Beneficial Ownership of Royalties in Bilateral Tax Treaties

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CHAPTER 3
ROYALTIES

3.1. INTRODUCTION

For purposes of this study there are two main aspects as to the meaning of royalties. The first, which is discussed in this chapter, is the almost factual (although legal issues arise as well) question of what types of income constitute royalties for the purposes of tax treaties. This depends on the definition of royalties for the specific case under investigation. Problem areas include the distinction of income from royalties from that for personal services, rentals and business profits. Problems of classification are also caused by new business developments, for instance in the fields of software and the Internet. Mixed contracts are another problem area.

The second aspect of the meaning of royalties concerns the legal nature of royalties as far as the term is used in conjunction with beneficial ownership. This aspect is dealt with in Chapter 4 and concerns questions such as whether royalties are property, whether they can be owned, and the object of the ownership of royalties.

The remainder of this chapter only deals with the meaning of royalties as mentioned in the first paragraph above. Although there may be a general domestic meaning of royalties in many states, and there certainly is a common law meaning, it appears that, because of the difficult distinction between royalties and other types of income, many states have, both for domestic and international tax purposes, provided a specific definition for royalties. There is also considerable case law on the meaning of royalties in an international context.

The fact that bilateral tax treaties contain their own definitions of royalties means that domestic meanings of the term are irrelevant for treaty purposes. In order to put the treaty meaning of royalties in perspective, however, it is useful to compare it with available

domestic meanings. This chapter therefore first looks at the common law meaning of royalties in the United States and Australia. As the Civil Code of the Netherlands does not specifically define royalties, no investigation of the general meaning thereof in the Netherlands or any other civil law state is included. The second part of the chapter investigates the definition of royalties in the OECD Model.

3.2. COMMON LAW MEANING

3.2.1. United States

The meaning of “royalties” has been considered by the United States’ courts on several occasions. Many of these cases concern tax-exempt organizations.

Certain organizations, although classified as tax-exempt under IRC Section 501(c), are still taxable on “unrelated business taxable income” (“UBTI”) under IRC Sections 511-13.1. IRC Section 512(b)(2), however, excludes “all royalties” from UBTI, thus rendering the royalty income of a tax-exempt organization nontaxable. “Royalties” as used in Section 512(b)(2) is not defined by statute or by regulation and over the years there have been several cases considering the meaning thereof in the context of tax-exempt organizations. The background to these cases is the practice of tax-exempt organizations utilizing two of their most important intangible assets to raise funds: a list of members and the organizations’ own good names. The names from their mailing lists may be rented out to other organizations for a fee. In addition, they may charge a fee for the use of their names and logos in connection with revenue producing activities such as an affinity credit card program. In terms of such a program, the credit card issuer is authorized to use the organization’s name and logo to market the credit card to the exempt organization’s

33. See, for example, Disabled American Veterans v. United States, 227 Ct. Cl. 474, 650 F.2d 1178 (1981); Disabled American Veterans v. Commissioner, 94 T.C. 60 (1990); Disabled American Veterans v. Commissioner, 942 F.2d 309 (6th Cir. 1991); Fraternal Order of Police v. Commissioner, 835 F.2d 717 (7th Cir. 1987); Mississippi State University Alumni, Inc. v. Commissioner, T.C. Memo 1997-397.
members and supporters. Over the years the courts on several occasions had to deal with the question of whether the income by the tax-exempt organizations from these activities represent “royalties”. At the centre of this debate is the view held by the IRS that only so-called passive income can constitute “royalties”. This view seems to require that, in order to be a royalty, the taxpayer simply has to sit back in return for another’s use of his intangible assets. Because the exempt organizations normally also render services such as customizing mailing lists, marketing, etc., so the argument goes, the income is not passive and therefore not “royalties”.

The IRS, with reference to several court cases, provided its view on the matter by issuing a ruling, in terms of which the following is said on the meaning of royalties:

To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes. Similarly, payments for the use of a professional athlete’s name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties. On the other hand, royalties do not include payments for personal services. 34

Although revenue rulings are not binding upon the courts, 35 subsequent court decisions have referred with approval to this definition. 36

*Sierra Club*37 is one of the last cases which considered the status of income from name rentals and affinity credit card programs and properly summarizes the issues. The court, noting that because “royalties” were not defined it was necessary to look to the “ordinary, everyday senses” of the word, then comments as follows on the dictionary meanings of “royalties”:

36. See, for example, *Disabled American Veterans v. Commissioner*, 94 T.C. 60 (1990), at 70; *Sierra Club Inc. v. Commissioner*, 1996 TNT 124-13 (9th Cir. 1996).
37. *Sierra Club*, supra note 36.
From the above we glean that “royalty” commonly refers to a payment made to the owner of property for permitting another to use the property. The payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right—such as a patent, trademark, or copyright—or a right relating to the development of natural resources.38

The court held that royalties are by definition passive and, for purposes of IRC Section 512(b), are defined as payments received for the right to use intangible property rights and such definition does not include payments for services.39 The court reconciled the aforementioned viewpoint as follows with the extreme opposing arguments of the two parties:

Thus, to the extent the Commissioner claims that a tax-exempt organization can do nothing to acquire such fees (e.g., providing a rate sheet listing the fee charged for use of each copyrighted design or retaining the right to approve how the design is used and marketed), the Commissioner is incorrect. However, to the extent that Sierra Club appears to argue that a “royalty” is any payment for the use of a property right—such as a copyright—regardless of any additional services that are performed in addition to the owner simply permitting another to use the right at issue, we disagree.40

3.2.2. Australia

Because of considerable case law on the subject in that country, Australia is a good place for the investigation of the common law meaning of royalties.

