Beneficial Ownership of Royalties in Bilateral Tax Treaties

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CHAPTER 7

SUMMARY AND CONCLUSION

7.1. SUMMARY

Chapter 1:
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.” Therefore, 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.

Chapter 2:
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. Chapter 2 therefore investigates the meaning of “intellectual property” and “intangibles”, in particular the way in which the different objects of the definition of royalties in Article 12(2) of the OECD Model relate to these terms.

It is concluded that, because of differences in domestic law, it is not possible to generalize on what is to be included under “intellectual property” internationally. Based on the structure of the royalties definition in Article 12(2) of the OECD Model, however, it can be concluded that, in a broad international sense and for purposes of Article 12(2), the first group of objects (copyright, patent, trade mark, design or model, plan, secret formula or process) can be considered intellectual property. As far as the last object of the definition, that is, information concerning industrial, commercial or scientific experience (know-how) is concerned, however, it does not...
involve the granting of any rights and can therefore not be regarded as property. It simply represents the provision of information.

Chapter 3:

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.

The main conclusion is that there can be no generalization as to the meaning of royalties in bilateral tax treaties. The definition as per the OECD Model is arbitrary and quite different from the common law (or other possible domestic) meaning. The types of income to be included under the royalties definition is a matter for negotiation between the treaty partners. The investigation revealed that 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.

Chapter 4:

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 therefore to first investigate the meaning of ownership. Chapter 4 therefore investigates the meaning of ownership and related issues, such as the classification of rights, in the common law and civil law states.

It is concluded that, despite major differences in the legal systems of the common law and civil law states discussed, it appears that there is great similarity in the concept of ownership internationally. The question of ownership is a legal question and involves an investigation into the nature of the rights held by different persons. In this regard the question of whether the rights held by a person involves a claim of performance against one person only, or is a claim to a thing that can be asserted against the whole world, is very important.
Despite the similarities it was noted, though, that there are also differences which are important for purposes of this study. As is discussed more fully in the next two chapters, the common law states allow the splitting of ownership between a legal owner and a beneficial owner, whereas splitting of ownership is, generally speaking, not allowed in the civil law states.

This chapter also investigates the question: What is the object of the beneficial ownership of royalties for purposes of tax treaties? Does the ownership of royalties refer to the ownership of the underlying intellectual property, ownership of the licence, ownership of the right to receive payment (the debt or claim) or ownership of the actual payment received? To use the legal language of England: What is the thing that is owned as far as royalties are concerned?

It is concluded that an investigation into the ownership of royalties must focus on the ownership of the actual payment received. The ownership of the right to receive payment can also be considered. The ownership of the underlying intellectual property should not be considered at all, whereas reference to the ownership of the licence can be helpful, but should be treated with caution.

Chapter 5:

This chapter investigates the domestic meaning of beneficial ownership in those states, being the common law states, in which the term is recognized for purposes of domestic law. The term “beneficial ownership” is not defined for purposes of its use in Article 12 of the OECD Model. In order to establish its meaning for purposes of international tax treaties, the domestic meaning thereof may provide important clues. As is argued in Chapter 6, such domestic meaning should be taken as the starting point for finding the international tax meaning.

It is concluded that beneficial ownership does have a clear meaning in the common law states. In order to understand the meaning of beneficial ownership it is necessary to realize the distinction between two branches of English law, namely the common law and equity. The common law takes the position that ownership is indivisible and consequently only recognizes legal ownership. Equity, on the other hand, allows divided ownership, with legal title being in
one person and beneficial ownership in another. The right of beneficial ownership is a property right that binds the whole world, except a bona fide purchaser of a legal estate for value without notice. In line with the foregoing, the court in Sainsbury concluded that the real test for beneficial ownership is to consider the nature and extent of the rights held by the different parties. The characteristics of beneficial ownership, and the relation between legal and beneficial ownership, as analysed by the courts, are summarized in more detail in Chapter 6.

Chapter 6:

In Part one of Chapter 6 the current available information on the international tax meaning of beneficial ownership, such as decisions by the courts, opinions by commentators and governments, and information from the OECD is investigated. It is concluded that there is no agreement on the meaning. Opinions range from an economic approach in the United States to a legal approach in Belgium and France. About the only point of consensus is that formal agents and nominees are not beneficial owners.

It is noted, though, that the decision in the Royal Dutch Oil dividends case in the Netherlands, and the views expressed in the OECD Conduit Companies Report support the conclusion reached in Chapter 5, namely that the identification of the beneficial owner involves an investigation into the ownership rights held by different persons.

The commentaries and opinions by others are criticized for not following the steps for treaty interpretation as prescribed by the Vienna Convention. No evidence was found of these persons making a thorough analysis of the textual meaning of beneficial ownership and then using that meaning as the starting point of interpretation.

Part two of Chapter 6 is dedicated to this study’s own interpretation of the international tax meaning of beneficial ownership by closely following the steps as prescribed by the Vienna Convention.

