Beneficial Ownership of Royalties in Bilateral Tax Treaties

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CHAPTER 1
INTRODUCTION

1.1. IMPORTANCE AND FOCUS OF STUDY

There can be little doubt as to the growing importance of intellectual property as the new millennium is entered. Interbrand has calculated the contribution of intangible assets, as opposed to tangibles, to earnings for the different business sectors as follows: financial services, 80%; luxury goods, 75%; info tech, 70%; pharmaceutical and food and drink, 60%; automotive, 50%; and utilities, industrial and retail, 30%.

Further evidence of the importance of intangibles is gained by comparing the total value of certain large multinational corporations with the value of their tangible assets. For example, in terms of its share price in 1996, the value of the Coca-Cola Corporation was approximately $115 billion. If the value of tangible assets of $15 billion as per the balance sheet is subtracted, it means that the market believed that there was $100 billion of value in the corporation over and above the purely tangible assets which appeared on its balance sheet.

Likewise, decades ago the richest persons in the world were people such as oil millionaire Paul Getty or car pioneer Henry Ford. At the end of the 1990s the prominent names on the list include the likes of Bill Gates, Paul McCartney and Andrew Lloyd Webber whose wealth is based on the copyright to software or songs.

Interbrand observes that in merger and acquisition activity, the percentage of the bid price made up by the intangibles was 20% in the 1980s. Ten years later, some brand-rich companies were quoting a figure of over 70%.

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1. For the distinction between intellectual property and intangibles, see Chapter 2.
3. Id. at 117.
4. Id. at 176.
In addition, globalization is on the increase. The valuable intellectual property owned by a resident of one state is often utilized in many other states. This is often done by way of licensing, both within a group of companies as well as to third parties. This raises the important issue of royalties. There are no reliable figures available on the value of royalties paid annually across borders, but there is little doubt that this amount is large and increasing.

Because royalties are paid across borders, the issue of royalty payments is of international tax concern and it comes as no surprise that the OECD Model specifically deals with royalties in Article 12. An article on royalties is included almost without exception in all bilateral tax treaties between states.

The wording of Article 12(1) of the OECD Model is the main focus of this study. That wording is: “Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.” Paragraph 1 lays down the principle of exclusive taxation of royalties in the state of the beneficial owner’s residence. In theory that means that the royalties should not be subject to withholding tax in the source state, provided that the person claiming such treaty benefits in the other state is the beneficial owner of the royalties.

The wording of the OECD Model has been used either without change or in some adapted form in numerous bilateral tax treaties. A search in the Tax Treaties Database of the IBFD in July 1998 revealed that the terms “beneficial owner” or “beneficially owned” occurred in 1,073 treaties covering 140 states.

Given the high value of the international flow of royalties it comes as a surprise that, more than twenty years after its incorporation into the OECD Model in 1977, there still exist so much confusion and dispute as to the exact and international tax meaning of beneficial ownership. As will be clear from the discussion in the
later chapters, there has been little evidence up to now of any conclusive answer as to such meaning.

At the 1998 IFA\textsuperscript{8} congress in London, "the concept of beneficial ownership in tax treaties" was one of the topics discussed in seminar A. Two main issues for discussion were identified by the chairman of the seminar, professor Klaus Vogel. First, whether beneficial ownership is a term to which Article 3(2) of the OECD Model applies, in other words, that the domestic law of the contracting states must be referred to for the understanding of beneficial ownership, or whether the context of Articles 10, 11 and 12 of the OECD Model require that beneficial ownership be interpreted as an autonomous treaty concept, part of an international tax language which is separate from domestic law? Second, if the concept of beneficial ownership is not seen as a reference to domestic law, the question is: How should the concept be interpreted? What then is beneficial ownership?

This study agrees that these are the two main issues at stake. Even though it seems that the second issue arises only if the first issue is answered in a certain manner, the approach is rather that both issues are so controversial that each of them can be regarded as a separate issue.

Although this study also deals with the first issue, the focus is on the second.

In conclusion, whether or not a person is the beneficial owner of a royalty determines whether that person qualifies for treaty benefits and also affects the allocation of the right to tax the royalties between the two contracting states. The purpose of this study is to find the meaning of beneficial ownership as it relates to royalties in bilateral tax treaties.

In this study the terms "beneficial owner", "beneficially owned" and "beneficial ownership" are used, as is the case in most literature on the subject, interchangeably. These terms are all mere variations of the same notion.

\textsuperscript{8} 52nd Annual congress, 4-9 October. The author attended the seminar and was kindly allowed by IFA to make a transcript of the cassette recording of the seminar.
Some thoughts on the delimitations of the study: Beneficial owner and its variants are also used in bilateral tax treaties in relation to interest and dividends. This investigation, though, only looks at the meaning of these terms in relation to royalties. Also, although royalties can be paid in respect of tangible property, the investigation is purely in respect of royalties relating to intangibles. As is seen from the discussion in Chapter 2, the aforementioned qualification is somewhat superfluous as Article 12 of the OECD Model only deals with royalties in respect of intangibles. Lastly, the study only looks at the OECD Model and does not deal with other model conventions, such as those of the United States and the United Nations.

The reason for these delimitations is simply because in research one has to draw the line somewhere. No doubt most of the findings on the meaning of beneficial ownership and its variants in respect of royalties apply equally to interest and dividends. Similarly, because of the great level of correlation among the different model conventions, especially as far as the use of beneficial ownership is concerned, the findings may equally apply to other model conventions.

