

# The impact of international direct taxation on the economic exploitation of copyrights

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The importance of Intellectual Property Rights (IPR) as assets and their ability to generate income have not gone unnoticed in the area of domestic and international taxation. Income Tax laws of a good number of countries include specific provisions for the tax treatment of the income and associated expenditures of these assets<sup>1</sup>. Several countries also create special tax regimes to attract such income. Even more, Double Taxation Conventions on Income (DTCs) deal with copyright royalties already since 1931<sup>2</sup>. Nowadays, the number of DTCs in force in the world exceeds 2000. Many DTC follow recommendations drafted by International Organizations (IO) such as the Organisation for Economic Cooperation and Development (OECD) and the United Nations (UN). Other countries, like the USA and the Netherlands, have also drafted their own unilateral Model Conventions (MCs). Works commanded by IO on the subject are substantial.

IPR are by nature not limited to man-made geographical border and hence have an international dimension. From an economic and legal perspective this means that IPR have the capacity to create income or losses at an international level. Such international potential is not incidental and is often the result of a series of activities and investment to create, protect and trade IPR in the country of origin as well as in all other places wherein their exploitation is possible and occurs. Many different interests and stakeholders are involved in the

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<sup>1</sup> Already since the early twentieth century, e.g. The 1918 British Income Tax Law stated refers to “any royalty or other sum paid in respect of the user of a patent”, J.P. HANNAN, *A treatise on the principles of income taxation, stated or deduced mainly from decision and pronouncements of British and Australian Courts*, in: The Law book co. of Australasia Pty Ltd: Sydney, 1946, p. 99. A Canadian Tax law of 1927 subject to tax the rentals, royalties or similar periodical payments of non residents, PIERRE GONTHIER, *Les déclinaisons de la notion de redevance selon l'impôt de la partie XIII: Redevance et concept élargi de redevance*, *Canadian Tax Journal/Revue fiscale canadienne*; vol. LI, n°. 5, 2003, p. 1829.

<sup>2</sup> BELGIQUE ET LE GRAND DUCHÉ DE LUXEMBOURG: Convention ayant pour but d'éviter la double imposition en matière d'impôts directs et de garantir l'assistance réciproque des deux pays pour le recouvrement des ces impôts, 9 Mars, 1931, in *Recueil des traités*, vol. CXXXVII, n° 3161.

IPR- tax environment. Among the stakeholders one can find the creators (authors), investors, IPR owners and beneficiaries of their use. However, private interests are not exclusive. Public interests of more than one individual country are also involved. For example, the interests of the residence country on the one hand (e.g. the country of the IPR's origin, the country of residence of the IPR's beneficial owner, or IP Financial Centers), and on the other hand the interests of the countries in which the property is used or commercialised (the source country).

In order to avoid double taxation of IPR income/gains, at least two important issues have to be addressed: which country is entitled to levy tax on royalties earned in cross border transactions, and the extent of such taxation. These issues have proved to be very complex and with extensive consequences. The taxation of royalty income can create or remove obstacles in the international trade of goods and services. Obstacles are especially created if both, the country of residence and the source country exercise their domestic right to tax the same income simultaneously. This situation is even worse if taxation at source is high. One negative effect of these obstacles is the high risk of discouraging inward investments of know how and intangible property into a source country. If both countries invoke their taxation rights, problems of double taxation will most likely arise<sup>3</sup>. Such double taxation in turn often creates substantial barriers to cross border economic activity and investments. In addition the principle of neutrality in capital export and import are likely to be affected.

The aim of this paper is to show the influence of the abovementioned issues in the economic exploitation and management of copyrights and related rights from a legal perspective and limited to some issues of international juridical –double- taxation<sup>4</sup>. This paper also includes a brief description of several domestic and international tax law measures that have created a new framework for the economic exploitation of copyright. Issues related to economic double taxation are not covered by this research<sup>5</sup>. The analysis will reveal some of the

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<sup>3</sup> As stated in general to the problems related to the double taxation of income by The International Financial Conference held in Brussels in 1920, see: SOCIÉTÉ DES NATIONS, *L'Application des Principes de la Conférence Internationale Financière de Bruxelles*, ref. A.22(I).1922 (C.628) et (629), vol. I, SN: Genève, 1920, p 7-8; League of Nations, Committee of Technical Experts: *Double taxation and tax evasion*, ref. C.216.M.85., Geneva: April, 1927, p 4119.

