"BENEFICIAL OWNER" - CRA'S ASSESSMENT OF VELCRO DOESN'T STICK

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The Tax Court has once again considered the meaning of the phrase "beneficial owner" for purposes of the tax treaty between Canada and the Netherlands. It has also once again ruled in favour of the taxpayer in determining that a Dutch holding company was the "beneficial owner" of amounts received from a related Canadian company.

On February 24, 2012, the Tax Court of Canada released its eagerly-anticipated decision in *Velcro Canada Inc. v. Her Majesty the Queen*[1], which addresses the applicable Canadian withholding tax rate in respect of cross-border royalty payments within a multinational corporate group. The decision comes almost four years after the Tax Court released its landmark decision in *Prévost Car Inc. v. The Queen*[2], which dealt with the identical treaty interpretational issue in the context of cross-border dividend payments. These decisions are relevant to any multinational enterprise using a foreign holding company as an investment/financing vehicle and provide considerable comfort concerning the tax effectiveness of such structures. Click here for prior coverage of *Prévost Car Inc.*

Background – Domestic Tax Law and Tax Treaties

Canada's *Income Tax Act* (the "**Act**") requires that a Canadian company withhold 25 percent of royalties paid to non-residents and remit this amount to the Canada Revenue Agency (the "**CRA**") on behalf of the non-resident. However, Canada has entered into numerous bilateral tax treaties with various countries that reduce this withholding tax rate generally to 10%, although in some cases the withholding tax is completely eliminated. To benefit from these reductions or eliminations of Canadian withholding tax, the treaties generally require (among other things) that the recipient qualify as the "beneficial owner" of the royalty. Similar "beneficial owner" requirements apply for dividends and interest

Canada's tax treaties are generally based on the model income tax convention drafted by the Organisation for Economic Cooperation and Development (the "**OECD**" and the "**OECD Model**"). The OECD Model and its commentaries generally provide that a resident of a contracting state will be the beneficial owner of a dividend received from a resident of the other contracting state so long as the recipient was not acting in its capacity as an agent, nominee, fiduciary or administrator on behalf of a person not resident in that state. There is little additional insight into the intended meaning or possible interpretations of this term. In this respect, most income tax treaties (including the Treaty in question) require that undefined terms are to take the meaning that they have under the laws of the state seeking to apply the treaty unless the context otherwise requires. Recent proposals from the OECD concerning the meaning of "beneficial owner" have caused considerable concern in the international tax community due to possible ambiguities in the scope and proper application of this term.

[1] 2007-1806(IT)G ("*Velcro*").

[2] *Prévost Car Inc. v. The Queen*, 2009 D.T.C. 5053 (F.C.A.), affirming 2008 D.T.C. 3080 (T.C.C.).

The Long Shadow of Prevost

The majority of the Tax Court's decision in *Velcro* centres on its earlier decision *in Prévost Car Inc.* and the Federal Court of Appeal's affirmation of the outcome in that case. This attention to *Prévost Car Inc*. is warranted, given the identical nature of the interpretational issue facing the court and the unambiguous manner in which the Tax Court and the Federal Court of Appeal outlined what has now become known as the "beneficial ownership test". A brief summary of that case is critical to understanding the outcome in *Velcro*.

Prévost Car is a corporation resident in Canada that manufactures motor coaches and related products. In 1995, Volvo Bussar A.B. (a Swedish company) and Henlys Group PLC (a U.K. company) agreed to acquire Prévost Car and determined that the most appropriate acquisition and holding structure involved the creation of a Dutch joint venture company. At the completion of the acquisition, Volvo and Henlys held, respectively, 51 percent and 49 percent of the Dutch holding company ("**DutchHoldCo**"), and DutchHoldCo, in turn, held all of the shares of Prévost Car.

As part of the joint venture, Volvo and Henlys entered into a shareholders' agreement in which they agreed, among other things, to a policy that 80 percent of the profits of DutchHoldCo and Prévost Car would be paid out as dividends to their respective shareholders, subject to certain capital requirements. Prévost Car and DutchHoldCo generally adhered to those dividend policies and paid such dividends during the course of several years. In accordance with its obligations under the Act and the Treaty, Prévost Car withheld Canadian tax from the dividends at a rate of 5 percent on the basis that DutchHoldCo was the beneficial owner of the dividends.

The Crown argued that the lower rate was not available because the holding company acted as a mere "conduit" with respect to the dividends (i.e., a fiduciary or administrator) and, therefore, could not have been the beneficial owner.

The Tax Court ruled that Prévost Car was the "beneficial owner" of the dividends. The Court acknowledged that the term "beneficial owner" was not defined in the Treaty and canvassed the ordinary and technical meanings of the terms, and their meanings at common law, Quebec's civil law, Dutch law and international law. The Court concluded that 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". Furthermore, the Court ruled that courts are not to pierce the corporate veil unless a corporation is a "conduit" that has "absolutely no discretion" as to the use of the funds flowing through it.

The Court concluded that DutchHoldCo owned the shares of Prévost Car, and the dividends therefrom, on its own account. Despite the shareholders' agreement, Volvo and Henlys had no recourse against DutchHoldCo for failing to follow the stated dividend policy. DutchHoldCo's directors still had to declare dividends to Volvo and Henlys in accordance with Dutch law—there was no automatic flow of funds—and until so declared, dividends received from Prévost Car formed part of the assets of DutchHoldCo available to satisfy its creditors. Accordingly, DutchHoldCo was the "beneficial owner" of the Prévost Car dividends.