In McCauley v. Federal Commissioner of Taxation41 the landowner entered into an agreement with another person in terms of which that person acquired the right to cut and remove the standing timber on a portion of the land for the “price or royalty” of three shillings for each and every hundred superficial feet of such milling timber so cut. The person agreed to cut and remove all the milling

38. Sierra Club, supra note 36, at paragraph 27.
39. Sierra Club, supra note 36, at paragraph 29.
40. Sierra Club, supra note 36, at paragraph 38.
41. (1944) 69 CLR 235.
timber from the property within a period of twelve months, and to pay monthly the appropriate “price or royalty” under the contract. The High Court, by majority decision, held that the amounts received by McCauley were royalties. Latham C.J. commented as follows on the meaning of royalty:

In my opinion the word “royalty” is properly used for the purpose of describing payments made by a person for the right to enter upon land for the purpose of cutting timber of which he becomes the owner, where those payments are made in relation to the quantity of timber cut or removed.42

Woellner observes that the payments in McCauley exhibited all the classic indicia of a common law royalty: “They were paid for the right to remove the timber, the amounts payable were measured by the quantum of timber removed, and the payments were made contemporaneously with the exercise of the right.”43

Stanton v. Federal Commissioner of Taxation44 also concerned dealings in timber. The agreement stated in essence that the vendors sold to the purchaser three million super feet of millable timber, with the right to cut and remove the timber from the land. The price was a fixed lump sum to be paid in equal quarterly instalments without interest. Payment was required whether or not the saw miller cut any timber, although there was provision for a proportional rebate if there were found to be less than three million super feet of timber on the land. The High Court found that the payment was not a royalty because the “essential notion” of a royalty was absent. The amount to be paid was not related to the quantity or value of timber felled, or to the occasions on which the relevant right was exercised. According to the court the transaction was in substance the sale of a capital asset (timber) at a lump sum price. In the course of the judgment the court provided the following further explanation on the meaning of a royalty:

It may be noted, however, that the modern applications of the term seem to fall under two heads, namely the payments which the grantees of monopolies such as patents and copyrights receive under licences

42. Id. at 241.
44. (1955) 92 CLR 630.
and payments which the owner of the soil obtains in respect of the tak­
ing of some special thing forming part of it or attached to it to which he
suffers to be taken.45

In *Federal Commissioner of Taxation v. Sherritt Gordon Mines
Ltd*46 payments for the provision of know-how were held not to be
common law royalties because the payments were not made in con­sideration of the grant of a right or in respect of the particular exer­
cise of that right. In that case, so far as is relevant here, Sherritt
agreed to provide Western Mining with technical assistance and
information, make available the services of its qualified personnel in
Australia and grant Western Mining the right to use its know-how
and processes in Australia. In consideration of this assistance,
Western Mining agreed to pay Sherritt an “aggregate sum expressed
as a percentage of the aggregate sales value of the nickel and by­
products produced”, the payments being spread over a period of fif­
ten years. The High Court by majority held that the payments were
not common law royalties, Mason J. stating as follows:

Here the substantial, if not the sole, consideration for the payments was
not the grant of a right but for the provision of technical assistance and
information which Western Mining was entitled to use once it was sup­
plied, without the grant of any additional right so to do.47

In *Barrett v. Federal Commissioner of Taxation*,48 Owen J. held
that payments received by the owner of land and quantified by ref­
erence to the amount of soapstone removed from his land were not
royalties because the owner of the land did not own the minerals.
The remover of the soapstone entered into a separate agreement with
the owner of the mineral rights but agreed to make these payments
to Barrett, the landowner, “for the damage to and diminution in
value of the said land and other loss and inconvenience necessarily
suffered by him in consequence of such operations”. The payments
were therefore not made in consideration of the grant of rights with
respect to the soapstone.

45. Id. at 642.
46. (1977) 137 CLR 612.
47. Id. at 626.
48. (1968) 118 CLR 666.
With reference to the cases discussed above, and other cases, Woellner concludes that a common law royalty normally has the following features:

1. It is a payment made in return for the right to exercise a "beneficial privilege" or right (e.g. to remove minerals, utilize a process, or produce a play);
2. The payment is made to the person holding the ownership or other rights which enable him to confer that beneficial privilege;
3. The consideration payable is linked to the amount of use made of the right acquired (e.g. a payment of x cents per performance, per cubic yard taken or per item manufactured/sold);
4. The consideration will usually be paid as and when the privilege acquired is exercised. This is not necessarily so, however, and a lump sum may constitute a royalty where it is a pre-estimate or ex post facto recognition of user;
5. An amount unrelated to any estimate of likely amount of use, and which is simply an amount paid to acquire the right to exercise a privilege (regardless of whether or not that right is actually used) will not normally be a common law royalty, even if paid in instalments.49

3.3. BILATERAL TAX TREATY MEANING

3.3.1. General analysis

Article 12(2) of the OECD Model reads as follows:

The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Except for one change in 1992, this definition has been unchanged from 1963 to 1997. The change in 1992, on the basis of paragraph 23 of the OECD Leasing Report, was to delete from the definition the phrase: "or for the use of, or the right to use, industrial,

commercial, or scientific equipment”. The reason for this amendment is discussed in 3.3.3.2.2.

The first point to note is that the definition is intended to be exhaustive. Hence royalties within the ordinary meaning of the term which do not also come within the treaty definition are not royalties for purposes of bilateral tax treaties.

The second point, as is fully discussed in the previous chapter, is that the first part of the definition deals with the use of, or the right to use certain types of intellectual property. The second part, which does not involve the granting of any rights, deals with the provision of know-how.

