-95. Under this ruling, if the service includes both of these two types of service, the total payment will be allocated by the content of the contract or a reasonable standard of allocation.} Because of this ruling, personal services will be disregarded for tax purposes if the corporation provides the services as a means of technology transfer. Under this ruling, a permanent establishment will normally not arise even where the licensor locates its employees in Korea for a considerable period of time, as long as the employees confine their roles to the technology transfer. This contrasts sharply with technological service projects, to which the Korean rulings apply a six month threshold to find a permanent establishment for Treaty country corporations. This article goes beyond these rulings to argue for the elimination of any minimum duration requirement.

Presupposing a bottom limit threshold for permanent establishment for service income, the policy choices here include gross basis and net basis taxation. Under either alternative, the payment is not tax exempt. Accordingly, the ruling can be supported from a tax administration perspective. Breakdown will increase tax administration and taxpayer compliance costs while having a negligible, or even a negative, revenue effect.

C. F.C.I.A. Tax Exemption from Korean Withholding Taxes

Under the Treaty, the C.I.T.A. withholding tax rate is limited to ten percent for copyright or film royalties and fifteen percent for industrial or other royalties.\footnote{Treaty, supra note 15, art. 14(1), (2), 30 U.S.T. at 5284.} Considering the non-Treaty Korean local tax of 7.5%,\footnote{Treasury, supra note 15, art. 14(1), (2), 30 U.S.T. at 5284.}
the withholding tax rate is 10.75%\textsuperscript{207} for copyright or film royalties, and 16.875%\textsuperscript{208} for industrial or other royalties.

The withholding tax may be exempted under the F.C.I.A. tax holiday,\textsuperscript{209} but the exemption requires ministerial approval. Currently, ministerial approval is mandated and available only when the duration of the contract exceeds three years and the royalty amount is above a defined threshold level. The threshold level is $100,000 for a lump sum payment, and $50,000 for a down payment, plus two percent for running royalty.\textsuperscript{210} Furthermore, the government grants tax holidays only for technology satisfying the M.O.F. standard. The standard, designed after review by a statutory committee, is intended to give tax holidays to such technology that is imperative to the national economy and difficult to develop independently within Korea.\textsuperscript{211} The current standard of tax exemption as published by the M.O.F. is as follows:\textsuperscript{212}

1. The technology must be used in one of the specifically listed activities. These activities are defined by manufactured product or by line of industry. They include limited products of machinery, electronics, defense, petroleum refining, precision chemistry, bio-engineering, new materials, and alternative energy sources.
2. The process requiring the technology must be conducted in Korea.
3. The technology must be new to Korea. If the same or similar technology was introduced into Korea more than four years prior, the tax exemption will not be granted.
4. The technology must significantly enhance the national economy in terms of industrial restructuring and competitiveness.

If qualified, the technology will be exempt from Korean income taxes for five years from the date when the agreement was accepted by the approval ministry.\textsuperscript{213}

As previously stated, the policy purpose of the F.C.I.A. tax incentive is to develop domestic technological capabilities,\textsuperscript{214} and the tax break only applies to technology imperative to the national economy and difficult to develop independently.\textsuperscript{215} However, the current system does not have any measures to ensure that the tax-benefitted technology actually fulfills the

\textsuperscript{206} Jibangse Beob (Local Tax Act], Pub. L. No. 827, amended by Pub. L. No. 4415, art. 176(2) [hereinafter Local Tax Act].
\textsuperscript{207} 10\% (C.I.T.A. withholding tax rate) x 1.075 (local tax) = 10.75\%.
\textsuperscript{208} 15\% (C.I.T.A. withholding tax rate) x 1.075 (local tax) = 16.875.
\textsuperscript{209} F.C.I.A. art. 24; see supra part II for the history of the F.C.I.A. tax break.
\textsuperscript{210} F.C.I.A. E.D. art. 4(3); M.O.F. Goshi [Notice], supra note 60.
\textsuperscript{211} F.C.I.A. E.D. art. 24(2). The committee mentioned in the text is the Foreign Capital Inducement Review Committee, which is essentially the cabinet plus several other members. Id. art. 39(1).
\textsuperscript{212} M.O.F. Goshi [Notice], supra note 60, art. 12-1.
\textsuperscript{213} F.C.I.A. art. 24(1).
\textsuperscript{214} See supra text accompanyig notes 68-76.
\textsuperscript{215} F.C.I.A. E.D. art. 24(2).
stated intention. There are no specific standards by which to measure the abstract principles declared in the F.C.I.A. E.D. and the M.O.F. Instruction. The system also lacks follow-up measures to monitor the contribution of the imported technology to the national economy. Therefore, a licensee and the licensor obtaining the necessary approval obtains a guaranteed five year tax holiday regardless of the actual contribution of the technology to the national economy.

The F.C.I.A. should develop and implement a monitoring system to re-view the importance of the technology in the national economy. The specific assumptions that supported the initial grant of the tax break should be periodi-cally reviewed as a continuing condition for the tax exemption. If the technology does not actually produce the expected effect on the national economy, the tax break should be reduced or canceled.

D. F.C.I.A. Tax Incentives for Foreign Investment and Its Defect

Elaboration on the tax exemption standard and follow-up measures are necessary not only for the royalty withholding tax, but also for foreign invest-ment tax incentives in general. As discussed in part II, under the current F.C.I.A., the development of domestic technology represents virtually the only occasion to grant tax incentives for foreign investment. The F.C.I.A. provides exemptions for the Korean subsidiary's corporate income tax, the dividend withholding tax, and the local taxes on property. However, Korea grants these exemptions only where the foreign investment project involves sophisticated technology necessary for the restructuring of the national economy and furthers a national competitive edge.