On appeal, the Federal Court of Appeal held that the Tax Court had captured the essence of the concept of “beneficial owner” and that its formulation was congruent with the model tax treaty commentaries produced by the OECD. Furthermore, the court wrote:

> Counsel for the Crown has invited the Court to determine that "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 tax treaties seek 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.

Velcro and the Meaning of “Beneficial Owner” in the Context of Royalties

The Facts

Velcro Canada Inc. (“**Velcro Canada**”) was in the business of manufacturing and selling fastening products using certain Velcro brands and technologies. Velcro Canada had licensed these brands and technologies from a related Dutch company (“**VIBV**”) and paid royalties to VIBV between 1997 to 1995. Velcro Canada withheld and remitted 10 percent of these royalties pursuant to the relevant provision of the Treaty.

In 1995, VIBV undertook a corporate migration and continued under the laws of the Netherlands Antilles. Canada does not have a tax treaty with the Netherland Antilles and consequently any royalties paid by Velcro Canada to VIBV would have been subject to a 25 percent withholding tax. However, VIBV assigned its rights under the license agreement with Velcro Canada to a wholly-owned Dutch subsidiary (“**Dutchco**”). Velcro Canada was required to pay all royalties to Dutchco (the agreements referred to Dutchco’s requirement to “collect” the royalties paid by Velcro Canada) and Dutchco was required to pay a certain percentage of all such royalties onward to VIBV. VIBV was an express third-party beneficiary of the agreements between Velcro Canada and Dutchco with the ability to enforce Dutchco’s rights under the agreements.

The Issue

The sole issue before the Tax Court was whether Dutchco was the “beneficial owner” of the royalties it received from Velcro Canada for purposes of the Treaty. If Dutchco was the beneficial owner, Velcro Canada would have been required withhold and remit only 10 percent of the royalties it paid to Dutchco between 1996 and 1998 and would not have been required to withhold any amount for royalties paid after 1998 (this is due to a change in the Treaty at that time relating to the applicable withholding tax rate for certain royalties). If Dutchco was not the beneficial owner, the 25 percent statutory rate would have applied for all years in question.

The CRA’s position was that Dutchco was not the beneficial owner of the royalties because Dutchco did not have possession, use, risk or control of amounts that it received from Velcro Canada; Dutchco was a conduit that passed amounts onward to VIBV automatically or in a pre-

determined manner. In this respect, the CRA applied a 25 percent withholding tax on the royalties and assessed Velcro Canada for approximately $8.5 million in tax and approximately $900,000 in penalties.

Velcro Canada asserted that Dutchco retained sufficient ownership and discretion over the royalties such that it satisfied the "beneficial ownership test" described in *Prévost*.

The Court rejected all of the CRA's arguments and repeatedly cited a handful of facts as the basis for its conclusions. The Court emphasized that Dutchco was in the business of (i) holding shares in subsidiaries; (ii) providing lending services to subsidiaries; and (ii) managing licence royalty streams (which was the most significant portion of its business). Consistent with other recent jurisprudence, the fact that management over these activities was largely outsourced to an arm's length management company was not considered relevant. Dutchco received funds from multiple income sources (including the royalties from Velcro Canada), and these funds became comingled in Dutchco's bank account. These comingled funds were used at Dutchco's discretion to carry out a variety of its business activities and to satisfy a variety of its legal obligations. Interest on these comingled funds accrued solely for the benefit of Dutchco and Dutchco bore some foreign currency risk associated with the funds that it kept on deposit. The Court also noted that, despite Dutchco's obligation to pay to VIBV a certain percentage of the royalties that it received from Velcro Canada, it was not required (and was unable because of its comingled bank account) to deliver the exact same physical dollars that it received from Velcro Canada. In the Court's view, all of these facts indicated that Dutchco had possession, use, risk and control of the royalties it received from Velcro Canada.

The CRA emphasized in its argument the contractual relationship between the parties, which obligated Dutchco to pay VIBV a fixed percentage of any royalties it received from Velcro Canada. In the CRA's view, this crossed the line between discretion as to the application of funds and a contractual requirement to collect and remit funds and resulted in Dutchco becoming a "conduit" within the meaning described in the *Prévost Car Inc.* case. In this respect, the payments made by Dutchco to VIBV were very different from the payments of discretionary dividends paid by DutchHoldCo in *Prévost Car Inc.* in that Dutchco was required to make defined payments at defined intervals pursuant to a legal contract. However, the Court had no hesitancy in concluding that Dutchco had *some* discretion as to the use of the royalties (the Court generally recited the same facts that it referred to in respect of its possession, use, risk and control analysis in coming to this conclusion). The Court therefore concluded that Dutchco could not have been a conduit based on the test outlined in *Prévost Car Inc.*, which requires that a conduit have *absolutely no discretion*.

The Court also rather quickly dismissed the CRA's arguments that Dutchco was an agent or nominee essentially on the basis that Dutchco did not fit the Court's definition of a "legal agent" and because Dutchco acted on its own account in dealing with the royalties.

Relevance of Velcro

The Tax Court's decision is significant in that it reaffirms the general legal principal of respecting the legal form of holding companies unless the holding company clearly lacks the indicia of

beneficial ownership as defined in the *Prévost Car Inc.* decision. Holding companies commonly lack complete discretion in the manner in which they can apply their sources of income; however, based on the Tax Court's decision in *Velcro*, even a minimal level of discretion over particular aspects of a revenue stream may be sufficient to satisfy the "beneficial ownership test".

It is unclear at this time whether the CRA will appeal the Tax Court's decision in *Velcro* to the Federal Court of Appeal. The tax community will continue to watch the progress of this case (if any) with great interest.