

**AN INSIGHT INTO THE DEVELOPMENT OF THE
ROYALTY DEFINITION CONTAINED IN MODERN
MODEL TAX CONVENTIONS AND THE EVOLUTION OF
THE INTERNATIONAL TAX MEANING OF
'BENEFICIAL OWNERSHIP'**

by
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DECLARATION

I, Johannes Barend Greyling, hereby declare that the work on which this thesis is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, or is to be submitted for another degree in this or any other University.

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Johan Greyling

Cape Town, 29 October 2010.

SUMMARY

The study's focus is to provide an analysis of the development of the definition of royalties in the context of Model Tax Conventions ('MTC'). The secondary focus of the study is to analyse the evolution of the concept of beneficial ownership as a limitation to the application of the treaty benefits contained in royalty provisions of the MTC's.

In terms of the focus of the study, it is concluded that the most significant developments with regards to the definition of royalties, since originating in the League of Nations Model Convention's first Draft Model in 1928, occurred during the final Committee meetings held in Mexico and London (producing the Mexico and London Draft Models respectively) and in terms of the Organisation for European Economic Cooperation ('OEEC'), which set out the founding principles of the definition. It is also concluded that the later MTC's did not significantly change the Treaty royalty definition but added clarification as to the meaning of the term by way of the Commentaries to the MTC.

The secondary focus of the study concludes that the term has not really changed since it was first used in an international context. The most recent case law on the matter confirmed that the attributes of the concept is that of ownership and that the matter is one which needs to be decided from a legalistic perspective and should not be based on the economic interpretation of the term 'beneficial ownership', which could effectively turn the concept into a broad anti-avoidance provision.

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Chapter 1

INTRODUCTION

1.1 BACKGROUND

One of the primary reasons for the occurrence of double taxation is the fact that not all countries follow the same premise in the manner upon which they tax their citizens or residents. Some countries levy tax on its citizens or residents worldwide income and gains, whereas other countries impose tax only on income sourced in that State. There are also countries that apply a combination of the above approaches.

As a result of these different bases of taxation, taxpayers who engage in cross-border transactions often suffer double taxation in some form or another. This double taxation has led to a proliferation of agreements between countries in an attempt to prevent or reduce juridical double tax¹ as an inhibiting factor to economic activity.

From the inception of the first bilateral double tax convention ('DTC') concluded between Prussia and Saxony in 1869, the main purpose of DTC's has been the avoidance of double taxation.² This purpose is echoed by the original Model Tax Convention ('MTC') introduced by The League of Nations in 1928³ ('Geneva Model') as pointed out in the following extract of Article 1:

The present Convention is designed to prevent double taxation in the sphere of direct impersonal or personal taxes, in the case of taxpayers of the Contracting Parties, whether nationals or otherwise.

Since the 1928 Geneva Models there have been numerous MTC's from different international organisations such as the Organisation for Economic Co-operation and Development ('OECD') and the United Nations ('UN'), which have attempted to clarify, standardise and confirm the fiscal position of taxpayers who are involved in cross-border transactions. The method whereby these Models attempt to achieve their goal is mainly by way of the allocation of taxing rights between the residence and Source States.

The latest versions of the most widely used MTC's include the 2010 OECD Model Tax Convention on Income and Capital ('2010 OECD Model'), 2001 UN Income and Capital Model Convention ('2001 UN Model'), 2006 United States Model Income Tax Treaty ('2006 US Model')

¹ Please refer to section 2.1.1 below for the distinction between juridical and economic double tax.

² Holmes. 2007. *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application*. Amsterdam: IBFD at 56.

³ League of Nations. 1928. *Double Taxation and Tax Evasion*. Report presented by General Meeting of Government Experts on Double Tax and Tax Evasion. Geneva.

and the 1994 CARICOM agreement. These Models are the culmination of decades of development in the field of double taxation.

A factor of ever-increasing importance in the arena of international taxation is that of intangible assets, both in developing as well as developed economies. A recent report from the OECD, which looks at the creation of value from intellectual assets, points out that these assets are becoming strategic factors as regards the creation of value.⁴ This is specifically evident in light of globalisation and the emergence of information technology and the manner in which knowledge is created, disseminated and applied in the modern age across international borders.

As royalties are often paid across international borders, it is not surprising to learn that the issue regarding the international taxation of such royalties is specifically addressed in virtually all modern MTC's.

It does however appear that royalties have not always been as important a factor as other categories of income when it is taken into consideration that economists did not even mention royalties when discussing intangible property.⁵ These discussions were limited to real estate mortgages, corporate securities, government bonds and private credit which were, according to the League of Nations 1923 Report,⁶ regarded as the 'most important classes in this category'.

Later, in the 1928 draft of the League of Nations Report, royalties were included in the category of 'other income' and taxable by the Resident State.⁷ In the subsequent Draft Reports from the League of Nations in 1931 and 1933, the categorisation of intellectual property was further defined and ultimately provided for in a separate provision dealing exclusively with royalty income.⁸ The details of this development will be analysed in Chapter 3 of this study.

The question which then remains to be answered is what is a royalty? The answer lies of course in the definition of a royalty as provided by the treaty and the interpretation thereof by the different parties to the agreement. With regards to the meaning of this definition in terms of the MTC's, a great deal of insight is to be gained from the Commentaries to these Model Conventions. Although not legally binding on South African courts, the official Commentaries to these Models, and specifically that of the OECD, have at least once been referred to by the South African

⁴ OECD. "Creating value from Intellectual Assets". *Policy Brief*. IBFD. Paris.

⁵ Tadmore. "Source Taxation of Cross-border Intellectual Supplies – Concept, History and Evolution into the Digital Age" *Bulletin for International Taxation* 2 5 to 7.

⁶ League of Nations. 1923. *Report presented by the Committee of Technical experts on Double Taxation and Tax Evasion*. IBFD: Geneva.

⁷ League of Nations. 1923. *Report on Double Taxation. Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*. League of Nations, E.F.S.73.F.19.

⁸ Doernberg and Hinnekekens. 1999. *Electronic Commerce and International Taxation*. Kluwer Law International. The Hague at 16 to 17.

Supreme Court of Appeal in the case of *SIR v Downing*⁹ as an authoritative source in aiding with the interpretation of specific provisions of DTC's which are based on one of the versions of the OECD's Model Tax Conventions.

The reason why the Commentaries to these Models are considered as useful aids is due to them being the most probable source from which the intention, of the contracting parties to the DTC at the time of the negotiation, may be gathered. These Commentaries therefore provide great insight into the development of the treaty provisions as they assist in clarifying the reasoning behind the use of certain phrases which shaped the development of these provisions.

One such phrase is the term 'beneficial ownership' which, by way of a simple explanation, provides a means of determining whether a person qualifies for Treaty benefits as the real or beneficial owner thereof, i.e. the person who assumes all the attributes of ownership. The basic aim or reasoning behind the inclusion of the term 'beneficial ownership' appears to be a means of limiting the application of Treaty benefits in an attempt to prevent possible Treaty abuses.¹⁰

1.2 OBJECTIVES

Firstly, the objective of this study is to analyse the most widely used Model Tax Conventions with specific reference to the provision contained therein pertaining to royalty income. This is done by tracking the development of these provisions since the inception of the first Model Conventions, the Geneva Models, up to the current OECD Model Tax Convention on Income and Capital.

This analysis will be carried out by exploring the development of the specific provisions relating to the definition of royalties within these MTC's. The study will take into consideration MTC's dating from the initiation of the 'founding' Model¹¹ (the Geneva Model) and will include the most widely used Models up to and including the latest 2010 OECD Model.

At this point, it must however be clearly stated that immediately preceding the completion of this study, the OECD published its latest Model Tax Convention on 22 July 2010, namely the 2010 OECD Model which strictly speaking is the current OECD MTC. Consequently, where this study refers to the current OECD MTC, it must be interpreted as referring to the 2008 OECD Model Tax Convention on Income and Capital ('2008 OECD MTC') unless specifically indicated otherwise.

⁹ 1975(4) SA 518 (A) at 523 and 526, see also *COT v Aktiebolaget Tetra Pak* 1966 (4) SA 198 (RA) at 200.

¹⁰ Pijl "The Definition of 'Beneficial Ownership' under Dutch Law". *Bulletin for International Fiscal Documentation*, June 2000 at 256, and see also Oliver, Libin, Van Weeghel and Du Toit "Beneficial Ownership". *Bulletin*. IBFD (July 2000) 310 at 319

¹¹ See 1928 League of Nations - Geneva Model *supra*.

Secondly, the aim of this study is to ascertain the manner in which the principles contained in the MTC's on which the modern DTC's are based, are employed in creating the final treaties that establish the basis of taxation applied between Contracting States.

In summary, the benefit of the research is firstly to provide answers to the question of why the provisions surrounding royalty income in MTC's are formulated in the manner which they are, i.e. illustrating the underpinnings to the specific Models; and secondly to provide an insight into the differences in the application of the various Models tax Treaties included in this study.

The following are the key objectives of the study and include statements as well as questions which are set out below and will be discussed in chapters 2 to 4 in an attempt to clarify and substantiate the aim of this study:

- To provide a basic understanding of the working of Model Tax Conventions and the legal status of the official Commentaries to these Conventions and their interpretation;
- To determine what royalties are and whether or not there has been a significant variation in the definition of royalties used in the earlier treaties as opposed to those applied by the 'modern' MTC's and if so, what are the consequences thereof on double taxation?;
- Illustrate the role of beneficial ownership in treaties whilst asking the question of how this principle is used and the efficacy thereof as an anti-avoidance measure;
- Analyse the development of the term 'beneficial ownership' and the international tax meaning of the concept.

The methodology used to meet the objectives as outlined above mainly comprises the consultation of international tax literature and case law on the subject.

1.3 TERMINOLOGY

The terminology applied in this study will as far as possible be uniform without moving too far away from their technical meanings.

Furthermore, the terms 'Double Tax Convention', 'Double Tax Agreement', 'tax treaty/ies' and 'treaty' are used interchangeably and are merely variations of the same notion.

All references made in this study to 'Model' or 'Model treaties' refer to Model Tax Conventions on Income and on Capital.

The term 'State' will be used in the same manner as it is used in the contexts of MTC's in which circumstances it refers to the State of residence or the State of source. These different States represent the States where the income is generated i.e. the Source State and likewise the Resident State which indicates the State in which the owner of the royalty income is resident.¹²

1.4 CHAPTER INDEX

Chapter 2 provides a basic understanding of the working of double tax treaties and their history and place in international law. This chapter will illustrate what international double taxation entails and how tax treaties aim to provide relief in these circumstances.

Chapter 3 investigates the definition of royalties whilst taking into consideration the development of the term. The reasoning behind this is to establish exactly what type of income falls into the category of royalty income in terms of the various MTC's.

Chapter 4 deals with the concept of beneficial ownership and provides a brief run-through of the development of the term during the past 45 years and the influence thereof on the taxation of royalties in terms of the provisions contained Model Tax Conventions and international taxation.

Chapter 5 contains the summary and conclusion.

¹² Please note that in a number of the more recent treaties an anti-avoidance measure is included in the royalty article of the MTC's/DTC's in that the provision requires the owner of the income generated by the royalties to be the 'beneficial owner' of the royalty income. See Du Toit. 1999. *Beneficial Ownership of Royalties in Bilateral Tax Treaties*. IBFD. Amsterdam at 208.

Chapter 2

THE WORKING OF DOUBLE TAX TREATIES AND THEIR PLACE IN INTERNATIONAL LAW

2.1 INTERNATIONAL DOUBLE TAX

This study deals mainly with the development of specific provisions contained in various MTC's relating to royalty income. It does not primarily consider the question of what constitutes international double tax. However, some knowledge of what international double taxation encompasses is essential to gain an overall understanding of the application of double tax agreements and the methods by which double tax is to be eliminated or minimised by such agreements as well as by specific domestic tax law provisions to fully appreciate the intricacies of the Treaty definition of royalties and the international tax meaning of the term 'beneficial ownership'.¹³

The concept of international double tax is briefly analysed below.

2.1.1 What constitutes international double tax

There are two forms of international double tax that an entity can suffer as a result of cross border transactions, economic double tax and legal double tax.

Economic double tax entails the taxing of commercially the same income on two separate occasions and most notably in the hands of different taxpayers. Economic double taxation only occurs in the instance where corporate profits are taxed twice, i.e. this takes place when a company's after-tax profits are distributed to its shareholders by way of a dividend and these dividends are once again taxed, but this time in the hands of the shareholders.¹⁴

Legal, or more commonly referred to as juridical double taxation, entails comparable taxes being imposed on the same subject, in the hands of the same taxpayer in two or more countries during the same tax period. The term international double taxation and juridical double taxation can therefore be used as synonyms.¹⁵

¹³It should be noted that double tax agreements do not provide the only means by which double tax can be minimised or eliminated. There are various provisions contained in the domestic legislation of practically all tax jurisdictions, such as that of section 6 quat of the South African Income Tax Act No. 58 of 1962, which provides relief against double taxation by allowing a rebate against the South African tax payable in respect of foreign income included in South African taxable income, limited of course to the South African tax attributable to the foreign income.

¹⁴ Olivier and Honiball. 2008. *International Tax. A South African Perspective*. Fourth edition. Siber Ink at 314 to 317.

¹⁵ Ibid.

Juridical double taxation occurs as a consequence of source and residence conflicts arising from the application of the domestic laws of two or more countries.¹⁶ There are three different forms in which these conflicts can arise namely in terms of residence/residence conflicts, residence/source conflicts and lastly as a result of source/source conflicts.¹⁷

2.2 JURISDICTION TO TAX

To appreciate the conflicts that arise in each of the above situations one must have an understanding of the working of the residence and source rules. These fundamental rules provide the answer to the question of whether a connecting factor or *nexus*¹⁸ exists between the income arising, and the ability of a particular country to levy an enforceable tax on that said income.¹⁹

The connecting factors are laid out in the domestic law of each particular country which determines whether the person who earned the income, is connected either to that country or to the activity from which the income was earned. These connections are referred to in the first instance as the residence jurisdiction and in the second as the source jurisdiction.

In this regard, it could be pointed out that South Africa's income tax base was fundamentally altered by the Revenue Laws Amendment Act, 59 of 2000. This Act effectively introduced the system of residence-based income taxation whereby natural and legal persons who are considered tax residents of South Africa, became liable to income tax chargeable on their worldwide earnings. For 'persons other than residents'²⁰ the "old" basis of income taxation remains in place which imposes income tax only on the income received, or deemed to be received, from a source located within the Republic.²¹

2.2.1 Residence

Internationally there are numerous methods by which means the residence of a non-natural entity can be established. For example the place of incorporation, location of its registered office,

¹⁶ Arnold and McIntyre. 2002. *International Tax Primer*. Second edition. Kluwer Law International at 27.

¹⁷ See Holmes *supra* at 23.

¹⁸ Danziger. 1991. *International Income Tax. The South African perspective*. Butterworths. Durban at 3 submits that States would only seek to exercise jurisdiction in other States if there is a link or connection between the State and the object which supplies the right or interest which the State has in exercising jurisdiction over that object.

¹⁹ See Olivier *supra* at 50 where it is pointed out that without the existence of the necessary *nexus*, the collection of taxes would be near impossible, as there would be no realistic method of enforcement.

²⁰ The shorthand description 'non-resident' will be used throughout this study.

²¹ A variation, which broadens the tax base considerably in the case of the residence base of taxation, is to be found in the citizen or nationality and the domicile jurisdictions. The term 'residence' however has a very specific meaning for tax law purposes and should not be confused with terms such as 'nationality/citizen' or 'domicile'.

place of residence of the directors, shareholders or managers or the place of effective management, etc.²²

The residence basis of taxation is also popularly referred to as the worldwide basis of taxation. This is due to the fact that in its broadest form, residence based taxation allows the country in which the person is resident, to tax that person on its worldwide income on the basis that it is tax resident in that country. As few countries, from an administrative approach, have the capacity to enforce such a broadly cast tax net, the 'residence minus' approach is followed, which exempts certain categories of income.

In the South African context, the term resident (pertaining to non-natural persons) is defined in section 1 of the Income Tax Act, 58 of 1962 (as amended) ('the Act') and reads as follows:

'resident' means any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic; but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double tax.

The above definition broadly provides two tests: firstly, that of the place of incorporation, establishment or formation and secondly, that of the place of effective management.²³ These tests for residence are similar to that of the first sentences contained in both the OECD and UN MTC's definition of a resident in Article 4 which reads as follows:²⁴

For the purpose of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of effective management or any other criteria of similar nature... This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

It should be noted that the 2001 UN MTC's definition includes place of incorporation.²⁵

The first mentioned test provides simplicity to the determination of the residence status to both the revenue authorities as well as taxpayers, as entities are considered to be resident as long as

²² See Rohatgi. 2002. *Basic International Tax*. Kluwer Law International at 209 to 210.

²³ For the purposes of double tax agreements entered into by two States, a person who is deemed to be exclusively a resident of the one State, cannot be taxed as a resident in the other, even though that person meets the residence criteria of the other State.

²⁴ OECD. 2008. *Official Commentary on the OECD Model Tax Convention on Income and Capital*. Condensed version. Paris at § 1 of Article 4.

²⁵ United Nations. 2001. *Income and Capital Model Convention*. IBFD. Paris at § 1 of Article 4.

they are incorporated, established or formed in country, irrespective of where their place of effective management is.

Due to the lack of formal connecting factors and the ease in which corporations can be formed and registered in most jurisdictions, this test may however not necessarily reflect the economic reality of the circumstances. A prime example is found in the United States of America (“US”) where, once a corporation is incorporated, momentous tax consequences follow. US domestic corporations are taxed on their worldwide income,²⁶ whilst foreign entities are taxed only on income generated from investments or business in the US.

The second test, ‘place of effective management’, is not defined in the Act. There is also no single internationally mandated meaning of this term which is to be found in most double tax treaties as it is used to determine the residence status of dual resident companies under the tie-breaker rules. These tie-breaker rules are important as an entity can only be resident of a single State with regards to the application of a DTC. In respect of both the UN and OECD MTC’s the tie-breaker rules with regards to non-natural entities is contained in Article 4(3) of the 2010 OECD Model and reads as follows:

Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

It is important to note that the exact meaning of the term differs between countries and constitutes a fact-based test. The OECD MTC describes the meaning of “place of effective management” as:²⁷

...the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made... A company can have more than one place of management, but it can only have one place of effective management.

The South African Revenue Authority (‘SARS’), however, follow a different approach as outlined in Interpretation Note 6 to in the Act²⁸ (at paragraph 3.2) and takes the view that the place of effective management of a company may be located at the place where it is:

...**managed on a day-to-day** basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.

²⁶ Section 7701(a)(4) of the Internal Revenue Code of 1986.

²⁷ See 2008 OECD MTC *supra* at § 24 of the Commentary on Article 4.

²⁸ The Interpretation Notes to the Act do not carry legislative authority, but are merely SARS’s interpretation as to the meaning of a specific section.

[Emphasis added]

Various commentators as well as international case law contradict the above position of the SARS. Examples of these include German case law on the meaning of the phrase 'the place of management of an enterprise' as well as the commentaries of Dr. Klaus Vogel which state that the meaning of the phrase 'place of management of an enterprise' refers to the place where the management's important policies are actually made:²⁹

What is decisive is not the place where management directives take effect but rather the place where they are given. According to consistent case law of the *BFH* [Bundesfinanzhof, i.e. the German Federal Fiscal Court] the centre of management activities of a company generally is the place at which the person authorised to represent the company carries on his business-management activities.

Vogel's further comments on the subject include the following:³⁰

Decisions taken at a place of management must be of significance to the enterprise as a whole. Although the English term 'management' may be subject to a broader interpretation, the French version '*siège de direction*' shows without a doubt that only managerial activities are intended... A place where decisions are taken is one where the crucial decision-making process takes place, where the authoritative words are spoken.

From the aforementioned, it is evident that the 'real' management and authority of a company vests in the board of directors as they have the decision-making capacity to significantly influence the policy and direction of the company.

2.2.2 Source

In source jurisdictions, otherwise known as territorial jurisdictions,³¹ a country's right to tax depends on whether the income is generated from activities which were performed within its borders. This basis of taxation is found mainly in developing and capital importing countries.

The term 'source' is usually not defined in the legal statutes of countries and, as is the case in South Africa, the burden of establishing the meaning of the term is left up to the courts to decide. The South African courts, however, have not laid down a concise definition of the term 'source' but rather provided some indication of the tests and factors that are to be considered, and depending

²⁹ Vogel. 1997. *Klaus Vogel on Double Taxation Conventions*. 3rd edition. Kluwer Law International at 262 to 264.

³⁰ *Ibid* at 296

³¹ Olivier *supra* at 50.

on the circumstances, to be applied in deciding where the source of the income is located.³² The US is however the exception, and have laid down specific rules which govern situations affected by this principle in their statutes.³³

The source basis of taxation restricts the country's tax base in contrast with the residence basis, and is therefore usually not applied in its pure form, but supplemented by deemed source provisions otherwise known as 'source plus' rules.³⁴

As pointed out earlier, even though South Africa moved away from the source basis, in favour of a residence based system of taxation, the rules relating to source are still relevant in a number of situations apart from the fact that they are applied to the income of non-residents. These situations include double tax treaties where the source of the income can often determine which State enjoys the primary taxing rights. It also serves to ring-fence expenditure incurred outside of South Africa,³⁵ and further provides that a rebate for taxes payable is only available in respect of non-South African sourced income.

In determining the source of the income in a South African context, a two-pronged approach is followed. The first leg consists of establishing the originating cause³⁶ of the income and once this has been done, the second step is to determine the country in which the income generating activities were conducted.³⁷ The source of the income can therefore be said not to be the quarter from which it comes but rather the originating cause of its receipt.³⁸

2.2.3 Examples of source and residence conflicts

It was eluded to earlier that there are three types of conflicts, namely that of residence/source, residence/residence and source/source, and that international double taxation arises as a result of

³² In South Africa, the court by way of Centlivres, C.J. in the case of *CIR v Epstein* 1954 (3) SA 689 (A) at 698 noted that the legislature were probably aware of the difficulty in defining the phrase ("from a source within the republic" and consequently gave no definition. Watermeyer, C.J. in *CIR v Lever Brothers and another* 14 SATC 441, commented that it would be impossible to formulate a definition of the phrase.

³³ Amatucci. 2006. *International Tax Law*. Kluwer Law International at 191.

³⁴ See *Kergeulen Sealing and Whaling Co Ltd v CIR* 10 SATC 363; *ITC 749* 18 SATC 319 and *ITC 1170* 34 SATC 76.

³⁵ Section 20(2) of the Act.

³⁶ In instances where there are more than one originating cause, but it is not possible to determine which is dominant, logic suggests that it would be appropriate to apportion the income between the countries concerned. The South African courts have however never been fond of this approach as is evident from the following case law; *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax*, Botswana 29 SATC 97; *CIR v Black* 21 SATC 226; *COT v Shein* 22 SATC 12 and *SIR v Kirsch* 40 SATC 95.

³⁷ The case law dealing with the source principle often creates the impression that a 'common sense' approach is followed in determining the source and thereafter providing a basis for the decision such as in the case of *Rhodesia Metals Ltd (In Liquidation) v COT* 11 SATC 244 where it was held that: 'Source means not a legal concept but something which a practical man would regard as real source of income'; 'the ascertaining of the actual source is a practical hard matter of fact'.

³⁸ *CIR v Lever Brothers and Unilever Ltd* 14 SATC 441 at 449.

these conflicts.³⁹ Below examples of these conflicts are considered from a South African perspective.

An example of a residence/residence conflict arises in instances where the different States each follow the residence basis of taxation but apply different tests for establishing the residency of taxpayers. Should the specific circumstances of the taxpayer satisfy the test laid down in both States, the resultant effect would entail that the taxpayer may be treated as a tax resident in both States. An example of the above situation is most commonly encountered where a taxpayer's enterprise is incorporated in one State, but the effective management thereof is conducted from another State. In order for the residence/residence conflict to be in point in this type of circumstance, the first mentioned State must base its residency criteria on the place of incorporation of the enterprise, whilst the second State applies the 'place of effective management' test. The result is therefore "dual residency" and the taxpayer suffers tax twice on its worldwide (i.e. the same) income.

