



LOYENS & LOEFF

# Royalties v. income from rendering services under tax treaties

Kees van Raad – Loyens & Loeff Webinar

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## OECD Model Art. 7, par. 1: business profits

**main rule:** Profits of an enterprise carried on by a resident of one State shall be taxable only in that State

**exception:** unless the enterprise carries on business in the other State through a permanent establishment ['PE']:

>> profits attributable to that enterprise may be taxed in the other State

**overall:** in the absence of PE: business profits may not be taxed in the other state

## OECD Model Art. 7, par. 4 (pre-2017: par. 7):

To the extent that profits are also covered by other treaty articles; those articles have priority



## Art. 12.2 OECD Model:

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:
  - >> *payments for use of intellectual property rights*
  
- for information concerning industrial, commercial or scientific experience (knowledge & experience how-to-do things)::
  - >> *know how payments*
  
- *until 1992:* or for the use of, or the right to use, industrial, commercial or scientific equipment:
  - >> *rental fees*



## OECD Model Art. 7, par. 4 (pre-2017: 7):

To the extent that profits are also covered by other treaty articles; those articles have priority.

## OECD Model Art. 12, par. 1: royalties

Royalties arising in one State and derived by a resident of the other State shall be taxable only in that residence State

**thus:** the State where the royalties are from, may not tax

**Overall:** whether business income is or is not covered by Art. 12: no difference: the other State may not tax.

**UN Model Art. 12, para.s 1 and 2 :** provides for (withholding) tax (WHT)

## Art. 12 non-OECD:

The other State may subject the royalties to WHT



## Issue:

The performance by the provider includes elements of

- both *service* rendering,
- and supplying *existing knowledge and experience* (also referred to as `EKE` or `know-how`).

To be examined: does Art. 12 (Royalties) apply:

- only in instances where knowledge and experience are exploited on a stand-alone basis
- or also in instances where the information etc. is directly related to activities that have been undertaken earlier by the person providing such information, etc



## Example 1:

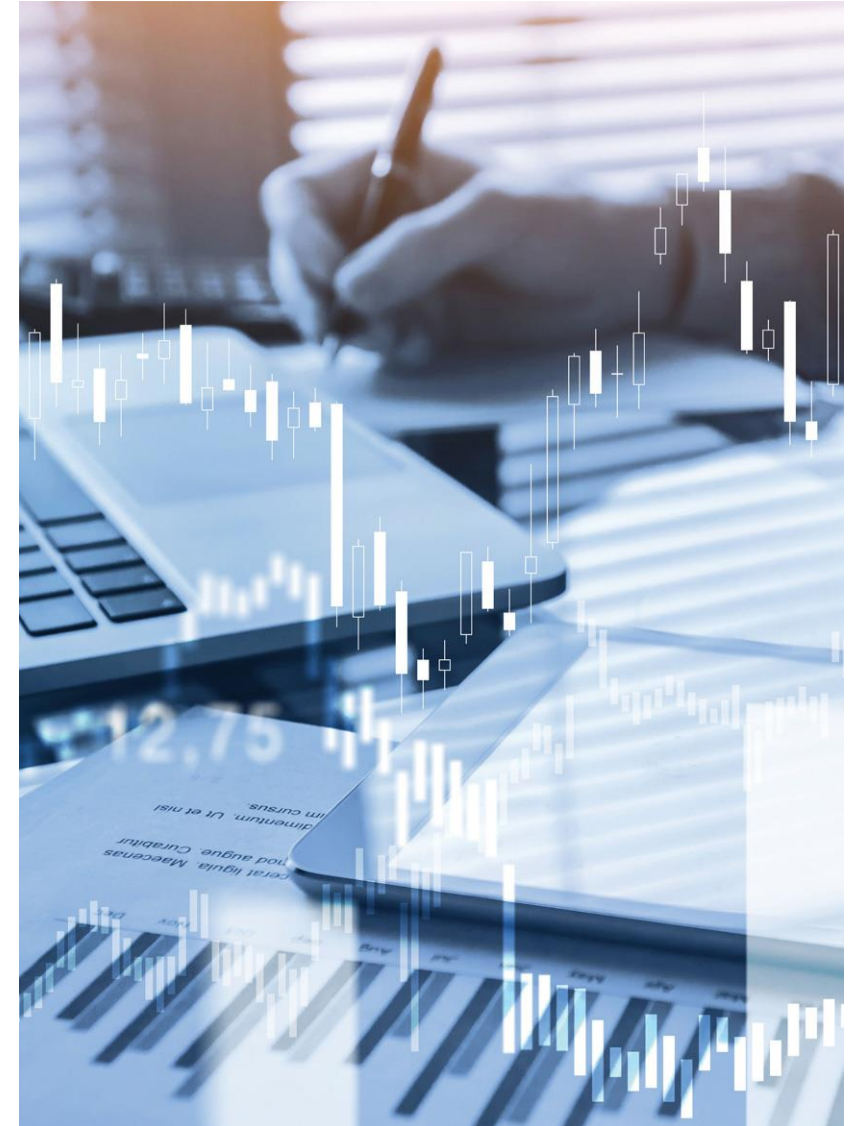
- A.** A clever but inexperienced junior lawyer at a large law firm is asked to prepare a comprehensive and detailed memo for a client. It takes the lawyer 100 hours and at his hourly rate of € 200 the client is charged a fee of 100 h @ € 200 = € 20.000.
- B.** If the same job would have been done by a senior lawyer of the firm (hourly rate € 1000), the writing of the memo would have taken only 20 hours. While in the latter case the client would have been charged the same amount of € 20.000, that amount would have been specified differently: 20 h @ € 1000.



