

THE DEFINITION OF ROYALTIES IN INTERNATIONAL TAX LAW: THE COPYRIGHT, INDUSTRIAL RIGHTS AND KNOW-HOW.

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Contents:

- Abstract.
- Summary of the thesis: conclusions and assessments.

ABSTRACT

This dissertation focuses on determining when income must be deemed to be royalties in tax treaties pursuant to the definition contained in Art. 12.2 of the OECD Model and following the explanations of its Commentary. The Ph. D. thesis also draws attention on the particular issues arising in Spanish tax treaty practice. Likewise, the dissertation carries out a comparative research on the definition of royalties envisaged in other tax sources differing from the OECD Model, such as other Model Tax Conventions, Multilateral Tax Treaties or European Law.

Specifically, the main issues discussed in the Ph.D. are five. Firstly, some general considerations are made with a twofold purpose, i.e., a) to stress the importance of classifying income as royalties in tax treaties and b) to set out the main features of the definition of royalties in the OECD Model. Secondly, the dissertation focuses on analyzing the most controversial issues raised in the definition of royalties of the OECD Model, such as software and know-how related payments. Thirdly, the international tax treatment of these payments is thoroughly discussed in the context of the Spanish tax treaty practice. Fourthly, a comparative research is made with the aim of analysing and comparing the definition of royalties of the OECD Model to corresponding provisions envisaged in other tax model conventions, multilateral tax treaties and European Law. Finally, the Ph. D. dissertation contains a chapter of conclusions.

SUMMARY OF THESIS: CONCLUSIONS AND ASSESSMENTS

1. GENERAL

1. The doctoral thesis deals with the definition of royalty income in international and European tax law. Cross-border transaction involving intangibles assets have resulted in numerous disputes regarding the characterization of their payments for tax treaty purposes. One of the main tax issues raised by

intangible assets is how to classify the payments for them as regards the different types of income envisaged in tax treaties.

2. The importance lies in the fact that most tax treaties envisage shared taxation by the source and residence states in respect of royalties and the exclusive taxation by the residence state of the other income cited. (This assumes that the presence of a permanent establishment is disregarded.) Accordingly, the source state is entitled to tax royalties by way of withholding, but only within the limits set out in the relevant tax treaty, whereas, with regard to other types of income, such as business profits, capital gains and income from independent personal services, the income is taxable only in the residence state. In short, the consequences in tax treaty practice of giving a certain characterization to intangibles payments are of major economic importance because of the numerous transactions involving intangibles and the different tax allocation rules in many tax treaties

3. The definition of royalties is an issue that has more to do with the competition between capital-importing and capital-exporting countries in a global economy than it has with substantive legal implications. As a result of the shared taxation envisaged for royalties in many tax treaties, the scope of the definition of royalties varies depending on whether states concerned are considered to be technology-importing or technology-exporting countries. In this respect, states that import technology and pay royalties are interested in a broad concept of royalties so that they can levy tax on more income at source. Conversely, states that export technology and receive royalties defend a narrower concept of royalties so that the source state levies less tax on income. Consequently, the residence state would not have to grant relieve and would be able to exercise an exclusive residence state taxation for this income, as the income would not be royalties subject to shared taxation, but, rather, business profits or independent personal services subject to exclusive taxation in the state of residence.

2. OECD AND EUROPEAN UNION ISSUES

(Please, note that the same assessments made in respect of the OECD Model may also apply to the European Union definition of royalties since both definitions are quite similar. More specific E.U. issues are indicated in paragraphs 7 and 8 of this summary).

1. The definition of royalties, both in the OECD Model and tax treaties, should be revised and redrafted in order to tailor it to new technological assets covered by intellectual property. There is a need of adapting the definition of royalties of the OECD Model to new categories of intangible property, such as domain names in Internet, since such a definition has hardly changed since it was first drafted more than 40 years ago. The same can be said in respect of other new technological assets, such as topographies of semiconductor products (also referred to as chips), since this asset is protected under European Law neither by the copyright nor by the industrial rights included in the OECD definition (e.g. patents) but chips are protected by other type of industrial rights different than patents. Thus, the OECD definition is nowadays behind the times and it would

therefore be desirable to widen the wording of the definition in order to cover all income arising from the use of intangibles regardless of the type of intangible from which income arise.