Residence/source conflicts arise where the States each apply a different basis of taxation but the taxpayer and the income it produces falls into both the different categories in either State. An example would encompass the situation in which a South African tax resident earns income which is sourced from a State that applies the source basis of taxation. The taxpayer is therefore taxed in South Africa in terms of its worldwide income and in the other State on the source of the profits.

Source/source conflicts arise where both States apply the source basis of taxation with each of these States contending that it is entitled to impose tax on the income on the basis that it is either sourced or deemed to be sourced in that State. An example of this type of conflict can be found in the working of the withholding tax provisions imposed on royalties⁴⁰ which deem the royalties to be from a South African source⁴¹ even though they may actually be sourced in another State. It should however be noted that DTC's do not address the issue of source/source conflicts, relief for double tax in this context must be sought in terms of the domestic law of the State in which the taxpayer resides.⁴²

2.2.4 Conclusion

From the above it is clear that international tax can best be regarded as the legal provisions of different countries covering cross-border transactions.⁴³ Apart from the European Union, there can be said to be no overarching body of international tax law applicable to countries who choose to

³⁹ See Arnold and McIntyre *supra* note 16.

⁴⁰ Section 35 of the Act.

⁴¹ Section 9(1)(b) of the Act

⁴² See Olivier *supra* at 51 to 60.

⁴³ See Holmes *supra* at 2 to 3.

comply with it and the phrase “international tax” is therefore somewhat of a misnomer.⁴⁴ Whilst a global taxing body does not currently exist, it has been predicted that such a body may however be created in the near future.

It is therefore a generally accepted convention that whilst countries are free to levy tax it chooses, it cannot enforce its tax claims on the territory of another country, as the right to tax forms part of a State’s sovereign powers.

The bridging of these and other issues with regards to the field of international double taxation are dealt with as part of the aim of tax treaties.⁴⁵

2.3 THE AIM OF DOUBLE TAX TREATIES

Similar to other types of treaties, the main objective of a tax treaty is contained in its preamble. The preamble to the OECD MTC, through its introductory paragraphs, conveys the premise that its main purpose is to provide a means of settling, on a uniform basis, the most common problems that arise in the field of international juridical double taxation.⁴⁶ The UN Model Convention follows a similar approach and describes the main aims of double tax conventions as the protection of taxpayers from double taxation, in the form of either direct or indirect taxes, and the prevention of discouragement to the free flow of international trade and investment and the transfer of technology which can be created by taxation. Furthermore, it aims to prevent discrimination between taxpayers in an international context and to provide an element of legal and fiscal certainty within which international operations can be carried on.⁴⁷

Most other preambles, such as those contained in the US⁴⁸ and Intra-Asean (‘ASEAN’)⁴⁹ MTC’s and CARICOM Agreement, are in fact quite similar to those contained in the above OECD and UN Model Treaties. The preambles to these first mentioned MTC’s all States the aim of the convention to be the avoidance of double taxation and the prevention of fiscal evasion, with the exception of the CARICOM agreement which goes slightly further and includes the following:⁵⁰

⁴⁴ The EU imposes directives such as Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes, upon its 27 Member States. These directives govern *inter alia* how certain cross-border transactions between Member States are treated for tax purposes.

⁴⁵ See Shelton. 2004. *Interpretation and Application of Tax Treaties*. Tottel Publishing. Bloomsbury Professional at 534 to 539.

⁴⁶ See 2008 OECD MTC *supra* at § 3 of the Commentaries to the introduction.

⁴⁷ See 2001 UN MTC at § 2 of section A of the Commentaries to the introduction.

⁴⁸ 2006 United States Model Tax Convention. IBFD. Paris.

⁴⁹ Intra-ASEAN Model Double Tax Convention on Income. IBFD. Paris.

⁵⁰ Bierlaagh. 2000. “The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation?” *Bulletin – Tax Treaty Monitor*. IBFD. Amsterdam at 99.

... with respect to taxes on income, profits or gains and capital gains and for the encouragement of regional trade and investment.

There are a multitude of terms used to describe DTC's such as 'double tax treaty', 'double taxation agreement', 'double taxation convention' or simply 'tax treaty'. The definition of DTC's in terms of the *International Tax Glossary* holds as follows:⁵¹

... an agreement between two (or more) countries for the avoidance of double taxation. In fact, there are various types of tax treaty of which the most common are treaties for the avoidance of double taxation of income and capital (usually known as a comprehensive income tax treaty). Such treaties are also commonly expressed to be aimed at the prevention of fiscal evasion. In avoiding double taxation, such treaties also provide for the distribution between treaty partners of the right to tax, which rights may either be exclusive or shared between treaty partners.

The purpose of DTC's has further been noted by the OECD Committee on fiscal Affairs to not only be the prevention of double taxes, but to prevent or to provide relief against double taxation in order to promote the exchange of goods and services across international borders. An extract from the Commentaries reads as follows:⁵²

The principle purpose of double taxation conventions is to promote, by eliminating double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of the convention to prevent tax avoidance and evasion.

It is clear from both captions above that the purpose of DTC's is not only to provide relief against double taxation, but also the prevention of fiscal evasion in order to promote international trade.

The purpose of promoting 'trade' is fundamentally achieved or rather aimed to be achieved by DTC's in providing relief from juridical double taxation, i.e. comparable taxes imposed on the same subject in the hands of the same taxpayer in two or more jurisdictions. The second purpose of DTC's is to prevent fiscal evasion which reduces a State's tax base by taxpayers with economic connections in more than one State.

The main object of a treaty can therefore be said to depend on the perspective of the person or body asking the question. From the perspective of taxpayers, treaties provide protection against double taxation and discriminatory practices based on nationality.

⁵¹ Larking (ed.). 2005. *International Tax Glossary*. 5th edition. Amsterdam: IBFD at 411.

⁵² See 2008 OECD MTC *supra* at § 7 of the Commentaries to Art. 1.

Other than the main objectives of treaties, outlined above, there are numerous other aims which include amongst others the removal of administrative obstacles to international business, the provision of certainty regarding the taxpayer's affairs, the adjustment of prices in transactions between associated enterprises where these prices do not reflect the arm's length price, the collection of taxes through the exchange of information and the curtailing of the abuse of tax treaties through treaty shopping.⁵³ Treaty shopping generally refers to a situation where a person, who is resident in one country (Resident State) and who earns income or capital gains from another country (Source State), is able to benefit from a tax treaty between the Source State and a third State through an intermediary company in the third State. This situation often arises where a person is resident in a State (the Resident State) which does not have a tax Treaty with the Source State.⁵⁴

There is an ongoing debate pertaining to whether it should be one of the objects of treaties to prevent double non-taxation. This is a term used to describe the outcome where a treaty gives rise to the income not being taxed in either of the contracting States.⁵⁵ The OECD Commentaries however, suggests that treaties should not be interpreted in such a way that would result in double non-taxation. This interpretive rule has however not been elevated into the objectives of the MTC.

2.3.1 Relief from double taxation

In terms of domestically available relief, the most prevalent methods which are applied internationally are the deduction, exemption and credit methods.

The deduction method provides residents with a deduction for taxes paid to a foreign State on foreign source income. The exemption method exempts foreign earned income in the State of residence⁵⁶ and the credit method provides residents with a credit for foreign taxes payable to a foreign State on foreign sourced income.

DTC's take a slightly different approach and generally apply either the exemption or the credit method,⁵⁷ but to prevent abuse, the credit method is often limited. The deduction method on the

⁵³See Danziger *supra* at 327 to 328 and Shelton *supra* at 15 to 22.

⁵⁴Di Sciullo. "ABA Members Call for Legislation to Resolve Estate Tax Uncertainty" available at [www.http://services.taxanalysts.com/taxbase/taxnotes.nsf/\(ME/D8CDC0ED03E91B13852577F80010EEAB?](http://services.taxanalysts.com/taxbase/taxnotes.nsf/(ME/D8CDC0ED03E91B13852577F80010EEAB?) (visited on 1/1/2011).

⁵⁵See 2008 OECD MTC Commentaries *supra* in terms of Articles 15, 19 and 23.

⁵⁶See 2008 OECD MTC *supra* at § 34 which regards this as the most practical method since it relieves the State of residence of from undertaking the investigation the actual taxation position of the other State.

⁵⁷Both the OECD and UN MTC's provide for the exemption and credit methods, but not the deduction method. The US MTC on the other hand only allows for the deduction method.

other hand has fallen out of favour due to it being the least generous method of granting relief as it in essence merely provides for a deduction of the foreign taxes suffered.⁵⁸

In its most basic form, foreign tax credit relief entails the Resident State of a taxpayer allowing the foreign tax suffered by that resident as a 'credit' against the tax it (the residence State) imposes on that person. The credit can be said to be a deduction of foreign tax against domestic tax.

Foreign income exemption relief usually excludes a specific foreign income item from the tax base in the Residence State.

Apart from these methods, treaties further provide relief by way of various other means. One such method is in instances where one of the Contracting States enjoys the exclusive right to levy taxes on certain forms of income such as interest, provided for example that the beneficial owner of the said interest is a resident of that State.⁵⁹ Another method which could be applied in terms of tax treaties is that the treaty specifically provides that a credit be granted for the full notional foreign tax that the resident would have had to pay, had it not been for the tax incentive provided by the contracting State.⁶⁰

2.3.2 Prevention of fiscal evasion

The prevention of fiscal evasion is built into treaties in a number of ways which include amongst others the provisions contained in Articles 9, 26 and 27 of the OECD MTC and similarly Articles 9 and 26 of both the UN and US MTC's. These provisions relate to transfer pricing, the sharing of information and assistance in the collection of taxes by revenue authorities.

The provisions contained in Article 9 of the OECD and UN, US and ASEAN MTC's relate to transfer pricing. Transfer pricing refers to arrangements in which goods and services are transferred at an artificial price as a means of transferring income or expenses between multinational enterprises. In doing so taxpayers for example move profits from high to low tax jurisdictions, and move expenses from low to high tax jurisdictions to relieve its tax burden.⁶¹ The 'arm's length price' is referred to in transfer pricing as the price that would have been charged had the parties dealt at arm's length, i.e. transacted as unrelated third parties.⁶² One of the main aims in applying the arm's length principle is the protection of the revenue of the country that was disadvantaged as a result of transfer pricing practices. The application of the transfer pricing

⁵⁸ See Olivier *supra* at 328 to 332.

⁵⁹ See 2008 OECD MTC *supra* at § 19 of the Commentaries to the introduction.

⁶⁰ This is often referred to as 'tax sparing'. See Prof. Jinyan Li "Fundamental enterprise income tax reform in China: Motivations and Major changes". *International Bulletin for International Taxation*. December 2007 at 520. IBFD. See also Vogel. *Tax treaty news*. IBFD November 2007 at 474.

⁶¹ PricewaterhouseCoopers. *Income Tax Guide 2008 -2009*. Lexis Nexis at 260.

⁶² *Ibid*.

principles with regards to DTC's pertain to transactions between two trans-national divisions of the same entity⁶³ and between two associated, but separate legal entities.

Article 26 allows the tax administrations of Contracting States to obtain information, which they would not be able to otherwise obtain domestically, to ensure the preservation of their taxing rights.⁶⁴ The standard of "foreseeable relevance" is intended to provide exchange of information to the widest possible extent with a view to laying the basis for the implementation of domestic laws of the Contracting States and the application of the Convention. The text of the Article further makes it clear that it is not restricted to the persons or taxes covered in Articles 1 and 2 of the Convention and that the information may include particulars of non-residents. At the same time, the tax authorities are not to engage in "fishing expeditions" or request information which is unlikely to be relevant for a specific taxpayer.⁶⁵

In terms of Article 27 of the OECD MTC, Contracting States are obliged to assist one another in the collection of taxes owed to either State, provided that the relevant conditions set out therein are complied with. The Article has a wide reach, similar to that of Article 26. This provides that it is not restricted to revenue claims with regards only to persons or taxes contained in Articles 1 and 2 of the treaty. It therefore applies to a wider field than merely taxpayer debtors who are residents of one of the Contracting States. A 'revenue claim' in this respect is defined in the Article as follows:⁶⁶

... an amount owed in respect of taxes of every kind and description imposed on behalf of Contracting States, or of their political subdivisions or local authorities, in so far as the taxation thereunder is not contrary to this Convention or any other instrument to which Contracting States are parties, as well as interest, administrative penalties and cost of collection of or conservancy related to such amount.

As Article 27 provides for comprehensive collection assistance, States may wish to provide a more limited type of collection assistance.⁶⁷ The limitation of the assistance may be the only way in which they are able to provide assistance.

It should however be noted that in contrast with Article 26, there are no corresponding Articles in either the UN, US, CARRICOM or ASEAN MTC's to facilitate the collection of taxes in Contracting States. Without the assistance provided to Contracting States in terms of Article 27, the

⁶³ Between head office and permanent establishments of the same entity.

⁶⁴ See Holmes *supra* at 391 where it is stated that exchange of information between Contracting States is one of the most powerful anti-avoidance provisions in general contained in DTC's.

⁶⁵ See 2008 OECD MTC *supra* at § 1 to 5 on the Commentaries to Art. 26.

⁶⁶ *Ibid* at Article 27(2).

⁶⁷ *Ibid* at § 2 of the Commentaries to Article 27.

judgements from courts in one country can generally not be enforced in another country. This effectively renders any such judgements in favour of a tax administration ineffective.⁶⁸

Fiscal evasion is further prevented by one of the guiding principles contained in tax treaties. This principle provides that should the main purpose for entering into a certain transaction or arrangement be to secure a more favourable tax position, that the provisions of the treaty should not be available. This guiding principle is included in the OECD Commentaries to Article 1:⁶⁹

... the benefits of a double taxation convention should not be available where the main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

The prevention of evasion in terms of the above is quite relevant as the extension of DTC's greatly increases the risk of tax abuses in terms of the artificial legal constructions created thereby, including for example treaty-shopping.

An important factor in curbing abusive actions is the legal status of Tax Treaties in that specific State and the interaction thereof with domestic law provisions.

2.4 INTERPRETATION AND LEGAL STATUS OF TAX TREATIES

Treaties, which include tax treaties,⁷⁰ essentially represent contracts concluded between two or more Contracting States made within the parameters of 'international law'.⁷¹ Under customary international law, treaties are binding on Contracting States.⁷² Customary international law can be described as the general and consistent practice of States which is followed due to the sense of legal obligation.⁷³

The interpretation of treaties is therefore governed by the principles and rules of customary international law⁷⁴ and the appropriate international conventions such as the Vienna Convention of

⁶⁸ See Holmes *supra* at 395 to 396 emphasises the importance of assistance provisions contained in DTC's as an effective measure of preventing tax avoidance.

⁶⁹ See 2008 OECD MTC *supra* at § 9.5 to the Commentaries on Art. 1.

⁷⁰ Other treaties include treaties pertaining to international trade between nations or peacekeeping treaties, etc.

⁷¹ See Dugard. 2000. *International law – A South African perspective*. Juta. Cape Town at 1 where 'international law' is defined as a legal system and principles which are binding upon States in their relation with each other.

⁷² Kobetsky "The Aftermath of the Lamesa case: Australia's Tax Treaty Override" June 2005 *Bulletin – Tax Treaty Monitor* 236 to 237. IBFD. Paris.

⁷³ *United States v. David Struckman*; No. 08-30312 available at <http://services.taxanalysts.com/taxbase/tnt3.nsf/dockey/8BCE0ED2F9EE201A85257752000D6936?OpenDocument&highlight=0,customary+international+law> (visited 3/1/2011).

⁷⁴ OECD Commentary, *a Tax Treaty Override*, November 1977, Revision service 8 at 5. IBFD. Paris.

the Law of Treaties 1969 ('Vienna Convention').⁷⁵ As the Vienna Convention is a codification of customary international law, the provisions thereof apply to all treaties and bind all nations, even those treaties entered into between States which have not signed the Convention.⁷⁶ There are, however, writers who are of the opinion that the provisions of the Vienna Convention only apply to treaties that have been entered into after the entry into force of the Convention (23 May 1969),⁷⁷ pursuant to Article 4 of the Convention.⁷⁸

Due to the fact that the interpretative provisions of the Vienna Convention are binding on all international treaties, it is worthwhile to recall section 3 of the Vienna Convention which provides the essence of the provisions of the Convention pertaining to the interpretation of treaties in Articles 31 to 33:⁷⁹

Article 31

GENERAL RULE OF INTERPRETATION

[1] A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

[2] The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

[3] There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

⁷⁵ See Holmes *supra* at 71 and Olivier *supra* at 32.

⁷⁶ Arnold, B.J. "The Interpretation of Tax Treaties: Myth and reality" *Bulletin for International Taxation*. IBFD. November 2009 at 3.2.

⁷⁷ For purposes of international law, a treaty comes into existence when declaration of consent both contracting States is given in terms of Art. 9(1) of the Vienna Convention. Such declaration is ordinarily made by the head of State.

⁷⁸ Engelen. 2005. *Interpretation of Tax Treaties under International Law*. IBFD. Paris at 539.

⁷⁹ Vienna Convention on the law of Treaties 1969. United Nations – Treaty series volume 1155 at 331.

[4] A special meaning shall be given to a term if it is established that the parties so intended.

Article 32

SUPPLEMENTARY MEANS OF INTERPRETATION

[1] Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable.

Article 33

INTERPRETATION OF TREATIES AUTHENTICATED IN TWO OR MORE LANGUAGES

[1] When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.

[2] A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.

[3] The terms of the treaty are presumed to have the same meaning in each authentic text.

[4] Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

Taking the above sections of the Vienna Convention into consideration, the legal status of the OECD Commentaries will be considered in general. The application and legal status of the said commentaries will also be applied in a South African context as South Africa it is not a member State of the OECD.

2.4.1 Legal status of official Commentaries to OECD MTC

The question to what extent the OCED Commentaries can be used to interpret actual DTC's require amongst other things an enquiry into the role and status of these Commentaries. In this

respect, the OECD committee on Fiscal Affairs enunciates their view in paragraph 29 of the introductory to the Commentaries which reads as follows:⁸⁰

Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can never the less be of great assistance in the application an interpretation of conventions and, in particular, in the settlement of any disputes.

Two problems with the OECD Committee's view above include firstly, the difficulty of fitting the Commentaries within the meaning of "context" provided in Article 31(2) or the extension thereof in Article. 31(3) of the Vienna Convention. This is due to the Commentaries not usually forming part of the text of DTC's or subsequent agreements between the Contracting States or an applicable rule of international law which rules it out as something which should be taken into account in terms of section 31(3) of the Vienna Convention. This said, room still exists to argue that the Commentaries constitute a 'subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation'.⁸¹ Secondly, there is uncertainty as to the status of the Commentaries in instances where the treaties entered into pre-date the Commentaries as well as where one or both of the Contracting States are not OECD Member States.⁸²

Should Article 32 of the Vienna Convention, which provides limited assistance, be applied to the Commentaries, the effect would be that the Commentaries are regarded as a supplementary means of interpretation. In this respect, the Commentaries may be used only to confirm a meaning already ascertained, or to establish a meaning to prevent absurdities and abnormalities.

In practice, the OECD Commentaries are taken into account in interpreting DTC's as the OECD Model has been used in numerous treaties entered into by Contracting States and subsequently provides these States with reliable material to enable them to interpret the meaning of the provisions of the treaty. It can also be said that the Commentaries help develop a common body of international tax law and provide a degree of certainty to both taxpayers and administrators.⁸³

Numerous articles have been published on the subject of the legal status and interpretation of the Commentaries to MTC's taking into account the rules of interpretation laid down in the Vienna Convention discussed above such as that of Van Raad, discussed briefly hereafter. Van Raad in

⁸⁰ See 2008 OECD MTC at § 29 to the introductory Commentaries.

⁸¹ The Article 31(3) of the Vienna Convention.

⁸² See Holmes *supra* at 75 to 77.

⁸³ Ibid at 76.

1978 originally, though hesitantly, contended that, in light of the fact that the Commentaries are adopted by mutual consent, and that each member is provided the opportunity to make an observation should it disagree on that specific point, it seems justified to include the Commentaries as an instrument within the meaning of Article 32(1)(b) of the Vienna Convention and accordingly as context for the interpretation of tax treaties based on the OECD MTC.⁸⁴ Van Raad, however, in a later article contended that Commentaries were merely a supplementary means of interpretation.⁸⁵ In 1996 Van Raad again reconsidered his earlier views on the legal status of the Commentaries in light of the Vienna Convention, where it appears he took a further step away from the use of the Commentaries in interpreting the DTC where he stated the following:⁸⁶

Is there a legitimate reason to use the official OECD Commentary as a guideline in interpreting treaties? Firstly, it should be noted that the OECD Model is not an actual treaty and that the Commentaries to it are not binding on OECD member States. The word “context” as used in the previously cited Article 31(1) of the Vienna Convention is defined in Article 31(2). However, under this definition, only documents and agreements existing at the time the Convention was concluded are included in the word “context” and the OECD Commentary can only with difficulty be considered one of these. The question then arises whether the Commentary can be seen as shedding light on the “object and purpose” of the treaty since on the grounds of Paragraph 1 it is this “object and purpose” which must be used in interpreting it.

Vogel’s view on the legal status of the Commentaries,⁸⁷ which is to a certain extent in contrast to that of Van Raad’s, holds that the Commentaries cannot be regarded as instruments in terms of Article 31(2)(b) of the Vienna Convention, but also that they provide more than just a mere supplementary means of interpretation. Vogel further states that, in so far as treaties entered into between Contracting States are identical or largely similar to the OECD MTC, it can be assumed that the parties interpreted the provisions in accordance with the Commentaries thereon.⁸⁸ Vogel’s conclusion is therefore that the Commentaries either reflect the ordinary meaning to be given to the terms of the treaty as per Article 31(4) of the Vienna Convention, or a special meaning, if the parties so intend it.

⁸⁴ Van Raad “Interpretatie van belastingverdragen”, 47 MBB 1978 2/3 at 49 to 56 and see also Engelen *supra* at 440 et seq.

⁸⁵ Van Raad “Het nationale recht bij de uitlegging van belastingverdragen” in J.F.M Giele et al (e.d.), *Van wet naar recht, opstellen aangeboden aan Prof. Mr. J.P. Scheltens*. Kluwer, Deventer, 1984 at 62.

⁸⁶ Van Raad “Interpretation and Application of Tax Treaties by Tax Courts”, 36 ET 1, 1996. The original Dutch version of this publication, entitled *Uitlegging en toepassing avn belastingverdraging door de belastingrechter*, is published in FED 1996/415, at 1412 et seq.

⁸⁷ See Vogel *supra* note 29 at 34 et seq.

⁸⁸ See Engelen *supra* at 442 et seq.

In 1993, Vogel and Prokisch expressed their view in their general report⁸⁹ that, in instances where OECD Member States conformed to the recommendations of the OECD Council to follow the OECD MTC when concluding new treaties or revising existing treaties, the Commentaries thereto may be regarded as forming part of the context of the treaty rather than being a supplementary means of interpretation thereof as proposed in Article 32 of the Vienna Convention. It was further said that this view may hold true in instances where the OECD MTC served as basis for the conclusion of a treaty, even though the Contracting States may be non-Member States.

It became clear however, whilst presenting the Maarten Ellis Lecture at the Institute of international and Comparative Taxation at the University of Leiden, that Vogel had reconsidered and revised his original views on the subject of the use of the Commentaries to interpret treaties. This was due to the increasing number of changes made to the Commentaries from 1992 onwards. He cited, in particular, the publication of the OECD MTC and its Commentaries in a loose-leaf format which, in his opinion, significantly reduced their accuracy and resultantly their reliability. It was his opinion that the result of the above was that the basic assumption, that the meaning conveyed by the Commentaries was either an ordinary or special meaning due to the parties to the treaty using the exact or significantly similar provisions of the MTC, and thereby must be presumed to have intended to give the meaning of the provisions; the meaning as given to them by the Commentaries, has been destroyed. The 'current practice of changing the Model at breathless intervals and by the way the changes are published' results in that 'we can no longer apply the Commentaries when interpreting tax treaties without severe reservations'.⁹⁰ Vogel's current view, however, consists of applying a step plan to determine the legal status of the Commentaries for the purpose of interpretation.⁹¹

According to Ault⁹² the use of the Commentaries as a supplementary means of interpretation in terms of Article 32 of the Vienna Convention, does not preclude the application of Article 31(4) to establish the parties' intention to give special meaning to a term. Ault, however, also stated that this approach would not be appropriate with regard to later changes to the Commentaries in so far as those changes are more than mere clarifications of the original meaning. Both Ward⁹³ and Avery Jones⁹⁴ are stated to be of the opinion that Commentaries may provide useful evidence of

⁸⁹ Vogel and Prokisch 1993. *General Report – Interpretation of Double Tax Conventions*, in: *Cashiers de droit fiscal international*, Vol. LXXVIIIa. Kluwer at 55 to 87 and 612 to 616.