This study agrees with the view expressed at the 1998 IFA Congress in London that the question whether beneficial ownership
is a term to which Article 3(2) of the OECD Model applies, is the first main issue for consideration. The second issue, on the assumption that the first one is answered in the negative, is: what is the international tax language meaning of the term? The focus of this study is on the second issue, and the first one is only discussed briefly.

In terms of the hypothesis of this study as to the international tax meaning of beneficial ownership, it is argued that 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. In respect of bilateral tax treaties of those states which have adopted the wording of the OECD Model in respect of beneficial ownership without adaptation or any indication that they intend the term to have a meaning different from that envisaged by the OECD Model, the common law states represent the source that the term was taken from, and the meaning in those states should be taken as the starting point for interpretation in terms of the Vienna Convention. The meaning in the common law states should then be modified, if necessary, in the context of the treaty and in the light of its object and purpose.

The approach as described above does not represent a situation where the domestic law of one state is applied in others. Rather, it is a case where the international community borrowed a notion from some of its members in order to apply it as an international notion.

Applying the provisions of Article 31 of the Vienna Convention, this study emphasizes the importance of starting the process of interpretation with the text, the letter, the wording. This is especially important as far as beneficial ownership is concerned. Despite the fact that there were several other options available to the OECD when they had to decide on a method to restrict treaty benefits, and the fact that the notion of beneficial ownership is not known in the domestic law of many of its member states, the choice of the OECD fell on beneficial ownership – maybe because of the unique and subtle characteristics of that term. The textual meaning of beneficial ownership should therefore be thoroughly investigated.
As far as the meaning of beneficial ownership that should be taken as a starting point for interpretation is concerned, this study has found no meaning of the term other than the legal sense in which it is used in the common law states. The main characteristics of beneficial ownership in terms of the case law discussed in Chapter 5, are the following: First, mere legal title without the right to deal with the thing to some extent as your own does not constitute beneficial ownership. Second, the right of beneficial ownership must be recognized by law and must be able to be enforced by the courts. Third, where something is acquired subject to the obligation to transfer it to others, such acquisition is not regarded as beneficial ownership. Fourth, out of the various similar terminology used by the courts in this regard, “ownership attributes” appear to be the most appropriate term to be used as the test for beneficial ownership. “Ownership attributes” has a wide meaning and includes not only rights but also other attributes such as depreciation. Lastly, there can be only one beneficial owner in respect of a thing at any specific point in time. From this it follows that the beneficial owner must be the person whose ownership attributes are more than that of any other person.

In terms of the above, the following meaning of beneficial owner, which should be taken as the starting point of interpretation, is formulated:

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

Both the issues of the identification of the ownership attributes and determining who holds the biggest weight, depends on the specific circumstances. The ownership attributes should, however, include the right to possess, use, manage, the income, the capital (including the power to alienate and the liberty to consume, waste or destroy), plus the risk of depreciation and the hope of appreciation. It is submitted that the Dutch Supreme Court’s phrase of “could freely avail of the distribution”, together with the fact that the taxpayer in that case also carried the risks in connection with the dividend distribution, aptly summarizes the ownership attributes in respect of the receipt of a payment.
The above analysis, which is based on the view in the common law states of split ownership between a legal and beneficial owner, may cause problems in the civil law states. The civil law, generally speaking, does not recognize similar divided ownership. The real rights of enjoyment are normally expressly defined and limited by the Civil Code.

It is suggested, however, that the civil law states can accommodate the approach of the common law states to ownership attributes. Instead of viewing the division between the legal owner and beneficial owner as a split in ownership, the issue should be viewed in the civil law as a legal owner holding legal title in accordance with the Civil Code, but subject to rights and obligations in respect of another person. The rights of the third party against the person holding legal title are personal and enforceable only against that person, as opposed to rights which can be enforced against the whole world. It is submitted that the fact that the rights enforced against the person holding legal title are personal, as opposed to rights that can be asserted against the whole world, makes no real difference for the purpose of determining the beneficial owner for treaty purposes. This is not a case where the competing interests of vendors, purchasers, possessors or others to a thing are at issue. From a tax treaty perspective, the object is to identify the person whose rights (whether they are personal, or can be asserted against the whole world) are greater than that of any other person.

Continuing with the application of the rules of the Vienna Convention, the study concludes that the information that can be gathered from the context, object and purpose of the treaty supports the meaning as formulated above. The same is true in respect of the available supplementary means of interpretation. It is noted though that, because of the fact that an inquiry into the reasons why a transaction is done in a specific manner does not form part of the beneficial ownership test, there is not always a direct relationship between the results of the beneficial ownership test and the purpose of anti-avoidance.

With reference to the MC Commentary, it is further concluded that not only agents and nominees are excluded from beneficial
ownership, but all other intermediaries of the same kind, in other words, those not holding the biggest weight of ownership attributes.