<sup>4</sup> According to the OECD, "International juridical double taxation can be defined as the imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income". See [http://www.oecd.org/document/15/0,3343,en\\_2649\\_33753\\_36156239\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/15/0,3343,en_2649_33753_36156239_1_1_1_1,00.html).

<sup>5</sup> "Economic double taxation means the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers." Ibid.

challenges, opportunities, advantages and disadvantages that tax strategies offer for the international exploitation of intellectual property and copyrights and the impact they have on trade and tax policy.

Topics of research include: a) tax structures used to optimize the benefits of IPR assets including DTC on income, low tax jurisdictions, tax havens and structures used worldwide for the royalty routing, b) withholding taxes on copyright royalties, and c) allocation of royalty income for DTC purposes, d) challenges posed by tax expenditure. Although the analysis considers the *status questionis* in a number of developed and developing countries, such as the United States of America, Australia, Spain, Netherlands, Luxembourg, Mexico, Argentina, Brazil, several Latin-American countries and Caribbean Islands it is not a comprehensive study.

## **1. IP tax paradises?**

The tax laws of several countries have encouraged multinational companies to locate specific Intellectual Property Assets (IPA) in low tax jurisdictions or jurisdictions with a beneficial IP tax regime. Countries offering a special IP tax regime include Ireland (patent box), Luxemburg, Belgium (patents), Malta (patent box), The Netherlands (patent box + conduit companies), Singapour, and Switzerland. Some jurisdictions, like the Cayman Islands, do not levy taxes on income or capital gains (including IP proceeds/gains). Tax measures vary from country to country and do not always include all kinds of IPR. Among other measures, it is possible to find investment deductions for research and development, payroll tax cuts for scientific personal, lowering or eliminating withholding taxes on royalties, granting exemptions for income/capital gains derived from IP or promoting the creation/establishment of IP holding companies. Given the magnitude of alternatives I will refer only to some examples.

According to article 50a of the Luxemburg Income Tax Law, 80% of the net income of companies will be exempted provided that they grant or use copyrights on software, licences, patents, designs or models. The same applies to taxpayers producing inventions protected by patents used in the course of their own business. A partial exemption of capital gains realised from the sale of one of the abovemention IPR is also granted. Among other requirements it is worth mentioning that although registration of the IPR is mandatory, the request of registration (initially) seems to be enough. For software,

an assessment of originality may be required, given the copyright protection as literary work and lack of registration. The IPR can be acquired from third parties but not from an affiliate company. The R&D localisation is not restricted to Luxemburg but can take place anywhere. Negative income related to IPR is deductible.

Apart from the absence of withholding taxes on royalties, the Dutch Corporate Income Tax Act also grants 80% exemption of net income and a capital gain exemption. The scope of the 80% exemption of net income is limited to certain types of software and intangible assets for which a patent or a special Research and Development (R&D) qualification has been granted (mainly new technical products or production processes and assets not qualifying for patents –trade secrets). The intangible has to be developed internally and neither acquired from a third party nor from an affiliated company. R&D can take place anywhere. Negative income related to IPR is deductible. Another incentive granted by the Netherlands regards the so-called “patent box” from 2007. Net earnings generated through one or more Dutch, European or foreign granted patents are, on request, taxable at a rate of 10% instead of the regular corporate income tax rate of 25.5%. The purpose is to stimulate innovation and investments in R&D by Dutch corporations complying with a number of requirements. In 2008 the “patent box” was extended to cover certain R&D expenditures not relating to patents. Other incentives for the development and holding of IP include a reduction of wage tax due on R&D employees salaries, tax deduction of qualified development costs and the deduction of royalties for tax purposes on royalty free licenses provided by related parties<sup>6</sup>.