⁹⁰ *Ibid* at 616.

⁹¹ See Engelen *supra* at 444 to 445.

⁹² Ault "The role of the OECD Commentaries in the Interpretation of Tax Treaties". *Intertax* 1994/4 at 144 to 148.

⁹³ Ward "Introduction to the Law relating to tax Treaties" in: *Ward's Tax Treaties 1996-1997*. Carswell at 37 to 41.

⁹⁴ Avery Jones "The Effect of Changes in the OECD Commentaries after a Treaty is Concluded" *Bulletin – Tax Treaty Monitor* March 2002 at 102 to 104.

the parties' intention to give special meaning thereto in terms of Article 31(4) of the Vienna Convention, and also the possibility that they constitute an agreement within the meaning of Article 31(2)(a) of the Vienna Convention. They also agreed, like Ault, that the argument loses much of its force with regards to changes or additions to the Commentaries adopted after the conclusion of the treaty as it would be difficult to accept that such later changes reflect the common intention of the parties as at the time of the conclusion of the treaty.⁹⁵

Whilst the argument on whether the static or ambulatory approach is to be followed regarding the use of the MTC Commentaries in the interpretation of tax treaties remains a moot point in terms of academic literature,⁹⁶ the Canadian court in the case of *Cudd Pressure Control Inc v The Queen Federal Court of Appeal*⁹⁷ found that in certain circumstances the Commentaries enacted after the conclusion of the DTC may be taken into account. The court stated the following in this regard:

The relevant commentaries ... were drafted after the 1942 Convention and therefore their relevance becomes somewhat suspect. In particular they cannot be used to determine the intent of the drafters of the 1942 Convention.

However, although the wording and arrangement of the provisions are significantly different in the two conventions, the 1942 Convention follows the same general principles as the OECD MTC. The OECD Commentaries, therefore, can provide some assistance in discerning the 'legal context' surrounding the double taxation conventions at international law.

The above-referred case by no means settles the dispute regarding the application of the ambulatory approach in all circumstances.⁹⁸

2.4.2 Legal status of South Africa's DTC's and the interpretation of the Commentaries to the OECD MTC

With regard to the applicability of customary international law in the context of South African law, the South African Constitution⁹⁹ ('the Constitution') makes it clear that customary international law is a source of South African law in so far as it is not inconsistent with the Constitution and that a court must, in interpreting legislation, prefer any reasonable interpretation which is consistent

⁹⁵ See also Lang "The application of the OECD Model Tax Convention to Partnerships: A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs", 11 *Schriftenreihe zum Internationalen Steuerrecht*. Linde Verlag (2000) at 15 to 20.

⁹⁶ See Avery Jones supra note 69 and Wattel and Marres "The Legal status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties" *European Taxation* Vol 7/8 No. 43 at 223 to 225.

⁹⁷ [1999] 1 C.T.C. 1 at 12.

⁹⁸ Lang "CFC Regulations and Double Tax Treaties" *Bulletin – Tax Treaty Monitor*, IBFD. February 2003 at 51.

⁹⁹ The South African Constitution Act 108 of 1996.

with international law rather than an interpretation which is not.¹⁰⁰ The above section simplistically holds that international customary law must be taken into account with regards to the interpretation of domestic legislation. Accordingly, the Vienna Convention, as a codification of customary international law must guide the courts in interpreting tax treaties.

As South African law includes statute, common law, international customary law and international law, it is critical to understand the legal position of international agreements in this system i.e. whether they have special status or whether it forms part of domestic law. In terms of Vogel,¹⁰¹ it is generally accepted that the specific legal framework of the relevant country must be considered in determining the authority of and relationship between domestic law and international taxation agreements.¹⁰² The issues in this regard have been summarised as follows:¹⁰³

It necessarily follows that the priority of the treaty rules over other domestic tax rules derives from and is itself subject to domestic law. It may be that the treaty has some special status in domestic law which automatically prevails over other domestic law. More often than not the treaty has the same status as other domestic tax law and it is possible that a treaty could have a status which is inferior to other domestic law (which in some senses characterises the UK).

In terms of section 108(2) of the Act, a Double Taxation Convention comes into force in South Africa once it has been approved by Parliament (as required by section 231 of the Constitution) and subsequently published in the Government Gazette. Once gazetted the DTC becomes effective as if enacted by the Income Tax Act and has the same legal effect as any other provision contained in the Act. Section 108(2) of the Act therefore does not create any special or privileged status to tax treaties.

Taking into consideration the general objective of tax treaties (contained in the preamble to the treaty) which in most instances is stated to be the avoidance of double taxation and prevention of fiscal evasion, it can be argued that any domestic legislation which has the effect of taxing the same income twice will be subordinate to the treaty provisions. This argument finds support in section 108(1) of the Act which states the following:

... with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the republic and of such other country, of tax in respect of the same income, profits or gains.

The above argument provides that should tax be payable in terms of income, profits or gains under the domestic law which, in terms of the relevant treaty, is not payable in South Africa, or that

¹⁰⁰ See Lang *supra* in terms of section 233.

¹⁰¹ Vogel *supra* note 29 § 30 of the Introduction.

¹⁰² See Olivier *supra* at 35.

¹⁰³ Vann, R.J. 1996 *Tax Treaties Linkages between OECD Member countries and dynamic non-member economies*. OECD at 6.

only a portion of the tax is payable, the treaty provisions will automatically take precedence and override that of the domestic provision. This view is largely based on an Australian court case, *Lamesa Holdings BV*¹⁰⁴ in which was held that tax treaties differ from other international agreements in that they confer rights and obligations onto others than those to the double tax agreement, i.e. the taxpayer, and thereby overrides other domestic law provisions. It should, however, be noted that this view is based on the pre-Constitutional system, and the interpretive relevance is therefore uncertain.

In terms of South Africa's current Constitution, treaties and other domestic laws rank equally and treaties, by the mere fact that they are international agreements, do not automatically override other domestic laws. The only difference between treaties and other domestic law provisions is the extent to which the international interpretive provisions would apply to solve conflicts. Whilst the starting point in interpreting conflicting positions should always be the domestic rules of interpretation, the international rules such as that of the Vienna Convention discussed above must also be taken into account in so far as they are relevant.

Accordingly, tax treaties do not automatically override other domestic law provisions, it is only by way of interpreting the treaty provisions in terms of customary international law, that conflicts are resolved.

With regard to the legal status of the Commentaries to the Model tax conventions, the South African courts, by way of the decision of *Secretary for Inland Revenue v Downing*,¹⁰⁵ have accepted the use of the OECD Commentaries in interpreting tax treaties.¹⁰⁶ This was done in spite of the fact that SA is not a Member State of the OECD and supports the view held by Vogel and Prokisch above.¹⁰⁷ In the *Downing* case, the court referred to the judgement of the Special Court which made an argument based upon:¹⁰⁸

a certain passage in the report of the OECD.

¹⁰⁴ 1997 35 ATR 239, 97 ATC 4229.

¹⁰⁵ 37 SATC 249.

¹⁰⁶ See Jiménez "The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A case for the Declining Effect of the OECD Commentaries?" *Bulletin – Tax Treaty Monitor*. January 2004 17 at 27 where he states the following: 'From an international law perspective, however, it is clear that the Commentaries are "soft law" (rules that have no binding force but are intended to produce practical effects) that may turn into "hard law" when the Commentaries are applied within a national tax system by the tax administration and the courts'. The decision of the court in the *Downing* case changed the status of the Commentaries into hard law in the South African context.

¹⁰⁷ See Vogel and Prokisch *supra* note 89 .

¹⁰⁸ 37 SATC 249 at 259.

This acceptance of the OECD Commentaries supports the notion that the OECD MTC and its Commentaries forms part of SA's customary international law.¹⁰⁹ In the United Kingdom the case of Sun Life assurance Company of Canada v Pearson¹¹⁰ the court similarly found that the OECD Commentary may be used to interpret the meaning of a specific Article.

2.5 CONCLUSION

This chapter provides a basic overview of the working of Double Tax Treaties, their history and place in international law as well as guidelines on the interpretation thereof based on the Vienna Convention.

From this basis the development of the definition of a particular Tax Treaty term 'royalties' will be analysed, through the natural evolution of the most widely used Model Tax Conventions and their Commentaries.

¹⁰⁹ See Olivier *supra* at 33.

¹¹⁰ 1984. S.T.C. 461 at 511b.

Chapter 3

ROYALTIES

3.1 INTRODUCTION

This chapter will focus on the development of the term 'royalties' as used in the most prevalent current Model Tax Conventions. The study will investigate the treaty meaning of the term 'royalties' and analyse its development in terms of the different Models.¹¹¹

A second aspect of the study which will be explored in significantly less detail is the development of the taxing rights, which in terms of the modern OECD Model, provides for zero taxation at source. Other Models such as the UN Model allows for limited source taxation of royalties.

3.2 CURRENT OECD MODEL TAX CONVENTION ROYALTY DEFINITION

In order to put the development of the definition and the taxing rights of royalties into perspective in terms of the various Model Tax Conventions, it is helpful to first refer to the current provision as outlined in Article 12 of the 2008 OECD MTC. This Model represents decades of work performed by the predominant body driving international development of Double Tax Agreements, the OECD.¹¹² From there the origins of the term shall be investigated and its development followed throughout the various Models which include *inter alia* that of the OEEC, OECD, UN, US and ASEAN Models.

3.2.1 2008 OECD MTC

Article 12 of the 2008 OECD Model reads as follows:

[1] 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.

[2] 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.

¹¹¹ See Edwardes-Ker. 1977. *The International Tax Treaty Service*, Volume 2. (In-Depth Publishing Limited. London, loose-leaf).

¹¹² See Holmes *supra* at 58.

[3] The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of the Contracting State, carries on a business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

[4] When, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right of information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

An analysis of the above definition of royalties, provided in paragraph 2, read together with its Commentaries, illustrates that the definition is divided into two clear sections.¹¹³ The first part of the definition pertains to the use of, or the right to use certain types of intellectual property. The second portion, in contrast, does not include the granting of any rights, but the consideration received for information for industrial, commercial or scientific experience.¹¹⁴ In essence, it deals with the provision of know-how.¹¹⁵ These last mentioned payments are not specifically mentioned in the above definition but the Commentaries provide a helpful insight in this regard in clarifying the meaning of the second portion of the definition.

The Commentaries clearly confirm the concept of know-how in distinguishing it from other types of services. It states that in terms of know-how agreements, one party agrees to impart his special knowledge so that the other party can use it for his own account. In contrast, an agreement pertaining to the provision of services in most instances provides that one of the parties undertakes to use his skills to execute the work himself for the other party.¹¹⁶

Further examination of the first part of the definition illustrates the following important characteristics of the definition as surmised by Olivier:¹¹⁷

- the definition is exhaustive and payments that are regarded as royalties under domestic law may not be regarded as royalties for treaty purposes;¹¹⁸

¹¹³ Simontacchi and Uustalu "Treaty Issues Related to the Provision of Know-How: Comment on Spanish Supreme Court Decision" in Russo, R. Fontana, R. (eds.). 2008. *A Decade of Case Law. Essays in honour of the 10th anniversary of the Leiden Adv LLM in International Tax*. IBFD. Amsterdam at 36.

¹¹⁴ Ibid at 36 states that this second portion originates from Article XXII(2) of the 1961 OEEC fourth report.

¹¹⁵ Du Toit *supra* note 12 at 36.

¹¹⁶ See § 11 of the Commentaries to Article 12 of the 2008 OECD MTC.

¹¹⁷ See Olivier *supra* at 351.

- the property for which the payments are made, need not be registered;
- payments should be for the right of use and not the acquisition of the asset;
- payments made for both legitimate as well as illegitimate use is covered by the definition; and
- amounts which do not fall within the definition of royalties such as a payment for the use of or right to use industrial, commercial or scientific equipment will fall under the business profits Article.

3.3 DEVELOPMENT OF ROYALTIES THROUGH MODEL TAX CONVENTIONS

In this section, the development of each of the above listed Models will be analysed focusing on the development of the most widely used Conventions including the OECD and UN Models. The aim of this section is to provide a greater understanding as to why modern Double Tax Conventions are written the way they are and use the language they do and to further provide an insight as to the reasoning behind the differences between the various Models. Answers to these questions will be ascertained through analysing the various Model Conventions as they developed.

3.3.1 The League of Nations

In determining the origins of the modern definition of the term 'royalties' as outlined above, one must look to the original Model Convention which was introduced by the League of Nations in 1928.¹¹⁹ A brief history of the League of Nations reveals that its finance committee appointed four economists from Italy, the Netherlands, Switzerland and the United Kingdom respectively in 1921 to study the problem of international double taxation. The committee soon appointed seven further technical experts and later included a broader committee of government experts drawn from twenty seven countries who produced the first Models consisting of the 1927 Double Taxation and Tax Evasion Report¹²⁰ and three alternative Models for bilateral income tax treaties in the 1928 Double

¹¹⁸ See also Du Toit *supra* note 12 at 36 where he provides that the definition of royalties in the context of bi-lateral treaties are intended to be exhaustive and therefore that royalties within the ordinary domestic meaning of the term which do not also come within the treaty definition are not royalties for purposes of that specific bi-lateral treaty.

¹¹⁹ See Vogel *supra* note 29 at 771 for a discussion of the historical background of royalties.

¹²⁰ League of Nations. 1927. *Double Taxation and Tax Evasion Report*. Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion. League of Nations. Geneva.

Taxation and Tax Evasion Report ('1928 Draft Model')¹²¹ No. 1A, 1B and 1C, referred to as Models 1a, 1b,¹²² and 1c.¹²³

A smaller permanent Fiscal Committee was later established which held a series of meetings in Geneva between 1929 and 1939 during which time it debated various issues and developed the Model treaty language for a variety of situations. Considerable attention was devoted to formulating rules for the allocation of business income of undertakings operating in various jurisdictions. The final meetings of the Committee enjoyed a broader representation and the Mexico (1940 & 1943) and London (1946) Models, were the first comprehensive Models since 1928 Draft Model, and represented the culmination of the League of Nation's work which was published in 1946. As is evident from their contents, the League of Nations Models were strongly influenced by the treaty practice between mainland European countries.¹²⁴

3.3.1.1 League of Nations 1928 Models

The 1928 Draft Models did not specifically mention intellectual property or royalties but it was expressly noted that 'income derived from patents and authors' rights were for future consideration.¹²⁵

The 1928 Draft Models therefore did not directly contribute to the royalty definition, but it is worth mentioning that 'services' were generally covered by the 'business profit' Article which included income from any 'industrial, commercial or agricultural undertaking and from any other trades and professions'.¹²⁶

3.3.1.2 League of Nations 1929 and 1930 Fiscal Committee meetings

During the 1929 meeting it was debated whether the issue of intellectual property was covered by the 1928 Draft Models even though it was never expressly mentioned. This development signifies one of the first debates surrounding the different language versions of the Models. From one perspective it could be argued that the 1928 Draft Model No. 1A ('Model 1a')

¹²¹ League of Nations. 1928. *Double Taxation and Tax Evasion Report*. Presented by the Meeting of Government Experts on Double Taxation and Tax Evasion. League of Nations. Geneva.

¹²² Model 1b was the US and British proposal with less source taxation, which also made no distinction between personal and impersonal taxation as this distinction is not meaningful in either country.

¹²³ Vann "The history of Royalties in tax treaties 1921 – 1961: Why?" in J. Avery Jones, Harris, Oliver (eds). 2008. *Comparative Perspectives on Revenue law: Essays in Honour of John Tilley* 166 to 196.

¹²⁴ Avery Jones, De Broe, Ellis, Van Raad, Killius, Maisto, Miyatake, Torrione, Vann, Ward & Wiman "The Origins and Expressions used in the OECD Model and their Adoption by States" *Bulletin – Tax Treaty Monitor*. June 2006 220 to 253 at 220.

¹²⁵ See Vann *supra* note 123 at 169.

¹²⁶ See Vogel *supra* note 29 at 771 for a discussion on the historical difficulties in reconciling conflicting tax claims with regards to royalties.

implicitly covered the issue by way of the language used in the last Article dealing with impersonal taxes and provided the Resident State with exclusive taxing rights:¹²⁷

Annuities or income from other sources not referred in the previous paragraphs shall be taxable in the State of fiscal domicile of the creditor of such income.

On the other hand it could however be argued that there were several indications of mistranslation of the English text in Model 1a in terms of the Leagues documents. These included 'créances' (debts or financial claims) translated as 'sources' and that the Model was not exhaustive of all kinds of income which in modern parlance equates to the fact that there was no other income Article. To decide the issue questionnaires were sent out to various countries to find out how this income was actually taxed. The results from 21 countries were tabled in the 1930 meeting where the Committee made the following conclusions without offering opinion on the drafting as it appears in Model 1a:¹²⁸

The Committee was of the opinion that, without going into these questions, one could solve the problem by determining the category of income derived from the author's or inventor's rights should be placed for purposes of the application of the model conventions.

This would make it possible to bring such income under the system contemplated for income of similar nature in the model conventions, and would thus have the effect of preventing such income from being taxed simultaneously in more than one country.¹²⁹

Four distinct categories are included in the above passage. Firstly, that of payments to individual authors or inventors. Secondly, payments to heirs. Thirdly, income from enterprises in acquiring rights from authors and inventors in relation to patents or copyrights exploited for their own business. The fourth category dealt with the collection of royalties on behalf of owners which in modern terms is covered by the beneficial owned language of the royalty Article.¹³⁰

With regards to the first category, the income was classified as 'professional income' and fell within the business profit rules. The second category was treated as professional earnings, whilst the third category, payments received by those to whom the right descended on death or gift, was treated either as professional earnings or as income from movable capital. The Committee concluded with the following statement:¹³¹

¹²⁷ See Vann *supra* note 123 at 169.

¹²⁸ *Ibid.*

¹²⁹ *Legislative History of the US Tax Conventions*. Volume 4 (US Government Printing Office, Washington, 1962) ('Legislative history') at 4208. See also Vann *supra* at 170.

¹³⁰ Legislative history at 4208-9.

¹³¹ *Ibid.*

adopted in first reading of the following conclusions:

Whether the income in question is regarded as professional earnings or income from movable capital in the international sphere, by following the rules laid down in the model conventions one always finds [sic], that the right of taxation belongs to the country in which the heir or assign is domiciled.

[Emphasis added]

Taking the background into consideration in terms of which it was unclear whether Model 1a dealt with the issue at all and the fact that the Committee had previously decided not to base its conclusions on this debated issue, it is quite unexpected that the Committee would state that the Resident State would enjoy taxing rights specifically with regard to the income from movable capital.

The 1928 Draft Model No. 1B ('Model 1b'), which contained an 'other income' Article, was the most favourable Model from the residence State's perspective as it gave exclusive taxing rights to the resident country.

The only Model to expressly mention movable capital was 1928 Draft Model No. 1C ('Model 1c') which provided as follows:¹³²

The income from movable asset shall be taxable in the State in whose territory the creditor has his fiscal domicile, i.e. his normal residence, the term "residence" being understood to mean a permanent home.

When the other Contracting State levies a tax, by means of deductions at source, on income from capital originating in the territory of that State, the right to this taxation shall not be affected by the rule in sub-paragraph I. In this case the State of domicile which, in addition to its ordinary direct tax, levies a special tax on income originating in the other State, shall refrain from levying that tax or shall deduct therefrom the tax paid in the other State.

In order to avoid or mitigate the effect of such double taxation as is not, under the various fiscal systems, prevented by the provision of the previous sub-paragraph, the Contracting State shall come to an agreement, if necessary, to allow either the remission, in respect of tax levied by the State of domicile, of the whole or part of the tax deducted...

[Emphasis added]

¹³² See Article 7 of the 1928 League of Nations Draft Model Treaty 1C.

It is clear from the last paragraph that some form of negotiation outside of the treaty will be required to determine which jurisdiction would give away its taxing rights, should double taxation arise due to a tax being levied at source.

It is noteworthy to refer to the phrase ‘first reading of the following conclusions’ of the above quoted paragraph which is indicative that these conclusions were only provisional. This view has been confirmed by the fact that during the 1931 meeting, the Committee declared the principles as ‘adopted at the second reading’ noting that they have been approved in various quarters including the International Chamber of Commerce. The legislative-like procedures and unwillingness to reopen some of the debates assigning taxing rights surrounding the 1928 Models, as well as the fact that the decisions made are hard to reconcile with either the 1928 Models and material received from the questionnaires, points to the controversial nature of these provisions.¹³³

As the 1930 Committee was fairly small and unrepresentative compared with the Committee that produced the 1928 drafts which included mainly large European countries, one could conclude that a political agenda might have been the cause of the seemingly irreconcilable conclusions drawn. On the other hand, it could very well be argued that the issues were merely technical and that political agendas played no part.¹³⁴

A strong argument for the latter line of reasoning may be found in the conclusions drawn from the 1930 meeting where it was confirmed that one of the principles of the Model is to prevent income from being taxed simultaneously in two States.¹³⁵ The concern remains that the differing classifications of the income could lead to countries applying different provisions that could ultimately result in double taxation. At this point, it may be worth mentioning that the above problem pertaining to the conflicts of qualification, have been reduced by the development of principles dealing with the situation where the characterisation in one country gives way to the other.¹³⁶ Such thinking however did not exist at the time of these Committee meetings.

A further technical argument in favour of the Committee’s conclusions may have been that it wished to ensure that royalties were covered by treaties which did not include an ‘other income’ provision to prevent it from defaulting to the domestic law or the need for some further agreement, such as the position in draft Model 1c.

¹³³ See Vann *supra* note 123 at 174.

¹³⁴ *Ibid.*

¹³⁵ Legislative history at 4208.

¹³⁶ OECD. “The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation”, 1999 no. 6. IBFD. Paris.

3.3.1.3 League of Nations 1931 Fiscal Committee meeting

Following the royalty debate of the 1930 meeting, one of the specific topics on the agenda of the 1931 meeting was the possibility of a multilateral tax treaty based on the League's work. To this end, a subcommittee was appointed during the 1930 meeting to produce a draft Model which was supplemented by two further drafts at the 1931 meeting. Although the Committee later decided that there was insufficient support for this initiative, the language used in these drafts clearly reflect the outcome of the royalty work performed during the 1930 meeting and can be said to be the origin of the residence only taxation in the current OECD Model.¹³⁷ The language referred to is contained in the following Article which was included in two of the draft documents, and although different in language, the effect of the third draft was similar:¹³⁸

Author's rights and income from patents shall be taxable only in the State of fiscal domicile of beneficiaries. If, however, they are collected by persons to whom these rights have been assigned for a consideration, or fall on any other grounds into the category of industrial or commercial income, they shall be taxable as such under the conditions laid down in Article 4 [on business profits of permanent establishments].

In the absence of a permanent establishment ('PE') in the Source State, income from patent rights would be taxable exclusively in the residence State.¹³⁹

3.3.1.4 League of Nations 1933 Fiscal Committee meeting

In the 1933 meeting the first draft of the transfer pricing rules were put forward. These dealt with the attribution of profits to PE's and the taxation of associated enterprises. This draft defined the income subject to business profits at some length and one of the categories which it completely excluded was the following:¹⁴⁰

Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulae, goodwill, trade marks, trade brands, franchises and other like property, provided the enterprise is not engaged in dealing in such property.

In terms of Vann¹⁴¹ the language used in the above excerpt is clearly the origin of the modern tax treaty definition of royalties. He further correctly noted that the language used in the excerpt came from sources other than the workings of the League of Nations, and continued to point out

¹³⁷ See Vann *supra* note 123 at 175.

¹³⁸ Legislative history at 4235 and 4238.

¹³⁹ See Doernberg *supra* note 8 at 16 to 17.

¹⁴⁰ Legislative history at 4244.