2. In order to accomplish the approach set out in the previous paragraph the OECD definition should be an open definition as opposed to its current feature as closed definition. In doing so a new sentence should be included in the OECD definition by stating that other types of rights or assets similar to those mentioned expressly may also bring about royalties. Some model tax conventions follow this approach and may be therefore taken into consideration, such the USA Model or the Andean Model. The former contains a reference to “other like right or property” in the royalties article and the latter refers to “other similar intangible property”. These expression intend to regard any intangible related payments as royalties and avoid disputes as to whether payments from new properties which are not mentioned in the definition may give rise to royalty income. This author is of the opinion that this kind of expressions should be included in the OECD definition to provide it with an open meaning.

3. The OECD Commentary on Article 12 should also help to develop this open character of the definition by including new paragraphs dealing with different types of intangibles as they are created. In this respect, the OECD Commentary should mention some of the intellectual rights on new intangible assets of the latest years, such as domain names, topographies of semiconductor products or vegetable varieties. This should be made in the Commentary as an illustration of the latest technological developments. It should also be stressed in the Commentary the fact that despite of these variety of properties the criteria to determine when income must be deem to be royalties will remain the same, i.e. that the payment is made in consideration for the use of or the right to use any intellectual property rights. The problems will be then again the same than exist so far, such as to determine what are the intellectual rights –either the copyright or industrial rights- in the new technological asset and to ascertain the difference between a license and a contract of sale as regards such rights.

4. There are therefore many outstanding issues in the OECD Commentary needing clarification, such as the differences between licensing and selling or the accurate content of copyright rights. Regarding the distinction between licensing and selling the Commentary refers only to an specific case but it does not provide for rules which allow States to distinguish both transactions. As regards the content of copyright rights, the Commentary refers only to a copyright right in software, such as the right to make copies to distribute them to the public, but the Commentary does not deal with other types of copyright rights in respect of software, such as the right to make derivative programs, the right to make a public performance or the right to publicly display a program. In contrast, USA tax law has established concrete rules to resolve these issues, both the differences between licensing and selling and the content of copyright rights. Thus, USA provisions might therefore be taken into consideration in future improvements to the Commentary. As the OECD Commentary does not deal either with a definition of licensing and selling or with the accurate content of the intellectual rights on a given work –the copyright or industrial rights-, states must apply their domestic laws to resolve these issues and there may be

therefore a risk of double taxation or exemption due to different approaches in the domestic law. For this reason, the content and wording of the OECD Commentary on Art. 12 should be reformulated in order to attain a common interpretation of the definition of royalties in tax treaty law. This author is not of the opinion that a common definition of royalties in international tax law should be attained, but in these paper, what it is supported, is a common or autonomous interpretation of the different definitions of royalties. A more developed guidelines on these issues in the OECD Commentary on Article 12 would be very helpful to achieve this outcome, despite of the fact that the role of the OECD Commentaries in tax treaty interpretation is not clear enough and there is not an international tax court.

5. There is however an important handicap to attain a common interpretation of the definition of royalties through the OECD Commentary and this handicap is not only considered with regard to the definition of royalties, but it may also apply to the OECD Model as a whole. This is what it is referred to as “cross of cultures” and although it is very rewarding from a tourist point of view it is not such from a tax treaty approach since it may lead to double or less than single taxation. As a result of these differences between domestic laws, either common or civil laws, what it is considered to be a contract of sale in a given country it may be regarded as a license in the other contracting state and what is protected as a patent in a country it may be protected as a different industrial right not included specifically in the relevant definition of royalties. A consensus in the Commentary on these issues is quite unlikely and there would be a great number of observations, but this should not be a drawback to develop paragraphs to harmonize the interpretation of royalties since the general rule in the Commentary in respect of other many issues is the lack of consensus among several states.