Dutch royalty conduit –licensing- companies are very attractive to re-route income/gains derived from IPR including copyrights too. Such companies act as intermediary between the owner/creator of IPR who is not resident in the Netherlands and a potential user of the rights in a third country. The IPR’s owner is usually located in a tax haven or low tax jurisdiction. The Netherlands does not impose any withholding tax on royalty payments from the Netherlands to the home country. Given the extensive network of Dutch DTC, royalties paid to the Netherlands will mostlikely benefit of none or very low withholding tax. Without such intermediation tax payments would be much higher. This explains why the most commonly used strategy for large multinational companies for effective foreign tax reduction is the use of a holding

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<sup>6</sup> See MACHIEL LAMBOOIJ, WIEKE VON ANGEREN, (Netherlands), *Cut your IP Tax Bill*, Managing Intellectual Property”, May, 2010.

company in a low-tax jurisdiction<sup>7</sup>.

By making use of the Licensing/Holding companies, multinational companies expect potential tax savings and significant fiscal advantages. Hence, tax considerations become very important in the establishment of the IP strategy. A common one will be to establish the convenience of centralised or decentralised ownership and/or management of an IP portfolio. The location or relocation of the IP assets in an offshore jurisdiction is usually necessary for tax purposes. The IPA could be donated, sold or moved gradually to an offshore owning company, depending on the circumstances. Cost-sharing arrangements are an alternative too.

The Netherlands is not the only country that has established favorable conditions to attract royalty conduit companies. Good locations for this kind of companies include the UK, Cyprus, Malta, Switzerland, The Netherlands Antilles, etc. The existence of DTC is very important for the reasons above mentioned. Tax havens usually do not have tax treaties and therefore the full withholding will be payable. Although the process is simple, specialized advice is necessary and this paper is not intended to provide such advice but to document the way international taxation of IP is influencing the exploitation of IPR. Many more issues are involved, in particular transfer pricing and the increasing attention of the tax authorities eager to more closely examine IP holding structures. Whether the royalty conduit company has “substance” will be also very important.

It is clear that Governments establishing beneficial tax regimes for IP holding companies have their expectations too. Indeed, whilst establishing tax conditions on which companies maximize their tax efficiency, a country not only attracts foreign investment but also promotes the generation of jobs. This seems to be the Dutch experience. According to SOMO, “It has been estimated that the activities of the 12,500 SFIs (Special Financial Institutions) present in the Netherlands, which facilitate these flows and largely consist of ‘mailbox companies’ and ‘paper headquarters’, generate some 2,500 direct jobs and a total direct revenue for the Dutch state of €1.7 billion”<sup>8</sup>.

Some authors have raised concerns about negative consequences for third countries. According to SOMO: “It affects both the capacity of developing country governments to supply essential services to

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<sup>7</sup> MICHAELA VROUWENVELDER, *Tax Planning to reduce foreign taxes for U.S. multinationals – an EU and Netherlands tax update*, Tax Management International Journal, vol. 30, No. 9, 2001, p. 403ss.

<sup>8</sup> MICHIEL VAN DIJK, FRANCIS WEYZIG y RICHARD MURPHY, *The Netherlands: A Tax Haven?*, Stichting Onderzoek Multinationale Ondernemingen. Amsterdam, 2006, p. 4.

their populations and the capacity of developed country governments to provide finance for development in the form of debt relief and official development aid.... Furthermore, it has a substantial negative impact through the resulting shift of the tax burden to other sources of income such as labour, and the reduced possibilities for smaller companies to compete with multinational corporations”<sup>9</sup>.

International tax competition for IPR income/gains or holding companies dealing with them is clear. The practices described are not necessarily illegal or prohibited. However, from a policy perspective the advantages or disadvantages of promoting them have to be established. Source countries may need to establish in each case if the use of tax structures such as those described above is performed solely for the purpose of defrauding the tax authorities, tax evasion or abuse of DTC, but this is not easy to prove. Over time royalty conduit companies have been making sure that enough “substance” is involved.