¹⁴¹ See Vann *supra* note 123 at 176.

actual treaties entered into, since the 1921 treaty between Germany and Czechoslovakia, used the term 'royalties'. He also raised another issue pertaining to the debate surrounding the question of whether the 1928 Draft Models covered royalties at all.¹⁴² A further remark in the context of the treaties entered into during the 1930's, was that there is no strong evidence of countries struggling to retain source taxation rights and having to give them away in order to conclude a treaty.

One conclusion to be drawn from the above is that Resident States' taxing rights of royalties were not contrived through political means of the Committee members, but that actual treaties entered into freely agreed to these terms.¹⁴³

3.3.1.5 League of Nations 1943 Mexico Draft Model Bilateral Convention for the Prevention of the Double Taxation of Income ('Mexico Draft')¹⁴⁴

The Latin American influence of source-only taxation was clear in the 1943 Mexico Draft's emphasis of providing taxing rights to the Source State.¹⁴⁵ Article X(2) & (3) of the treaty read as follows:¹⁴⁶

[1] Royalties from immovable property or in respect of the operation of a mine, a quarry, or other natural resource shall be taxable only in the Contracting State in which such property, mine quarry, or other natural resource is situated.

[2] Royalties and amounts received as consideration for the right to use a patent, a secret process or formula, a trade mark or other analogous right shall be taxable only in the State where such rights are exploited.

[3] Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use a musical, artistic, literary, scientific or other cultural work or publication shall not be taxable in the former State.

This Model provides the exclusive taxing right of royalties to the Source State, with the exception of payments for copyright. However, it does not contain any provisions relating to the carrying on of a business by the resident in the other contracting State by way of a PE or the requirement of an arms' length royalty between connected parties.

¹⁴² Ibid at 176 to 179.

¹⁴³ See Sweden/Finland 1931, Sweden/Denmark 1932, France/Switzerland 1937 as examples.

¹⁴⁴ League of Nations. 1943. *Model Bilateral Convention for the Prevention of the Double Taxation of Income*. Prepared by the League of Nations. Mexico.

¹⁴⁵ See Legislative history at 4347, see also Wang Wang "International double taxation of income: Relief through International Agreements". *Harvard law review*, 1945 at 96.

¹⁴⁶ See Article X of the Mexico Model *supra*.

3.3.1.6 League of Nations 1946 Draft Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property ('London Draft')¹⁴⁷

During the Fiscal meeting held in London, producing the 1946 London Draft, the dominance from the European States was evident. Although the Europeans would have undoubtedly preferred to return to their predominant residence only taxation, the Mexico Model could not be undone. In this light, an approach similar to that of the Mexico Model was adopted with the qualification that source taxation of royalties was only permitted between associated enterprises on a net basis.¹⁴⁸

The royalty Article from the Mexico Model was changed to the following in the London Draft, with the exception of paragraph 1 which remained unchanged:¹⁴⁹

[2] Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use a patent, secret process or formula, a trade-mark or other analogous right, shall not be taxable in the former State.

[3] If, however, royalties are paid by an enterprise of one Contracting State to another enterprise of the other Contracting State which has a dominant participation in its management or capital, or *vice versa*, or when both enterprises are owned or controlled by the same interests, the royalties shall be subject to taxation in the State where the in consideration of which they are paid is exploited, subject to the deduction from the gross amount of such royalties of all expenses and charges, including depreciation, relative to such rights and royalties.

[4] Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use an artistic, scientific or other cultural work or publication shall not be taxable in the former State.

The effect of the changes to the Model is that the royalties from patents and similar rights are taxable in terms of paragraph 2 exclusively in the Resident State of the grantor. Paragraph 3, on the other hand, restricts the above principle and provides for source only taxation in terms of royalties between inter-related enterprises.¹⁵⁰

¹⁴⁷ League of Nations. 1946. *Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property*. Prepared by the League of Nations. London.

¹⁴⁸ See Vann *supra* note 123 at 180.

¹⁴⁹ See Article X of the London Draft Model *supra*.

¹⁵⁰ See Legislative history at 4347.

3.3.1.7 Conclusion from the Mexico and London Draft Models

It is clear from excerpts of the Mexico and London Draft Models of 1943 and 1946 respectively, that the language used in the 1933 Fiscal Committee meeting has been replaced. In terms of the 1933 Fiscal Committee meeting royalties were defined as forming part of commercial and industrial profits. The language of the Mexico and London Models refer instead to it as forming part of the arena of intellectual property for royalties which provides the same effect.

An interesting issue raised by the Mexico Draft is the inclusion of royalties from both mining and intellectual property in the same Article. One conclusion which can be drawn from this position is that the drafters of the Model intended to strengthen the position of Source State taxation of royalties from intellectual property, as it is highly unlikely that there would be any question as to the source taxation of mining royalties.¹⁵¹

The separation of copyright and patent royalties into different categories was not in accordance with the previous practice or the principles set out by the Fiscal Committee. The rationale behind the separation is however unclear. This separation by the Mexico Model led to the Article not comprehensively covering copyrights, which is difficult to justify, particularly from a modern perspective in which highly valuable items such as software is protected by copyright.¹⁵²

The qualification of the associated enterprises introduced by the London Model was a significant departure from the Fiscal Committee's previous practice. In comparing the modern royalty Article with that of the London Draft, it is clear, especially when taking into consideration the zero taxation or rate limitation, that the modern rules encourage the practice, against which the London Draft was apparently directed.¹⁵³

Two other issues of significant importance is the treatment of know-how, which is the border between property and services, and the meaning of 'use' and in particular the distinction between 'sale' and 'use' of intellectual property. These issues do not feature in the League of Nations Models but loom large in modern treaties.

With regards to know-how, the modern wording of the royalty definition generally associated with know-how i.e. 'payments for information relating to industrial, commercial or scientific experience' did not appear in the previous Model or actual treaty language. Nevertheless, it could be convincingly argued that know-how could very well be included either in reference to the 'secret

¹⁵¹ This method of strengthening the Source State's taxing position was suggested by Swedish treaty practice, See Vann *supra* at 181.

¹⁵² See Vann *supra* note 123 at 182.

¹⁵³ *Ibid.*

processes or formulae' or by the words 'analogous right' or variants of each.¹⁵⁴ To this end there is clear evidence that in some negotiations between the US and France during the 1950s that it was argued that know-how was already covered in the 1933 League wording as noted above.¹⁵⁵

In respect of the language used by the Fiscal Committee and most treaties at the time, it was more or less clear that payments for patents and copyrights were covered whether they involved licences or assignments. The current language which refers to 'for the use of or the right to use' any copyright etc. has its origins in the 1933 Fiscal Committee language.¹⁵⁶ The word used in that context was however 'privilege' rather than 'right'. The use of 'right' appeared in the Mexico and London Drafts. The London Draft in this respect raises the point of taxing certain patent royalties at source and provides for resident taxation of capital gains apart from immovable property and PE assets.¹⁵⁷ Recent developments have been much concerned with the meaning of 'use' and the distinction between the meaning of 'use and sale'.

3.3.2 The OEEC

In October 1946, after the London Draft, the Economic and Social Council of the United Nations, in its resolution 2 (III) of 1 October 1946, set up a Fiscal Commission which was requested to 'Study and advise the Council in the field of public finance, particularly in its legal, administrative and technical aspects'. The Fiscal Commission however stopped functioning in 1954 and focus in the field of international taxation shifted to the OEEC.¹⁵⁸

The Council of OEEC adopted its first recommendation concerning double taxation on 25 February 1955 which resulted in the establishment of the OEEC Fiscal Committee in March 1956. In 1958, the Committee was instructed to prepare a draft convention for the avoidance of double taxation with respect to taxes on income and capital as well as proposals for its implementation.¹⁵⁹ In reaction to the request, the Committee said the following:¹⁶⁰

Since the work of the League of Nations, the value of a Model Convention has been universally recognised not only by the national authorities but also by the taxpayers themselves.

¹⁵⁴ Tax Analyst, electronic document no. 2000–28062 of the Commentaries on Article VI. Available: <http://services.taxanalysts.com/taxbase/ta12.nsf/WWDocsSearch?OpenForm&Login&pub=wtt> (visited on 2/10/ 2010)

¹⁵⁵ Ibid.

¹⁵⁶ Ibid at 184.

¹⁵⁷ See Article X(2) and (3) of the London Draft *supra*.

¹⁵⁸ See § 5 of the Introduction to the 1980 UN MTC Commentary.

¹⁵⁹ Ibid at § 8.

¹⁶⁰ Ibid.

Between 1958 and 1961, four interim reports were produced by the Fiscal Committee published under the title 'The elimination of double taxation' that included 25 Articles, prior to the OEEC becoming the OECD in September of 1961.

3.3.2.1 Working Party No. 8 ('WP8')

Within the OEEC WP8 was formed to deal specifically with royalties and comprised of delegates from Germany and Luxembourg who produced a draft Article in their first Report of 12 February 1958 as follows:¹⁶¹

[1] Royalties and other amounts received as consideration for the use of, or the right to use any patent, licence to use a patent or other intellectual property (licence d'exploitation), copyright, design or pattern, trade mark or similar right (except a right to work natural resources) or manufacture process shall be taxable only in the State of which the taxpayer is resident.

[2] There shall be treated as royalties all rents and amounts received as consideration for the renting of cinematograph films (including cinematograph files intended to be exhibited on television), for the use of industrial, commercial or scientific equipment and for the supply of information concerning industrial or commercial experience.

[3] Where any royalty amount mentioned in paragraphs 1 and 2 exceeds an adequate consideration, then the State of which the taxpayer is a resident shall be entitled to tax only so much of it as represents an adequate compensation.

[4] Paragraphs 1 to 3 shall also apply to amounts received as consideration for the sale or disposal of any property mentioned in those paragraphs.

[5] Paragraphs 1 to 4 shall not apply where a person who is resident of one of the States possesses in the other State a permanent establishment or fixed place of business which is used for the performance of professional services and any income aforementioned is derived from that establishment or place of business. In such case the other State shall have the right to tax.

From the wording of the first paragraph, it is clear that the Draft Model follows the London Draft, or rather that it is a reversion to the principles of the League of Nations during the 1930's. This denial of source taxation immediately proved to be an obstacle, as a Luxembourg delegate noted that Luxembourg would not want to take this position in bilateral treaties.¹⁶²

¹⁶¹ FC/WP8 (58)1. Document numbers are in accordance with the OEEC/OECD numbering system.

¹⁶² See Vann *supra* note 123 at 186.

The denial of the residence State taxation in paragraph 3, which provides for instances where the royalty exceeds an arm's length amount, was a variation of the UK's practice which included provisions on excessive royalties in virtually all its treaties. The above position differs from the London Model in terms of which royalties paid to associated enterprises were subject to unlimited net tax at source as royalties.¹⁶³

Whilst the provisions specifically include equipment leasing and the rental of films, it is interesting to note that mining royalties are expressly excluded in paragraph 1 and left to be dealt with by the immovable property Article.

The wording in paragraph 2 pertaining to what is colloquially referred to as know-how is a new addition to the royalty provisions of Model treaties. The language of 'secret process or formula' which in the past have been argued to include know-how, have been omitted although the words 'similar right' still appears. The wording of the know-how section of the second paragraph suggests that the payment envisaged is additional advice to the supply of a patent for which an additional payment is made. The new wording 'and for the supply of information concerning industrial or commercial experience', in terms of the Commentaries is said to avoid any dispute as to whether the amounts should be treated as business income, professional income or royalties. It may also be noted that in terms of the way in which it was described in the report, it could have been interpreted as show-how instead of know-how, which pertains to the communication of existing knowledge as opposed to the services in assisting the use of a patent. From reading the OEEC materials from the period, there is the same feeling of uncertainty regarding the nature of the provisions specifically with reference to its origins - are they technical or rather political? In this respect, it may be helpful to note that there is some evidence that provides that countries originally applying source taxation of royalties were happy to give them up in treaties negotiated during this period.¹⁶⁴

As mentioned earlier, WP8 of the OEEC produced several reports of which the fourth and final was published in 1961 under the auspices of the OEEC.¹⁶⁵ Following this publication the OEEC became the OECD.

3.3.3 The OECD Model

The OEEC became the OECD in 1961 and continued on the work of the OEEC to produce the 1963 Draft Double Taxation Convention on Income and Capital ('1963 Draft Model').¹⁶⁶ This Draft

¹⁶³ See Vann *supra* note 123 at 186 where he refers to treaties entered into between the UK and Australia.

¹⁶⁴ In the treaties negotiated between Australia and the UK, the US, Canada and New Zealand up to 1960, Australia ceded taxing rights over many royalties. See Vann *supra* at 187.

¹⁶⁵ Legislative history at 4621 to 4647.

Model brought together and revised the material in the four OEEC reports, and also included new work with respect to the capital gains Article.¹⁶⁷

Since the inception of the original OECD Model Convention in 1963, there have been several updates to the OECD Model. It became apparent early in the 1970s that the 1963 Draft Model required reworking as tax systems became more complicated and new business sectors and organisations were emerging.¹⁶⁸ The first update to it was the 1977 OECD MTC ('1977 Model')¹⁶⁹ and fifteen years thereafter, the loose-leaf version was published in 1992 ('1992 OECD Model')¹⁷⁰. This publication marked a change in the OECD's approach of more regular updates to the Model and its accompanying Commentaries. Thereafter, further updates were published in 1997,¹⁷¹ 2000,¹⁷² 2003,¹⁷³ 2005,¹⁷⁴ 2008,¹⁷⁵ and the latest in 2010.¹⁷⁶

3.3.3.1 1963 OECD Model

The 1963 Draft Convention included a number of changes from that of the forgoing royalty Article contained in the OEEC report and read as follows:¹⁷⁷

[1] Royalties arising in a Contracting State and paid a resident of the other Contracting State shall be taxable only in that other Contracting State.

[2] 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 the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

An obvious difference from the foregoing royalty Article of the OEEC is that the first paragraph of the 1963 OECD Model is dedicated to, and clearly sets out the taxing rights of the Contracting States.¹⁷⁸ In doing so, it provides exclusive taxing rights to the recipient's Residence State. In this

¹⁶⁶ OECD. 1963. *Income and Capital Model Convention* ('1963 OECD Model'). Paris.

¹⁶⁷ See Vann *supra* note 123 at 188.

¹⁶⁸ See Holmes *supra* at 58.

¹⁶⁹ OECD. 1977. *Income and Capital Model Convention* ('1977 OECD Model'). IBFD. Paris.

¹⁷⁰ OECD. 1992. *Income and Capital Model Convention* ('1992 OECD Model'). IBFD. Paris.

¹⁷¹ OECD. 1997. *Income and Capital Model Convention* ('1997 OECD Model'). IBFD. Paris.

¹⁷² OECD. 2000. *Income and Capital Model Convention* ('2000 OECD Model'). IBFD. Paris.

¹⁷³ OECD. 2003. *Income and Capital Model Convention* ('2003 OECD Model'). IBFD. Paris.

¹⁷⁴ OECD. 2005. *The OECD Model Tax Convention on Income and Capital*. Condensed version ('2005 OECD Model'). IBFD. Paris.

¹⁷⁵ 2008 OECD Model.

¹⁷⁶ 2010 OECD Model

¹⁷⁷ Article 12 of the 1963 OECD Model.

¹⁷⁸ The first paragraph of the royalty provisions of the OEEC Model pertained to 'royalty and other amounts' and continues to categorise or define royalties.

respect it is however quite similar to that of the 1946 London Draft Model. The first paragraph provides no further information other than that the royalty must be payable to a resident of the other Contracting State.

The second paragraph pertinently defines the term 'royalties'. The wording used to define the term is however not that much different from the OEEC Draft Model and in keeping, does not apply to variable or fixed payments for the working of mineral deposits or other natural resources which are governed by the Article 6 on immovable property.

When presenting the 1963 Draft Report, the Fiscal Committee of the OECD had envisaged that the Draft Convention would possibly be revised at a later stage following further study. Such revision would take into account the practical experience of its Member countries, changes in the tax systems, the development of new sectors of business etc. and in 1971 the Fiscal Committee undertook the revision of the 1963 Draft Convention and of the Commentaries thereon.¹⁷⁹

3.3.3.2 1977 OECD Model

The second OECD Model Tax Convention was published in 1977, a full fourteen years after the OECD first published its 1963 MTC. From the outset the most notable amendment to Article 12 is contained in the first paragraph whilst the definition of what constitutes 'royalties' remains unchanged in the second. The first two paragraphs of the royalty Article read as follows:¹⁸⁰

[1] Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.

[2] 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 the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

The first paragraph contains an immensely important variation from that of its predecessor in terms of the inclusion of the phrase 'if such resident is the beneficial owner of the royalties'. The qualification that the resident receiving the royalty must also be the beneficial owner of such royalty, effectively means that nominees or agents which are interposed between the payer and the beneficial owner will not be able to apply this Article. The beneficial owner concept and implications thereof will be more fully explained in Chapter 4.

¹⁷⁹ See § 7 *et seq* of the introduction to the Commentary of the 2010 OECD Model.

¹⁸⁰ 1977 OECD Model.

The only other difference between the 1963 and 1977 Drafts pertaining to Article 12, is the expansion of the Commentaries thereto, to include, not only a section on the implications of the beneficial ownership clause, but also a broader general explanation of the applications of certain provisions in so far as they are only applicable to residents of the Contracting States. Consequently, this Article cannot be applied to royalties arising in a third State, or royalties attributable to a permanent establishment of an enterprise in the other State.

As noted above, no changes have been made to the definition of the term 'royalties' in the second paragraph. The only difference to the Draft Convention is the expansion of the Commentaries to the Article. In this respect paragraph 8 of the Commentaries on Article 12(2) states that 'As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of the other Article of the convention'.

The clarifications in the Commentaries included, amongst other aspects, the treatment of payments constituting consideration for the sale of equipment in contrast to royalties paid for the use of such equipment, rents in respect of cinematograph films, performances by artist, payments in respect of the working of mineral deposits and the concept of know-how.¹⁸¹

Unlike the foregoing Commentary on the 1963 Model, the Commentary to the 1977 OECD MTC expressly identifies 'information concerning industrial, commercial or scientific experience' with know-how in paragraph 12 which reads as follows:¹⁸²

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'.

The Commentary goes further and contains a definition of know-how given by the *Association des Bureaux pour la Protection de la Propriété Industrielle* ('ANBPPI') the scope of which is limited to industrial activities.¹⁸³

3.3.3.3 1992 OECD Model

In 1992, the OECD published its third Model Convention, fifteen years after the previous Model. The wording of the 1992 Model Convention reads as follows:¹⁸⁴

¹⁸¹ See § 9 to 14 of the Commentaries to Article 12(2) of the 1997 OECD MTC.

¹⁸² Russo, R and Fontana, R. (eds.). 2008. *A Decade of Case Law. Essays in honour of the 10th anniversary of the Leiden Adv LLM in International Tax*. IBFD. Amsterdam at 37.

¹⁸³ The ANBPPI no longer exists.

¹⁸⁴ Article 12(2) of the 1992 OECD Model.

[2] 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 the use of, or the right to use, industrial, commercial or scientific equipment,~~ or for information concerning industrial, commercial or scientific experience.

[Own emphasis]

The royalty definition provided in Article 12(2) has been amended since the 1977 Model and excludes payments 'or for the use of, or the right to use, industrial, commercial or scientific equipment'.¹⁸⁵ The effect of the amendment is that leasing income is covered by Article 7 (business income) of the OECD Model and the Source State should refrain from taxing such income unless the income is attributable to a permanent establishment in the Source State.¹⁸⁶ With regard to the above amendment to the royalty definition Jacques Sasseville of the Fiscal Affairs division of the OECD commented that:¹⁸⁷

This change, which has been recommended in the 1983 report on the *Taxation of Income Derived from Industrial, Commercial or Scientific Equipment* results in the income from the leasing of such equipment falling under Article 7 (Business Profits) rather than Article 12. Thus, such rental income will avoid withholding taxes on royalties where countries do not adhere to the OECD formulation of Article 12. It should be noted, however, that a large number of member countries have made reservations indicating that they wished to continue using the previous definition of 'royalties'.

The only other amendments regarding the royalty definition of the 1992 Model are contained in the Commentaries thereto. In this respect, numerous paragraphs have been added to the Commentaries which pertain specifically to the computer software and are a direct result of the rapid expansion of computer technology, and aims to provide guidance on the subject.¹⁸⁸

In essence, the conclusions recorded in the Commentary include that, although the rights in computer software are a form of intellectual property, the transfer of such rights could occur in a number of ways ranging from the alienation of the entire right, to the sale of a product with restrictions on the use to which it is put. The consideration for such transfer could further also take

¹⁸⁵ See also § 9 of the Commentaries to the 1992 OECD MTC on Article 12(2).

¹⁸⁶ See Kusters "The United Nations Model tax Convention and Its Recent Developments". *Asia Pacific Tax Bulletin*. IBFD. January/February 2004 1 at 6.

¹⁸⁷ Sasseville "The New Model Tax Convention, *SA Tax review* Vol.6, 1993 at 119.

¹⁸⁸ See § 12 to 17 of the Commentaries to the 1992 OECD MTC on Article 12(2).

on many different forms which would make determining the boundary line between software payments qualifying as royalties and other types of payments quite difficult.¹⁸⁹

The Commentaries go on to differentiate between three specific situations. These situations include firstly, where less than the full rights of the software are transferred, in terms of which the likelihood is slim that it will represent a royalty. Secondly, a situation may occur where payments are made as a consideration for the alienation of rights attached to the software. In this scenario, the transfer of full ownership can obviously not represent a royalty. The third scenario pertains to a situation in which payments are made under mixed contracts. In this position, the Commentaries propose that the contracts be broken down based on the information contained therein, or by way of a reasonable apportionment, and for the appropriate tax treatment to be applied to each apportioned part.¹⁹⁰

3.3.3.4 1997 OECD Model

The 1997 OECD Model Convention amended the language used in the first paragraph of Article 12 to read as follows:¹⁹¹

[1] 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.

The amendment to Article 12(1) changes the provision as set out in the 1977 OECD Model. The amendment to this paragraph brings it in line with that of the 1981 US Model Convention, which effectively allows the benefit of the royalty Article only to the beneficial owner thereof, residing in the treaty country. The wording of the 1977 OECD Model clearly attempted to do the same, although it could technically be argued that did not achieve that goal. The Commentaries have also been amended to reflect this change.¹⁹²

There were no further amendments to either the 1997 OECD Model or its Commentaries.

3.3.3.5 2000 OECD Model

Apart from the amendment to the wording of Article 12(3) no other amendments were made to the royalty Article in the 2000 Model Convention. Numerous amendments were however made to the Commentaries thereto.

¹⁸⁹ See § 12 of the 1992 OECD Commentaries on Article 12(1).

¹⁹⁰ Ibid at § 13 to 17.

¹⁹¹ Article 12(1) of the 1997 OECD Model.

¹⁹² See § 1 to 5 of the Commentary on Article 12(1) of the 1997 OECD Model.

A number of these amendments were made with regards to the Commentaries to Article 12(2) and include the amendment of paragraph 10 in terms of which the words 'industrial or commercial' have been replaced with 'business profits'. The vast majority of the amendments to the Commentaries on Article 12(2) however pertain to software and bolsters the importance of this category of royalties in the modern age.

The wording of the Article 12(3) of the Model was amended as noted above and reads as follows:¹⁹³

[3] The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting 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 Article 7 ~~or Article 14 as the case may be~~ shall apply.

The amendment effectively removes the restriction of the beneficial owner performing independent personal services in the Source State and thereby not being allowed the relief provided by Article 12. The commentaries to paragraph 3 reflect the change by deleting paragraph 21 of the Commentaries to the 1997 OECD Model.

3.3.3.6 2003 OECD Model

The 2003 OECD Model did not bring about any amendments to the royalty Article. The only amendments brought about by the new Model are contained in its Commentaries.

The Commentaries dealing with Article 12(1) have been broadened significantly and now provide a more detailed account of the term 'beneficial ownership' and the practical applications as to the relief provided against double taxation. These amendments will be discussed in section 4.6.5 below.

With regards to Article 12(2), the Commentaries have been considerably expanded and for example provide a list of criteria aiding taxpayers in making the distinction between know-how payments and the provision of services in paragraph 11.3.¹⁹⁴ These criteria include *inter alia* that, with regards to services, the supplier undertakes to perform services which may require the use of his special knowledge but not the transfer of his knowledge, skill and expertise.¹⁹⁵ Paragraph 11.4

¹⁹³ Article 12(3) of the 2000 OECD Model.