The specific tax exemption standards under these provisions are similar to the standard applied to the technology import tax incentives. Several provisions govern the tax exemption follow-up. These measures were designed when the F.C.I.A. granted broad tax incentives for foreign investment. These measures no longer apply as effectively now that tax incentives are only exceptionally available. The current F.C.I.A. provides for the retroactive or future cancellation of foreign investment tax breaks for the corporate income tax, dividend withholding tax, and local tax only when the foreign investor satisfies certain requirements. Tax benefits may be cancelled if the foreign invested company i) does not introduce the foreign currency or capital goods as approved within two years or some extended period, ii) ceases operation or suspends it for two years or more, iii) commits an illegal or improper act and does not follow the governmental order for correction,

216. See supra text accompanying note 75.
217. See F.C.I.A. art. 14(1)(1); F.C.I.A. E.D. art. 13(1).
218. See M.O.F. Goshi [Notice], 91-20, art. 48 (Dec. 19, 1991), (virtually the same as M.O.F. Goshi [Notice], supra note 60, art. 11, except for minor occasions of tax exemptions existing in connection with free export zones).
iv) misuses the introduced foreign currency or capital goods, or v) falls under several other minor cases specified in the F.C.I.A. Unfortunately, the above causes for the cancellation are unrelated to their actual contribution to the national economy.

E. Reformulation of the Standards for Tax Incentive

What factors should be considered for furthering the policy of increasing domestic technology? If technology transfer occurs in an intra-company setting as part of a foreign investment, the most typical form of technology transfer, designing criteria assessing the effect on the national economy involves delicate issues. As G. Sipa-Adjah Yankey notes, "technology transfer is never complete until it is absorbed and diffused throughout the transferee country's industry." A technology has not been transferred in the national economic development sense when kept only by the MNC's local subsidiary. In many cases, the transfer of skills is incomplete, particularly in critical high-level management and engineering. In part, this is due to deliberate decisions of the parent company to retain expatriates in key positions. Further, even if the MNC hires local Koreans for the technological positions, the same result can occur because the Korean employees are the employees of the MNC organization.

In the U.N. formulation, technology transfer consists of the following three stages: i) acquisition of technology, ii) assimilation and diffusion, and iii) development of indigenous capabilities. Obviously, the important stage for the development of the national economy would be the assimilation and diffusion stage, that is, when the technology diffuses beyond the local subsidiary. Enos and Park recognize that technology transfer at the level of a firm must be distinguished from national absorption. Yet, they identify the latter with the replacement of expatriates by Korean engineers and the subsequent increases in productivity. Although concluding that absorption of imported technology to the Korean national economy has been "rapid and successful," they found that the diffusion of the imported technology has been insignificant.

As the MNCs strive to achieve firm level absorption for their own benefit, policy emphasis should be placed on the assimilation and diffusion stages. A license to an independent Korean entity comes closer to achieving the pol-

220. F.C.I.A. arts. 17, 18.
221. See supra text accompanying note 9.
223. U.N. Centre on Transnat'l Corps., supra note 7, at 180.
224. Id. For a more sophisticated model in the same direction, see ENOS & PARK, supra note 4, at 5-12.
225. ENOS & PARK, supra note 4, at 104.
226. Id. at 104-05.
227. Id. at 103-06.
icy objective, but does not necessarily justify granting a tax incentive. Foreign technology import will have little effect on the national economy if the licensee is legally restricted in the use of the technology. If an MNC hires a Korean firm as a contractor and transfers technology to manufacture the product, technology flows to the Korean contractor. However, if the contractor is forbidden from using the technology for any purpose other than the manufacture of the MNC product during and even after termination of the contract relationship, the technology has not actually been transferred to the national economy.

Policy makers need to pay particular attention to creation of linkages to the national economy. The tax policy involved when granting F.C.I.A. tax incentives should include consideration of the position of the licensee in the nexus of the national economy. If the licensee is a subsidiary of an MNC, the diffusion of the technology backwards (to local vendors), forwards (to local buyers), or laterally (to competitors through labor mobility) should be the criteria. If the licensee is not related to the licensor, the legal nature of the technology transfer contract must be carefully reviewed to determine the availability of the tax break. If the Korean government concludes that imported technology will contribute to domestic technological capabilities, the specific assumptions underlying this conclusion should be imposed as conditions for the tax incentive grant. Compliance should then be monitored.

F. Tax Sparing Credit and F.C.I.A. Tax Break

Is the F.C.I.A. tax break effective in attracting U.S. technology? Here, the tax sparing credit represents a key concept. The use of tax sparing credit by the United States allows U.S. licensors to credit against U.S. taxes the amount of taxes waived by the Korean government under the F.C.I.A. or other tax incentives. The Treaty did not adopt a tax sparing credit, although the Korean Government has been granting tax holidays under the F.C.I.A. and its predecessors. The United States has adamantly defied any developing country's attempts at tax sparing credits since 1959 when Stanley Surrey testified before the Senate that the tax sparing credit should be

228. U.N. Centre on Transnat'l Corps., supra note 7, at 182; see also Enos & Park, supra note 4, at 247-57 (for policy implications).

229. Korea regulates restrictive business practices of MNCs (e.g., export restrictions or handling of competitive products) as part of the antitrust law measures. The standard for such review could be relevant for tax incentive decisions as well. See Hyun, supra note 58, at 69-80 for an analysis of these measures before they were amended by Kukje Geyaksang Bulgongsjeong Georai Eui Beomwi Eh Kwanhan Kijun [Standard of Unfair Trade Practices in International Agreements], No. 90-9, (July 5, 1990).


abolished from the draft treaty with Pakistan. Surrey's argument formed the basis of later U.S. policy. Essentially, he argued that the tax sparing credit unfairly benefits overseas investors. These investors typically represent the largest and wealthiest corporations. Further, the credit also impedes capital export neutrality.

