Update

Taxpayer Wins "Beneficial Ownership" Case: *Velcro Canada Inc. v. The Queen*

The Tax Court of Canada recently allowed the taxpayer's appeal in *Velcro Canada Inc. v. The Queen*. The issue on appeal was whether a Dutch company was the beneficial owner of royalties paid to it by a Canadian taxpayer for purposes of the *Canada-Netherlands Income Tax Convention* (the Treaty), despite the Dutch company having an obligation to pay a further royalty, in an amount equal to 90% of the royalties received from Canada, within 30 days to an affiliate in the Netherlands Antilles. The court held that the Dutch company was not a mere conduit for the Netherlands Antilles company as had been alleged by the Crown. This decision is important as it provides further clarification of the circumstances under which taxpayers may arrange for payments to be made to a company in a treaty jurisdiction without loss of treaty relief for Canadian sourced payments. In particular, the decision extends the guidance regarding beneficial ownership provided by the Federal Court of Appeal in *Prévost Car Inc. v. The Queen*[1] (see our Osler Update dated March 2, 2009) – a case which had considered clearly discretionary payments (dividends) – to contractually mandated payments such as interest or royalties.

BACKGROUND FACTS

In 1987, Velcro Industries BV (Velcro Industries) entered into a licence agreement with Velcro Canada Inc. (Velcro Canada), granting Velcro Canada the right to use Velcro Industries' intellectual property to manufacture and sell fastening products in exchange for royalty payments (the Licence Agreement). At the time, Velcro Industries was a resident of the Netherlands. From 1987 to October 1995, Velcro Canada paid royalties to Velcro Industries and withheld Canadian tax at the applicable 10% rate under the Treaty, rather than the 25% rate that would apply absent any treaty relief.

The Velcro group of companies underwent a reorganization on October 26, 1995, resulting in Velcro Industries becoming a resident of the Netherlands Antilles, a country

1 2009 DTC 5053 (FCA), affirming 2008 DTC 3080 (TCC).

with which Canada did not have an income tax treaty. The next day, Velcro Industries assigned its rights and obligations under the original Licence Agreement to Velcro Holdings BV (Holdings), a subsidiary resident in the Netherlands. Under an assignment agreement, Holdings was assigned the right to grant licenses for Velcro Industries' intellectual property to Velcro Canada and to receive royalties from Velcro Canada. Holdings would pay Velcro Industries an arm's length percentage of net sales of the licensed products, which represented approximately 90% of the royalty payments received from Velcro Canada, within 30 days of receiving royalty payments from Velcro Canada. The ownership of the intellectual property remained with Velcro Industries.

Velcro Canada withheld tax from royalty payments to Holdings at a rate of 10% pursuant to the Treaty until December 1998, when the royalty rate was changed to zero. The CRA assessed Velcro Canada for failing to withhold and remit withholding tax of 25% of the royalties paid to Holdings, during the 1996 – 2004 taxation years. The taxpayer appealed.

The Crown argued that Velcro Industries, the Dutch Antilles resident, rather than Holdings, the Dutch resident, was the beneficial owner of the royalties from Velcro Canada between 1996 and 2004, thereby disentitling Holdings to the reduced royalty rate under the Treaty. The taxpayer's position was that Holdings was the beneficial owner of the royalties.

DECISION OF THE TAX COURT OF CANADA

Associate Chief Justice Rossiter turned to Chief Justice Rip's definition in *Prévost* of the "beneficial owner" of income as the person who receives the income for his or her own use and enjoyment and assumes the risk and control of the income he or she received. Rossiter A.C.J. distilled four elements from *Prévost* to consider in determining where beneficial ownership lies: (a) possession; (b) use; (c) risk; and (d) control. He also repeated Rip C.J.'s comments in *Prévost* that a court is not likely to pierce the corporate veil unless the corporation has "absolutely no discretion" with regard to the use and application of the funds.

Rossiter A.C.J. concluded that the taxpayer demonstrated it was the beneficial owner of the royalties on each of the four elements. Although the reasons pointed to a number of factors, the court relied on the following main factors: Holdings (not Velcro Industries) had the legal right to receive the royalties from Velcro Canada; the funds paid as royalties by Velcro Canada were deposited in an account owned by Holdings over which it had exclusive possession and control; such funds were comingled with other monies in Holdings' accounts and not held in a separate account; Holdings converted the funds from Canadian to US dollars to pay Velcro Industries (exposing itself to currency fluctuation risk); the money earned interest belonging to Holdings; Holdings did not have to seek instructions in dealing with the funds; and the amount of the royalty payments received from Velcro Canada differed from the amount paid by Holdings to Velcro Industries.

The fact that the royalty payments were comingled with other money in Holdings' accounts (derived for example from Holdings' lending activities) weighed heavily in the taxpayer's favour because, according to the court, this gave Holdings discretion in the use of the funds. In Rossiter A.C.J.'s opinion, this meant that the funds could be used by Holdings in any way it saw fit – whether to make loans, invest, or make payments on other legal obligations. The royalties were treated as assets listed on Holdings' financial statements, making them available to creditors, with no priority given to Velcro Industries as a creditor. Another corollary of comingling was that although Holdings was obligated to pay 90% of the royalties to Velcro Industries, the funds actually paid were not necessarily the same funds received, meaning there was no automatic flow of specific funds because of the discretion of Holdings with respect to the use of those funds. The other 10% was subject to the discretionary use, enjoyment and control of Holdings.