¹⁹⁴ See § 11 of the Commentaries on the 2003 OECD Model.

¹⁹⁵ *Ibid.*

on the other hand, contains examples of payments which should be considered to be received, not for the provision of know-how, but rather the rendering of services and includes 'payments obtained as consideration for after-sale service' and 'payments for pure technical assistance'.¹⁹⁶

The provisions surrounding software have also been expanded on from the Comments of the previous Model in paragraph 17 pertaining to mixed contracts and provide specific examples, and more importantly provides guidance in deciding the nature of payments by means of determining 'that for which the payment is essentially made'.

The Commentaries to Article 12(4) that pertains to the arm's length nature of payments have been expanded on, and permits that only the amount of the royalty may be adjusted and that a reclassification of the royalty in such a way as to give it a different character is not allowed.¹⁹⁷

3.3.3.7 2005 OECD Model

The only amendment brought about by the 2005 OECD Model compared to the previous Model is contained in the additional paragraph to the Commentaries on Article 12(2) of the Model.

The additional paragraph added, paragraph 8.1, specifically includes payments made to 'secure the exclusivity of information or an exclusive right to use that property' as royalties in respect of information or the right to use property as referred to in Article 12(2).

3.3.3.8 2008 OECD Model

The royalty definition contained in paragraph 12(2) of the 2008 OECD MTC as quoted earlier in this chapter, does not contain an amendment to the wording of the preceding 2005 Model. The only changes to the royalty Article are contained in the Commentaries to the Model, as is the method tax practitioners have become accustomed to from the OECD.

The revision of the 2008 Commentaries to the Model includes several points aimed at clarifying certain positions. One of the clarifications pertains to the fact that royalties are generally paid for the use of property rather than for the acquisition of property or other rights. In some instances, this distinction becomes less clear for example; in the situation where there is a partial disposition of intangible property for a limited period of time or limited geographical area. It is suggested in the revised Commentary that the key question is whether the rights constitute 'distinct

¹⁹⁶ Ibid at § 11.4.

¹⁹⁷ Ibid at § 22.

and separate property' and that the geographically limited rights, are more likely to constitute property than time limited rights.¹⁹⁸

Another aspect which is specifically clarified is that payments for the acquisition of exclusive distribution rights are not in fact royalties, as they are not paid to use the property, but for the right to sell it.¹⁹⁹ The Commentaries further clarifies that payments made for the development of a plan, design or model are payments for services, whereas payments for the right to use a previously developed product are royalties.²⁰⁰

Clarification is also provided as to the concept of know-how and defines the terms as 'undivulged information of an industrial, commercial or scientific nature arising from previous scientific experience, which has practical application in the operation of an enterprise from the disclosure of which economic benefit can be derived'.²⁰¹

Paragraph 14 provides clarification with respect to the issue of the distribution of computer software and that intermediaries are often granted the right to distribute copies of the software. It provides that payments for these rights do not constitute a royalty even when they are distributed electronically.²⁰²

3.3.3.9 2010 OECD Model

The 2010 OECD MTC does not amend the provisions of the royalty Article. A number of additions are however made to the Commentaries to the Model.

The first addition to the Commentaries pertains to satellite operators and 'transponder leasing' agreements in terms of which the satellite operators allow their customer to utilise the capacity of a satellite transponder to transmit information. Such payments will typically be made for the use satellite transponder capacity and will not constitute royalties, as they are not 'for the use of, or right to use' property or information, as referred to by the definition of royalties in terms of Article 12(2) as the satellite technology is not transferred to the customer.²⁰³

Further additions to the Commentaries specifically state that the payments made by a telecommunication network operator to another network operator under a 'roaming' agreement, as well as payments for the use of all or part of the radio frequency spectrum, do not constitute

¹⁹⁸ Arnold "The 2008 Update of the OECD Model: An Introduction" *Bulletin for International Taxation*. IBFD. May/June 2008 at 180.

¹⁹⁹ See § 10.1 of the Commentary on Article 12 of the 2008 OECD Model.

²⁰⁰ *Ibid* at § 10.2

²⁰¹ *Ibid* at § 11.

²⁰² *Ibid* at § 14.4

²⁰³ See § 9.1 of the Commentaries to Article 12(2) of the 2010 OECD MTC.

royalties. The reason being that the payments are not for the use of or right to use property or information defined in the definition provided in Article 12(2).²⁰⁴

Amendments and inclusions have also been made to the Commentaries pertaining to Article 12(3) of the Model and includes stricter rules with regards to abuse of the paragraph by stating that ‘more than merely recording the right or property in the books of the permanent establishment for accounting purposes’ it will be required to prove that a right or property is ‘effectively connected’ to such permanent establishment.²⁰⁵ The commentary goes on to provide that royalties will be effectively connected to the permanent establishment and form part of the business assets, if the ‘economic ownership’ of that right or property is allocated to that PE.²⁰⁶

3.3.4 The United Nations Model

During the first decades of its existence, the United Nations did not occupy itself with the development of Model Tax Conventions.²⁰⁷ Therefore, when the OECD published the 1963 Draft Model, followed by the 1977 Model Convention, it quickly became the worldwide standard used in tax treaty negotiations. In view of the increase in international trade and the end of colonialism, the need for tax treaties between developed and developing countries was increasingly felt.²⁰⁸ Consensus also existed that the OECD Model was more appropriate for negotiations between developed countries and less suitable for capital importing or developing countries.²⁰⁹ The following excerpt from McIntyre confirms the above statement:²¹⁰

The widespread success of the OECD model in the 1970s provoked a reaction from developing countries. Those countries, being outside the OECD, were excluded from effective participation in the design of the model. Under the League of Nations, the developed countries were a dominant force in designing a model convention. Only in the Mexico draft were the interests of the developing countries given high prominence. Still, the developing countries were represented in the process of approving model conventions. With the capture of the model treaty process by the OECD, the participation by developing countries ended. They were disenfranchised at a time when the number of developing countries was increasing markedly, due in large to the collapse of colonialism in Africa and Asia after World War II.

²⁰⁴ *Ibid* at § 9.2 and 9.3.

²⁰⁵ *Ibid* at § 21.1.

²⁰⁶ *Ibid* at 21.2.

²⁰⁷ Holmes *supra* at 59 states that an ad hoc group of experts on tax between developed and developing countries was established in 1968 by the direction of the UN Economic and Social Council.

²⁰⁸ See Kusters *supra* at 4.

²⁰⁹ See section B. Historical setting of the 1980 UN Model Double Taxation Convention at 5.

²¹⁰ McIntyre “Calculations of the Share of Corporate Profits Subject to Tax in 2002”. *Citizens for Tax Justice*. Washington, (January 2003).

The above culminated in pressure on the UN to form an independent working group of tax treaty experts and the creation of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries in 1986, by the UN Secretary General. This group consisted of members from Latin America, America, Africa, Asia and European countries and became known in 1980 as the Ad Hoc Group of Experts on International Cooperation in Tax Matters.²¹¹

The Fiscal and Financial Branch of the Department of International Economic and Social Affairs of the UN Secretariat published a 'Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries' based on guidelines previously devised by the Ad Hoc Group of Experts. This report was followed in 1980 by the first UN Model Convention, the United Nations Model Double Tax Convention between Developed and Developing Countries. It was largely based on the 1977 OECD Model Convention, but granted greater taxing rights to Source States i.e. the capital importing and developing countries, particularly with respect to the taxation of business income and passive investment income. The ultimate difference between the UN and OECD Models is that the first mentioned provides better taxing rights to the Source State, however, these Models do not have widely divergent viewpoints but are rather variations on a theme.²¹²

The Commentary accompanying the UN Model took advantage of the accumulated technical expertise embodied by the OECD Commentaries by reproducing it where appropriate and in doing so acknowledged the widespread use thereof amongst Member and non-member countries.²¹³

Against this background, it should be noted that the UN Model has widely been used by most developing countries and some of its provisions are included in the provisions of developed countries, particularly if they are also capital-importing countries.²¹⁴

3.3.4.1 1980 UN Model

The 1980 UN Model, in reproducing the provisions contained in the 1977 OECD Model, made substantive changes to paragraphs 1 and 3, adds additional paragraphs i.e. paragraphs 2 and 5, and provides a drafting adjustment in paragraph 4. In this section, Article 12 of the 1980 UN Model will be compared to the 1977 OECD Model on which it is based. The 1980 UN Model reads as follows:²¹⁵

²¹¹ See Kusters *supra* at 4.

²¹² Wills "South African Double Tax Treaties: Royalty Reform in the Light of the Australian Experience" *Revenue Law Journal*. Volume 5, Issue 1 at 59.

²¹³ See Holmes *supra* at 59 to 61.

²¹⁴ See Wijnen and Magenta. 1997. *The UN Model in Practice*. IBFD. Amsterdam at 574 to 585.

²¹⁵ 1980 UN Model Convention. IBFD.

[1] Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

[2] However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed ... per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

[3] 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, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

[4] The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting 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 (a) such permanent establishment or fixed base, or with (b) business activities referred to under (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

[5] Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connexion with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

[6] Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

It is clear the UN Model departs substantially from the OECD Model in paragraph 1 which must be read together with paragraph 2 in order to be compared with the first paragraph of the

OECD Model. Where the OECD Model provides the residence State with exclusive taxing rights, the UN Model provides that 'the other Contracting State, i.e. the residence State, may tax the income'.²¹⁶ The UN Model further provides in paragraph 2 that the Source State may also tax the royalties, limited by mutual agreement if paid to the beneficial owner thereof.

The only difference in terms of definition of royalties provided by the respective Models is that the UN definition specifically includes as royalties 'films or tapes used for radio or television broadcasting' in addition to cinematograph films.²¹⁷ The UN Model Commentaries are a reproduction of the OECD Commentaries in all other respects on terms of this paragraph.

The first difference between paragraph 4 of the UN Model and paragraph 3 of the OECD Model is that the UN Model includes reference to both the first and second paragraphs for obvious reasons. The main difference is, however, the additional exclusion of royalties by the UN Model which are paid in connection with business activities referred to in subparagraph (c) of Article 7, even if the business activities are not carried on through a permanent establishment or fixed base.²¹⁸

Paragraph 5 of the UN Model provides a definition of the source of royalties and represents an innovation as compared with the text of the OECD Model.²¹⁹

Paragraphs 4 and 6 of the respective Models, pertaining to the arm's length rate of the royalties, are identical, as are the Commentaries thereto.

3.3.4.2 The 2001 UN Model Convention

In the 1990s the Ad Hoc Group of Experts on International Cooperation in Tax Matters recognised that significant changes had taken place in the international economic, financial and fiscal environment in addition to the advent of new financial instruments, transfer pricing mechanisms, the growth of tax havens and the effect of globalisation.²²⁰ It also took notice of the fact that the OECD Model had been revised four times by the 1992, 1994, 1995 and 1997 updates since the original UN Model published in 1980.

²¹⁶ This paragraph provides non-exclusive taxing rights to the residence State.

²¹⁷ See Article 12(3) of the 1980 UN Model.

²¹⁸ The activities described in subparagraph (c) of Article 7 pertain to 'other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

²¹⁹ See 1980 UN Model Commentaries on § 5.

²²⁰ See § 11 of the Introduction to the 2001 UN Models Commentaries.

Consequently, at the eighth meeting held in Geneva in 1997, a focus group was established to proceed with the revision of and update to both the UN Model Convention as well as the Manual for Negotiating Bilateral Tax Treaties between Developed and Developing Countries.²²¹

The bulk of the changes can however be said to have been made to bring the Model more in line with that of the OECD Model, and as expected the 2001 UN Model is based on the 2000 OECD Model.²²²

When comparing the 1980 and the 2001 UN Models with each other, the only difference to the provisions contained in the royalty Article are of an editorial nature and pertain to the provisions of Articles 12(2) and 12(5). The language used in the first mentioned amendment changes the excerpt from reading as follows:²²³

... but if the recipient is the beneficial owner of the royalties...

to reading:²²⁴

... but if the beneficial owner of the royalties is a resident of the other Contracting State...

The purpose of this amendment is to allow the benefit of this Article to the beneficial owner residing in the treaty country, whilst continuing to deny it when the beneficial owner is not such as resident.²²⁵

The second editorial amendment found in Article 12(5), however, does not affect the substance of the provisions.

A comparison between the 2001 UN Model and that of the 2000 OECD Model on the other hand reflects that it differs in two substantive respects. The first pertains to the definition of royalties contained in these Models. In contrast with the UN Model's definition, which remains unchanged from its original 1980 definition, the OECD Model's definition no longer includes the following phrase which was removed by the 1992 OECD Model and consequently pertains only to industrial royalties (including trade marks), cultural royalties and know-how:²²⁶

... or for the use of, or the right to use, industrial, commercial or scientific equipment.

²²¹ Ibid.

²²² See § 45 of the Introduction of the 2001 UN Model Convention.

²²³ Article 12(2) of the 1980 UN Model.

²²⁴ Article 12(2) of the 2001 UN Model.

²²⁵ See paragraph of the 2001 UN Model Commentaries

²²⁶ Please refer to section 3.3.3.3 above detailing the amendment.

The second difference pertains to Article 12(4) of the UN Model and Article 12(3) of the OECD Model. The UN Model in contrast with that of the OECD Model, still contains the following phrase which has been removed by the OECD Model in its 2000 update:²²⁷

... or performs in that other State independent personal services from fixed base situated therein...

As the Commentaries to the 2001 UN Model consist generally of a replication of that of the OECD Model where appropriate, the changes made to the OECD Commentaries in the various updates are likewise incorporated into the UN Model Commentaries.

3.3.5 The United States Model

The United States employs its own MTC which largely tracks the provisions of the OECD Model as the United States have actively participated in the development of the OECD Model.²²⁸

The US Model was first published on 17 August 1977 and has since been updated several times, namely on 16 June 1981, 17 July 1992, 20 September 1996 and 15 November 2006. These Models reflect the interest of the United States as a capital exporting country and protects its taxing rights as a country of residence due to it taxing its residents on a worldwide basis.

3.3.5.1 The 1981 US Treasury Model Convention

The first US Model Tax Convention was published in 1981 and read as follows:²²⁹

[1] Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

[2] The term "royalties" as used in this Convention 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 (but not including cinematographic films or films or tapes used for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof.

[3] The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State, in which the

²²⁷ Please refer to section 3.3.3.5 above detailing the amendment.

²²⁸ See Thuronyi. "Tax Cooperation and a Multilateral Tax Treaty". *Brooklyn Journal of International Law* 2001 at 1641.

²²⁹ Article 12 of the 1981 US Model Convention.

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 royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business profits) or Article 14 (Independent personal services), as the case may be, shall apply.

[4] Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

In comparing Article 12(1) of the 1981 US Model to that of the 1977 OECD Model it is evident that both provide exclusive taxing rights to the Residence State.

In applying the beneficial ownership requirement, the US Model does so differently to the OECD Model as it allows the benefit of the royalty Article only to the beneficial owner thereof, residing in the treaty country. In contrast, the OECD Model, of the time, aims to do the same but in terms of the technical phrasing of the provision, the benefit will apply if the royalty is paid to the beneficial owner, even if that beneficial owner is not a resident of the Contracting State. The OECD only rectified this oversight in its 1997 Model Convention.

Another difference between the US and other Model Conventions pertaining to paragraph 1, is the US Model's use of the word 'derived' as opposed to 'paid'. The significance of the differences is pointed out in the Commentaries to the 1996 US Model Convention which state the reason for the deviation from the wording of the conventional Models, as that of eliminating any inference that an amount must actually be paid to the resident, before it is subject to the provisions of Article 12.²³⁰

In terms of the definition of royalties, the 1981 US Model refers not to the definition of royalties for the specific Article, as the UN or OECD Models, but for the entire 'Convention'.²³¹ Other differences from the UN and OECD Models with regards to the definition of royalties include the specific exclusion of 'cinematograph films, or films or tapes used for radio or television broadcasting', the inclusion of 'other like right or property' in contrast to 'industrial, commercial or scientific equipment' as applied by the other Model Conventions.²³² This inclusion of the catch-all category 'other like right or property' widens the application of the provisions and was again

²³⁰ See explanation of § 2 of the Commentaries to the 1996 US Model Convention.

²³¹ See Article 12(2) of the 1981 US Model Convention.

²³² Royalties therefore do not include income from leasing personal property.

included in the 1996 US Model but removed in the 2006 US Model.²³³ Another difference from the royalty definition of the other Model Conventions is the inclusion of 'gains derived from the alienation of any such right or property which are contingent on the productivity, use or disposition thereof'. The Commentary to the US Model provides that where the gains derived are not contingent on their productive use, it will not be classified as royalties but will fall into Article 13 of the US MTC 'Gains'.

Paragraphs 3 and 4 of Article 12 of the US Model pertaining to royalties derived from a permanent establishment or fixed base and the arm's length principle respectively, are identical to the corresponding provisions of the UN and OECD Models.

3.3.5.2 The 1996 US Model Convention

Similar to the OECD Model Convention, the US Model is intended to be an ambulatory document that may be updated from time to time to reflect further considerations in the light of experience and changes in the nature or significance of transactions.²³⁴

Apart from the amendment to the definition of royalties contained in Article 12(2), there are no significant changes to the royalty provisions of the 1996 Model compared to the original 1981 US Model. The amended royalty definition of Article 12(2) reads as follows:

[2] The term 'royalties' as used in this Convention means:

(a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and

(b) gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use, or disposition of the property

The most notable change in the definition from the previous US Model pertains to the section that specifically includes 'computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction' which, with the exception of computer software, was specifically excluded from the royalty definition of the original Model. The Commentary on this section provides the reasoning behind the specific inclusion as due to the fact that 'subsequent

²³³ See Simontacchi and Uustalu *supra* note 113 at 36.

²³⁴ See Purpose of Model Convention and technical explanations to the 1996 US Model Convention.

technological advances in the field of radio and television broadcasting will not affect the inclusion of payments relating to the use of such means of reproduction in the definition of royalties'.²³⁵

A further specific inclusion to the 1996 US Model already noted in the above paragraph, is that of 'computer software'. In terms of the Commentaries, computer software is generally included in copyright laws worldwide and treated as either royalties or business profits depending on the facts.²³⁶

It should also be noted that the language used Article 12(1) establishing the exclusive taxing rights of the royalties to the residence State has been amended to be more in line with that of the OECD Model and now reads 'may be taxed only' instead of 'shall be taxable only'.²³⁷

3.3.5.3 The 2006 US Model Convention

The differences between the 1996 and the 2006 Models are not dramatic, and in most instances merely indicate the need to update the 1996 US Model to reflect the changes in the OECD Model and USA treaty policy since 1996.

The first amendment to the royalty Article is that the definition of royalties contained in Article 12(2) pertains only to the respective Article and not to the Convention as a whole as was the case with the 1996 US Model.²³⁸ In addition to the above mentioned change, Article 12(2)(a) has been amended to be almost identical to that of the OECD Model. The only difference being the use of the phrase 'literary, artistic, scientific or other work' instead of 'literary, artistic or scientific work' as used by the OECD Model.

3.3.6 The Association of the South-East Asian Nations ('ASEAN') Model Convention

ASEAN was formed in 1967 by Indonesia, Malaysia, the Philippines, Thailand and Singapore with Brunei, Vietnam, Laos and Myanmar and the Kingdom of Cambodia joining later. In the late 1980s ASEAN was taking important steps towards economic integration which led to the creation of the ASEAN Model Convention for the avoidance of double taxation ('ASEAN Model') in 1987 and the ASEAN Free Trade Area in 1992.

²³⁵ See Commentaries to Article 12(2) of the 1996 US Model Convention.

²³⁶ *Ibid.*

²³⁷ It should be pointed out that the words 'may be taxed' usually have a different meaning from the words 'shall be taxed', and that in the latter mentioned case it usually indicates the provision of exclusive taxing rights. It has however been decided in the Australian case of *Chong v COT*, 2000 FCA 635 that these words must be interpreted in the context in which they are used. In the present case, i.e. the amendment by the Model Convention to use 'may' instead of 'shall' must therefore be seen in context. In this regard, the use of the word 'only' provides the deciding factor indicating that the amendment does not affect the meaning of the phrase as it retains the position of providing exclusive taxing rights to the residence State.

²³⁸ Avi-Yonah and Tittle "The United States Model Income Tax Convention". *Bulletin for International Taxation*, Volume 61 at 225.

The ASEAN Multilateral Convention is based on the 1977 OECD Model which was 'in force' during the time at which the ASEAN Model was being drafted. Although based on the OECD Model it adopts many of the UN Model's features and can be said to be more in favour of developing countries than the UN Model in certain respects. This comment is based on the fact that the ASEAN Model, in contrast to the UN Model, includes a tax sparing credit as well as deeming provisions which provides that dependent agents may be deemed to be a permanent establishments without having the authority to conclude contracts if they habitually act as agents in the Source State.

The ASEAN Model reads as follows:²³⁹

[1] Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

[2] However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed 15 per cent of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

[3] 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, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

[4] The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting 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 Article 7 or Article 14, as the case may be, shall apply.

[5] Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed

²³⁹ ASEAN. 1987. The Intra-ASEAN Model Double Taxation Convention. IBFD. Paris

base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

[6] Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

From the outset the ASEAN Model follows the UN Model in stating that royalties ‘may be taxed’ in the residence State which does not provide exclusive taxing rights to that State and allows the Source State to also tax the royalties, but limited to fifteen percent.²⁴⁰

The definition of royalties also follows that of the UN Model in terms of the inclusion of the phrase ‘films or tapes used for radio or television broadcasting. It further, as it was published in 1987, does not exclude ‘the use of, or right to use, industrial, commercial or scientific equipment’ from the definition of royalties which was omitted from the 1992 OECD Model.²⁴¹ Many ASEAN members are however of the view that payments for the use of equipment constitutes rent and does not belong under the royalty article.²⁴²

Apart from the numbering, the remainder of the royalty Article not only follows that of the 1977 OECD Model on which it is based but also the 2005 OECD Model which confirms that static approach to the wording of the OECD royalty article.

Apart from the bilateral agreements discussed above, there are a few multilateral agreements in force. The royalty provisions contained in these multilateral agreements will now be briefly compared to that of the OECD and UN Models.

3.4 MULTILATERAL TAX CONVENTIONS

As eluded to earlier, the attempts of the OEEC to form a multilateral treaty between all its then Member States failed, leading to the establishment of the OECD.

Two of the better known multilateral treaties that have been entered into are the CARRICOM Agreement and the Nordic Income Tax and Capital Treaty (‘Nordic Convention’). Although these Double Tax Conventions are not Model Conventions, they do, to a certain extent, provide a Model

²⁴⁰ See Article 12(1) and (2) of the ASEAN Convention.

²⁴¹ Ibid at Article 12(3).

²⁴² Gesaruang “Linkages”. *NMCP 23/1*, OECD. Paris, 1996 at 101.

which may be followed by other organisations wishing to enter into multilateral agreements. On this basis, this Convention is included in the study and compared to the OECD and UN bilateral Model Conventions.

3.4.1 The CARRICOM Income Tax Agreement

Treaties for the avoidance of double taxation are usually bilateral as evident from the various Model Conventions outlined above. As mentioned earlier, the OEEC attempted to draft a multilateral treaty but failed and instead the OECD was formed in 1961.

The CARRICOM agreement has been signed by eleven of the fourteen Member States of the Caribbean Community, an organisation for the economic cooperation between countries of the Caribbean region.²⁴³ The CARRICOM Agreement in broad lines follows the OECD and UN Models, although it differs considerably in terms of the order in which the items of income are dealt with and the wording used. The fact that the wording used in the CARRICOM Agreement is so different from that of OECD and UN Models renders the Commentaries to these Models of little assistance in the interpretation of the CARRICOM Agreement.²⁴⁴

The provisions pertaining to royalty income is dealt with in Article 13 and reads as follows:²⁴⁵

[1] Royalties arising in a Member State and paid to a resident of another Member State shall be taxable only in the first-mentioned State.

[2] The rate of tax shall not exceed 15% of the gross amount of the royalties.