In contrast to Surrey's argument against the tax sparing credit, developing countries have tried to incorporate the tax sparing credit. Most developed countries, with the exception of the United States, have accepted the tax sparing credit. Many Korean treaties contain the tax sparing credit provision, although the exact mechanism differs depending upon the treaty. Without the tax sparing credit, a unilateral tax incentive granted by a developing country will only shift revenue from the source country to the home country. The tax holidays granted by a host country will benefit foreign investors only with a tax sparing credit system. According to economist Dan Usher,

in the absence of tax sparing, the incentive boils down to a transfer of income from the government of the host country to the government of the home country of the investing firm, leaving the firm no better off than it would have been in the absence of the incentive.

From this analysis, the F.C.I.A. tax incentive can be seriously criticized. Approximately forty-five percent of the royalties have been paid to the United States. Thus, almost half of the tax waived by the Korean Government has been directly transferred to the United States. If Korea had simply disqualified U.S. licensors from the F.C.I.A. tax holiday, the Korean Government would have collected the revenue without discouraging technology import.

In reality, the mechanism of the tax sparing credit is more complex. A more sophisticated analysis concludes that revenue shifts will occur only when new equity capital finances the investments, the profits are repatriated, and no excess credit exists. The first two conditions involve complex theoretical and empirical aspects.

The third condition regarding excess credits becomes particularly significant when the foreign effective tax rate on foreign sourced income exceeds the effective tax rate in the home country. Given excessive credit, a unilateral

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233. Id. at 27.
234. Qureshi, supra note 231, at 38.
236. Qureshi, supra note 231, at 38.
237. See Dan Usher, The Economics of Tax Incentives to Encourage Investment in Less Developed Countries, in TAXATION IN DEVELOPING COUNTRIES, supra note 79, 165, 168.
238. See Appendix 1; Kim Linsu, supra note 53, at 263.
239. See Usher, supra note 237, at 165.
reduction of host country tax will be attributed to the taxpayer rather than the home country government. At present, an excess credit situation exists in most U.S.-based MNCs since the corporate tax rates were reduced in the 1986 Tax Reform Act. Thus, a tax sparing credit would not effectively change the behavior of U.S. corporations, and the F.C.I.A. tax incentives would likely be attributed to the U.S. licensors rather than the U.S. Government. Consequently, the defect in the F.C.I.A. tax incentive may be left intact for the moment. If the tax rates in the United States and other countries later converge, the F.C.I.A. tax incentive will have to be reconsidered with respect to the treatment of U.S. corporations. A possible approach would require the foreign licensors to substantiate that the F.C.I.A. benefit will accrue to themselves rather than the home country governments.

VI. TAXATION OF TECHNOLOGY SALE

The Treaty also contains a capital gains clause. This clause exempts all capital gains from a host country tax. Under this clause, a U.S. corporation “shall be exempt from [Korean tax] on gains from the sale, exchange, or other disposition of capital assets unless . . . . the property giving rise to the gain is effectively connected with a permanent establishment” of the U.S. corporation in Korea. If technology as a form of property falls under the capital gains clause, any gain on its sale will be exempt from the source country tax. If the proceeds from the sale, exchange, or other disposition, however, are “contingent on the productivity, use, or disposition of such property or rights,” they will be taxable in the host country. If the United States is the home country, capital gain will be taxed at a lower rate, subject to gain and loss netting requirements for foreign tax credit purposes. The key concepts here are the source rule and the distinction between a license and sale of technology.

240. Ross, supra note 19, at 334. Relevant statistics after the 1986 Tax Reform Act were unavailable to the author. Even before that, however, U.S. corporations in total were in an excess credit situation. See Vergie Mose, Corporate Foreign Tax Credit, by Industry, 1984, in I.R.S. Stat. of Income Bull. 57, 60 (Winter 1989-1990).


243. Id. art. 16(1)(b), 30 U.S.T. at 5286-87. The permanent establishment issue in the capital gains context is no different from the technology license context discussed in part V. In part VI it is assumed that the U.S. corporation does not have a permanent establishment in Korea to which the gain is effectively connected. Likewise, in discussing the I.R.C. treatment, it is assumed that the gain is not effectively connected with a U.S. trade or business.

244. Id. art. 14(3), 30 U.S.T. at 5284.

245. Id. art. 14(4)(b), 30 U.S.T. at 5285.

246. I.R.C. § 1(h).

247. Id. § 904(b)(2).

The Treaty provisions reflect the I.R.C. approach to taxing foreign licensees. The C.I.T.A. does not distinguish between a sale and a license of an intangible property. The concept of royalty encompasses both gains on sales and license fees. The I.R.C. uses the sale versus license dichotomy in taxing a technology transfer transaction. Royalties for the use of intangible property are regarded as "fixed or determinable annual or periodical" income and are subject to a flat rate withholding tax. In contrast, absent U.S. trade or business, gains from the sale of intangible property remain free from U.S. tax. A contingent basis sale of intangible property will be subject to royalty treatment. The necessity and effect of the sale versus license distinction under the Treaty and the I.R.C. remains unchanged, except for the conceptual differences between a permanent establishment and a U.S. trade or business.

B. "Capital Assets": Unilateral Inapplicability of the Capital Gains Clause

The use of the term "capital assets" in the Treaty presents a perplexing issue. The drafters of the Treaty (at least those in the U.S. Treasury) understood that a sale of intangible property would be governed by the capital gains provision unless done on a contingency basis. The U.S. Treasury Technical Explanation regarding Article 14 of the Treaty states:

The term [royalty] also includes gains derived from the sale, exchange, or other disposition of any such property or rights... to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 16 (Capital Gains) will apply.