In the context of bilateral tax treaties, the notion of beneficial ownership is used in connection with the prevention of tax avoidance. There are various other anti-tax avoidance measures which may be relevant to tax treaties, for example, the substance over form principle or the test as to whether a certain entity was interposed in a chain of transactions solely or mainly to make use of treaty benefits. This study solely investigates the meaning of beneficial ownership and is not concerned with the question of whether any of the other measures or tests may apply. In fact, it is appropriate to observe at this stage that often investigations into beneficial ownership stray onto questions such as the reason for the transaction. Such questions may not be relevant at all as tests to establish beneficial ownership.

9. In practice, though, certain payments in respect of tangibles are dealt with as royalties by some bilateral tax treaties.
10. For further discussion, see infra note 134, and 6.2.2., 6.2.5., 6.3.2.2., and 6.3.2.8.3.
The study does not deal with transfer pricing or ownership for purposes of transfer pricing. Enough has been written on that subject.

The approach of the investigation is international and the principles applied are that of international tax law. The aim is to find the universal meaning of an international tax language term. This may be easier said then done. Although there is ongoing cooperation amongst states, many treaties are based on the OECD Model, and there is an ongoing development of international tax law, there are still major differences of opinion and interpretation amongst states and commentators. Some reasons for the differences are the importance states place on their sovereignty, and the different legal backgrounds of judges, commentators and tax authorities who have to apply international tax law. A major factor is the scarcity of binding legal interpretation and precedent in respect of many areas of international tax law, including the interpretation of beneficial ownership. This study contains several examples\textsuperscript{11} of wide differences of opinion amongst tax commentators. In fact, the student of international tax law can be fairly certain that for each authority he quotes in support of his view, someone else is probably able to quote authority supporting the opposite view. This is simply a factor that one has to live with, and which is to be expected of a subject such as international tax law, which is still, to some extent, in its pioneering stage.

Although the focus of the study is international, it was sometimes necessary to investigate the situation in specific states. In this respect the United Kingdom\textsuperscript{12} and, in some instances, the United States were chosen as examples of common law states, and the Netherlands was chosen as an example of a civil law state. They were chosen because of the accessibility of their tax information, the fact that they are all important role-players in international tax law, and because the author is proficient in the Dutch and English lan-

\textsuperscript{11} See, for example, 6.3.1. on the application of Article 3(2) of the OECD Model, and 6.3.2.9. on the role of the MC Commentary in interpretation.

\textsuperscript{12} As far as tax law and intellectual property law are concerned, this study refers to the “United Kingdom”. The study refers to “England” when property law is discussed.
guages. The research, however, is not a comparative study of the situations in these states, neither are they the only states referred to. Because of the scarcity of information on the meaning of beneficial ownership, any information, from whichever state, has to be grasped. Further, because the author is not proficient in languages such as German, French, Spanish and Italian, it could mean that important literature in these languages is not incorporated in this study.

Lastly, both the common law and civil law legal families are represented in the OECD list of member states. It is therefore important to take both these legal families into account when interpreting a term such as beneficial ownership. Because beneficial ownership is a term which is used primarily in the common law states, however, the space allocated in the study to the discussion of sources from the common law states is more than that allocated to sources from the civil law. In addition, as far as case law is concerned, the common law states, with their elaborate style of reporting cases, become a great ally of the student of international tax law. This is in contrast to the civil law states, where the more cryptic style of reporting and sometimes a complete lack of reasoning do not provide the same assistance.

1.2. STRUCTURE OF STUDY

It is appropriate to state the hypothesis of this study as to the meaning of beneficial ownership already in this introductory section (see 6.3.2.1. for further discussion):

The term was taken from the common law states and incorporated into the OECD Model. The term is not known in the domestic law of states other than the common law states. It can properly be classified as international tax language. It is not defined in the OECD Model. No OECD member state has expressed either a reservation or an observation as to its meaning in the OECD Model. The meaning of beneficial owner at the source that it was taken from, that is, the common law states, should therefore be taken as the starting point for the investigation of its international tax meaning in
those bilateral tax treaties which have adopted the wording of the OECD Model. This meaning should then be modified, if necessary, in the context of the treaty and in the light of its object and purpose. This whole process of interpretation should be in accordance with the steps as prescribed by the Vienna Convention.

By applying the reasoning and steps as described above, the following answer is reached:

The beneficial owner is the person whose ownership attributes outweigh that of any other person.

In the investigation of the validity of the above stated hypothesis, the study is structured as follows:

Chapter 2 investigates the meaning of intellectual property. Because the study investigates the beneficial ownership of royalties in respect of intellectual property, it is important to have an understanding of what intellectual property is all about.

This study is about the meaning of beneficial ownership, but it is also about royalties. Chapter 3 therefore investigates the meaning of royalties as defined in Article 12 of the OECD Model.

Chapter 4 investigates the meaning of ownership in the common law and civil law states. The reasoning behind this is that beneficial ownership is a kind of or a degree of ownership. A good starting point in order to find the meaning of beneficial ownership is to first investigate the meaning of ownership. After a general investigation in the first part of the chapter, the focus then turns specifically to ownership of royalties.

Chapter 5 aims to establish the domestic meaning of beneficial ownership in those states, being the common law states, where the term is known in the domestic law. In terms of the above stated hypothesis, the meaning in those states should be taken as the starting point for the investigation of the international tax meaning of beneficial ownership.

Chapter 6 deals with the international tax meaning of beneficial ownership and forms the heart of this study. Part one of the chapter analyses existing case law, commentaries and other information on
the subject. In Part two, this study makes its own interpretation by closely following the steps prescribed by the Vienna Convention.

The summary and conclusion, which is fairly comprehensive, is in Chapter 7.

Although all of the chapters build on each other, each of the chapters also, to a more or lesser extent, stands on its own.