[3] In this Article, the word “royalties” payments of any kind received as consideration for the use of, or the right to use any copyright of literary, artistic or scientific work, including cinematograph films and films and tapes of radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process or other like property or rights to use industrial, commercial or scientific plant or equipment, or for the information concerning industrial, commercial or scientific experience; but does not include royalties or other amounts paid in respect of the operation of mines or quarries or in respect of the extraction or removal of natural resources.

[4] Royalties shall be deemed to arise in a Member State in which the copyright, patent, trade mark, design, model, plan, secret formula, process or non-patented technical knowledge or other similar intangible property is used.

²⁴³ See Bierlaagh *supra* note 50 “The CARRICOM Income Tax Agreement for the Avoidance of (Double) Taxation?” IBFD. Amsterdam at 99.

²⁴⁴ *Ibid.*

²⁴⁵ CARRICOM. 1994. The CARRICOM Income Tax Agreement. IBFD.

In terms of Article 13(1) it is clear that unlike the OECD or UN Models, taxing rights are provided solely to the Source State. Another difference in the wording which may be worth pointing out is the use of 'shall be taxable only' in contrast to the phrase 'shall be taxed only' as used in the OECD and UN Models. Although the wording 'shall be taxed' suggests some form of mandate or obligation to levy a tax,²⁴⁶ Model Tax Conventions by their very nature cannot levy tax.²⁴⁷

The definition of royalties contained in Article 13(2) is however similar to that of the earlier OECD and UN Models i.e. the 1980 and 1992 UN and OECD MTC's respectively, which were 'in force' at the time of the drafting of the CARRICOM agreement.

3.4.2 The Nordic Model Convention

The Nordic multilateral convention for the avoidance of double taxation with respect to income and capital was concluded by the Nordic countries which include Denmark, Sweden, Finland, Iceland and Norway. The royalty Article is based on the OECD Model Convention and has been adapted into a multilateral format and reads as follows:²⁴⁸

[1] Royalties arising in a Contracting State and paid to a resident of another Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.

[2] If the beneficial owner of royalties, being a resident of a Contracting State, has a permanent establishment or fixed base in a Contracting State other than the State of which he is a resident, and the right or property in respect of which the royalties are paid is effectively connected with a business carried on from that permanent establishment, or with independent personal services performed from that fixed base, as the case may be, the royalties arising in a Contracting State and paid to such beneficial owner may, notwithstanding the provisions of paragraph 1, be taxed in accordance with the provisions of Article 7 or Article 14, as the case may be, in the Contracting State in which the permanent establishment or fixed base is situated.

[3] 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 and films and tapes for radio and television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

²⁴⁶ See Bierlaagh *supra* note 50 at 102.

²⁴⁷ In a recent seminar held by the South African Fiscal Association on 9 and 10 September 2010, which the author had the pleasure of attending, Professor Kees van Raad (as speaker) submitted his opinion as to the difference in meaning of the phrase 'shall be taxed' as opposed to 'shall be taxable'. He concludes that there is no real practical difference and that these phrases have the same effect. The phrase 'shall be taxable' therefore does not imply that a tax must be levied.

²⁴⁸ Nordic Income and Capital Tax Treaty ('Nordic Convention'). IBFD.

[4] Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State involved, due regard being had to the other provisions of this Convention.

In terms of Article 12(1) the Resident State enjoys taxing rights similar to that provided by the OECD Convention, where the Resident State has exclusive taxing rights, and the Source State has none unless the royalty is connected with a PE or fixed base in that State. The provisions also include the requirement that the recipient must be the beneficial owner of such royalties in order to claim treaty relief.²⁴⁹ An important aspect which must be taken into consideration is the EU Directive prohibiting the Source State from levying a withholding tax on a royalty paid between two associated companies in respect of EU Member States. This may affect the application of the Nordic Convention due to the fact that certain of the Nordic States, such as Denmark and Sweden form part of the EU.²⁵⁰

Article 12(3) of the Nordic Convention defines the term 'royalties' for purposes of this Article and is substantially similar to the OECD Convention's definition thereof in Article 12(2). This means that the Commentaries to the OECD Model are quite helpful in interpreting the royalty provisions contained in the Nordic Convention.²⁵¹

The definition of 'royalties' provided in Article 12(3) is exhaustive and does not refer to the domestic definition of royalties, which therefore becomes irrelevant except in the instances of interpreting undefined terms in the express definition of royalties in terms of Article 3(2) of the Nordic Convention.²⁵²

It may be noted that the Nordic Convention's definition of royalties does not include know how, or stated differently, payments received as consideration for after-sale services, for services rendered by a seller to a purchaser under a guarantee, for technical assistance or for an opinion given by an engineer, advocate or accountant. These payments normally constitute business

²⁴⁹ See Chapter 4, for a discussion on the concept of beneficial ownership.

²⁵⁰ See Helminen "Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention". Bulletin for International Taxation. February 2007 49 to 64 at 61.

²⁵¹ Please refer to section 2.4.1 *supra*.

²⁵² See Helminen *supra* at 62.

profits in terms of Article 7 or Independent personal services covered by Article 14 of the Nordic Convention respectively.²⁵³

Similar to the latest version of the OECD Model Convention the Nordic Convention does not cover royalties paid for the use of, or right to use, industrial, commercial or scientific equipment.²⁵⁴ This type of payment from leasing tangible property such as machines or containers in most instances constitutes business income.²⁵⁵ It is interesting to note that the Nordic Convention includes an Article specifically with regards to the profits from the rental of containers.²⁵⁶

As certain of the Nordic States fall within the European Union, the Nordic Convention which must be read with the EC Interest – Royalties Directive ('the Directive'), which has its own definition of royalties in Article 2(a), which is relevant for determining the scope of its benefits only. As the Nordic Convention prohibits the Source State from levying tax on royalties, the Directive is relevant to Nordic countries which are EU Member States where the royalty definition is broader than that of the Nordic Convention.²⁵⁷ The Directive only covers royalties paid between associated companies in two different Member States and defines royalties as:²⁵⁸

Payments of any kind received as a consideration for the use of, or right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

The royalty definition of the Directive differs from that of the Nordic Convention, as the latter does not specifically include reference to 'software'. This is however not particularly relevant as payments for the use of, or right to use software, normally qualify as royalties under the provisions of the Nordic Convention despite the omission. A further difference is that the Nordic Convention also does not mention payments for the use of, or right to use, industrial, commercial or scientific equipment. This difference may concern lease payments which would normally qualify as business profits or fall under the other income provisions of the Nordic Convention. This difference in classification is also irrelevant as only the Resident State enjoys taxing rights with respect to business profits or other income, unless the income is connected with a permanent establishment.²⁵⁹

²⁵³ *Ibid.*

²⁵⁴ The 1963 Draft and 1977 OECD Models included these types of payments as royalties.

²⁵⁵ See Article 7 of the Nordic Convention and e.g. KHO 1986/1679, where the Supreme Administrative Court of Finland did not treat payment under a contract for leasing an aircraft as royalties.

²⁵⁶ See Helminen *supra* at 63.

²⁵⁷ See Helminen *supra* at 63.

²⁵⁸ EC Interest and Royalties Directive 2003/49/2003.

²⁵⁹ See Helminen *supra* at 63.

3.5 CONCLUSION

It can safely be concluded that the modern definition of royalties originated from the League of Nations Draft Models. Although initially there existed some uncertainty regarding whether or not the 1928 Models did in fact deal with royalty income, there can be no argument that the specific exclusion of 'rental or royalties' from business profits during the 1933 Fiscal Committee Meeting, was the origin of the modern Tax Treaty meaning of the term. Following from this meeting both the Mexico and London Draft Models set out the underpinnings to the definition of the term which are easily recognisable in the current MTC's. It has also been noted that no strong evidence exists suggesting that countries entering into treaties during this period were struggling to retain their source taxing rights and that these rights had to be abandoned in order to conclude treaties.

During the period between 1946 and 1958 the OEEC took over the reins from the League of Nations and continued to expand the royalties Article and further developed the Treaty definition of what constitute royalties in the process. In doing so, it included what is colloquially referred to as know-how, which on the wording of the paragraph could also have been interpreted as show-how.

Since the inception of the OECD in 1961, it would be fair to say that there have been very few if any significant amendments to the Model Tax Treaty definition of royalties. This can be said based on the fact that the definition of royalties can in both the latest OECD MTC and the 1958 OEEC Model be divided into two clear sections, the one dealing with the use of, or right to use intellectual property and the other the consideration received information regarding scientific and commercial experience. It has been the style of the OECD to follow a static approach to the wording of the Model Treaty as a means of maintaining a sense of certainty, and to affect changes or updates to the Model by way of expanding the Commentaries thereto. In this regard the Commentaries have been greatly expanded as a means of clarifying the provisions contained in the Model which is unfortunately not without its own problems, most notably that of the uncertainty surrounding the legal status of these Commentaries.

In comparing the OECD Model to the UN Model it is evident that the latter is aimed at being used between developed and developing nations rather than between two developed nations, due mainly to the greater source taxing rights it provides. This is achieved by the Source State being allowed limiting taxing rights to also tax the royalties through providing that it 'may also be taxed in the Contracting State in which they arise'. It may also be stated that the provisions of the ASEAN Model are also quite similar to that of the UN Model which is logical given the developing nature of the Member States.

The 1981 US Model Conventions definition of royalties differs from that of the OECD's during the same period in the sense that it defines the term in applying to the entire Treaty rather than

simply for the royalty Article and other minor issues such as the inclusion of cinematograph films. The definition of royalties between these Models is quite similar which is evident from the fact that the amendments to the latest US Model Convention (2006) merely reflect the changes in the OECD Model since the 1996 US Model.

In broad terms, there has been very little change in the Model Convention definition of royalties since the inception of the OECD Model Convention in 1961. As a result of the static nature of the Treaty wording, the Commentaries clarifying the intended meaning of the provisions have been greatly expanded.

A development which does however have far reaching consequences in respect of the taxing rights of States, the limitation of treaty benefits, has been the inclusion of the term 'beneficial ownership' in Articles 10, 11 and 12 pertaining to dividends, interest and royalties. In the context of Article 12, this concept effectively limits the treaty benefits provided in the MTC to only the beneficial owner of the royalty. The development of the concept of beneficial ownership since its inclusion in Tax Treaties will be discussed in the following chapter.

Chapter 4

BENEFICIAL OWNERSHIP

4.1 INTRODUCTION

Following on from Chapter 3, which investigated the development of the definition of royalties in the context of Model Tax Conventions, this chapter will briefly consider the origin and international tax meaning of the term 'beneficial ownership'. The consideration will focus on the use of 'beneficial ownership' with regards to royalties in MTC's as well as its practical application. This concept is decisive in determining whether a person qualifies for treaty benefits and for allocation of the right to tax between two Contracting States in respect of royalties, dividends and interest. This chapter will also investigate the development of the term 'beneficial ownership' over the past 45 years since it was first used in the international tax environment.

A statement often made in articles and other studies pertaining to the meaning of beneficial ownership, with which the author agrees, is that of absolute surprise as to the uncertainty surrounding the actual meaning of the said term. This is especially startling when taking into consideration the high volume and value of transactions emanating from the international flow of interest, royalties and dividends and the fact that the term has been used for over thirty years.²⁶⁰

In focusing on the development of the term 'beneficial ownership' in relation to royalties, Article 12(1) of the OECD Model Convention is of particular importance and reads as follows:

[1] 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.

[Emphasis added]

The interpretation of the 'royalty article' is crucially important to ensure the correct application and understanding of beneficial ownership in the context of royalties.

4.2 INTERPRETATION

It must be stated from the outset, that the author agrees that there are two main issues in determining the meaning of the term beneficial ownership as pointed out by Professor Klaus Vogel

²⁶⁰ See Du Toit "The Evolution of the Term 'Beneficial Ownership' in Relation to International Taxation over the Past 45 years". *Tax Treaty Monitor*. Bulletin for International Taxation. IBFD. October 2010 at 500 where he notes the confusion which still exist regarding the exact international tax meaning of the term which was introduced to Model Conventions by the 1997 OECD MTC.

at the 1998 International Fiscal Association ('IFA') congress held in London.²⁶¹ The first issue is whether Article 3(2) of the OECD Model applies. This provision essentially states that where a term is not defined in a treaty, the domestic meaning of the term shall be used unless the context requires otherwise. Secondly, the issue is that if the meaning of the concept is not to be taken from the domestic law, then how should it be interpreted? What is the international tax meaning of beneficial ownership?

Unfortunately, although there have been numerous articles written on the subject, it is still unclear what role and priority should be given to Article 3(2). This study does not deal with the issue in more depth than simply elucidating some of the reasons in favour of applying the international tax meaning of the term 'beneficial ownership' which is not defined in any of the Model Conventions.

In terms of Vogel,²⁶² the foremost reason why the term beneficial ownership cannot be interpreted with reference to the domestic law of the State applying the treaty is due to the fact that the national tax systems of most States do not provide a precise definition of the term. Vogel carries on in stating that the term should be interpreted in accordance with the context of the treaty and more particularly with a view to the particular purpose pursued by the restriction.²⁶³

A further argument for the use of the international tax meaning of the term is submitted by Dr Prokisch, who strongly supports the existence and the use of an international tax language.²⁶⁴ The basis of the argument is founded on the presumption that in order to avoid misinterpretation, a common understanding of treaty terms is necessary. Dr Prokisch defines the term international tax language as follows:²⁶⁵

International Tax Language is the common international understanding of terms which are used in the formulation of tax treaties. If two States use such a term in a bilateral treaty, then they use it in this international sense, unless they prefer to give the term a special meaning, either by way of formulating a special definition of the term or by using a term which has a clear relation to a domestic law.

²⁶¹ See the comments of Du Toit *supra* note 12 at 17 regarding the 52nd Annual IFA congress who also agrees with Vogel's statement.

²⁶² See Vogel *supra* at 562.

²⁶³ Wheeler "The Attribution of Income to a Person for Tax Treaty Purposes" *Bulletin for International Taxation* (Volume 59) 47 at 48 confirms the fact that the IFA panel at Eilat in 1999 dismissed the possibility that beneficial ownership is a domestic concept to be applied through Article 3(2) of the OECD Model and that it was unequivocally concluded that the term has a treaty meaning which is in-line with the London IFA panel (1999) that clearly veered towards the term having a treaty meaning.

²⁶⁴ See Du Toit *supra* note 12 at 182.

²⁶⁵ Prokisch "Does It Make Sense If We Speak of an 'International Tax Language'?" in Klaus Vogel (ed.) *Interpretation of Tax Law and Treaties and Transfer Pricing in Japan and Germany*. Kluwer Law International. London, 1998) at 103 to 110.

It is also the view of Edwardes-Ker, that international tax language in tax treaties should always be interpreted in adopting an autonomous approach which provides that tax treaty terms must be interpreted in their treaty context. He continues to state that there is no alternative to the use of the autonomous approach in terms of those treaty terms which have their genesis in other tax treaties, and consequently have no similar term or provision in their domestic law.²⁶⁶

A similar stance is taken by Du Toit who argues that although certain States can make a valid case for the application of Article 3(2) of the MTC, there still has to be an international meaning of the term. This is due to the fact that there are many States which do not have a similar principle in their domestic legislation and must consequently revert to the international tax meaning of the term.²⁶⁷

Accordingly, this chapter will focus on the second issue, the international tax meaning of beneficial ownership as stated above, and the development of the term since it was first used in a Model Tax Convention in 1977.

4.3 FIRST USE OF THE 'BENEFICIAL OWNERSHIP' IN A MODEL TAX CONVENTION

It is evident from the development of the various MTC's discussed in Chapter 3, that the expression 'beneficial ownership' was first used in the context of a Model Tax Convention in 1977 when it was incorporated into Articles 10, 11 and 12 of the OECD MTC. The 1981 UN Model which is largely based on the OECD Model also incorporated the use of the term. Neither Model however defined the term nor have any reservations or observations been expressed by any of the OECD Member countries.

The Commentaries to the 1997 OECD Model only contain fleeting remarks on the subject of beneficial ownership. It suggested that the treaty benefits would not be available should a third party be interposed between the payer and the beneficiary to create the appearance that the income is attributable to such party who is a resident in another State. In essence, it is an anti-conduit or otherwise known as a treaty shopping explanation.²⁶⁸ In this regard paragraph 4 of the Commentaries simply states the following:²⁶⁹

...the exemption from tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State.

²⁶⁶ Edwardes-Ker. 1994. *Tax Treaties Interpretation* (In-depth Publishing. London Loose leaf) at 7.02. For further support of the autonomous approach, see Vogel *supra* note 29 at 329.

²⁶⁷ See Du Toit *supra* note 12 at 171.

²⁶⁸ Radcliffe, P. Walker, M "Beneficial Ownership in Esperanto" *Tax Journal*.

<http://www.taxjournal.com/tj/node/20261> (visited on 7-10-2010).

²⁶⁹ See § 4 of the Commentaries to Article 12 of the 1977 OECD Model.

It should however be noted that the 1977 OECD MTC was not the first use of the term beneficial ownership in the international tax sphere. The term was used earlier in the 1945 in Article III of the United Kingdom ('UK') – United States ('US') on inheritance tax which included the provision:²⁷⁰

...shares or stock held by a nominee where the beneficial ownership is evidenced by the scrip dividends or otherwise.

Prior to the 1977 OECD MTC the term was first used in an income tax treaty by being incorporated by means of a supplementary protocol in 1966 into the UK – US treaty (both common law countries). An explanatory note attached to one copy of the protocol read:²⁷¹

Relief from tax on dividends, interest and royalties ... in the country of origin will no longer depend on whether the recipient is subject to tax in the other country, but will depend on the income being beneficially owned by a resident of the other country.

The explanatory note provides no further information on the meaning of the term beneficial ownership. A conclusion which can be drawn from the note is that the meaning of beneficial ownership is different from 'subject to tax'. The conclusion is confirmed by the 1987 Protocol to the 1968 UK – France treaty which replaced the 'subject to tax' requirement with a beneficial ownership requirement.²⁷²

Although there are many earlier examples of the use of beneficial ownership in treaties prior to the 1977 OECD MTC such as the 1968 UK – Netherlands treaty, 1969 Australia – Japan treaty, 1975 UK Spain treaty and the 1968 France – Ireland treaty, the question as to the origin of the term remains.

4.4 ORIGINS OF BENEFICIAL OWNERSHIP

The notion of beneficial ownership was developed and existed in the domestic law of common law countries for many years in a non-tax related context. The origin of this concept is said to have been founded in English trust law where it was contrasted with the concept of 'legal ownership'.²⁷³

²⁷⁰ See Oliver, Libin, Van Weeghel and Du Toit "Beneficial Ownership" *supra* note 10 at 325.

²⁷¹ *Ibid* at 311.

²⁷² See Du Toit *supra* note 12 at 180.

²⁷³ Cameron "Constructive Trusts in South African Law: The Legacy Refused". *Edinburgh Law Review*. Edinburgh. 1999.

4.4.1 Concept of ownership

In determining the meaning of the term beneficial ownership, as used in treaty context, it is insightful to take into consideration the meaning of ‘ownership’ as a fundamental concept of the term in both common law and civil law States such as England and the US compared to the Netherlands.²⁷⁴ This is necessitated due to the fact that the common law meaning of ‘ownership’ differs from that of civil law and that the Netherlands is the leading authority in terms of case law on the subject of beneficial ownership.²⁷⁵ In comparing the above meanings of ownership²⁷⁶ Du Toit reached a conclusion which provides that even though there are major differences in terms of these two legal systems, the similarities between the definition of ownership being the strongest right or bundle of rights in common law States, and the most comprehensive right encompassing all other rights in the civil law States, is remarkable. Other similarities include the acknowledgement of the residual nature of ownership and that ownership is subject to certain restrictions. In investigating the similarities and differences of ownership, the issue is best summarised by Honoré as follows:²⁷⁷

There is indeed, a substantial similarity in the position of one who “owns” an umbrella in England, France, Russia, China, and any other modern country one may care to mention. Everywhere the “owner” can, in the simple uncomplicated case, in which no other person has an interest in the thing, use it, stop others using it, lend it, sell it or leave it by will. Nowhere may he use it to poke his neighbour in the ribs or to knock over his vase.

For all the similarities, the most important difference between these legal systems for the purpose of this chapter is that the common law states allow for a split or separation of ownership between the legal owner and the beneficial owner, whereas the civil law States do not.

From the above findings, it is clear that the question of ownership is a legal question and accordingly pertains to the nature of the rights held by different persons. It is fitting to then consider whether the ownership of royalties refers either to the ownership of the intellectual property, the ownership of the licence or right to receive the payment or the ownership of the actual payment received.²⁷⁸ This question shall be considered with regard to the definitions provided on the subject.

²⁷⁴ See Du Toit *supra* note 12 at 59 where it is submitted that ‘beneficial ownership is a form of, or degree of, ownership.

²⁷⁵ See *Royal Duct Petroleum and Indofood cases sub note 315 and 325 respectively.*

²⁷⁶ See Du Toit *supra* note 12 at 95 for an in-depth comparison.

²⁷⁷ Honoré “Ownership” in A.G. Guest (ed.), *Oxford Essays in Jurisprudence* at 108.

²⁷⁸ See Du Toit *supra* note 12 at 89 to 95.

The term 'royalties' is defined in Article 12(2) of the current OECD MTC as 'payments of any kind received for...' is in line with other definition of the term which includes 'payments received, or to be received, for the right to...';²⁷⁹ 'a sum paid to a patentee for the use of ...';²⁸⁰ and 'a payment mechanism...'.²⁸¹ The definition of 'royalty owner' is further defined as:²⁸²

An owner, who is entitled to compensation for the use of property, usually copyrighted material, patent or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced.

From the above definitions, it can be said that the object of the beneficial ownership of royalties is the actual payment. An investigation into the ownership of royalty is therefore an investigation into the actual payment received.²⁸³

Apart from the origin of beneficial ownership as a treaty concept, the domestic law provisions pertaining to the origins of the term provides insight as to the possible treaty meaning thereof.

4.4.2 Beneficial Ownership in terms of the domestic law of common law countries

A brief analysis of the domestic law meaning of beneficial ownership in terms of certain common law countries that apply the term provides interesting results, as discussed below.

With regards to the English law meaning of the term, a distinction must first be made between common law which provides that ownership is indivisible and recognises only legal ownership and equity that allows divided ownership.²⁸⁴ The court, in *J Sainsbury plc. v O'Connor (Inspector of Taxes)*²⁸⁵ concluded that the real test for beneficial ownership is to consider the nature and extent of the rights held by the different parties. The test can therefore be said to be that of a legal question. The legal test is not used in a formalistic sense, but rather to establish who holds the ownership rights without reference to the economic value thereof. Another important factor is the issue of 'control' in the sense of controlling actual payments.

The US, in contrast places of a lot of emphasis on the economic nature such as the vesting of any appreciation or depreciation of the property's value. Although the issue of 'control' is very

²⁷⁹ *West's Tax Law Dictionary*. 1995 at 752.

²⁸⁰ *The Concise Oxford Dictionary of Current English*, 1995 at 1203.

²⁸¹ *Bainbridge Intellectual Property*. Pitman Publishing. London at xxxi.

²⁸² *West's Tax Law Dictionary*, *supra* at 753.

²⁸³ See Du Toit *supra* note 12 at 92.

²⁸⁴ *Ibid* at 139.

²⁸⁵ [1991] STC318, CA.

important, case law however suggests that only the control which results in the benefits accruing to the person exercising the control is considered.²⁸⁶

The Canadian position on beneficial ownership appears to be closely linked to the question of whether an agency relationship exists and in this respect, it is understood that a parent company is not the beneficial owner of the assets of its subsidiary unless the subsidiary holds the assets as an agent or nominee of the parent.²⁸⁷

Although the term ‘beneficial ownership’ is not used in the domestic law of civil law States, the concept that another person, apart from the legal owner, may hold economic benefits relating to a property, is not a completely foreign concept in all civil law States. Although there are important differences, the distinction between legal and economic ownership is similar to the concept of beneficial ownership in the Netherlands. It should however be taken into consideration that there is a difference between beneficial ownership in common law States and economic ownership in the Netherlands, which is only binding on contractual parties, whereas the first mentioned is binding upon the whole world.²⁸⁸

Following the brief high-level discussion regarding the origin of beneficial ownership, the study will turn to the international tax meaning of the said term.