The term "capital gains" as used in Article 16 of the Treaty is also troublesome. This term has a statutory meaning under the I.R.C., but no comparable concept exists under the C.I.T.A. The term "jabon jeok jasan" (the Korean language correspondent used in the Korean version of the Treaty)
cannot be found anywhere in the C.I.T.A.257 A similar problem exists in the U.S.-Germany Treaty of 1954. The English version uses the term capital assets, but the German version uses the term “Vermögenswerte,” meaning assets in general.258 The International Bureau of Fiscal Documentation (IBFD) Handbook suggests that the U.S. tax authorities follow the English version and German tax authorities follow the German version.259

One N.T.A. ruling, addressing the issue of capital gains derived by a U.S. corporation from the disposition of shares in a Korean affiliate,260 held that the capital gain would not be taxed in Korea under Article 16 of the Treaty.261 In this ruling, however, the N.T.A. failed to consider important policy considerations in its interpretation of the Treaty. Another interpretation could better fulfill Korean policy objectives while remaining within the confines of the Treaty. Under the Treaty, an undefined term will be interpreted under the laws of the country whose tax is involved, until the competent authorities establish a common meaning of the term.262 The term “capital assets” or its Korean equivalent is meaningless under the C.I.T.A., and the exemption of “gain on the disposition of capital assets” is meaningless to the extent that Korean taxes are concerned. As a result, the capital gains provision may apply to the United States, but not to Korea.263

In many treaties, a category of income left out of a treaty is ruled by the other income clause. For example, the O.E.C.D. and U.S. Models have other income clauses that provide for exclusive taxation by the country of residence.264 Unfortunately, the Treaty lacks an other income clause. As a result, the Treaty does not cover a capital gain from the sale of an intangible property accruing to a U.S. corporation and, therefore, the sale will be taxed by the C.I.T.A. Korea can tax the capital gains derived by a U.S. corpora-

257. It should be noted that both the English and Korean versions are official.
259. HELMUT DEBATIN & OTTO L. WALTER, HANDBOOK OF U.S. GERMAN TAX CONVENTION ¶ 27 at 23 (1977) (commentary on art. 9(a)).
261. Before the 1986 Tax Reform Act in the United States, Korea taxed the capital gains derived by a U.S. corporation on the disposition of shares issued by a Korean corporation, because the Treaty, supra note 15, art. 17, 30 U.S.T. at 5287 (the holding company investment clause), subjects a capital gain to host country tax if the home country awards tax preference for such gain. After U.S. abrogation of the capital gains preference in 1986, the N.T.A. exempted such a capital gain. Given the resurrection of capital gains preference in the United States by the 1990 Revenue Reconciliation Act, it can be anticipated that Korea will again tax capital gain derived by U.S. corporations. Therefore, no difference will exist between the N.T.A. position and this article so long as the I.R.C. maintains a capital gains preference.
263. Under the rules of the Vienna Convention on Interpretation of the Law of Treaties, if discrepancies between different language versions cannot be reconciled, the provision is inapplicable. See VOGEL ET AL., supra note 17, at 28.
264. O.E.C.D. MODEL, supra note 26, art. 21; U.S. Model, supra note 30, art. 21.
tion, regardless of the presence or absence in the United States of a capital gains preference.265

C. Treaty Source Rule: Place of Sale

The applicability of the Treaty source rule presents a further problem. The Treaty does not contain a separate source rule for the disposition of capital assets. Thus, the source rule for capital gains is covered by the source rule for sale of personal property, which cannot be challenged.266 The source rule of place of sale still binds Korea when taxing intangible property capital gains, although the capital gains clause itself is arguably meaningless for the purpose of Korean taxes. A capital gain, like any other income, can be taxed by Korea only if sourced within Korea.267 Accordingly, a review of the Treaty source rule for capital gains is necessary.

The C.I.T.A. source rule for the sale of intangible property is the place of use or the residence of the payor.268 Although the C.I.T.A. language is ambiguous, a U.S. corporation selling technology for use in Korea can easily satisfy the Korean source rule. Further, the issue here is the policy behind, not the interpretation of, the existing C.I.T.A. language, because the C.I.T.A. language can be amended to enable taxation if necessary. The more difficult issue is the Treaty source rule of place of sale. Under the Treaty, "income from the purchase and sale of intangible ... personal property (other than [a contingency basis sale]) shall be treated as income from sources within one of the Contracting States only if such property is sold in that Contracting State."269

The Treaty rule of place of sale originates from the I.R.C. before the 1986 Tax Reform Act. "Gains, profits, and income derived from the purchase of personal property without the U.S. ... and its sale or exchange within the U.S." were sourced within the United States.270 The place of sale was the place of effective delivery of the property, that is, where the beneficial ownership and title passed to the purchaser.271 A number of cases determined the source of income for the sale of non-instrumental property (e.g., patents, copyrights, trademarks, and know-how) by the place of contract acceptance.272

In AMP, Inc. v. United States,273 however, the court ruled that the title passage test makes little sense for the sale of a patent.274 A U.S. corporation