Applying guidance found in the Commentary to the OECD Model Tax Convention on Income and on Capital (the Commentaries), Rossiter A.C.J. then considered whether Holdings acted as an agent, nominee or conduit in respect of the royalties from Velcro Canada. He concluded that Holdings did not have the capacity to affect the legal position of Velcro Industries, and therefore was not its legal agent. Holdings was not a nominee because it acted on its own account at all times subject to the assignment agreements. Lastly, in order to find that Holdings was a conduit of Velcro Industries, the court would have to find that Holdings had absolutely no discretion with respect to the funds, as set out by *Prévost*. Rossiter A.C.J. concluded that the limited discretion which Holdings did exercise in respect of the funds prevented the court from piercing the corporate veil.

IMPLICATIONS OF THE DECISION

In *Velcro Canada*, Rossiter A.C.J. stated that in cases where the issue is whether a treaty resident company is a mere conduit, rather than the beneficial owner of Canadian source payments, "one must take a close look at where the right to use and the enjoyment and assumption of risk and control of the payments lie". The decision itself is helpful in both distilling such elements of the beneficial ownership concept as possession, use, risk and control and providing a helpful road map as to how one takes a nuanced and "close look" at the legal and commercial facts relevant to the location of those elements. The decision further clarifies the Canadian approach to cases involving the selective use of treaty resident entities to receive Canadian sourced payments of dividends, interest or royalties. Specifically, the case clarifies that:

- Where a treaty resident is contractually obligated to make a further payment in connection with a prior Canadian sourced payment, such a contractual obligation is not necessarily tantamount to the type of "automatic flow of funds" that could result in the treaty resident entity not being the beneficial owner of the Canadian sourced payment;

- An intermediary entity in a back-to-back arrangement does not need to have unfettered discretion with respect to what it can do with a payment from Canada; limited discretion can suffice for beneficial owner status; and
- as stated in *Prévost*, neither Canadian domestic law, the international community nor the Canadian government through the process of objection to OECD materials have adopted a pejorative view of holding companies established in favourable treaty countries; as noted by the court, the OECD Conduit Report warned of the dangers of readily looking through corporations which is "incompatible with the principle of the legal status of corporate bodies, as recognized in the legal systems of all OECD Member countries".[2]

Unless reversed on appeal, *Velcro Canada* represents yet another loss of a "treaty shopping" case by the Crown, and would seem to highlight the limitations of attempting to use the beneficial ownership concept as a broad anti-avoidance rule to address perceived treaty shopping arrangements. Instead, it would appear that countries should negotiate specific limitation on benefits provisions to the extent that they intend for treaty benefits to be limited to particular classes of taxpayers.

However, taxpayers should continue to exercise caution in this area for a number of reasons. First, in 2011 the OECD published proposed amendments to the Commentaries' interpretation of "beneficial ownership" that look for "the full right to use and enjoy the [income] unconstrained by a contractual or legal obligation to pass the payment received to another person."[3] This proposed formulation of the "beneficial ownership" test, if accepted by Canada and other countries, would be more difficult to satisfy than the one applied in *Velcro Canada*. Second, not all taxpayers implementing back-to-back arrangements will have the benefit of an intermediary treaty entity like Holdings, with multiple sources and uses of funds. In the case of a single-purpose vehicle, it may be more difficult to break the equation insisted on by the Crown in *Velcro Canada* between a contractual obligation to make further payments based on Canadian source payments and an "automatic flow of funds". Finally, there are other tools at the CRA's disposal to combat treaty shopping, including Canada's statutory general anti-avoidance rule (GAAR). In 2007, in *MIL (Investments) S.A. v. The Queen*, the Federal Court of Appeal held that GAAR did not apply to deny treaty benefits to a Cayman Islands company continued into Luxembourg for purposes of (among other things) taking advantage of the favourable capital gains article in Canada's treaty with Luxembourg. However, there is a case currently before the Supreme Court of Canada (commonly known as *Garron*) that, depending on the outcome, may provide greater traction for GAAR-based challenges

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2 OECD, "Double Taxation Conventions and the Use of Conduit Companies" (OECD, Paris, 1987), at paragraph 24(i).

3 OECD, "Clarification of the Meaning of 'Beneficial Owner' in the OECD Model Tax Convention" (Paris: OECD, 29 April 2011 to 15 July 2011).

of treaty shopping arrangements.[4] Taxpayers should monitor further judicial and administrative developments relating to the use of treaty-based holding company structures, and to apply existing case law to their own facts with due regard for the facts considered relevant by the courts in the earlier decisions. Osler's international tax specialists are well-placed to advise on such matters.

If you have any questions or require additional information, please contact any member of our National Tax Department.

4 *St. Michael Trust Corp. v. The Queen*, 2010 FCA 309, affirming *Garron et al. v. The Queen*, 2009 TCC 450.

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