Although the fact that treaties contain a specific definition precludes any interpretation of royalties by reference to domestic law, it may still be necessary to revert to domestic law to interpret terms used within the definition.50

Importantly is that, after the 1992 amendments, Article 12 deals only with royalties in respect of intangibles. Vogel further categorizes the contents of Article 12(2) as follows:

- the essential core of all intangible property rights enjoying absolute protection (copyrights, patents, trade marks);
- the “lesser” exclusive rights (designs, models, plans);
- secret knowledge enjoying relative protection, if any; and finally
- unprotected know-how (information concerning industrial, commercial or scientific experience).51

3.3.2. Comparison with common law meaning

A comparison between the definition as per the OECD Model and the features of a common law royalty as discussed in 3.2.2. is a useful exercise. First, it proves the point that the definition as per the OECD Model is arbitrary and quite different from the common law (or any other possible domestic) meaning. The reason for the inclu-

51. Id. at 791.
sion or exclusion of certain types of income under the royalties def-
inition has more to do with a view of whether the source or residence
state should have the right to tax, than it has to do with the proper
classification of the income as royalties in domestic law. Second, it
is a basis for explaining some of the reasons for the wording of the
OECD Model definition.

3.3.2.1. Right to exercise a beneficial privilege or right

Although the first key characteristic of a common law royalty,
namely a payment for the right to exercise a beneficial privilege or
right, to a great extent corresponds with the first part of the OECD
Model definition, the last mentioned definition is more restricted as
far as the types of property in respect of which the payments are
made. It does not include natural resource royalties. This fact is con-
firmed by paragraph 19 of the MC Commentary on Article 12. This
type of income (e.g. from mining) is dealt with in Article 6 of the
OECD Model, i.e. income from immovable property. Article 6 gives
the right to tax income from immovable property to the state of
source, which explains why this type of royalty is not dealt with in
Article 12.

As far as the fact that the payment must be for the right to exer-
cise a right is concerned, the OECD Model definition, apart from its
inclusion of know-how (see also Chapter 2), corresponds with the
common law. The concept of payment “for the use of, or the right to
use” in the OECD Model covers all forms of exploitation of a right
of property short of outright sale of the right or property.52 Payment
for the outright sale of property is therefore neither a common law
royalty nor a royalty in terms of the OECD Model definition.

A last important distinction is that payments for know-how are
included in the OECD Model definition. In terms of Sherritt (see
3.2.2.) such payments are not common law royalties.

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### 3.3.2.1.1. Pierre Boulez

It is appropriate to discuss the controversial and often quoted United States case of *Pierre Boulez v. Commissioner of Internal Revenue*\(^{53}\) at this stage. The decision in that case, dealing with the United States-Germany bilateral tax treaty, has been severely criticized, especially the fact that Körner J. reverted to domestic law in order to interpret the meaning of royalties and the fact that the decision resulted in double taxation. In the opinion of this study, however, although the judge may not have followed the correct route for interpreting an international tax treaty, he arrived at the right answer.

The case concerned payments by a United States record company to Pierre Boulez, the famous orchestra conductor. Boulez, a French citizen, was resident in Germany and a nonresident of the United States. The payments were taxed as royalties in Germany. The question for decision by the United States court was whether these payments were for personal services (and taxable in the United States) or for royalties (and exempt under the treaty). The agreement between Boulez and the record company, although containing wording suggesting an employer/employee relationship, also referred to royalties. In essence the agreement was that Boulez agreed to provide his services to make private recordings for the purpose of making phonograph records. For these services and for the “rights granted” the record company agreed to pay him “royalties”, calculated on the number of records sold. According to the court, before a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sale gives rise to the income. The agreement contained no language indicating either a conveyance or a licensing of any copyright. On the court’s interpretation of the agreement, Boulez did not have any property interest in the recordings which he could hire or sell to produce royalty income. The contract was one for the performance of personal services and was subject to tax in the United States.

Edwardes-Ker criticizes the focus of the court on whether Boulez had a property interest in the recordings, a fact which he regards as not relevant. According to him, the existence of copyright

does not determine whether a payment is a royalty. In his view the payments took the form of royalties. He also states that the payments clearly were in respect of use. He further places weight on the fact that the payments were related to the number of products distributed and also that royalties are income from “letting”.

The opinion of this study is that, if the factual finding of the court is correct that the copyright was owned by the record company from the beginning, then the decision is correct. The bilateral treaty defined royalties as payments for the use of, or the right to use copyright. That means that the person receiving the payments must have the right to grant the copyright, either because he is the copyright owner or has a licence to use the copyright. Boulez had none of these. The focus by Körner J. on property interest was therefore not misplaced.

3.3.2.1.2. Cession

There is another issue which should be discussed under the heading of “use of, or the right to use”, namely the effect of a cession of the right to receive a royalty payment. The legal nature and effect of cession are a vast subject, a full discussion of which is beyond the scope of this study. The discussion of cession in this study is therefore limited and merely aims to point out some of the questions that may arise. Scott, speaking from a South African perspective, defines cession as an act of transfer whereby a creditor (the cedent) transfers his claim against his debtor to a third person (the cessionary) in such a way that the cessionary becomes the creditor of the debtor. Scott adds the following: Cession is basically aimed at the transfer of personal rights. The same obligation which existed between the cedent and the debtor before cession, exists

56. Scott, Id. at 1, points out that the historical development of cession in countries such as France, the Netherlands, Germany and England followed roughly the same pattern.
57. Id. at 12.
between the cessionary and the debtor thereafter. By cession, the cedent transfers only his rights and not his duties and it should be distinguished from an assignment, which is a transference of both rights and obligations.