266. Id. art. 6(7), 30 U.S.T. at 5270.
267. C.I.T.A. art. 1(3).
268. See supra text accompanying note 190.
269. Treaty, supra note 15, art. 6(7), 30 U.S.T. at 5270.
270. I.R.C. § 861(a)(6).
271. See 1 ISENBERGH, supra note 29, § 4.30.1 (discussing Compania Gen. v. Collector, 279 U.S. 306 (1929)).
274. Id. at 34.
had granted exclusive licenses of patents for the life of the patents to its subsidiaries in each country where a subsidiary was located.\footnote{Id. at 29.} One issue in this case involved the sale versus license distinction.\footnote{Id. at 31-33.} Even assuming that payments received by the taxpayer were proceeds from a sale, the proceeds qualified as foreign source income because the sales occurred outside the United States.\footnote{Id. at 35.} The court rejected the Government’s argument that title to the patent passed in Pennsylvania simply because the language of the agreements provided that they were made in Pennsylvania.\footnote{Id. at 34.} The court noted that patents are effective only in the issuing country.\footnote{Id. at 35.} The court held that the place of title passage was not applicable under the following facts and circumstances: i) all the goods were manufactured outside the United States, ii) the goods were sold by companies outside the United States and all payments under the agreements came from these companies, and iii) the only connection the United States had with the relevant patents and transactions was that AMP was a domestic corporation and the agreements were formally signed in the United States.\footnote{Id.}

One commentator stated that the AMP decision effectively restricts the title of passage rule to truly portable personal property.\footnote{WILLIAMS, supra note 99, at A-40. Under the current I.R.C., however, the place of sale rule defined by title passage applies only to inventory. I.R.C. § 861(a)(6). Other personal property including intangibles is sourced by the residence of the seller. I.R.C. § 865(a), (d). The 1986 amendment to I.R.C. § 865(a) and (d) will override AMP Note, however, that our issue here is not the I.R.C. source rule, but the interpretation of the Treaty source rule of place of sale. Accordingly, AMP is still valid for purposes of this article.} A patent has effect only in its country of issue and is not movable.\footnote{AMP, 492 F. Supp. at 35.} Under AMP, then, the sale of a Korean patent from a U.S. corporation to a Korean corporation will be sourced within Korea.\footnote{Id.}

U.S. courts will probably extend the AMP logic to all intellectual property. The law of a given country creates the intellectual property right in that country.\footnote{Id.} If that right is assigned or transferred, the place of sale remains, by definition of intellectual property rights, in the country under whose law the property was created and continues to exist.\footnote{Id.} A Korean patent does not exist outside Korea,\footnote{Id.} and the place of sale cannot be anywhere except Korea.\footnote{Id.} Accordingly, if Korea decides to tax the income derived by a U.S. corporation from the sale of a Korean intellectual property right in Korea,
AMP will estop the United States from denying the source jurisdiction of Korea.

What about technology not patented in Korea? A U.S. patent not registered in Korea represents such a technology. Korea does not protect the U.S. patent per se. The U.S. patent is considered know-how unless registered in Korea. It is possible that, for the purpose of interpreting the Treaty source rule of place of sale for unpatented technology, the U.S. court will return to the title passage test and apply the place of acceptance or other standards based on the technicality of the contract terms. For example, if the information can be sufficiently transferred in recorded form and no personnel are dispatched, the delivery of the information closely resembles the transfer of tangible property.

Korea does not need to follow the title passage test to define the know-how source rule under the Treaty. From a host country point of view, distinguishing between patented and unpatented technology is unnecessary, because the technologies are used identically in Korea whether patented or not. Moreover, the title passage test allows the seller and buyer to arbitrarily manipulate the taxability of the profit in a country.

D. Setting Korean Tax Rate for Sale of Technology

In the previous section, this article argued that Korea can tax gains from a sale of patented or unpatented technology to be used in Korea under the C.I.T.A. and the Treaty source rule of place of sale. Under the existing C.I.T.A., a 26.875% withholding tax applies on the gross payment. This represents a far higher tax than the Treaty withholding tax on a royalty. This result is not justifiable from a Korean policy perspective. To further the goal of building an independent domestic technology base, the purchase of technology should not be subject to a greater tax burden than a license of technology. The C.I.T.A. withholding tax rate for the technology sales price should be lowered at least to the level of the Treaty withholding rate on royalties. Korea may decide to allow the deduction of basis for the seller of technology, but this complicates tax administration. Maintaining the current C.I.T.A. policy of gross income based taxation would be preferable.

If the redesigned C.I.T.A. disallows the deduction of basis and imposes approximately the same withholding tax rate as the Treaty, the final tax burden on U.S. technology sellers will not be heavier than that on U.S. licensors. In fact, the burden may possibly be lower, if the capital gains preference applies in the United States. This result is consistent with the Korean policy

289. C.I.T.A. art. 59(1)(3); Local Tax Act art. 176(1)(2).
290. For a discussion of the conditions for capital gains treatment for U.S. technology transferors, see BISCHL, supra note 110, at A-2 to A-4.
target. Finally, note that any F.C.I.A. tax break applicable to foreign licensors will also have to apply to foreign technology sellers.

E. License versus Sale

According to the interpretation of the Treaty proposed in this article, the sale/license dichotomy does not determine the taxability of U.S. technology transferors in Korea. The distinction is nonetheless necessary because Korean tax treatment could be changed. The royalty clause of the Treaty governs a license transaction. A sales transaction, arguably not covered by the Treaty, would be taxed under the C.I.T.A. The license/sale distinction is necessary for U.S. tax purposes as well for determining foreign tax credits (characterization under a particular basket and different source rules) and capital gains preference.

An assigned intellectual property right clearly represents a sales transaction. An issue arises principally for exclusive licenses. In Myers v. Commissioner, the Tax Court held that a license will qualify as a sale if it is both effective for the life of a patent and exclusive within a designated territory. In Coplan v. Commissioner, the Tax Court reaffirmed the principle that sale treatment may still be given to an exclusive license of a patent if the patent satisfies the Myers conditions: life of license and exclusivity. This result is unaffected by any licensor’s right to terminate the license for either the licensee’s insolvency or failure to meet quantity requirements. Moreover, the I.R.S. has indicated that the sale treatment of an exclusive license presupposes that the licensed trademark or know-how must be legally protected in the country of transfer. The transferor must transfer the right to enjoin others from use or disclosure of the technology in the territory or field of transfer.