## **2. Withholding taxes on copyright royalties**

The taxation of income derived from the transfers/use of intellectual property varies from country to country. Each nation is sovereign to define its tax rules with very few limits. Tax policy is constrained to the objective of raising revenue to cover public needs/services and achieve public goals. However, sometimes it is also conditioned to the interests seeking protection or achievement by fiscal policy. Whether IP proceeds deserve a special treatment compared to other sources of income should be established for residents and non residents covered by the Income Tax Acts (ITA). Domestic law from a number of countries show different trends. A political answer to the question of whether to tax or not to tax domestic/foreign income becomes more important in the international arena.

Direct taxation of copyright income is usually regulated with other IPR assets. The power to tax royalties is exerted in different ways depending on the country approach. In the majority of cases the domestic tax law reflects whether a country is an IP importer, exporter or IP financial center. Since tax systems levy taxes on residents but also on income derived by non-residents, double taxation may arise. In other words: If X has income from a source in one country

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<sup>9</sup> Ibid, p 4.

and is resident in another, X may be liable to pay tax in both countries under their domestic tax laws. Main problems arise on cross border transactions of IP including trade via e-commerce.

The majority of the source<sup>10</sup> countries impose a withholding tax on royalties earned by non-residents (outbound). These withholding tax rates vary substantially per country. Few countries, however, do not levy any withholding tax on royalties<sup>11</sup> or exempt them (see table on withholding tax rates). Withholding taxes almost unavoidably result in double taxation in cross-border transactions. As such they can restrict such transactions and hence have a negative impact on the freedom of establishment and movement of capital.<sup>12</sup> Since these freedoms are fundamental rights within the EU there has been a major effort to at least eliminate withholding taxes amongst the EU Member States.

The high risk of withholding taxes resulting in an excessive (double) taxation is aggravated by the fact that withholding taxes are imposed on gross revenues, whereas income taxes are imposed on net earnings/profits. In a perfect world withholding taxes are a simple pre-payment of income tax and ultimately "refunded" as a tax credit. However, in cross-border transactions the credit will (almost) never exceed the regular income tax on the income. In addition, withholding taxes are always a good reason for treaty shopping, leading to other complicated issues in the application of tax treaties.

Some tax experts argue that high withholding taxes are detrimental because they increase the risk of the tax burden being shifted from the licensor to the licensee of technology. As a consequence the use of foreign IPR will be more expensive. Polläth refers to Germany as an example. Germany imposed a low withholding tax during the post-war period given the substantial necessity of foreign licenses to rebuild the country. In Polläth's view, a high withholding tax would have passed the burden to the German licensees<sup>13</sup>. Similar considerations are made for tax treaties, as we will explain later.

Domestic withholding tax rates for royalties paid to non-residents in a number of countries by the end of 2009 are as follow:

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<sup>10</sup> In the USA, royalties from the licensing of intellectual property are generally sourced where the intellectual property is used. See, US Internal Revenue Code (IRC), §861, a-4.

<sup>11</sup> E.g. The Netherlands, Norway, Luxemburg.

<sup>12</sup> FREDERICK ZIMMER, *Withholding Tax*. EATLP, annual meeting Cambridge, 2008, available in [www.eatlp.org/uploads/public/Withholding%20Tax1.docp.1](http://www.eatlp.org/uploads/public/Withholding%20Tax1.docp.1), p.1.

<sup>13</sup> KLAUS VOGEL; MORIS LEHNER, *Doppelbesteuerungsabkommen: DBA der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen. Kommentar auf der Grundlage der Musterabkommen*, 4a ed., C. H. Beck, München, 2003, Article 12, nm 7, p 1163.