In terms of the aforementioned rules, it is possible for a licensor to cede his personal right to receive a royalty payment. The cessionary then has the right to claim the payment from the licensee. The important question, however, is whether the payment received by the cessionary can be regarded as a royalty in terms of Article 12(2) of the OECD Model, which defines royalties as consideration for the use of, or the right to use, intellectual property? Can such payment be regarded as "for the use of, or the right to use, intellectual property" in the hands of the cessionary, bearing in mind that the duty to provide such use of, or the right to use, has not been transferred and remains with the cedent? And what about the amount received by the cedent as compensation for the cession? Can this amount be regarded as a royalty?

This question is of importance to determine which of the cedent or the cessionary is entitled to treaty benefits in respect of royalties. One way to approach the issue is to decide whether it should be viewed from the point of view of the debtor or the creditor. For purposes of this study, the question is left unanswered. Suffice to say that parties to cessions should be aware of the possible problems.

3.3.2.2. Payment to the owner of the rights

By a first reading of the OECD Model definition it may appear as if the second characteristic of a common law royalty is not incorporated therein. There is no requirement in Article 12(2) that the payment has to be made directly to the person holding the ownership or other rights in terms of which the use of, or the right of use is granted. Before reaching a conclusion on this matter, however, it is

58. Id. at 128 and 153.
59. Id. at 164 and 222.
60. The uncertainty is not whether the cessionary is the beneficial owner of the payment. If he can freely avail of the right to receive payment and the payment itself, he most probably is the beneficial owner (see also 4.7., 6.2.2., and 6.3.2.10.). The uncertainty is whether what he receives is a royalty.
important to also consider the provisions of Article 12(1). In terms of Article 12(1) the royalties must be beneficially owned by the resident of the relevant state, which implies a direct relationship between the royalties and the grantor of the use of, or the right to use the intellectual property, or the provider of know-how. This aspect is at the heart of the investigation in this study.

It is appropriate at this point to consider the 1997 amendments to Article 12(1) of the OECD Model in order to determine the effect thereof. In addition to the deletion of the words “paid to” during the 1997 amendments, there was also a slight amendment in respect of “beneficial owner”. Vogel, in his discussion of the amendments, concludes that they are of no major effect:

In Article 12(1) “Royalties ... paid to a resident ... if such resident is the beneficial owner of the royalties” was replaced by “Royalties beneficially owned by ...”. Here the new wording eliminates doubt in cases where the royalty is paid to an intermediary, e.g. a bank, which even may be a resident of a third state, but where the “real” recipient is entitled to treaty protection. On the other hand, the new wording may be misleading by not mentioning payment any more in contrast to Articles 10 and 11 which are structured identically to Article 12. One might be induced to suspect that this difference is of major significance which indeed it is not.\(^\text{61}\)

In conclusion, Article 12(1) no longer refers to payment, but the term still appears in Article 12(2). The amendments clarify that there is no requirement that remuneration must pass directly from the licensee to the licensor. No matter to whom the royalties are paid, what is important in order for Article 12(1) to apply is that royalties arising in one state must be beneficially owned by the resident claiming the treaty relief in the other state.

3.3.2.3. Consideration linked to amount of use

The third common law characteristic (which can be dealt with together with the fifth) is not incorporated in the OECD Model definition. There is no requirement that the consideration payable must

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be linked to the amount of use made of the right acquired. There are no conditions as to how the amount should be computed.\textsuperscript{52}

3.3.2.4. Timing of payment

The fourth common law characteristic is not a hard and fast rule and states that the consideration is usually paid as and when the privilege acquired is exercised. A lump sum payment can, however, also be a common law royalty. The position is the same under the OECD Model definition, in terms of which lump sum payments can also be royalties.\textsuperscript{63}

3.3.3. Problem areas

It is next necessary to investigate some of the problem issues concerning Article 12, including the distinction between royalties and other types of income. As background to the discussion, it is worthwhile considering why it was decided to favour the country of residence as far as the taxing rights of royalties are concerned. According to Vogel, there is consensus among the majority of the OECD member states that one reason for advocating a complete waiver of taxation by the state of source in favour of unrestricted taxation by the state of residence is that the state of residence has forfeited tax by having had to allow as a deduction the costs of developing the rights, etc. in respect of which the royalties are paid. There is normally no comparable underlying burden of costs on the state of residence where, for example, interest payments are concerned.\textsuperscript{64}

In addition, Article 12, being a provision dealing with income from assets, takes precedence over Article 7 (business profits), which means that, as a rule, royalty payments received by an enterprise from its business activities come under the provisions of Article 12 and not the provisions of Article 7.\textsuperscript{65} In terms of Article

\begin{itemize}
\item 62. Vogel, \textit{supra} note 50, at 787.
\item 63. Vogel, \textit{supra} note 50, at 786.
\item 64. Vogel, \textit{supra} note 50, at 772.
\item 65. Vogel, \textit{supra} note 50, at 772.
\end{itemize}
12(3), however, the provisions of Article 12(1) do not apply if the beneficial owner of the royalties carries on business in the state in which the royalties arise through a permanent establishment situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of either Article 7 or Article 14, as the case may be, apply.

3.3.3.1. Payments for know-how versus payments for services

Paragraph 11 of the MC Commentary on Article 12 deals with this issue and starts out by noting that, in classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of “know-how”. Know-how is defined by the Association des Bureaux pour la Protection de la Propriété Industrielle as 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 progress of technique.