To summarize, three requirements for sale exist: i) perpetual transfer, ii) exclusive transfer, and iii) vesting the power of protection of the transferred

292. the C.I.T.A. withholding tax rate on gain from sale of technology is designed to be the same as the Treaty rate on royalty and the C.I.T.A. does not allow deduction of basis, the sale/license distinction will not be necessary.
293. I.R.C. § 904(d).
295. I.R.C. § 1(h).
296. 6 T.C. 258 (1946). This case involved payment contingent on the sales of the products. Under the current I.R.C., the conclusion would be different. See supra note 253.
297. 6 T.C. at 263-64.
298. 28 T.C. 1189 (1957).
299. Id. at 1191.
300. Id. at 1190.
property. The sales treatment remains unaffected when the transferor reserves either the right to institute an infringement action (provided that the transferee also has such power) or the right to terminate the agreement upon breach or technical breach.

From a Korean policy point of view, the characterization of a transaction as an exclusive license should depend upon its contribution to the build-up of the domestic technological base. If a license satisfies the three conditions for a sale treatment under the U.S. law, this policy purpose is well served. One further condition should be imposed for sale treatment: a serious restriction on the use of technology should disqualify the sale treatment. If the licensed technology can be used only to produce items to be supplied to the licensor or its affiliates under an exclusive sales or distribution agreement, the technology should not be considered to have been purchased in the national economic sense. Territorial restriction would not present a serious problem. Despite a territorial restriction, a licensee would have command over the technology within the unrestricted territory. If the territorial restriction were so broad as to virtually prohibit a sale to any entity other than the licensor or its affiliate, the license would not benefit from the sale treatment.

F. Source Rule for a Contingency Based Sale

The Treaty provision for contingency based sales of intangible property originated from the Foreign Investors Tax Act of 1966.305 The intention was to tax a contingency based sale by the rule of place of use of the property. Toward this end, the I.R.C. specifies that the “source of [contingent] payments shall be determined . . . as if such payments were royalties.”306 The Treaty provides that gains from a contingency based sale are included in the definition of a royalty and taxed in the host country where the gains are sourced.307 Under the suggested interpretation of the Treaty, however, the contingency based sale provision loses its importance, because an outright sale is also taxable in Korea as the host country. For this reason, the distinction between a contingent and an outright sale becomes unnecessary in this article. Nevertheless, the contingency based sale provision deserves some analysis, because another problem arises in the interpretation of the Treaty.

The Treaty includes a contingency based sale under the concept of royalty. Under a literal reading of the Treaty, however, a contingent sale is not governed by the royalty source rule. The royalty source rule (place of use) only covers “payment . . . for the use of, or the right to use, property” and

303. For a detailed description, see BISCHEL, supra note 110, at A-2 to A-4.
304. Id. at A-2 to A-3.
305. See 1 ISENBERGH, supra note 29, § 8.20.
308. For more on the concept of contingency in the I.R.C., see 1 ISENBERGH, supra note 29, § 8.20 (discussing Treas. Reg. § 1.871-11).
does not cover a contingent sale.\textsuperscript{309} The royalty source rule is silent about the contingency based sale. The contingency sales gain is not ruled by the source rule for sale of personal property either, because it was expressly left out from this rule.\textsuperscript{310} Apparently, the drafters of the Treaty (at least in the U.S. Treasury) believed the royalty source rule would apply to the contingency sales gain.\textsuperscript{311} The Treaty was incorrectly drafted for that intention, however. The misdrafting makes no difference for U.S. tax purposes, because the I.R.C. source rule for the contingency based sale is the place of use.\textsuperscript{312}

When Korea is the host country, however, this misdrafting presents an interesting issue. The C.I.T.A. source rule will apply by operation of the general compensatory source rule of the Treaty.\textsuperscript{313} According to the compensatory source rule, an undefined source should be defined by each country in accordance with its own law.\textsuperscript{314} Under the C.I.T.A., the royalty source rule covers gains from a contingency basis sale. As discussed above, Korea arguably recently expanded the C.I.T.A. source rule for royalties to incorporate the “residence of payor” rule.\textsuperscript{315}

A contingency basis sale capital gain will be sourced within Korea upon satisfaction of either the place of use rule or the residence of the payor rule. Consistent with the original intention of the Treaty drafters, the contingency based sale gain will be taxed in Korea if the place of use is in Korea. The taxation of Korean companies that purchase U.S. intangible property for use in their U.S. operations, however, could provide a different answer. Korea can resort to the residence of payor rule and characterize such payment as Korean sourced income if it is based on a contingency. As more and more Korean companies become internationalized, this will be a potentially significant issue. The U.S. Government will likely object to such a characterization, because the place of use rule is a long standing U.S. tax policy. According to the policy analysis presented in this article, such a revenue motivated attempt will be unjustified, resulting only in difficulty for Korean corporations wishing to acquire U.S. technology.

VII. Conclusion

This article presents a number of proposals. The main proposals or criticisms are summarized below:

\textsuperscript{309} See Treaty, supra note 15, art. 6(3), 30 U.S.T. at 5268 (mirroring the language in art. 14(4)(a), 30 U.S.T. at 5285 “the use of, or the right to use” a property). Comparing this language to art. 14(4)(b), 30 U.S.T. at 5285 (covering “[g]ains derived from the sale... contingent on the productivity, use”) demonstrates that the royalty source rule does not cover contingency basis sales.