4.5 THE INTERNATIONAL TAX MEANING OF BENEFICIAL OWNERSHIP

In following the approach of Vogel and the IFA of moving away from the unilateral method²⁸⁹, in terms of which Article 3(2) of the OECD Model which provides that, where the term is not defined, the State applying the treaty shall apply its domestic definition of beneficial ownership unless the context provides otherwise, a number of scholars have attempted to define the term ‘beneficial ownership’ in terms of the international tax meaning thereof.

These scholars include *inter alia* Prof Vogel whose definition of the term provides that:²⁹⁰

...the ‘beneficial owner’ is he who is free to decide (1) whether or not the capital or other assets should be used or made available for use by others or (2) on how the yields therefrom should be used or (3) both.

²⁸⁶ See *Montana Catholic Missions v Missoula County* 200 U.S. 118 [1906] (‘Montana case’) and *Engineered Timber Sales Inc. v Commissioner* 74 T.C. 808 (1980).

²⁸⁷ See *Cowan v Nova Scotia (Minister of Finance)* [1978] C.T.C. 557, 28 N.S.R. (2d) and *Jodrey Estate v Nova Scotia (Minister of Finance)* [1980] C.T.C. 437.

²⁸⁸ See Du Toit *supra* note 12 at 142 for a more detailed analysis.

²⁸⁹ See Wheeler *supra* at note 263.

²⁹⁰ See Vogel *supra* note 29 at 562 in § 9.

In contrast with Vogel, who includes the element of control over both the capital and the income, Danon focuses his definition of the term only on the legal, economic or factual control of the income which reads as follows:²⁹¹

...the person who legally, economically or factually has the power to control the attribution of income.

In this regard Van Weeghel concluded after considering various options that it is preferable to limit the role of the concept of 'beneficial ownership'.²⁹² In contrast to the view of Pijl,²⁹³ Van Weeghel concluded that the term 'paid to' should be construed only by looking at a formal debtor/creditor relationship²⁹⁴ and proposed the following meaning to be used by the OECD MTC in defining the term which reads as follows:²⁹⁵

...the creditor of the income, or, if the creditor is acting as agent or nominee, the principle for the account of whom the agent or nominee is acting.

Van Weeghel made the above conclusion seemingly by the application of logic whereas Du Toit below follows a different approach and in the authors opinion correctly applies the principles contained in the Vienna Convention.

In writing specifically with regards to the meaning of beneficial ownership in respect of royalties, Du Toit noted that there are various definitions of beneficial ownership. In applying the provisions of Article 31 of the Vienna Convention in interpreting the meaning of the term²⁹⁶, he concluded that the definition for treaty partners who apply the OECD Model without any alterations should be as follows:²⁹⁷

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

[Emphasis added]

²⁹¹ Danon "Switzerland's Direct and International Taxation of Private Express Trusts" in Oberson, Xavier (ed.), *Droit Fiscal Suisse et International* (Zurich: Schulthess Juristische Medien AG, 2004), Vol. 1 at 340.

²⁹² See Wheeler *supra* at 263 where it is suggested that the only certainty regarding the meaning of the term 'beneficial ownership' is that it excludes persons whose entitlement to income is founded on a formal, legal claim.

²⁹³ See Pijl "Beneficial Ownership and Second Tier Beneficial Owners in Tax Treaties of the Netherlands" *Intertax* 353 (No. 10, 2003), at 359.

²⁹⁴ Van Weeghel. 1998. *The Improper Use of Tax Treaties*. Kluwer Law International at 91.

²⁹⁵ *Ibid.*

²⁹⁶ The interpretation of treaties is governed by the principles of customary international law, please see *supra* note 74.

²⁹⁷ Du Toit *supra* note 12 at 236 to 237.

The above definition provided by Du Toit is widely regarded as the international tax meaning of the term.²⁹⁸ The question however remains as to the application thereof in a group scenario.

In practice, the meaning of the term is especially problematic with respect to group companies. The issue is accurately summed up by Baker as follows:²⁹⁹

The practical question remains whether, for example, a company under the control of another – and therefore likely (though not legally obliged) to pay to its ultimate owner any sums received – could be regarded as beneficial owner of the dividends it receives. Or, to take another example, suppose that a member of a multinational group borrows money and then lends the money on to another group company: the two loans are not tied together, and the lending company is not obliged to use the interest it receives to pay interest on the loan it received – in practice, however, it is likely to do so.

From the above excerpt, it is clear that the issue is whether the concept of beneficial ownership is a legal as opposed to a factual or economic substance test.

The evolution of the concept of beneficial ownership will now be discussed as it progressed since it emerged more than forty years ago.

4.6 EVOLUTION OF THE CONCEPT OF BENEFICIAL OWNERSHIP

As stated by Bierlaagh,³⁰⁰ the concept of beneficial ownership originated in common law countries and that accordingly a more common view of the term should be applied in different legal systems. He further stated that:

...it may not be a reasoning on the basis of the text and literal meaning of the words, but rather the object of the object and purpose of the treaty which dictates its international meaning, largely based on the common law, but not identical to it.

The focus of this Chapter is on the question of whether the concept of beneficial ownership has evolved since it first appeared in DTC's in 1966, more than 40 years ago to a more international meaning 'largely based on the common law, but not identical to it'.

In lieu of the fact that the concept of beneficial ownership originated in the common law and was first used in DTC's between common law countries, i.e. the 1966 protocol to the 1945 UK –

²⁹⁸ See *Prévost Car Inc. v Her Majesty the Queen* 2008 TCJ 231 (TCC) at § 30.

²⁹⁹ Baker, P. 2009. *Double Taxation Conventions*. Loose leaf, October. Sweet & Maxwell. London at 10B to 15.

³⁰⁰ Bierlaagh, Senior Principle, IBFD, Amsterdam, reported in Oliver, Libin, Van Weeghel and Du Toit, "Beneficial Ownership and the OECD Model". *The British tax Review* 1 (2001) at 65.

US treaty referred to above,³⁰¹ it would be difficult to argue that the meaning of the term was not the meaning as used in the UK and the US. The first question is then whether the meaning of the term applied to the treaty between these two States changed following the use thereof in the 1977 OECD MTC. A further question is whether this meaning has changed or evolved since the introduction thereof in the 1977 OECD Model to the present day.

For the purpose of investigating the evolution of beneficial ownership, specific influential events will be discussed which occurred during its existence in the past 4 decades.

4.6.1 The first use of beneficial ownership

In section 4.3 above, the first use of the concept of beneficial ownership in a tax treaty context was correctly stated as being the 1966 protocol to the UK – US tax treaty.³⁰²

As this was the first use of the term in an international document, it is logical to assume that the term's meaning was the same as the domestic meaning of the term in both these common law States.³⁰³ An investigation into the domestic law meaning of beneficial ownership of different common law States, however, revealed that, in the study performed by Brown³⁰⁴ and that of Brender³⁰⁵, beneficial ownership had different meanings under the Canadian Income Tax Act depending on the provisions. This illustrated the fact that there is no settled definition of beneficial ownership even in common law States.

The fact that there is no single definition of the term, and that the meaning of the term must be determined with reference to the context in which it is used is neither a new nor an unusual concept.

The remarks of Hattingh³⁰⁶ in this instance are quite fitting where he concludes the following in writing on the subject in a South African context (which is also a common law country):

There is probably no perfect well-described all-encompassing definition of beneficial ownership that lies hidden in a case or an old authority waiting to be discovered.

³⁰¹ It should be noted that both the UK and the US are common law countries.

³⁰² See note 271 *supra*.

³⁰³ See Avery Jones and De Broe et al in note 124 *supra* who casts some doubt on the intended meaning at 249 where he states that although the reason for adopting the expression was to provide relief from withholding tax for charities and pensions funds, which could not qualify under the former 'subject to tax' test. However he goes on to state that neither charities nor pension funds would qualify as beneficial owner if the trust law meaning applied.

³⁰⁴ Brown "Symposium: Beneficial ownership and the Income Tax Act". *Canadian Tax Journal* 1 2003 at 424 to 427.

³⁰⁵ Brender "Symposium: Beneficial ownership and the Income Tax Act". *Canadian Tax Journal* 1 (2003) at 315 to 318.

³⁰⁶ Hattingh "Beneficial Ownership and Double Tax Conventions, Part II", in De-Kocker, A and Brincker, E. (eds.) *International Tax*. Lexis Nexis. Durban. (Forthcoming).

and:

The term beneficial owner is rather like a chameleon, taking its content of the personal rights to which it is attached as a label. It is not in the nature of a chameleon to nail its colours to the mast.

The principles obtained from comparing various meanings of the term taken from a number of common law countries, is that of a journey into the attributes of ownership, as the name suggests.³⁰⁷ A further important question, on which the cornerstone of the meaning of beneficial ownership rests, is whether beneficial ownership can be said to be a question of law or a question of fact as he concluded in his Doctoral work as follows:³⁰⁸

The study has found no evidence, neither that in the OECD Model nor the MC Commentary, to support the a different meaning for international purposes, namely that beneficial ownership is excluded not only where a person is under a legal obligation to pay out a royalty but also where it is paid on in fact and in the absence of a legal obligation to do so.

4.6.2 The first use of beneficial ownership in a Model Tax Convention

The first use of the concept of beneficial ownership in the 1977 OECD MTC has been discussed in some detail earlier in section 4.3 above, where it was stated that no reservations or observations were articulated by any of the Member countries and that the Convention did not include a definition of the new term.

It should however be added that the position regarding the availability of materials used by the OECD in drafting the provisions and thereby providing insights as to their true intentions have recently become available. A document dated 9 May 1967 included the following statement from the UK under the heading 'Article 10: Dividends':

In our view the relief provided under these Articles ought to **apply only if the beneficial owner** of the income in question **is resident** in the other contracting State, for **otherwise the Articles are open to abuse by taxpayers who are resident in third countries who could, for instance, put their income into the hands of bare nominees who are resident in the other Contracting State**. You will have no doubt noticed that our recent protocols with the United States and Switzerland we have introduced this test of beneficial ownership which clearly reflects what was intended by the Committee when the Model Convention was prepared.

[Emphasis added]

³⁰⁷ See Du Toit *supra* note 260 at 502 and § 4.4.1 *supra*.

³⁰⁸ See Du Toit *supra* note 12 at 227.

The use of the concept of beneficial ownership to deny treaty benefits to the 'bare nominee' is sensible in that it provides a method of combating treaty abuse such as treaty shopping.³⁰⁹ When comparing the provisions of Article 12(1) of the OECD prior to the 1977 amendment thereto this object becomes clear, even though it could be said that the phrasing of the provision did not quite stand up to the task as pointed out earlier in section 3.3.3.4.³¹⁰

The above OECD document also points to the fact that the OECD borrowed the notion of beneficial ownership from the common law to be used as a treaty concept.³¹¹

4.6.3 The 1986 OECD Conduit Companies Report

The 1986 report from OECD's Committee of Fiscal affairs entitled 'Double Taxation Convention and the Use of Conduit Companies'³¹² ('Conduit Report') was adopted on 27 November 1986 and unambiguously expressed the Committee's concern regarding the abuse of DTC's by way of treaty shopping.³¹³

In part II, this Conduit Report further discussed the anti-avoidance provisions under paragraph B of the section of the report which stated:³¹⁴

[14] The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a "conduit company".

(a) ...

(b) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not the "beneficial owner". Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraph 12, 8 and 4 of the Commentary to Articles 10,11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, also apply to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or agent. Thus a conduit company can normally

³⁰⁹ See Vogel *supra* note 29 at 561 where he describes the purpose of the restriction introduced by the 1977 OECD MTC as to 'help prevent tax avoidance' and goes on to specifically state that persons not entitled to treaty benefits were prevented from obtaining its benefits with the help of interposed persons i.e. treaty shopping. See also Killius "The concept of 'beneficial ownership' of items of income under German tax treaties" *Intertax*, 1989/8-9, at 340.

³¹⁰ See note 199 *supra* § 1 to 5 of the Commentary on Article 12(1) of the 1997 OECD Model.

³¹¹ See Du Toit *supra* note 260 at 503.

³¹² OECD, "Double Taxation Convention and the Use of Conduit Companies", *International Tax Avoidance and Evasion, Four Related Studies*, Issues in International Taxation Series No.1 (Paris: OECD, 1987).

³¹³ See Wheeler *supra* note 263 at 47 where she states that the Conduit Company Report signalled treaty shopping as a risk and that states have only been addressing the issue in the last ten years.

³¹⁴ See Conduit Report *supra* at (R) 9 to 10.

not be regarded as the beneficial owner if, though the formal owner of assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).

From the above excerpt, it can be ascertained that the function of the report appears to be the expansion of the limitation on treaty benefits, or rather the exclusion of persons from being the beneficial owners. The expanded exclusion from beneficial owners has been widened from nominees or agents, as mentioned in the MTC Commentaries, to formal owners with limited or narrow powers who do not from a legal perspective hold the biggest weight of the ownership attributes.

Apart from OECD reports, probably the most insightful authority as to the meaning of beneficial ownership is enunciated by way of the Dutch case law on the subject in terms of a chronological view of the evolution of the term.

4.6.4 Netherlands Supreme Court decision in the *Royal Dutch Petroleum case*³¹⁵

Since the 1986 OECD Conduit Companies Report the leading case regarding the treaty interpretation of beneficial ownership, not only with respect to Dutch law, was that of the *Royal Dutch Petroleum case*, also referred to as the 'Market Maker' case, heard by the Supreme Court (*Hoge Raad*) with regards to dividends. This case concerned a dividend-stripping situation in order to receive a reduction in withholding taxes.

Although the case dealt specifically with dividends, there is no reason why it could not be applied to royalties as the case focussed on the issue to be decided, i.e. that of beneficial ownership.³¹⁶

The facts stated that the taxpayer was a company established in the UK and registered as a stockbroker who bought dividends coupons, for a price of approximately 80% of the gross nominal value of the dividend, of Royal Dutch Petroleum shares without acquiring or possessing the underlying shares. At the time of purchasing the coupons, the dividends had been declared but were not yet made payable.

After the dividend had been made payable, the taxpayer collected the dividends which were diminished by a 25% withholding tax withheld by the Belgium paying agent, according to the Netherlands domestic tax law. On payment, the taxpayer claimed the reduced withholding tax rates

³¹⁵ *Hoge Raad*, 6 April 1994, No. 28 638, BNB 1994/217. IBFD Tax Treaty Case Law summary.

³¹⁶ See Du Toit *supra* note 12 at 151.

in terms of the Netherlands – UK tax treaty which equated to a 10% refund of withholding taxes paid.

The *Hoge Raad* found in favour of the taxpayer in that he was indeed the beneficial owner of the dividend and accordingly permitted to apply the Netherland – UK tax treaty to reduce the applicable withholding tax rate on the dividend payment. In doing so, the court established some important principles regarding beneficial ownership. Firstly, that there is no need to be the underlying owner of the property, or shares in this case. Secondly, the court focussed on the rights in respect of the coupons and payment in that it had independent powers to freely decide whether to sell or keep the dividend coupons and to enjoy the proceeds therefrom, making it the beneficial owner. Thirdly, the court held that beneficial ownership must be determined at the time when the payment takes place. Fourthly, it should be stated that the court supported its finding on the fact that the taxpayer did not act as an agent.³¹⁷

A final point on the importance of the case, which has already been eluded to earlier, is the fact that the court focussed only on the issue to be decided, i.e. the beneficial ownership and did not apply another test such as whether the reason for the scheme was to obtain treaty benefits.³¹⁸

The author agrees with the observation made by Du Toit³¹⁹ in that the transaction does not appear to have been motivated by tax reasons and states that it appears from the decision of the *Hoge Raad* that the beneficial ownership test is not ‘for the main or sole reason to obtain a tax benefit’ test. In this regard, Sporken comments as follows:³²⁰

It should be borne in mind that in the above case, the Supreme Court held only in respect of the beneficial ownership test and left for another day the question of whether it would have granted the refund after a treaty-abuse test, since the issue was not brought up by the Netherlands Revenue.

4.6.5 Significant amendments to the 2003 OECD Commentaries on Article 12

In continuing the chronological approach it was pointed out in Chapter 3 that the 2003 Commentaries to the OECD Model contained substantial changes regarding the interpretation of

³¹⁷ Ibid at 153 where it refers to F.W. van Brunschot, whose commentary is attached to the case, comments (at 1645) that the reference to *zaakwaarnemer* and *lasthebber* should not be seen as a separate test, because such persons by definition cannot freely deal with the payments.

³¹⁸ See Du Toit *supra* note 260 at 503 to 504.

³¹⁹ See Du Toit *supra* note 12 at 153.

³²⁰ Sporken “Dutch Planners Test the Bounds”. *Tax Planning International Review* 1994/9 at 13.

beneficial ownership compared with those of the 1977 Model when the concept was introduced. These amendments to the Commentaries read as follows:³²¹

The term “beneficial ownership” is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purpose of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

It is interesting to note that the above amendments to Commentaries include aspects of the 1986 Conduit Report in the sense that the 1977 exclusion of agents and nominees are retained and, more importantly, that beneficial ownership should not be understood in a narrow technical sense, but rather in the context of the Convention.

It could be further pointed out that the last phrase of paragraph 4 of the 2003 OECD Commentaries ‘understood in its context and in light of the object and purpose of the Convention’ confirms the view of the Eilat IFA Panel which is that the term beneficial ownership should not be interpreted by way of Article 3(2) of the MTC, but that it should be read in its context, i.e. that the term has an autonomous treaty meaning independent from the domestic law of the Contracting States.³²²

Generally, the amendments brought about by the OECD Commentaries regarding the development of the term beneficial ownership have been described as ‘arguably the most dramatic’.³²³ Fittingly, the issue at the heart of the matter regarding the meaning of beneficial ownership, i.e. the question whether the test thereof is that of a legal or economic substance test, is addressed in a very subtle manner, with far reaching consequences, by an amendment in paragraph 4.1 of the 2003 OECD Commentaries. The amendment referred to reads as follows:

... cannot be regarded as the beneficial owner if, though the formal owner, it has, **as a practical matter**, very narrow powers which render it ...

[Own emphasis]

The use of the phrase ‘as a practical matter’ which has not been included previously in the OECD Commentaries, appears to be a departure from the accepted view that beneficial ownership is question of law.³²⁴

³²¹ See § 4 of the Commentaries to the 2003 OECD MTC.

³²² See Oliver et al *supra* note 270 at 325 where the panel concludes that beneficial ownership is not a term which is to be given its meaning by domestic law under Article 3(2).

³²³ See Du Toit *supra* note 260 at 504 and Jiménez “Beneficial Ownership: Current Trends” *World Tax Journal*. (February 2010) 35 at 52 to 60.

³²⁴ See Du Toit *supra* note 12 at 227 where it is submitted that the beneficial ownership is a question of law.

It is interesting to note that in two of the latest cases regarding the meaning of beneficial ownership, namely the *Indofood International Finance Ltd v JP Morgan Chase Bank N.A. London Branch*³²⁵ ('*Indofood*') and *Prévost Car Inc. v Her Majesty the Queen*³²⁶ ('*Prévost*'), both courts reliance on the Commentaries differed. In *Indofood*, the court relied strongly on the 'practical matter' test whereas in the *Prévost* case the court was not willing to go as far as to stretch the meaning of beneficial ownership to 'a practical matter' test.

With regards to the above court's interpretation of the meaning of beneficial ownership Du Toit, in the authors opinion, correctly points out that the approach followed by these courts can justifiably be criticised.³²⁷ The reasons being firstly, that the courts cannot refer to the Commentaries as the first or only source of the meaning of beneficial ownership as the correct first step is the elucidation of the wording of the text.³²⁸ It is only after the wording has been investigated that the Commentaries may be used, provided that there is a legal basis to prove that the Contracting States intended the Commentaries to be a source of establishing the treaty meaning of the terms used therein. A further hurdle is the justification in using the later Commentaries which were added after the conclusion of the DTC entered into between the Contracting States, especially since the Commentaries referred to changed the meaning of the terms under investigation. Du Toit also restates the importance of first determining the ordinary meaning of the word as the term beneficial ownership:³²⁹

...it is a term with unique and subtle characteristics, which must have played a role in the decision of the OECD to employ it as a treaty concept.

In concluding on the amendments pertaining to the 2003 OECD Commentaries, the question must be asked why the Model perseveres with the term beneficial ownership, when such a stretch of the 'original' common law meaning of the term is required for it to effectively be used a method of denying treaty benefits in the situation of paying money 'as a practical matter' in the absence of a legal obligation to do so?

4.6.6 The *Indofood* case

The *Indofood* case of 2006 appears to present the English courts with their first opportunity to provide a definition for the term 'beneficial ownership' in a treaty context, i.e. the international tax

³²⁵ [2006] 8 ITLR 653, STC 1195.

³²⁶ 2008 TCJ 231 (TCC).

³²⁷ See Du Toit *supra* note 260 at 505.

³²⁸ Pijl "The Theory of the Interpretation of Tax Treaties, with reference to Dutch Practice". *Bulletin for International Fiscal Documentation*, 1997/12.

for International Fiscal Documentation 12 and Edwardes-Ker *supra* note 111 at 4.01.

³²⁹ See Du Toit *supra* note 260 at 505.

meaning of the term as opposed to the domestic common law meaning thereof. Unfortunately, on the facts, the case did not concern the English law but Indonesian law and is not the eagerly anticipated English case providing a treaty definition of beneficial ownership.

The case does however provide answers to a number of important questions such as whether or not beneficial ownership is excluded where a person is under an obligation to pay dividends, interest or royalties and also where these amounts are paid in the absence of a legal obligation to do so. A further crucial element of the case is the specific investigation of back-to-back loans which has been cited by a number of authorities³³⁰ as a notoriously difficult issue in that nothing puts beneficial ownership to a greater test.³³¹

The brief facts of the case are that an Indonesian trading group ('Indo') wanted to raise finance by issuing internationally marketed interest-bearing notes to the public. This was done through a Mauritian Special Purpose Vehicle ('SPV') in order to benefit from the low withholding tax rates provide by the Mauritius – Indonesia DTC.³³² Two years after the issue of the Notes, the Indonesian government decided to terminate the said DTC which meant that the 20% Indonesian withholding tax would apply in absence of the provisions of the treaty.

Following the termination, Indo tried to initiate a get-out clause and gave notice to the trustees of the bondholders (JP Morgan) of its intention to redeem early.³³³ On the basis that Indo had not taken reasonable measures to prevent the situation, the trustees refused the early redemption. It was put forward that one such method would have been the setting-up of a Dutch SPV to perform the same function as the Mauritian SPV using the Indonesian – Netherland DTC.³³⁴ The issue at stake can be reduced to the question whether the introduction of the Netherland SPV between the Indonesian borrower and the Mauritian company, holding back-to-back loans for the same amounts and receiving and again paying the same amount of interest can be regarded as the beneficial owner?

On appeal the court decided in favour of Indo by finding that the Dutch SPV could not be the beneficial owner of the interest paid by Indo, and therefore not a reasonable measure of avoiding the adverse change in Indonesian law.

³³⁰ See Du Toit *supra* note 260 and note 12, see also Pijl *supra* note 10.

³³¹ See Du Toit *supra* note 260 at 505.

³³² Should the notes have been issued from Indonesia, a withholding tax of 20% would have been levied compared to the 10% in Mauritius.

³³³ In terms of the agreement, Indo would be allowed to redeem early in the case of an adverse change in the Indonesian law, if the effect could not be avoided by Indo taking reasonable steps.

³³⁴ Due to the creation of this fiction it is debatable whether the finding of the case would have international application.

In coming to its decision the court examined the OECD Commentary and confirmed that the term 'beneficial ownership' should be understood in the context and in light of the object and purpose of the OECD Model, namely that of the avoidance of double taxation and the prevention of fiscal evasion. The court concluded that the concept of beneficial ownership did not align with that of the formal owner who does not have the privilege of directly benefiting from the income. Looking however at the legal, commercial and practical structure, it was concluded that neither the Mauritian nor the Dutch company could be regarded the beneficial owners either, but rather administrators of the income.