The MC Commentary continues by pointing out that the grantor in a know-how contract is not required to play any part himself in the application of the formulas 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 after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7 (business profits) or Article 14 (independent personal services).
According to Vogel, the criterion used to distinguish the provision of know-how from rendering advisory services is the concept of "imparting". An adviser or consultant, rather than imparting his experience, uses it himself.66

According to the Australian Taxation Office, the one main distinctive feature of know-how is that it is an asset and, as such, it is something which is already in existence and is not something brought into being in pursuance of the particular contract. In any case being examined, therefore, the first question to be answered is: Is the contract one for the supply, for the use by the "buyer", of a "product" which is already in existence (or substantially in existence), or is it one which requires the contractor to apply special skills and knowledge for his own purposes in order to bring the "product" into existence for the buyer? In the first case the contract is for the supply of know-how and gives rise to a royalty. In the second it is a contract for services rendered.67

3.3.3.2. Leasing

3.3.3.2.1. Distinction with royalties

The MC Commentary on Article 12 begins in paragraph 1 with the following statement: "In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting." In Canada, in Vauban Productions v. Her Majesty the Queen, it was stated that royalties are akin to rental payments.68 Traces of the likeness between the two terms are also noticeable in the OECD report on leasing of containers discussed in 3.3.3.3. Paragraph 38 of that report refers to Article 12 of the OECD Model which, before the 1992 amendments, "exempt[ed] royalties (including rents) for scientific, industrial or commercial equipment from taxation in the State of source" [emphasis added]. This raises the question of the relationship between royalties and rents: Is a royalty a rent? Is a rent a royalty? This question is maybe not that important for purposes of bilateral

66. Vogel, supra note 50, at 790.
tax treaties which, as already mentioned, usually contain their own definitions. An investigation of the similarities and differences between royalties and rents in domestic law, however, may provide valuable background for the way in which it is treated in tax treaties.

In *Sierra Club*, discussed under the United States in 3.2.1., it was held\(^\text{69}\) that royalty is differentiated from rent by the nature of the property the owner is permitting another to use. This view was based on dictionary meanings, defining “rent” as “compensation or fee paid, usually periodically, for the use of any property, land, buildings, equipment, etc.”, whereas “royalty” was defined with reference to intangible property or natural resources. In another United States case it was held, with reference to relevant case law, that payments for the right to use intangibles generally are royalties for personal holding company purposes, whereas payments for the right to use tangible property are generally rents.\(^\text{70}\)

The Australian Taxation Office, explaining the definition of “royalties” for domestic tax purposes, comments that payments for the use of scientific equipment constitute only royalties because of its specific inclusion in the domestic royalties definition.\(^\text{71}\) This view seems to suggest that income from tangible property does not constitute royalties within its common law meaning.

Lastly, paragraph 18 of the OECD Leasing Report, discussed in 3.3.3.2.2., refers to royalties for copyrights, patents, know-how, etc. as “royalties proper”, which seems to suggest that income from intangibles are to be regarded as “real” royalty income, as opposed to income from leasing, which should not be regarded as “proper” royalty income.

It is not possible to get to a conclusive answer on the difference between royalties and rents and, as mentioned before, neither is it crucial for bilateral tax treaties, which normally clearly define what is to be included under “royalties”. From the discussion above, however, it is probably fair to conclude that, at least in the common law, royalties normally refer to income from intellectual property or a

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69. *Sierra Club*, supra note 36, at paragraph 27 (footnote 12).
right relating to the development of natural resources, whereas
income from tangibles (other than a right relating to the exploitation
of natural resources) are regarded as rent.

3.3.3.2.2. Treatment in bilateral tax treaties

As mentioned above, the phrase "or for the use of, or the right to
use, industrial, commercial or scientific equipment" was deleted
from Article 12(2) of the OECD Model in 1992, following a recom-
mendation in paragraph 23 of the OECD Leasing Report. This
amendment was deemed necessary because member states of the
OECD did not strictly adhere to the provisions of Article 12 of the
OECD Model, that is, to tax royalties only in the state of residence.
It was therefore decided to remove income from leasing of equip­
ment from Article 12. The intention is that leasing of equipment
should be dealt with under Article 7, as business profits. In the
absence of a permanent establishment in the source state by the
lessor, income from such leasing is therefore taxed in the state of
residence only.

The following extracts from paragraph 18 of the above-men­
tioned report provides further background to the amendment. In
addition, it sheds more light on the purpose and focus of Article 12:

i) Income derived from the leasing of industrial, commercial or sci­
entific equipment [ICSE] is usually of a different nature than royalties
proper for which Article 12 of the OECD Model has been primarily
designed, i.e. income from intangibles with a substantial intellectual
content;
ii)...
iii) When extending taxation at source of royalties proper to income
from leasing of ICSE, such income would be subject to taxation on a
gross basis; this might easily result in an excessive tax, as expenses of
the lessor (including depreciation or costs of financing the acquisition
of the assets leased) are disregarded, and the tax at source may not be
fully credited in the country of residence, where income is taxed on a
net basis. Although relevant to royalties of any kind, these considera­
tions are especially important in the case of the leasing of industrial
equipment.

It appears that, despite the amendment to the OECD Model,
some states (see, for example, discussion in 3.3.4.) still include
income from the leasing of equipment under royalties as per Article 12.

3.3.3.3. Leasing of containers

At the same time when the aforementioned report on leasing was issued, the OECD also issued a report entitled: "The taxation of income from the leasing of containers". After an in-depth analysis of all the special issues and problems raised by the leasing of containers, the report concluded that there is no basis for treating income from leasing of containers differently from the leasing of other equipment.

After the amendments to Article 12 in 1992, income from the leasing of containers are also removed from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits in Article 7.

3.3.3.4. Software

Not surprisingly, considering that we are living in the computer age, the question of whether payments received as consideration for computer software may be classified as royalties has become a much discussed issue. It is dealt with extensively in paragraphs 12 to 17 of the MC Commentary on Article 12.\(^72\) It is also the topic of many articles.\(^73\)

In a bilateral tax treaty context, the relevance of the issue is mainly whether consideration relating to software should be dealt with under Article 12 as royalties or under Article 7 as business profits. In some circumstances it may also be dealt with under Articles 13 (capital gains) or 14 (independent personal services). Since so many bilateral tax treaties still allow for some tax on roy-

\(^{72}\) An amended commentary was adopted by Working Party No. 1 of the OECD Committee on Fiscal Affairs and handed out at the 1998 IFA Congress in London. The discussion in this study is based on this amended commentary.