## Example 2:

The memo that the senior lawyer of *Example 1* prepared for the client is assumed to deal with a complex legal issue. A few months after completing the memo, the senior lawyer is approached by (unrelated) client 2 who asks the lawyer to prepare a memo on the same issue (and who does not have knowledge of the existing memo the lawyer prepared for client 1).

The lawyer produces for client 2 a memo 2 through copying & pasting from memo 1 (virtually no work) and charges client 2 for this memo 2 the agreed amount of (again) € 20k.



## Sec. 11:

`... information of an industrial, commercial or scientific nature arising from *previous* experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived`.

`... the definition relates to information concerning previous experience, the Article does not apply to payments for *new* information obtained as a result of performing services at the request of the payer.`

## Australian Taxation Office (ATO), IP 2660 para. 27:

Summary of Australian case law: ways in which an owner can exploit his own (existing) know-how:

- `using it himself in the process of his own trade` (letter d), and
- `to use it in his own business` (letter f),





## **Sec. 10.2:**

a payment is to be considered a royalty only in instances in which the payment is made for the granting a right to use information `without performing any additional work`.

## **Sec. 11.2:**

Art. 12 does not cover any payments made under a contract in which a provider undertakes `to use the customary skills of his calling` in providing his services.

## **Sec. 11.3:**

In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise *but not the transfer of such special knowledge, skill or expertise to the other party.*

>> *questionable*



## Sec. 11.6

In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods.

### ***In those cases: split on basis of 'reasonable allocation'***

The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto.



The character of a payment received is to be determined by whether or not the payment is directly connected with activities engaged in by the performer currently or earlier.

If the payment is indeed effectively connected with (current or earlier) work of the provider, it should be treated as service income.

>> **Art. 7**

If no work has been performed by the provider in connection with the supply of information etc., the payment gives rise to capital income (payment for the supply of know-how)

>> **Art. 12**



## Preceding analysis

instances where a person (whether or not through a single contract) both renders services and supplies information to the same person within a single time period.

## Next :

instances where the two events do not take place more or less simultaneously but sequentially:

*first*, the activities are undertaken through which knowledge and experience (‘product’) are created,

*followed by* a phase in which the product, i.e. the accumulated KE, is exploited by the person that created the product, by making it available to others at a fee.



## Example: Producing a good followed by making it available to others at a fee

Independent lawyer L, who has also a strong background in IT, has ideas about developing a digital IT-tool for a particular type of legal research. He discusses with law firm F the possibility of developing such a tool for the firm.

In an alternative scenario, the law firm itself has ideas about a particular IT-tool for legal research and considers hiring L to develop it. In each scenario the two parties agree that it will be L who is going to engage in the activities for developing such a tool for the F law firm and that, further, F may not license or sell the tool to a third party.

The two scenarios can be summarized as follows:

- A. L will be hired as an independent contractor by F at a given fee and will build the tool for F with the ownership of the tool to be vested in F: *service rendered by L to F*
- B. L will build the tool in his own time and for his own account, and will be the owner of the tool. When the tool is ready, L will grant the exclusive and time-unrestricted use of it to F at a given price: *L makes the use of his existing knowledge and experience available to F*



## Variation in example:

### >> business carried on through staff

Now, the business of independent lawyer L is not a one-person operation; he has a staff of ten persons who do most of the actual work and who are closely supervised by him.

Main difference between this scenario and the one-person business is that in the former scenario a large part of the payments received will be used to pay for the staff, while as a one person operation L's own remuneration is not deductible from his profits (unless L operates his one-person business in the form of a company).

The deduction of salaries is relevant because an additional way of distinguishing between rendering services and supplying know-how is considering the level and nature of expenses incurred by the provider. .



‘... a contract for the performance of services would, in the majority of cases, involve [in comparison to cases involving the supply of know-how] a very much greater level of expenditure by the supplier in order to perform his contractual obligations.

For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.’



## OECD position is subscribed to in para. 32 of ATO's IT 2660

The second aspect of the expenditure element is the nature of the expenditure incurred by the contractor. In this regard, a contract for the performance of services would, depending on the nature of the services to be rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, purchase of parts for testing and costs associated with site and feasibility studies, as well as management and overhead expenses of types which would normally be incurred by a contractor in the course of performing such services.

The general purport of this paragraph - that in know-how cases the income recipient can be expected to have a low level of expenses whereas in cases where services are rendered expenses will usually be substantial - implies that a payment that is wholly a reimbursement of deductible expenditure is most likely not to be a royalty.





## Takeaways