In the last section of Chapter 6, the ownership attributes test is applied to situations where entities are interposed in intermediary states. In applying the test to practical situations, it is emphasized that beneficial ownership is a question of law. Beneficial ownership, in terms of its meaning in the common law states, represents a form of ownership, which, as has been discussed in Chapter 4, is a very strong right. The case law discussed has shown that in order to qualify as a right of beneficial ownership, a right must be recognized by law and be able to be enforced by the courts. This study has found no evidence, neither in the OECD Model nor in the MC Commentary, to support a different meaning for international purposes, namely that beneficial ownership is excluded, not only where a person is under a legal obligation to pay on a royalty, but also where it is paid on in fact and in the absence of a legal obligation. The question is therefore not whether a royalty is in fact paid on to a next person, but whether there is a legal obligation to pay it on.

Because of the nature of the relationship between a holding company and its subsidiaries, the identification of the beneficial owner in situations where all the entities in the royalty chain are from the same group, is problematic. The question is whether the control of a holding company over its subsidiary can be seen as a situation which places a legal obligation on the latter to pay on all royalties received, and consequently deprives the latter of the ownership attributes in respect of the receipt. Case law emphasizes that the concepts of control and ownership should not be confused. It is stated that the creation of power over property does not in any way vest the property in the person holding the power, though the exercise of the power may do so. As far as tax treaties are concerned, the question that arises is whether the fact that the holding company has used its control to compel the subsidiary to pay the royalties on to it, can be seen as an exercise of power which vested the beneficial ownership in the holding company?

In order to provide answers in group, and other, problematic situations, it is appropriate to turn to the question of agency or other representation. Even though the application of the ownership attrib-
utes test does not, in the first place, involve an investigation as to whether an agency or other representative relationship is present, it is evident that if it can be proven that such relationship does exist, it is conclusive evidence that such person is not a beneficial owner. It is submitted that, in the majority of cases, the question of whether a person is a beneficial owner is the converse of the question whether that person acts in an agency or other representative capacity.

Of particular relevance is the question of whether the relationship between a holding company and its subsidiaries is one of agency or other representation? Commentators differ on this issue. It does appear, however, that at least in the legal jurisdictions of some states, it may be possible to regard a subsidiary as an agent or other representative of the holding company with respect to specific transactions. But, it is very difficult to determine clear rules for the exact cut-off point when the control of a holding company over its subsidiary changes to an agency relationship. It is hard to determine the circumstances under which it can be said that the subsidiary is receiving a royalty payment on behalf of its holding company.

As was the conclusion in applying the ownership attributes test, the conclusion is similar when applying the agency construction, namely that neither test is easy to apply in group situations and subsequently neither test can be regarded as a certain and effective way of determining the beneficial owner in group situations.

7.2. CONCLUSION

The main finding of this study is that, contrary to views expressed by others, beneficial ownership has a meaning that can be applied for international tax purposes. The meaning makes sense against the background of the reasons for its introduction into the OECD Model, and it can be applied in both common law and civil law states.

The beneficial ownership test does have limitations, though. One reason for this relates to the fact that, although its incorporation into the OECD Model has an anti-treaty abuse purpose, the reasons why a transaction is done in a specific manner does not form part of
the beneficial ownership test. Consequently there is not always a direct relationship between the results of the beneficial ownership test and the purpose of anti-avoidance. Another problem with the beneficial ownership test, is the practical difficulties for the revenue authorities in the source state to determine the real nature of the relationship between parties in the resident and other states. It was also found that, because of the nature of the relationship between a holding company and its subsidiaries, the beneficial ownership test is not easy to apply in group situations.

The fact that the beneficial ownership test does not deal satisfactorily with all conduit entity situations is acknowledged by the OECD. The question then arises of how to address the issue. Should the OECD Model and the MC Commentary be changed?

The point is that it is really up to treaty partners to decide on the issue. On the one hand it can be argued that, for purposes of uniformity, the OECD should provide more detailed guidelines in the OECD Model and MC Commentary. On the other hand, though, there is also an argument that different states do not necessarily share the same views on treaty abuse and that the OECD should not be too prescriptive on the matter.

Various options are available to those states who are not satisfied with the current wording and provisions of the OECD Model and MC Commentary. The MC Commentary specifically provides member states with the opportunity to adopt their own definition of beneficial ownership. Some states have followed this recommendation. Others have brought in tests such as prohibiting treaty benefits to entities interposed with the sole purpose to make use of treaty benefits. The OECD Conduit Companies Report deals with various objective tests which member states can consider incorporating in order to address specific conduit situations. The United States “limitation on benefits” provision is a good example of an objective test to be used in conjunction with the beneficial ownership test.

There are therefore various options available to treaty partners. For those treaty partners who do not opt for any of the alternatives, but adopt the wording of the OECD Model without any adaptations, it is, however, submitted that the meaning of beneficial owner as determined in this study applies:
The beneficial owner is the person whose ownership attributes outweigh that of any other person.
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