# AIPPI Case Reporter

## Latest Developments in Japanese IP Cases

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### 1. Tax Jurisdiction For Patent Royalty

**Patent Infringement Settlement Fee/Japan-U.S. Double Taxation Prevention Treaty**

**Silver Seiko K.K. v. Higashi Murayama Tax Bureau**

Tokyo District Court, Decided October 20, 1992/Case No. Sho 63(gyo-u)191. Income Tax Law, Section 161, Para. 7; Japan-U.S. Double Taxation Prevention Treaty Section 6.

The Tokyo District took a new approach in determining the source country for a withholding tax on patent royalties. Putting more weight on the intent of contractual parties than the presence of a licensed Japanese patent, the court held that among other patents, a U.S. patent should be found as a main vehicle for taxation. However, case law teaches that a Japanese licensee is required under the tax treaty to deduct a 10% tax from its royalty payment to a foreign licensor when a license includes a Japanese patent. Since this decision deviates from the precedents, it would have significant effects on practice if it is affirmed by a high court where the case was appealed.

#### FACTS

Silver Seiko (Silver) was a manufacturer of printers in Japan and started marketing its printers in the U.S.A. in the early 1980's. Qume Corp., one of the major manufacturers of printers in the U.S., had various kinds of patents relating to printers. In 1983, Qume filed a complaint against Silver under Section 337 of the U.S. Tariff Act, alleging that Silver's products imported into the U.S. infringed one of its U.S. patents relating to a daisy wheel type printer.

Eventually, Qume and Silver entered into a settlement agreement under which Silver agreed to pay to Qume, a settlement fee comprising an initial payment and running royalties for the license under the U.S. patent and its foreign counterparts. The initial payment was to cover two compensations: (1) damages for past infringement in the U.S. ($230,000 but eventually discounted to $190,000) and (2) paid-up royalty of $570,000 which was creditable against future royalties. The agreement defined the paid-up royalty as an "advance" payment, but the term "past damages" was not necessarily clear from a tax point of view. The amount of the initial payment was determined based on past sales by Silver of allegedly infringing products in the U.S.

A local branch office of the Japanese Tax Agency officially notified Silver of its violation of the Income Tax Law of Japan. It charged that the advance payment in the amount of $570,000 was subject to the Japanese income tax law and that Silver was liable for the tax which was not withheld by Silver. Silver brought a suit against the tax authorities seeking a court order to cancel the official notice and charge by the tax office. In its complaint, Silver argued that part of the advance payment was damages under the U.S. patent and that such payment should not be considered taxable under the Japanese income tax law.

In contract, the tax authorities argued that whether a payment is taxable or not can be determined based on the "place of manufacture" of the product at issue. The authorities argued that the most important point in the context of taxation is determining the place where the patent in question is used. In this case, the license included a Japanese counterpart and Silver's Patent Department personnel were aware of the existence of the Japanese counterpart. In view of these facts, the tax authorities argued that the payment should be regarded as a consideration for the Japanese counterpart.

## HOLDING

1) Parties to a contract must abide by the contractual obligations, to the extent the contract is lawful. When taxation is applicable to income resulting from a contract, tax law can not deprive the parties of what they have secured under the contract. Thus, the issue of taxation on such income should be determined taking into account what the parties aimed at in the agreement, namely, their intent in contracting.

2) In this case, there is a settlement agreement between Qume and Silver. Upon the payment of the settlement fee, Silver has obtained from Qume, a worldwide license to manufacture licensed products under the licensed patent, and Qume's waiver of injunctive relief for Silver's past infringement. The settlement fee was, therefore, a consideration for all rights and titles obtained by Silver under the agreement.

The tax authorities asserted that allocating attribution to respective patents might be a fair approach but such approach is impractical for taxation. It opted for an interpretation that a substantial portion of Silver's initial payment to Qume was a consideration for a right under the Japanese patent application, in view of the place where the manufacture took place. The court rejected this argument for the following reasons:

> "[W]ith respect to the compensation in the amount of $570,000, it is clear that the payment was an advance payment of royalty for devices to be sold by Silver in the U.S. after the settlement. Although the nature of the paid-

up royalty is not necessarily clear, there is no question about the intent of the parties that the overall payments were to terminate the Section 337 procedures before the USITC and to resolve other disputes between Silver and Qume involving the U.S. patent and its foreign counterpart."

3) It is also clear from evidence that Silver was very concerned about the outcome of the ITC procedure and such a concern drove Silver to negotiations with Qume for settlement. The court stated as follows:

"It is recognizable that Silver, as a Respondent to the ITC procedure, felt a serious concern about the possible result that Silver might be prohibited from exporting its products into the U.S. market. Thus, Silver paid it outmost care and effort to avoid such situation. Under these factual situations, the court can not find that the existence of the Japanese patent application was considered when the settlement agreement was made, even if its personnel in charge of the settlement recognized that there was a Japanese counterpart."

4) The court found that the parties to the settlement agreement aimed at terminating existing and future disputes between the parties involving any of the Qume patents. The court also found that Silver paid to Qume past and future royalties in exchange for Qume's release of legal claims under its patent portfolio with emphasis on the U.S. patent. With these findings, the court rejected the argument of the tax authorities that the settlement fee should be recognized as royalty for the Japanese patent application. The court stated:

"Such allegation deviates from the parties' reasonable intent under the agreement. It attempts to single out certain acts from a number of acts that could have been legally taken at the juncture, in order for the Defendant to support a specific theory. Defendant argues that such approach is reasonable but this court would not take such approach."

## COMMENTS

Mainly for political reasons, commercial companies usually do not fight the tax authorities before the court. This is part of the reason why the number of intellectual property cases involving tax issues are very limited in Japan.

So far, only four cases have been reported, three decisions from the courts and one from the Tax Tribunal. A land-mark case is the "Compressor Case" in 1985 in which the Tokyo District Court weighed the place of manufacture more than the place of consumption in determining the source of tax. In this instant case, the tax authorities followed the arguments made in the precedent. However, facts are so different from each other so that the tax authorities were not persuasive. One notable difference was that know-how license was included in the Compressor Case while the present case was about a pure patent license.

Under the Japanese tax law, tax rates are variable depending upon the legal status of foreign entities. A key factor is whether there is a permanent establishment in Japan (the Japan-U.S. Tax Treaty supersedes tax rate provisions of the local tax law and the treaty provides the rate as 10%). When the tax law is applied, the licensee in the source country is responsible for the tax. In this case, the court found that sale in the U.S. constituted the "use" of the U.S. patent, thus concluding that the Japanese tax law is not applicable to the payment attributable to the sale in U.S.

It has been an established practice for accounting people to withhold a 10% tax from royalties under the Tax Treaty whenever a license includes a Japanese patent. Therefore, this decision has caused confusion among practitioners because this case would create uncertainties about the standards for determining the source country.

This case has also fostered some theoretical debates on the issue of tax jurisdiction in connection with patent royalty. For example, the court's inclination towards arguments based on the territoriarity of patent was criticized. Another point under criticism was that the court failed in elaborating its rationale on the source rule — the real issue questioned in the case. There are comments in favor of this decision. They support it for the reason that this decision will bring the practice of Japanese tax authorities closer to one of the U.S.A. in the field of technical transfer.

This case is not new. However, the author believes that it still deserves value for publishing in this Case Reporter because the decision of this case created some confusion on corporate licensing practice in Japan and such confusion remains unsolved. A decision by the Appeal Court is awaited with intense interest.

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