\(^{73}\) See, for example, R.A. van der Laan, "Computer software in international tax law", *Intertax* 1991/5, at 266; Fred C. de Hosson, "Taxation of Cross-Border Software Payments (Article 12)", *Intertax* 1992/12, at 682; Gary D. Sprague and Robin A. Chesler, "Comments on the Commentary to Article 12 (Royalties) of the 1992 OECD Model Convention", *Intertax* 1993/6-7, at 310.
alty payments in the source state, it should in most circumstances be advantageous for the recipient to have the software payments characterized as business profits in order to prevent any tax on gross payments in the source state.

The rights in computer programs are a form of intellectual property. Research by the OECD into the practices of its members has established that all but one state protect rights in computer programs either explicitly or implicitly under copyright law.\textsuperscript{74}

An analysis of the software/royalties issue provides good insight into the subtleties and nature of Article 12 of the OECD Model. As is evident from the discussion below, it is necessary to distinguish between payment for the use or right to use the \textit{copyright}, which is a royalty; payment for use of the \textit{software} only, which is similar to the purchase of a commodity, therefore not a royalty, and falls under either Article 7 or Article 14; and payment for transfer or assignment of the full ownership of the copyright, which is a full alienation of rights, not a royalty, and falls under either Article 7, Article 14 or Article 13.\textsuperscript{75}

Much of the confusion surrounding the issue of the proper characterization of software income lies in the difficulty to precisely determine the nature of property or rights transferred.\textsuperscript{76}

The MC Commentary discusses different situations of dealings with software. One conclusion from the discussion seems to be that consideration relating to software is a royalty only in limited circumstances.

Payments made for the acquisition of less than the full rights (without the transferor fully alienating the copyright) in the copyright represents a royalty where the consideration is for granting of rights to use the programme in a manner that would, without such licence, constitute an infringement of copyright. Examples of such arrangements include licences to reproduce and distribute to the public software incorporating the copyrighted programme. In these

\textsuperscript{74} MC Commentary, at paragraph 12.2.
\textsuperscript{75} See also Van der Laan, \textit{supra} note 73, at 268-270.
\textsuperscript{76} See also De Hosson, \textit{supra} note 73, at 685.
circumstances the licensee is granted the right to use the copyright itself.

Another type of transaction dealt with by the MC Commentary, is more aptly discussed by De Hosson: A transaction where application software ("prepackaged software") is sold solely for in-house use for a one-time, lump sum consideration should be characterized for tax purposes as a sale. The appropriate analogy would seem to be the sale of other copyrighted articles, such as books and records. In neither of these cases is the user obtaining the right to use any significant rights in the underlying copyright itself, which is what should determine the characterization of the revenue as sales proceeds rather than royalties.\(^7\)

Also where consideration is paid for the transfer of full ownership of the rights in the copyright, it is clear that the payment cannot represent a royalty. That follows from the fact that where the ownership of rights has been alienated in full, the consideration cannot be for the use of the rights. In addition, the MC Commentary concludes that the essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most states, by the fact that the payments are related to a contingency.

3.3.3.5. Films

Paragraph 10 of the MC Commentary on Article 12 states that rents in respect of cinematographic films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematographic films shall be treated as industrial and commercial profits and, consequently, subjected to the provisions of Articles 7 and 9.

\(^7\) De Hosson, \textit{supra} note 73, at 686. See, however, David I. Bainbridge, \textit{Intellectual Property}, 1996, at 13, who maintains that "[t]he ‘sale’ of computer software must include a licence because using the software will normally require the performance of an act restricted by copyright, unlike the case of reading a book. The licence may be express but will otherwise be implied."
Vogel comments that the addition of “including cinematograph films” in paragraph 2 is merely designed to clarify the position and that films for television and video are also “cinematographic”. On account of the heavy cost of producing such films, this addition to the concept of royalties becomes problematic whenever a bilateral tax treaty allows the state of source to retain the right to tax royalties.\textsuperscript{78}

3.3.3.6. Apportionment

Paragraph 11 of the MC Commentary on Article 12 discusses contracts which cover both know-how and technical assistance (services). One example of this type of contract is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is to do a reasonable apportionment on the basis of the available information. But, the MC Commentary concludes, if one part of what is being provided constitutes by far the principal purpose of the contract, the other parts being merely of an ancillary and largely unimportant character, the whole amount of the consideration can be applied to the principal part.

Another example of where an apportionment should be made, discussed in paragraph 17 of the MC Commentary, is where software payments are made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services.

Similarly, paragraph 21 of the OECD Leasing Report, discussed in 3.3.3.2.2., refers to cases where the rent for industrial, commercial or scientific equipment may include an element of “royalty proper”. An example is the lease of a machine used to manufacture products protected by a patent, where the rent covers both a consideration for the lease of the machine and a royalty for the use of the patent. Again the recommendation is that an apportionment be made.

\textsuperscript{78} Vogel, \textit{supra} note 50, at 793.
3.3.3.7. Full alienation of rights

In the discussion of the treatment of software in paragraphs 15 and 16 of the MC Commentary on Article 12, it is stated that it is clear that where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty in terms of Article 12. That follows from the fact that where the ownership of rights has been alienated in full, the consideration cannot be for the use of the rights.\textsuperscript{79} No doubt this principle also applies to property other than copyright.

The alienation of property or rights may fall under Articles 7 (business profits), 13 (capital gains), 14 (independent personal services), or 21 (other income).

