Treaty Shopping Explained – Velcro Canada Inc. v. The Queen

By Roberto Domagas, CA on Friday, 09 March 2012

The Canada Revenue Agency ("CRA") recently lost in Tax Court against a taxpayer that had structured their operations to minimize Canadian tax. The case, *Velcro Canada Inc. v. The Queen,* ("*Velcro Canada*") is the first case since the FCA decision of *Prevost Car Inc. v. the Queen* ("*Prevost Car*"), (see our blog on March 18, 2009) that deals with the concept of "beneficial ownership" in a treaty shopping context. The purpose of this blog is to outline how treaty shopping works and how the CRA has tried to assess against this practice.

By way of background, treaty shopping is generally a strategy where multinational corporations structure their affairs to minimize their overall global taxes. Some of the planning, as in this case, involves the use of intellectual property. Intellectual property may be "trade secrets" that allows one to manufacture and sell a particular product. As consideration for allowing someone to use their intellectual property, a royalty is often charged which may be based on a percentage of sales or based on the number of products produced. The key to treaty shopping is to ensure the intellectual property is resident in a country with low taxes which has favorable tax treaties with other countries.

In *Velcro Canada's* case, the company was subject to a royalty agreement with a corporation that was resident in another country where the royalty payments were not subject to either Canadian corporate or withholding tax.

As an illustrative example,[1] assume that a fastener is manufactured by a Canadian corporation and can be sold for $100 per unit, the domestic cost to manufacture the fastener is $50 per unit, and the production royalty is $50 per unit. Given this example, the company would have Canadian taxable income of $0 calculated as follows:

Income	$100
Production costs	($50)
Royalty costs	($50)
Income	$0

If the company was not subject to a royalty payment, the company would have $50 of income that would otherwise have been subject to Canadian corporate tax. This results in the shifting of income that has been earned in Canada to another country. The Canadian government has domestic tax rules that subjects royalty payments made to non-residents of Canada to a 25 percent withholding tax. However in the *Velcro Canada* case, the withholding tax rate was reduced to zero percent because of a specific article in the Netherlands / Canada Tax Convention (the "Treaty") that allows such payments to be exempt from withholding tax.

If we follow the taxation of this royalty along the international corporate chain, it was paid to a corporation resident in the Netherlands ("Netherlands Holdco"). The Netherlands Holdco was also subject to a royalty agreement such that 90 percent of the royalties that it received from Canada must be paid to yet another corporation ("ParentCo") that was resident in the Netherlands-Antilles, a jurisdiction with a historical low taxing rate.

In continuing on our example, the royalty payment made to the Netherlands Holdco would report the following income:

Royalty Income	$50
Royalty Expense	($45)
Income	$5

If we assume that the Netherlands' corporate income tax rate is 29.6 percent, it results in $1.48 of Netherlands corporate tax on the above profits. We also note that there is no Netherlands withholding tax on royalty payments between the Netherlands and the Netherlands-Antilles.

To summarize, the royalty has now been transferred to ParentCo which is resident in the Netherlands-Antilles a jurisdiction which provides for various participation exemptions and special incentives to royalty companies which may result in a two percent[2] tax rate. Accordingly, the tax paid in the Netherlands-Antilles would be $0.90 using our above noted example.

Accordingly, the *Velcro Canada* royalty would have been taxed as follows: $0 in Canada, $1.48 in the Netherlands and $0.90 in the Netherlands-Antilles for a total tax of $2.38. The effective tax rate would be 4.76 percent[3] ($2.38 of total taxes paid on $50 of royalties). Compare this effective rate with the Canadian corporate or withholding rate of 25 percent and this represents a significant tax saving.

In *Velcro Canada*, the Treaty prescribed a reduced withholding rate on royalty payments made to a “beneficial owner” resident in the Netherlands.[4] The CRA took offense to the fact that the corporation that received the Canadian royalty payment, the Netherlands Holdco, was under a contractual obligation to pay within 30 days, 90 percent of the royalties received from *Velcro Canada* to an affiliate corporation in the Netherlands Antilles. The CRA questioned how a corporation could be the beneficial owner if it is obligated to pay 90 percent of the Canadian royalty received to another corporation. They further argued that the Netherlands Holdco was an agent or conduit of ParentCo, which would have enabled the Court to pierce the corporate veil.[5]

The Tax Court refused to pierce the corporate veil in this instance. The Court expanded on the FCA’s decision in *Prevost Car* regarding beneficial ownership including an analysis of the four elements of beneficial ownership, these being “possession,” “use,” “risk” and “control”. The Tax Court found that, notwithstanding Holdco’s obligation to pay 90 percent of the royalty, Holdco exercised the four elements of beneficial ownership, and therefore met the conditions of the Treaty to be eligible for a reduced withholding tax rate.

It appears that unless there is a change to Canada’s tax treaties clarifying what “beneficial owner” means, the Canadian Courts will respect the form of the structure so long as one can demonstrate that they meet the common law tests for beneficial ownership. However, the OECD is keenly interested in this subject and has released a discussion draft clarifying what the concept of “beneficial owner” means in Articles 10, 11 and 12 of the OECD Model Tax Convention (which is how most of Canada’s tax treaties are modeled).

Stay tuned… this is a fast moving area of tax law.

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[1] Note that this example is not representative of the actual case facts of *Velcro Canada*, but is for illustrative purposes only.

[2] This rate applies to offshore companies like international holding companies and certain types of onshore companies. However, this could be as high as 10 to 30 percent depending on the particular circumstances of the corporation.

[3] This is only an estimate of the possible effective tax rate in such a structure, and serves only to illustrate the reduced tax rate that is possible though treaty shopping.

[4] See Article 12 of the Treaty.

[5] *Prevost Car,* see paragraph 100.