\textsuperscript{310} See id. art. 6(7), 30 U.S.T. at 5270.

\textsuperscript{311} U.S. Treasury Dep’t, supra note 255.

\textsuperscript{312} I.R.C. § 865(d)(1)(B).

\textsuperscript{313} Treaty, supra note 15, art. 6(9), 30 U.S.T. at 5270-71.

\textsuperscript{314} Id.

\textsuperscript{315} Id.
1. The concept of know-how for royalty treatment should be based upon a comparison with the then-current level of Korean technology. Such an interpretation, however, will lead to a dispute with the United States. In lieu of case by case bargaining with the United States for allocation of revenue, Korea should negotiate for a general agreement which reflects its policy purpose, using the revenue aspect to its advantage during the bargaining process.

2. A Korean attempt at finding a royalty based on the excess profit concept cannot be supported. It is not compatible with the proper standard based on the technological concept of know-how.

3. The Treaty source rule of place of performance for personal service income is meaningless.

4. The C.I.T.A. source rule for technological service income should be expanded. A possible approach is to incorporate a residence of payor rule. An alternative approach is to stipulate that any income which is subject to Korean taxes under an applicable treaty will be deemed to satisfy the Korean source requirement.

5. The threshold for finding a permanent establishment of foreign service contractors should be lowered to the lowest limit, as determined on a case by case basis. No minimum duration requirement should apply. For assembly or supervision services related to an import of foreign capital goods, the six month test must apply.

6. Personal service elements that are auxiliary to technology transfer need not be separately considered for the permanent establishment issue.

7. Regarding the F.C.I.A. tax break for royalty withholding tax, a follow-up monitoring system for the F.C.I.A. tax should be introduced. A similar measure is also necessary for the tax incentives for foreign direct investment.

8. If the U.S. tax rate and other country rates converge in the future, the F.C.I.A. tax incentives will have to be reconsidered to the extent U.S. corporations are concerned.

9. Gains on the sale of technology derived by a U.S. corporation can be taxed in Korea under the C.I.T.A. provisions, regardless of the capital gains clause and place of sale source rule of the Treaty. The C.I.T.A. withholding tax rate for such gain will have to be lowered at least to the level of the Treaty withholding rate.

10. Exclusive licenses should be regarded as a sale of technology upon satisfaction of several conditions.

These proposals will create a new regime consistent with the Korean policy objective of using technology import to build-up an independent domestic technological base. For consistency with the policy objective, the objective of these proposals is to make the final tax burden on service contractors not less than the burden on technology transferors. Technological service contractors
will be taxed on their Korean sourced profit under the bottom limit concept of permanent establishment. U.S. licensors will normally be subject to a withholding tax, because the personal service factor in the license transaction will be ignored. No definite conclusion about the relative final tax burden can be drawn, because of the difference between gross and net based taxation. Note, however, that the taxpayer compliance cost will be far higher in the service transaction because of the tax return requirement. A service contractor may also have some difficulty obtaining foreign tax credit in the United States, because Korean interpretation of the Treaty, as proposed in this article (source rule and permanent establishment), will be drastically different from that of the United States. If the remaining F.C.I.A. tax incentive applies to a technology transferor, its final tax burden will certainly be lower than that of a service contractor.

Between the technology licensor and seller, Korean tax policy demands that the tax on the licensor will not be less than the tax on the seller. If redesigned, C.I.T.A. treatment of a technology seller would be identical to the Treaty treatment of a licensor (that is, the same withholding tax rate and no deduction of basis) the final tax burden on the seller would be lower than on the licensor because of the capital gains preference in the United States.

Further studies must be done on the regulation of tax planning and transfer pricing. A good example is the trademark royalty paid by a local sales (non-manufacturing) subsidiary to its foreign affiliate owning the trademark. From a host country point of view, can such royalties be deducted from the local subsidiary's taxable income? From the United States as home country point of view, such a transaction will lead to a discussion of the complex system designed to regulate intra-company setting transactions such as the look-through rule under the basket limitation system or the super royalty provision. Today, the majority of technology transfer transactions take place in the intra-company setting. Realistic and practical conclusions can be drawn only after a full analysis of the intra-company tax planning attempt and the regulations of such attempts. The proposals formulated above are conditioned on these further studies.

316. I.R.C. § 904(d)(3).
317. Id. § 482.
## APPENDIX 1

### FOREIGN TECHNOLOGY TRANSFER TO KOREA

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<td>8841</td>
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Source: Kim Linsu, supra note 53, at 263.
APPENDIX 2
SELECTED PROVISIONS OF THE CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION

Article 2—General Definitions

(2) Any other term used in this Convention and not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. Notwithstanding the preceding sentence, if the meaning of such a term under the laws of one Contracting State is different from the meaning of the term under the laws of the other Contracting State, or if the meaning of such a term is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or to further any other purpose of this Convention, establish a common meaning of the term for the purposes of this Convention.

Article 4—General Rules of Taxation

(1) A resident of one of the Contracting States may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to any limitations set forth in this Convention. For this purpose, the rules set forth in Article 6 (Source of Income) shall be applied to determine the source of income.

(3) The provisions of this Convention shall not affect Korean law so as to deny benefits accorded residents of the United States under the provisions of the Korean Foreign Capital Inducement Law Number 2589 of March 12, 1973 as amended or any similar law to encourage investment in Korea.