Many bilateral treaties, however, include the alienation of rights or property in the definition of royalties. Examples of such cases are some German\textsuperscript{80} and United Kingdom (see 3.3.4.) treaties. The same is true for the United States. The definition of royalties in Article 12(2) of the United States Model Convention specifically includes a gain derived from the alienation of any property incorporated in the royalty definition, provided such gain is contingent on the productivity, use, or disposition of the property.

The fact that a full alienation of rights does not fall within the definition of “royalties” was also confirmed by the Amsterdam Court,\textsuperscript{81} which is, according to Hofland,\textsuperscript{82} the only Netherlands court case that addresses the question of what does and what does not constitute a royalty. In that case, as far as it is relevant here, the facts were that a group of persons, including the Dutch taxpayer, was in possession of a trade mark which was licensed out to German cigarette manufacturers in return for a royalty. Because of threats by the Egyptian authorities of nationalizing enterprises owned by foreigners, the trade mark was transferred to an Egyptian entity. As part of


\textsuperscript{80} Vogel, \textit{supra} note 50, at 773.

\textsuperscript{81} 30 January 1976, BNB 1977/258.

the transfer price it was agreed that the Egyptian entity pay the group of persons a share of 40% of certain of the gross royalties accruing to the Egyptian entity. Subsequently, Egypt levied a withholding tax on these annual payments and the question for decision by the court was whether the Dutch taxpayer was entitled to a credit for the withholding tax. The answer depended on whether the payments could be regarded as royalties. The relevant statute for the prevention of double taxation defined “royalties” as consideration for the use of, or the right to use the different types of intellectual property. The court found that the consideration was not for the use of, or the right to use the trademark but for the alienation of the trademark itself. Consequently, the consideration did not constitute “royalties”.

3.3.3.8. Infringement

Paragraph 8 of the MC Commentary on Article 12 clearly states that the definition of royalties covers both payments under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

3.3.3.9. Forbearance

The discussion in 3.3.4. on the royalties definition in Australian tax treaties refers to the inclusion of the phrase “consideration for total or partial forbearance in respect of the use or supply of any property or right referred to in this paragraph” in that definition. In the treaty with the People’s Republic of China it is differently worded as “giving up, wholly or partly, a right relating to the use or supply of any property or right referred to in this paragraph”.

The definition of royalty for purposes of Australia’s domestic tax law contains a comparable phrase. The reason for this is explained by the Australian Taxation Office as follows:

An example of this would be where a person who has acquired the right to use an industrial process or technology that is protected by patent or copyright, pays the owner of the process or technology not to make the process or technology available to any other person. Payments to prevent another person obtaining a dealer franchise are

83. Income Tax Assessment Act 1936, Section 6(1)(f).
another example. Paragraph (f) was added to the definition to remedy a defect exposed by the Victorian Supreme Court’s decision in *Acktiebolaget Volvo v. F C of T*, 78 ATC 4316; 8 ATR 747. Without paragraph (f), transactions could be implemented in a way that might result in payments not being regarded as royalties because they are paid for forbearance rather than for the use of the relevant property.\(^{84}\)

It is probably reasonable to assume that the above explanation is also the reason for the inclusion of “forbearance” in bilateral tax treaties. The question to be answered is to what extent payments for forbearance is covered by the royalties definition in Article 12(2) of the OECD Model.

A first observation is that the situation explained above, of paying the owner not to make the process or technology available to any other person, is very similar to an exclusive licence situation. An exclusive licence authorizes the licensee, to the exclusion of all other persons, including the owner, to exercise a right that would otherwise be exercisable exclusively by the rights owner.\(^{85}\) It can therefore be argued that an exclusive licence, which is certainly covered by the OECD Model definition, is to an extent also a payment for forbearance. A further observation is that the OECD Model definition refers to “the use of, or the right to use”. Therefore, any forbearance payment which simultaneously grants the sole right of use to the payer (whether or not he uses it) is also covered by the OECD Model definition, although a question of apportionment may arise under these circumstances. It is possible to imagine situations of forbearance payments, however, which are not covered by the OECD Model definition, for example, a payment to the owner preventing him to grant the use or right to use to any person, including the payer. Such situation, however, is probably not unintended in terms of the OECD Model definition, because it is very similar to a full alienation of rights by the owner.


\(^{85}\) For a more comprehensive discussion, see 4.6.2.
The fact that the answer to this question is by no means clear-cut, is confirmed by the fact that the OECD is currently dealing with the issue.\footnote{At the 1998 IFA Congress in London, Mr D. Lüthi, chairman of Working Party 1 of the OECD Committee on Fiscal Affairs, listed this as one of the issues currently under investigation. It appears that Australia requested that forbearance payments be included in the definition in Article 12. There is a view, however, that such payments are royalties and that only the MC Commentary needs to be amended.}

3.3.4. Deviations from the OECD Model

An investigation into the royalties definition in bilateral tax treaties confirms the earlier remark that the determination of such meaning has become an arbitrary exercise to be negotiated between the two states. This takes place against the background of the fact that no fewer than thirteen OECD member states have entered a reservation against the zero rate at source provided in Article 12 of the OECD Model. Likewise, thirteen states have entered reservations of some sort against the definition of royalties in Article 12(2).