An important issue, in respect of which there is uncertainty, is whether the Netherlands SPV would have had to pay over a specific amount of interest received or whether it could use money from another source, which is an important factor with regards to the beneficial owner test.³³⁵

The court therefore found that the Netherland SPV would not be the beneficial owner and held that:³³⁶

... the Issuer is bound to pay the Principal Paying Agent that which it received from the Parent Guarantor because it is precluded from finding the money from any other source by the Note Conditions ...

and:

But the meaning to be given to the phrase 'beneficial owner' is plainly not to be limited by so technical and legal an approach. Regard is to be had to the substance of the matter. In both commercial and practical terms the Issuer is, and Newco would be, bound to pay onto the Principal Paying Agent that which it receives from the Parent Guarantor ... In practical terms it is impossible to conceive of any circumstances in which either the Issuer or Newco could derive any "direct benefit" from the interest payable by the Parent Guarantor except by funding its liability to the Principle Paying Agent or Issuer respectively. Such an exception can hardly be described as the "full privilege" needed to qualify as the beneficial owner, rather the position of the Issuer and Newco equates to an "administrator of the income".

The most problematic aspect of the *Indofood* case is arguably the application of the economic substance test as opposed to the legal test that is to be applied to beneficial ownership which could however also be said to be the current position of the OECD Commentaries.³³⁷

³³⁵ Baker "Beneficial Owner: After Indofood". *Grays Inn Tax Chamber Review* Vol VI, No. 1 (February 2007) at 22 available at www.taxbar.com/gitc.html (visited on 14/10/2010).

³³⁶ *Indofood* at 43 and 44.

³³⁷ See Du Toit *supra* note 260 at 506.

The phrase ‘the full privilege’ used by the court could be said to be in line with the view of Vogel³³⁸ and Danon³³⁹ who are of the respective views that beneficial ownership is to be decided on the practical aspects or a combination of practical, legal and economic aspects.

In whichever light one looks at the case, there can be little doubt that the Indofood structure had an avoidance scheme at heart. In this respect, is the use of the term ‘beneficial ownership’ warranted to curb such blatant treaty abuse mechanisms? Another view is that the case is simply an example of a conduit entity with a lack of substance and function that was taken too far.³⁴⁰

4.6.7 The *Prévost* case

The 22 April 2008 judgement in the *Prévost* case was confirmed by the Canadian Federal Court of Appeal on 26 February 2009 in *The Queen v Prévost Car Inc.*³⁴¹ (*Prévost appeal*).

The *Prévost* case provides witness to an attempt to stamp out a mainstream and extremely widespread international corporate structure. This structure is designed for purpose of owning an investment as a funnel for its ultimate shareholders.

The facts of the case are relatively simple. *Prévost Canada* incorporated under the laws of Quebec was a resident of Canada and wholly owned by a Dutch company (*Prévost BV*) which was established by its two joint venture shareholders, Volvo in Sweden (51%) and Henlys in the UK (49%). *Prévost BV* had no physical office or employees in the Netherlands or elsewhere.

It was admitted in court that tax was a consideration of the structure, but that it was not an overriding consideration as follows:³⁴²

Tax was a consideration, but not an overriding consideration... Henlys did not want a Swedish company and Volvo did not want an English company. Both wanted a company resident in Europe where they have ‘a set-up’ for that type of activity that is not too expensive and where business could be conducted in English. The choices were Switzerland, Luxembourg, Belgium and Holland, the latter being very ‘neutral’.

From 1996 to 2001, *Prévost BV* received dividends from *Prévost Canada*. In terms of the Canadian – Netherlands tax treaty, tax should be withheld at 5%. Had the dividends however been paid directly to the UK or Sweden, the applicable withholding taxes would have been 10% and 15% respectively. The Canadian authorities refused to allow the application of the DTC by

³³⁸ See the definition of beneficial ownership provided by Vogel *supra* at note 290.

³³⁹ See definition of beneficial ownership provided by Danon *supra* at note 291.

³⁴⁰ See Du Toit *supra* note 260 at 506 and Baker *supra* note 335 at 25 who both agree with this statement.

³⁴¹ 2009 FCA 59. Available at <http://www.fca-caf.gc.ca> (visited on 19 October 2010).

³⁴² 2008 TCJ 231 (TCC) at § 9.

maintaining that Prévost BV was not the beneficial owner of the dividends received from Prévost Canada. This was based on the fact that Prévost BV did not have an office, assets, activities or employees in The Netherlands and that its only assets consisted of the shares held in Prévost Canada and that its expenses were paid by its shareholders. It should also be stated as part of the background facts that in terms of the shareholders agreement, no less than 80% of Prévost BV's profits were to be distributed to its shareholders (Volvo and Henlys).

The issue for the court to decide was whether the Dutch holding company and sole shareholder in Prévost Canada was the beneficial owner of the dividends received from Prévost Canada for the purpose of claiming Treaty relief (*vide.* a 5% as opposed to a 15% withholding tax on dividends). The key issue was therefore what discretion Prévost BV was entitled to exercise with regards to its income.

In its finding, the court *a quo* found no evidence that the dividends from Prévost Canada were *ab initio* destined for Volvo and Henlys, with Prévost BV as a funnel. The court thereby found that there was no predetermined flow of funds and based its decision on the fact that Prévost BV could only pay dividends that had been declared by its directors and subsequently approved by its shareholders. Accordingly, the court found Prévost BV to be the beneficial owner and was reluctant to pierce the corporate veil and look through to the joint-venture investors and stated as follows:³⁴³

When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as a conduit, or has agreed to act on someone else's behalf pursuant to that persons instructions without any right to do other than what that person instructs it, for example, a stock broker who is the registered owner of the shares it holds for clients.

The fundamental question of whether the concept of beneficial ownership is a legal as opposed to an economic substance test was specifically addressed in this case. The revenue authorities acting on behalf of the Crown contended that the term should not be given a narrow legalistic meaning, but that the ultimate beneficiary of the dividends must be identified, and specifically quoted the *Indofood* case in support for this argument. The Canadian Tax Court however applied a legalistic approach as opposed to the 'practical matter' test and provided a narrow meaning of the term which, although it is fair, is it at odds with the jurisprudence of other

³⁴³ See the decision of the court *a quo* in *Prévost Car Inc v Her Majesty the Queen* [2008] TCC 231 at § 100.

countries.³⁴⁴ There is also support for the statement that the court confined the meaning of the term in a practical sense to an attribution-of-income rule.³⁴⁵

An important aspect of the *Prévost* case in determining the international meaning of the concept of beneficial ownership is the approach the court followed in doing so. In this regard, it should perhaps first be pointed out that one of the main arguments of the Canadian Tax Administration was that the Canadian Tax Court gave the term 'beneficial ownership' the meaning which it has under common law and thereby ignoring its meaning in terms of both civil and international law.³⁴⁶ The Canadian Federal Court of Appeal however upheld the decision of the Canadian Tax Court, which in actual fact, provides a thorough analysis of the meaning of the term. This is based on the fact that the meaning of the plain wording as well as the meaning in terms of different sources including the OECD Commentaries had been ascertained. Du Toit³⁴⁷ correctly, in the opinion of the author, points out that the process followed by Rip J in his analysis of the term is a good example of following the principle of the Vienna Convention in determining the treaty meaning i.e. international tax meaning of treaty terms. The above statement is supported by the following extracts from the Court of Appeal:³⁴⁸

In his search for the meaning of these terms, the Judge closely examined their ordinary meaning, their technical meaning and the meaning they might have in common law, in Quebec's civil law, in Dutch law and in international law. He relied, inter alia, on the OECD [materials].

and:³⁴⁹

The Judge's formulation captures the essence of the concept of "beneficial owner", "*beneficiare effectif*" as it emerges from the review of the general, technical and legal meanings of the terms. Most importantly, perhaps, the formulation accords with what is stated in the OECD Commentaries and in the Conduit Companies report.

In an attempt to restrict the conflicting meaning of the term between different legal systems, Rip J narrows the test down to the payment of dividends as distinct from the share and found as follows:³⁵⁰

³⁴⁴ See brief comments on the decision from Arnold "Tax Treaty News", *Bulletin for International Taxation* 7 2008 at 263.

³⁴⁵ See Jiménez *supra* note 323 at 48 and Arnold *supra* note 344 at 263 who both agree with this statement.

³⁴⁶ *Ibid* at 49.

³⁴⁷ See Du Toit *supra* at note 260 at 507.

³⁴⁸ See *Prévost appeal* at § 8.

³⁴⁹ *Ibid* at § 14.

³⁵⁰ See *Prevost* at § 100.

In my view the “beneficial owner” of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is the beneficial owner of the dividend is the **person who enjoys and assumes all the attributes of ownership**. In short, the dividend is for the owner’s own benefit and this person is not accountable to anyone for how he or she deals with the dividend income.

[Emphasis added]

In analysing Rip J’s meaning of the term, it is interesting to focus on the phrase ‘all the attributes of ownership’ especially when this position is contrasted to the view of Du Toit³⁵¹ who submitted that the beneficial owner is ‘the person whose ownership attributes outweigh that of any other person’. In his recent article on the subject, Du Toit poses interesting questions as to the application of the meaning provided by Rip J as follows:³⁵²

... but how will Rip J’s definition be applied if there is a split in these attributes between different parties or is he suggesting that such a split is not possible? If such a split is not possible why does the OECD Model not simply use “ownership” instead of “beneficial ownership”? Was the use of the word “all” a further attempt to satisfy the members from both civil and common law families and to address sensitivities that any of these legal families may have on the splitting of ownership?

It is clear from the above issues raised that although the meaning of the term as put forward by the *Prévost* case does provide a manner of certainty there is still uncertainty as to the meaning of the term in instances where the facts are distinguishable, i.e. can the approach be similarly applied to royalties or interest payments.

A salient feature of the court *a quo* is that it mainly paid attention to the 1977 OECD Model Commentaries in respect of Article 10, which was the current Model ‘in force’ at the time that the 1987 Canada – Netherlands DTC and its protocol were signed.³⁵³ The Appeal court, as illustrated above, upheld the decision and took cognisance of the OECD materials published after 1987 which it said to be:³⁵⁴

...are eliciting [sic ‘elucidating’], rather than contradicting views previously expressed.

³⁵¹ See Du Toit *supra* note 12 at 236 to 237.

³⁵² See Du Toit *supra* note 260 at 507.

³⁵³ Jiménez *supra* note 323 at 48 suggest that the court probably also took into account the Commentary on Article 10 as amended by the 2003 OECD Model as well as the 1986 Conduit Companies report.

³⁵⁴ *Prévost appeal* case at § 12.

The Appeal court further stressed its view regarding the formulation of the meaning of beneficial ownership, as laid out in the court *a quo* as follows:³⁵⁵

...it not only emerges from the review of the general, technical and legal meanings of the terms, but most importantly, it accords with what is stated in the OECD Commentaries and in the Conduit Company Report.

Finally, despite all the differences between the *Indofood* and the *Prévost* cases, there appears to be a definite uneasiness in the latter to apply the 'practical matter test to the concept of beneficial ownership in respect of which the Federal Court of Appeal found as follows:³⁵⁶

Counsel for the Crown has invited the Court to determine the "beneficial owner", "*beneficiaire effectif*", mean the person who can, in fact, ultimately benefit from the dividend". That proposed definition does not appear anywhere in the OECD documents and the very use of the word "can" opens up a myriad of possibilities which would jeopardize the relative degree of certainty and stability that a tax treaty seeks to achieve. The Crown, it seems to me, is asking the court to adopt a pejorative view of holding companies which neither Canadian domestic law, the international community nor the Canadian Government through the process of objection, have adopted.³⁵⁷

In summary, little fault can be found in the Appeal court's decision of not only approving the finding of the court *a quo* that there were commercial reasons for forming Prévost Netherlands in Europe and further that it was not a conduit company as it was under no contractual obligation to on-pay the dividends it received, but also in confirming its conformity in applying the OECD materials. This latter confirmation provides verification that the meaning ascribed to the term 'beneficial ownership' by Rip J, is in fact the international tax meaning of the term.

A certain measure of uncertainty however remains in spite of the decision in the *Prévost* case as a result of the emphasises that the payment of a dividend requires discretion at source country level. It is however difficult to extend this principle to non-discretionary interest payments for example.

A further point of particular importance is the court's rejection of the economic interpretation the term 'beneficial ownership' which could effectively turn the concept into a mere broad anti-avoidance provision. The notion of the term as an anti-avoidance measure is discussed below.

³⁵⁵ Ibid at § 14.

³⁵⁶ Ibid at § 15.

³⁵⁷ See also Jiménez *supra* note 323 at 49.

4.7 BENEFICIAL OWNERSHIP AS AN ANTI AVOIDANCE MEASURE

With regards to the question of whether the concept of beneficial ownership is in fact an anti-avoidance measure to curb treaty abuses, such as treaty shopping, enjoys divided opinion. Arnold, after discussing the *Prévost* case states that:³⁵⁸

The international case law on beneficial ownership for treaty purposes is growing and inconsistent. Some courts consider the term to have a domestic meaning; others give it an international meaning. Some courts treat it as an anti-avoidance concept; others do not.

Another recent publication, that of Jiménez on the current trends in beneficial ownership discusses a number of international cases on the subject and states that:³⁵⁹

The trend to identify beneficial ownership with a broad anti-avoidance clause seems to be gaining ground ...

In a number of cases, such as that of *Prévost*, the court specifically rejected the idea of beneficial ownership being a mere anti-avoidance measure in rejecting the Crown's argument that a narrow legalistic approach to the term should be followed. The rejection of the economic interpretation of beneficial ownership would effectively turn this concept into a broad anti-avoidance measure.³⁶⁰

The author agrees with the decision of the Appeal court with regards to the application of a legalistic approach in determining the ownership attributes of a specific person and in so doing conclude whether that person can be said to be the beneficial owner.

4.8 CONCLUSION

Taking into consideration international case law and the developments pertaining to the OECD materials of the past four decades, can it be said that the meaning of the concept of beneficial ownership has evolved since its first use in an international context? The answer is resoundingly that it has not.³⁶¹

This conclusion is based on the attributes of this concept as set out by the most recent case law on the subject which provides the current international tax meaning of the term, compared to

³⁵⁸ Arnold 2009. "Tax Treaty News" *Bulletin - Tax Treaty Monitor* 175 at 176.

³⁵⁹ Jiménez *supra* note 323 at 47.

³⁶⁰ See Boidman and Kandev "Canadian Taxpayer Wins *Prévost* Appeal". *Tax Notes International* 10, 2009 at 864 have noted that the Canadian Federal Court of Appeal 'has swept aside the notion of purposive economic substance analysis in concluding as it did in *Prévost* in favour of merely distinguishing between agents and principals'.

³⁶¹ See Du Toit *supra* note 260 who agrees and states that the term has 'not really' evolved away from that of the common law States.

the original (common law) meaning of the term when it was first used in an international context. In analysing these meanings, it is clear that the issues are similar. Firstly, the question pertains to the attributes ownership and secondly, the matter is to be decided in a legalistic manner.³⁶²

The above conclusion has been reached based on an analysis of the meaning of the concept as used when it was first employed in an international context in the 1966 protocol to the UK – US treaty. In comparing the common law meanings of the term, it was concluded that there is no settled definition of beneficial ownership even in common law States which have been regarded as the origin of the concept.

The first use of the concept in the context of a Model Convention took place in the 1977 OECD Model and was also adopted in the subsequent UN, US and other Model Treaties.³⁶³ In 2003, the OECD by way of the Commentaries to the Model affected significant amendments regarding the interpretation of beneficial ownership which included aspects of the 1986 OECD Conduit Companies Report such as, that the concept should not be understood in a narrow technical sense, but rather in the context of the Convention.

Substantiating the above conclusion that the international tax meaning of the concept of beneficial ownership has not significantly changed since the first use thereof in an international context is the case law on the subject. The *Royal Dutch Petroleum* case supported the view that the identification of the beneficial owner requires an investigation into the ownership rights held by different persons. In the *Indofood* case, the court examined the OECD Commentary and confirmed that the concept of beneficial ownership should be understood in the context of the purpose of the OECD Model. The court however concluded that the application of the economic substance test is to be applied as opposed to the legal test. In contrast, the *Prévost* case confirmed, on Appeal by applying the Vienne Convention with regards to the interpretation of the Treaty meaning of the term, that the correct approach is that of the legal test and accordingly that the beneficial owner is the person who enjoys and assumes all the attributes of ownership.

³⁶² See *Ayerst (Inspector of Tax) v C&K (Construction) Ltd* [1975] STC 345, HL at 349 where Lord Diplock stated that 'the legal ownership of the trust property is in the trustee, but he holds it not for his own benefit but for the benefit of the *cestui que trusten* or beneficiaries'. See also the US *Montana* case *supra* note 286 at 127 to 128 where the court stated by way of Justice Peckham that 'beneficial ownership or interest in property is quite frequent in law, and means, in this connection, such a right to its enjoyment as exists where the legal title is in one person and the right to such beneficial use or interest is in another, and where such right is recognised by law, and can be enforced by the court, at the suit of such owner or of someone in his behalf.

³⁶³ In this respect it may be stated that on a strict reading of the first paragraph to Article 12 of the 1977 OECD MTC that the OECD's intended meaning of the term was not correctly reflected as the a taxpayer who is the beneficial owner will be allowed to apply the provision even though it is not a resident of that State. In Contrast, the 1981 US MTC's approach only provided the beneficial owner of the royalties residing in the Contracting State the use of the Treaty benefits.

As an anti-avoidance measure the most recent case of *Prévost* in judging that a narrow approach should be followed with regards to the interpretation concept of beneficial ownership confirmed that it is not a mere anti-avoidance provision. Baker,³⁶⁴ as pointed out in section 4.5 above, has however made the point that in terms a group context the narrow legalistic approach would in most instances be harder to argue due to the fact that there is less need in group situation to regulate and fix the flow of funds by way of contractual obligations as would be the case with third parties. This places a serious restriction on the efficacy of beneficial ownership as an anti-avoidance measure, but does provide sound reasoning as to the application of the 'practical matter' test to stamp out avoidance practices.

³⁶⁴ See Baker on *Double Tax Conventions supra* note 299.

Chapter 5

SUMMARY AND CONCLUSION

5.1 SUMMARY

5.1.1 Chapter 1

The study provides a broad overview of the working of double tax treaties and their place in international taxation. The main focus of the study is however the development of the definition of royalties in the context of Model Tax Conventions. The study followed the development of the definition from the original Draft Model Conventions put forward by the League of Nations in Geneva in 1928 up to the latest definition contained in the 2010 OECD MTC which reads.³⁶⁵

The term 'royalties' as used in this Article means payment 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 the information concerning industrial, commercial or scientific experience.

The secondary focus of the study analyses the evolution of the concept of beneficial ownership since its inception in DTC's in 1966 and MTC's in 1997 as an international treaty term.

5.1.2 Chapter 2

Due to this study's focus on international tax aspects, specifically pertaining to the meaning and definitions of tax treaty terms, the second chapter provides a brief examination of what the author believes to be the fundamentals of international tax, the aim of Double Tax Treaties and the interpretation and legal status of Model Tax Conventions and their Commentaries. This serves as the basis for the analysis of the definition of royalties and beneficial ownership discussed in the further chapters.

5.1.3 Chapter 3

The study's focus is the investigation into the development of the Model Tax Convention's definition of royalties since it originated in League of Nations Draft Models. It considers the development of the term in the most widely used MTC's which include that of the OECD, UN, US and other Models.

³⁶⁵ 2010 OECD MTC at § 12(2).

It is concluded from the analysis of the development of the Model Treaty definition of royalties that the most significant developments occurred during the period since the first League of Nations Committee meetings in 1921, up to 1961 when the OEEC became the OECD. It was during this era that the definition of the term and taxing rights were forged.

These developments included the Mexico Draft providing for source only taxation of royalties which was subsequently amended by the London Draft in permitting source only taxation of royalties only between associated enterprises on a net basis. With regards to development of the definition of the term, it could convincingly be argued that the London Draft's wording 'secret processes or formulae' or 'analogous right' included the concept of know-how which is specifically addressed by the words 'payments for information concerning industrial, commercial or scientific experience' in the Modern Models.

Since 1961, there have been very few changes to the Article other than the periodic expansion of the Commentaries thereto. Although the enhancement of the Commentaries is aimed at providing clarification regarding the meaning of certain paragraphs and phrases, they are also responsible for a great deal of uncertainty specifically with regards to their legal status, i.e. whether they may be relied upon, specifically if they only came into force after the conclusion of the actual Treaty.

5.1.4 Chapter 4

The secondary focus of the study investigates the international tax meaning of the term 'beneficial ownership' specifically in the context of royalties and the evolution of the concept through its use in MTC's and other OECD materials and Commentaries. The Chapter provides a brief analysis of the origin of the common law concept and aims to determine the international tax meaning of the term and whether it has evolved throughout the four decades of its existence. The anti-avoidance aspect of the term is also briefly illustrated.

It is concluded that the international meaning of the concept has not really changed since it was first used in a Treaty context as the most recent case on the subject, the *Prévost* case, considers the attributes of the concept to be that of ownership and that the matter is one which needs to be decided from a legalistic perspective. It should also be highlighted that the court rejected the economic interpretation the term 'beneficial ownership' as applied in the *Indofood* case which could effectively turn the concept into a mere broad anti-avoidance provision.

In comparing the meaning of the term provided by Du Toit which states that 'the beneficial owner is the person whose ownership attributes outweigh that of the any other person' the court in the *Prévost* case concluded by Rip J that 'the beneficial owner of the dividend is the person who

enjoys and assumes all the attributes of ownership'. An important question that remains to be answered is how this latest meaning will be applied outside of the dividend context which requires discretion at source country level as it is quite difficult to extend this principle to non-discretionary interest payments for example.

It may be concluded that in respect of unrelated party transactions, it would always be possible to discern the beneficial owner due to the parties transacting in an arm's length manner, thereby ensuring that the rights and obligations are specifically spelled out to provide certainty. In these instances, it should not be difficult to identify the beneficial owner.

As an anti avoidance matter measure the most recent case of *Prévost* in judging that a narrow approach be followed with regards to the concept of beneficial ownership confirmed that it is not a mere anti-avoidance provision. Baker³⁶⁶, as pointed out in section 4.5 above, has however made the point that in terms a group context the narrow legalistic approach would in most instances be harder to argue due to the fact that there is less need in group situation to regulate and fix the flow of funds by way of contractual obligations as would be the case with third parties. This places a serious restriction on the efficacy of beneficial ownership as an anti-avoidance measure, but does provide sound reasoning as to the application of the 'practical matter' test to stamp out avoidance practices.

5.2 CONCLUSION

As is evident from the conclusions below, the study has accomplished all the objectives set out in section 1.2.

The study provides a high-level discussion of international tax matters such as the jurisdiction to tax, what constitutes international double taxation and how it can be relieved or avoided. It also provides insights as to the aim of MTC and actual DTC' entered into by Contracting States. It further provides a basic introduction as to the rules regarding the interpretation of treaty terms which is critically important in analysing the development of definitions or concepts such as that of the royalty definition and concept of beneficial ownership.

From the analysis provided in Chapter 2, the study provides a clear understanding of the original as well as the current meaning of the term 'royalty'. The study concludes that the most significant developments occurred during the period shortly after its inception up to the establishment of the OECD. The study further concludes that a consequence of the definition remaining largely unchanged since 1961, is that the term is well understood and should

³⁶⁶ See Baker *supra* note 299.

accordingly be applied with certainty in DTC's based on the Model Tax Conventions included in the study.

In analysing the evolution of the term 'beneficial ownership', the study concludes that the term has had a significant impact in terms of the application of the royalty provisions contained in MTC's. This is due to it effectively disallowing the use of the treaty benefits provided by the royalty Article in instances where the person receiving the royalty is not also the beneficial owner thereof. The study thereby concludes that the concept of beneficial ownership dramatically influenced the application of royalty Article of MTC's.

The final conclusion reached by the study, is that there is still a great deal of uncertainty surrounding the anti-avoidance nature of the concept of beneficial ownership. Case law on the matter, such as *Indofood* and *Prévost*, provide conflicting views on the subject which necessitates further study that would be greatly aided by subsequent case law commenting on these judgements.

As a concluding remark, the author would like to comment that it would be quite interesting to see which of the differing definitions of the concept of beneficial ownership provided by Rip J and Du Toit respectively, is to be applied in future. Would Rip J's strict 'full ownership' approach be extended to apply in determining the beneficial owner of royalties and interest as it is to dividends, or would Du Toit's idea of the 'ownership outweighing' be applied to dividends, royalties and interest.

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