Article 5—Relief from Double Taxation

(1) The United States agrees to allow a United States citizen or resident as a credit against the United States tax the appropriate amount of Korean tax in accordance with the provisions and subject to the limitations of the law of the United States. In addition, in case of a United States corporation owning at least ten percent of the voting power (i.e., voting stock) of a Korean corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of Korean tax paid by the Korean corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid to Korea, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within Korea or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in
relation to taxes paid to Korea, the rules set forth in Article 6 (Source of Income) will be applied to determine the source of income.

Article 6—Source of Income

For the purposes of this Convention:

(3) Royalties described in paragraph (4) of Article 14 (Royalties) for the use of, or the right to use, property (other than as provided in paragraph (5) with respect to ships or aircraft) described in such paragraph shall be treated as income from sources within one of the Contracting States only if paid for the use of, or the right to use, such property within that Contracting State.

(6) Income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, or for furnishing the personal services of another person and income received by a corporation for furnishing personal services of its employees or others, shall be treated as income from sources within one of the Contracting States only to the extent that such services are performed in that Contracting State. Income from personal services performed aboard ships or aircraft operated by a resident of one of the Contracting States in international traffic shall be treated as income from sources within that Contracting State if rendered by a member of the regular complement of the ship or aircraft. For the purposes of this paragraph, income from labor or personal services includes pensions (as defined in paragraph (3) of Article 23 (Private Pensions and Annuities)) paid in respect of such services. Notwithstanding the preceding provisions of this paragraph, remuneration described in Article 22 (Government Functions) and payments described in Article 24 (Social Security Payments) shall be treated as income from sources within one of the Contracting States only if paid by or from the public funds of that Contracting State or local authority thereof.

(7) Income from the purchase and sale of intangible or tangible personal (including movable) property (other than gains defined as royalties by paragraph (4)(b) of Article 14 (Royalties)) shall be treated as income from sources within one of the Contracting States only if such property is sold in that Contracting State.

(8) Notwithstanding paragraphs (1) through (7), industrial or commercial profits which are attributable to a permanent establishment which the recipient, a resident of one of the Contracting States has in the other Contracting State, including income derived from real property and natural resources and dividends, interest, royalties (as defined in paragraph (4) of Article 14 (Royalties)), and capital gains, but only if the rights or property giving rise to such income, dividends, interest, royalties or capital gains are effectively connected with such permanent establishment, shall be treated as income from sources within that other Contracting State.
Article 8—Business Profits

(1) Industrial or commercial profits of a resident of one of the Contracting States shall be exempt from tax by the other Contracting States unless such resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein. If such resident is so engaged, tax may be imposed by the other Contracting State on the industrial or commercial profits of such resident but only on so much of such profits as are attributable to the permanent establishment.

(5) The term "industrial or commercial activity" means the active conduct of a trade or business. It includes the conduct of manufacturing, mercantile, insurance, banking, financing, agricultural, fishing, or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal property (including ships or aircraft). Such term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

(6)(a) The term "industrial or commercial profits" means income derived from industrial or commercial activity, and income derived from real property and natural resources and dividends, interest, royalties (as defined in paragraph (4) of Article 14 (Royalties)), and capital gains but only if the property or rights giving rise to such income, dividends, interest, royalties, or capital gains are effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State, whether or not such income is derived from industrial or commercial activity.

(b) To determine whether property or rights are effectively connected with a permanent establishment, the factors taken into account shall include whether the rights or property are used in or held for use in carrying on industrial or commercial activity through such permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income from such property or rights. For this purpose, due regard shall be given to whether or not such property or rights or such income were accounted for through such permanent establishment.

Article 9—Permanent Establishment

(1) For purposes of this Convention, the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity.

(2) The term "fixed place of business" includes but is not limited to:

(a) A branch;
(b) An office;
(c) A factory;
(d) A workshop;
(e) A warehouse;
(f) A store or other sales outlet;
(g) A mine, quarry, or other place of extraction of natural resources; and
(h) A building site or construction or installation project which exists for more than 6 months.

Article 14—Royalties

(1) The tax imposed by one of the Contracting States on royalties derived from sources within that Contracting State by a resident of the other Contracting State shall not exceed 15 percent of the gross amount thereof, except as provided in paragraphs (2) and (3).

(2) Royalties derived from copyrights, or rights to produce or reproduce any literary, dramatic, musical, or artistic work, by a resident of one Contracting State, as well as royalties received as consideration for the use of, or the right to use, motion picture films including films and tapes for radio or television broadcasting, may not be taxed by the other Contracting State at a rate of tax which exceeds 10 percent of the gross amount of such royalties.

(3) Paragraphs (1) and (2) shall not apply if the recipient of the royalty, being a resident of one of the Contracting States, has in the other Contracting State a permanent establishment and the right or property giving rise to the royalties is effectively connected with such permanent establishment. In such a case, paragraph (6)(a) of Article 8 (Business Profits) shall apply.

(4) The term "royalties" as used in this article means—

(a) Payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, copyrights of motion picture films or films or tapes used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), or ships or aircraft (but only if the lessor is a person not engaged in the operation in international traffic of ships or aircraft), and

(b) Gains derived from the sale, exchange, or other disposition of any such property or rights (other than ships or aircraft) to the extent that the amounts realized on such sale, exchange, or other disposition for consideration are contingent on the productivity, use, or disposition of such property or rights.

The term does not include any royalties, rentals or other amounts paid in respect of the operation of mines, quarries, or other natural resources.

Article 16—Capital Gains

(1) A resident of one of the Contracting States shall be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets unless—
(b) The recipient of the gain, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with such permanent establishment, []

Article 18—Independent Personal Services

(1) Income derived by an individual who is a resident of one of the Contracting States from the performance of personal services in an independent capacity, may be taxed by that Contracting State. Except as provided in paragraph (2), such income shall be exempt from tax by the other Contracting State.