6. There are also several technical issues needing modification in the OECD definition. Some definitions are proposed in the thesis in order to clarify the wording of the definition of royalties and update its content.

7. The EC definition of royalties is contained in the Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. This Directive have been adopted after more than ten years of disputes and it is the first communitarian measure dealing with the harmonization of direct taxation of royalties. The main purpose of the Directive is to grant an exemption from any taxes imposed on royalties and interests at the source state (see Art. 1.1). Notwithstanding that, some states importing technology –such as Spain- have introduced transitional rules whereby they are authorised not to apply the exemption to royalties until a certain date.

8. The definition of royalties of the Directive is largely akin to the OECD definition and the differences between both are due to a need of both adapting the OECD definition to economic interest of Member countries and coping with new problems raised by technology. Due to this resemblance between the definitions of royalties of the OECD and the Directive, the issue is then whether the OECD Commentary on Royalties (Art. 12) might be used to interpret the

definition of royalties of the Directive. Another interesting issue is the relation between substantive and fiscal laws in respect of the definition of royalties. It must be stressed the importance of a previous harmonization of substantive matters before making an harmonization of fiscal related issues

3. DOMESTIC ISSUES

1. An interesting issue, which has not been dealt with yet in the Model, is the characterization of payments for an indemnification of royalty withholding tax. This issue is addressed by the Australian Taxation Ruling 2004/17 considering the extent, if any, to which the recipient of a royalty payment, whose royalty withholding tax liability is indemnified by another person, is liable to pay royalty withholding tax on that indemnity. In other words, as the lessee is unable to make any payment to the lessor without a withholding the lessee shall immediately pay an additional amount so that the net amount received by the lessor will equal the full amount received had no such withholding been made. The issue is therefore whether the indemnity amount might be considered to be royalty income, since that indemnity is not paid as a consideration for the use of intangible properties but for eliminating the loss that the withholding tax involves. The Australian Tax Office has regarded those indemnity payments as royalties as they are made as a consideration for the use of the intangibles giving rise to royalties. This author is also of such an opinion since the definition of royalties refers to “payments of any kind” and this general expression would allowed to regard payments for an indemnity as royalties. Many doubts may however arise because these payments might not be considered to be a consideration for the use of a given intangible but for collecting or recovering the amount of money that has to paid due to the withholding tax. If it is not considered to be royalty income problems would compound when determining what part of the remuneration is paid for the use of the property of for the withholding tax and mixed contract rules would then apply. This is just a further example of the many controversial issues that have not been dealt with in the Commentary and that have already posed problems in some states.

2. On the other hand, with regard to Spanish tax treaty practice the way used by Spanish courts and tribunals to cope with the definition of royalties has been disconcerting and has jeopardized legal certainty for taxpayers. Cases in respect of software and know-how related payments considered in Chapter IV have been quite illustrative of this problem. The confusion and failure of the Spanish practice on these issues have taken place mainly in courts rather than in tribunals or tax authorities resolutions. In Spain there are not courts specialized on tax law, neither in domestic nor international taxation, but courts deal in general with any issue where an Administration is involved. This author is of the opinion that a major specialization of Spanish courts on tax law and mainly on international tax law would be wise.

4. CONCLUSION

Finally, after having analyzed several definition of royalties both in model tax conventions and tax treaties, as well as in the European law, it may be concluded that there is an international tax meaning of the term royalties.

Despite of the fact that there are many and very different definitions of royalties and that the content of such definitions depends on the economic and legal framework of the states concerned, a common meaning of the term royalties may be inferred from all those definitions. Thus, this author contends that for international tax purposes the term royalties may be briefly and generally defined as “any payment for the right to use intellectual property” and intellectual property would specifically involve three categories, i.e. the copyright, industrial rights and know-how. This would be therefore the core of definitions of royalties in international tax practice.

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