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Velcro Canada wins beneficial ownership case

Dutch intermediary not a conduit for royalty income

The Tax Court of Canada (the Court) has ruled that the Canada-Netherlands tax treaty applied to reduce Canadian withholding tax applicable to royalties paid to a Dutch company, despite that company having a contractual obligation to make a payment equal to 90% of the royalties to a Netherlands Antilles company within 30 days of receipt. The decision in *Velcro Canada Inc. v The Queen* applies and extends the Federal Court of Appeal approach in the case of *Prévost Car Inc. v. The Queen*, which held that a Dutch holding company had beneficial ownership of dividends received from a Canadian subsidiary.

The Crown argued that the Dutch company should not be considered the beneficial owner of the royalties due to the contractual obligation. However, the Court found that the Dutch company retained the attributes of beneficial ownership of the royalties, namely "use, enjoyment, risk, and control". Further, the Dutch company was not an agent, nominee or conduit. The Court agreed with the finding in *Prévost* that it is inappropriate to "pierce the corporate veil" and ignore the existence of a holding company unless it is a conduit with absolutely no discretion as to the use or application of funds. While the Court stated that the discretion of the holding company might be limited, it did exist.

Facts

Velcro Canada Inc. (VCI) paid royalties to a related company, Velcro Industries BV (VIBV), a resident of the Netherlands, calculated as a percentage of net sales. In 1995, VIBV became a resident of the Netherlands Antilles, and assigned its rights under the royalty agreement to a subsidiary, Velcro Holdings BV (VHBV), a resident of the Netherlands. In exchange for the assignment, VHBV agreed to pay to VIBV an amount calculated as an arm's-length percentage of net sales of the licensed products within 30 days of receiving royalty payments from VCI. The percentage was subject to the approval of the Dutch tax authorities, but was ultimately determined to be equal to 90% of the royalties received from VCI.

Canada does not have a tax treaty with the Netherlands Antilles, and if royalties were paid by VCI to VIBV, or VIBV were the beneficial owner of royalties paid to VHBV, the royalties would be subject to a 25% withholding tax, rather than the 10% rate under the Canada-Netherlands treaty (reduced to 0% in 1998).

The Canada Revenue Agency took the position that VHBV was not the beneficial owner of the royalties, as required by Article 12 of the treaty, and reassessed VCI for not withholding tax at the 25% rate, plus penalties.

Court's analysis

Associate Chief Justice Rossiter applied the following comments from the trial decision in *Prévost*, as approved by the Federal Court of Appeal:

> …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….When an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatory is acting…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 the funds put through it as a conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what the person instructs it…

The Court held that, similar to the finding in *Prévost*, there was no "pre-determined flow of funds" from VCI to VIBV, despite the contractual obligation between VHBV and VIBV. The Court noted that, upon receipt, the royalty payments were intermingled with VHBV's other accounts and used for a variety of purposes, at VHBV's sole discretion. The funds were not segregated and paid directly to VIBV. The funds were transferred to various other accounts in different currencies and used to earn interest and to fund various activities, including loans, investments in subsidiaries, operational expenses and professional fees. The funds were exposed to creditors of VHBV.

Based on these facts, the Court held that VHBV had the "possession, use, risk and control" of the funds, and was the beneficial owner of the royalty income. In addition, VHBV was not an agent or nominee. VHBV did not have the power to legally bind VIBV and was acting on its own behalf at all times. Further, VHBV was not a conduit or "mere channel". Applying *Prévost,* it was held that a conduit has absolutely no discretion with respect to funds received, which was not the case: "It is quite obvious that though there might be limited discretion, VHBV does have discretion".

Conclusion

The *Velcro* decision provides welcome clarity with respect to the impact of a related contractual obligation to the determination of the beneficial ownership of income. Admittedly, there were many facts supporting the taxpayer's position that might not be present in every case involving back-to-back payments. VHBV had other assets and sources of income (although there was little discussion of this aspect of the case so the quantum of income from other sources and the relevance of this fact are not clear). The Court did note that the funds paid to VIBV were not identical to the funds received from VCI due to currency conversion and the intermingling of funds. Nevertheless, the emphasis on the legal control over the funds received by VHBV should be helpful in other cases.

From a planning perspective, there are many helpful lessons:

- A holding company with other activities would be a good candidate for this purpose if available and commercially feasible

- It should have its own bank account to receive payments and the bank account should be under its sole legal control
- Payments should not be made by direction directly to anyone else, bypassing the holding company
- The payments received should not be segregated from any other sources of income of the recipient, and the funds should be used to pay other expenses as well as the related contractual obligation
- There should be a "spread" earned by the recipient, which ideally should be invested to earn income

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