An analysis by Vogel of the position in Germany shows a great degree of deviation as to the meaning of royalties, not only from the definition in the OECD Model, but also among the treaties with different states. This includes the following examples. Practically all treaties include remuneration for the use of, or the right to use, equipment. Some treaties include alienation in the royalties article. In others, royalties paid for cinematographic films are excluded. More recent treaties with developing countries tend to soften the concept of royalties in relation to consulting activities or similar services, such as by including commercial or technical assistance in the enumeration of subjects capable of being licensed. The treaty with Kenya includes in the royalty definition, as “management fees”, payments made in consideration of the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. Other treaties include (merely for the sake of clarification) the divulging of agricultural experience. The treaty with Korea expressly extends the royalty concept to cover ships and aircraft
leased under a bareboat charterer. Lastly, more than 50% of the treaties allows for some tax in the source country.\textsuperscript{87}

Hofland explains the position in the Netherlands as follows: As of 1 September 1996 there were fifty-eight bilateral tax treaties concluded by the Netherlands, all of which contain an article on royalties, although the definition of royalties varies. In comparison with the 1992-1995 OECD Model, the following groups of deviation can be distinguished: Seven treaties include payments for technical services in the term royalties. In twenty-nine treaties, the source state is given a taxing right, that ranges from 3% to 25%. In addition, many treaties apply special rates for industrial, cultural and scientific and other royalties.\textsuperscript{88}

An analysis of the first twenty\textsuperscript{89} Australian treaties in alphabetical order (from Austria to Malta) again shows a great degree of divergence from the OECD Model as well as among states. In almost all of the treaties the introductory paragraph is more comprehensive (mainly for the sake of clarification) than that of the OECD Model, referring to “payments or credits, whether periodical or not, and however described or computed”. All of the treaties include the use of, or the right to use, any industrial, commercial or scientific equipment. In addition, all treaties include, to a greater or lesser extent (different wording is used), the supply of assistance of an ancillary or subsidiary nature furnished as a means of enabling the application or enjoyment of such knowledge, information or other property or right to which the royalties article applies. Another addition in most of the treaties is “consideration for total or partial forbearance in respect of the use or supply of any property or right referred to in this paragraph”. The treaty with the Czech Republic includes the reception of, or the right to receive, visual images, or sounds, or both, transmitted to the public by satellite or cable, optic fibre or similar technology. The treaty with Fiji includes the supply of management services. The treaty definition with India provides an elaborate provision on the types of services included and

\textsuperscript{87} Vogel, supra note 50, at 780 and 797-803.
\textsuperscript{88} Hofland, supra note 82, at 579-580.
\textsuperscript{89} The first twenty treaties were selected merely as a sample. For the United Kingdom, in the next paragraph, thirty treaties were selected as a sample.
excluded. The aforementioned examples are not exhaustive and there are also other deviations.

An analysis of the first thirty United Kingdom treaties in alphabetical order (from Antigua to Germany) reveals a closer correlation with the royalty definition in the OECD Model as is the case with Australia. In quite a few of the treaties, the only divergences from the OECD Model are that they include the use of, or the right to use, industrial, commercial or scientific equipment and that they elaborate more on films, including not only cinematographic films, but also films or tapes for radio or television broadcasting. There are other divergences, though, which include the following examples. Quite a few treaties (e.g. Antigua, Belize and Brunei) do not specifically include know-how, although they do include the words “or other like property” after listing the different types of intellectual property. The treaty with Argentina includes the use of, or the right to use, news. The treaties with Bulgaria and France include the alienation of rights and property. The treaty with Bulgaria also includes the provision of technical services connected with the sale, use or right to use. The treaty with Egypt has no reference to films, whilst the treaty with Germany specifically excludes a rent or royalty paid in respect of cinematographic films. Curiously as to its purpose, namely whether it is only for clarification or whether there is some other reason, is that almost half of the treaties analysed specifically excludes “a royalty or other amount paid in respect of the operation of a mine or quarry or of other extraction of natural resources”.

3.4. CONCLUSION

There can be no generalization as to the meaning of royalties in bilateral tax treaties. The types of income to be included under the royalties definition is a matter for negotiation between the treaty partners. As the investigation in 3.3.4. has revealed, there is a lot of divergence on the meaning of royalties in bilateral tax treaties, not only from the definition in Article 12(2) of the OECD Model, but also among the different treaties of a specific state with other states. In actual bilateral tax treaties it is therefore necessary to refer to the
specific definition in the treaty concerned to determine which payments constitute royalties.

The definition of royalties in Article 12(2) of the OECD Model is, however, mostly used as the basis for the definition in the actual treaties between states. As far as the definition of royalties in Article 12(2), after the 1992 amendments, is concerned, the following can be concluded:

- The definition as per the OECD Model is arbitrary and quite different from the common law (or other possible domestic) meaning.
- The definition is exhaustive and includes only royalties which come within the definition.
- The definition deals with royalties only in respect of intangibles. No payment in respect of any tangible property falls within the definition. Specifically not included in the definition are natural resource royalties, payments for the use of, or the right to use industrial, commercial or scientific equipment and income from leasing of containers.
- It may be necessary to revert to domestic law in order to determine the meaning of terminology used within the definition.
- In order to be a royalty, the payment must be for the use of, or the right to use intellectual property, or for the provision of know how.
- A full alienation of the ownership of property or rights is not a royalty.
- There is no requirement that payment must be made directly to the owner of the property or rights, or the provider of the know how. No matter to whom the royalties are paid, what is important in order for Article 12 to apply is that royalties arising in one state must be beneficially owned by the resident claiming the treaty relief in the other state.
- There is no requirement that the consideration payable must be linked to the amount of use made of the right acquired. There are no conditions as to how the amount should be computed.
- It is not a requirement that the consideration be paid as and when the privilege acquired is exercised. A lump sum payment can also be a royalty.
Payments for services, as opposed to payments for know-how, are not royalties.

Consideration for software is a royalty only in limited circumstances, that is only where the user obtains the right to use any significant rights in the underlying copyright itself, but excluding situations where the ownership of rights has been alienated in full.

Where any consideration includes payment for royalties as well as payment for another purpose, it is necessary to make a reasonable apportionment.

Compensation for fraudulently copying or infringing a right also constitutes a royalty.

The extent to which payments for forbearance is covered by the definition is still under investigation by the OECD.