	Corporate income tax	Royalties (outbound)	Copyright
Argentina	35%	21%, 28% 31.5%	12.25%/ 13.96% (with grossing up) Royalties paid for agreements complying with the Copyright Law
Aruba	28%	None	
Australia	30%	30%	
Bolivia	25%	12,5%	
Brazil	25%	15%	
Chile	17%	30% for the use, enjoyment or exploitation of patents, models and industrial designs, layout sketches or layout of integrated circuits, and new vegetable varieties.	15% use or explotation of software in Chile 15% copyrights and edition 20% producers /trade of films or videos.
Colombia	33%	33%	30% on 60% of Software Licensing Payments 30% on 80% of Film Licensing Payments
Costa Rica	30%	25%	
Dominican Republic	25%	25%	
Ecuador	25%	25%	
El Salvador	25%	20%	
Germany	15%+surcharge	15% + 5.5% solidarity surcharge	
Guatemala	31%	31%	
India		20%	
Japan	40.87%		
Luxembourg	22.88%	None	
Mexico	28%	25% - 28%	
Netherlands	25.5%	None	
Norway	28%	None	
Panama	30%	50% on domestic royalty payments 15% on royalties for non-treaty countries	
Peru	30%	30%	
Puerto Rico	20% -39%	29% 10% if royalties are paid by grantees of tax exemption under the Puerto Rico tax incentives act	
Singapore	18%	10%	
Spain	30%	24% 10% (for EU MS)	
United States	35%	30%	

United Kingdom	20% -21%- 28%	20%	
Uruguay	25%	12%	
Venezuela	15% - 34%	30.60% (effective)	

The different withholding tax rates create a scenario worth to be considered for an efficient exploitation of IP rights as well as for trade and tax policies in this field. A quick look at Latin American countries show a quiet high withholding tax on royalties, with very few exceptions and few references to income derived from specific types of works protected by copyrights (mainly software and film licensing).

In the Andean Community all proceeds from the use of intangible technological contributions are sourced in the country of use of intellectual or industrial property. This applies to the relations among Member States and with third Countries. AC law establishes some obligations for the Member States, namely Bolivia, Colombia, Ecuador and Peru. The Decision 578 of the Committee of the Cartagena Agreement provides the grounds for the taxation of royalty payments within the AC, whereas Annex II of the Decision 40 governs the relations between Member States and third Countries. In both cases the Member States are obliged to tax royalty payments on a source basis. Apart from that, subject to the provisions of AC law, the Member States are competent to define the tax regime applicable to intangible technological contributions that are not capital contributions. The level of taxation varies depending on the country, but there is no possibility for tax exemption of royalty payments. The effective income tax rates for royalty payments range between 12.5% and 33%.

### **3. Tax treaties and international allocation of royalty income**

DTC are tools used to avoid or mitigate the double taxation of income and capital among countries. Whilst unilateral provisions apply where no treaty has been concluded, tax treaties give more certainty and security because they bind two contracting states and create a more reliable legal framework for the taxpayers covered by the DTC *on reciprocity basis*. Tax treaties allocate income and capital to one of the contracting parties and follow either the exemption or the credit method<sup>14</sup>. There are no tailor made tax treaties for the taxation of

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<sup>14</sup> According to the 2008 OECD MC, where, on the contrary, income or capital may, in accordance with the

copyrights. Instead, (general) DTC also deal with the taxation of income derived by the transfers of IPR, including licensing, sale and services related.

Every DTC includes different characterisation and allocation rules, reflecting the interests and negotiations of the contracting parties. However, Model Conventions drafted by IOs such as the OECD and the UN have influenced current DTCs. Some countries also have unilateral models, like the USA, Austria and The Netherlands. At a multilateral level, the only attempt to regulate this specific subject has apparently failed. Indeed, the 1979 WIPO-UNESCO Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties has not entered into force thirty years after its negotiation. One of the main issues of this Multilateral Convention is the failure to allocate the income and the methods to avoid double taxation<sup>15</sup>.

Under the structure of most DTC the income/gains derived from IPR may fall under the articles dealing with: 1) business profits, 2) royalties, 3) capital gains, 4) services (if any), 5) artistes and sporters, or 6) other income. The characterisation will vary depending on the circumstances. The royalty article is an exception to the general rule of business profits and deals with: “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, or for information concerning industrial, commercial or scientific experience”<sup>16</sup>. Sometimes DTC include other mentions, for example, to software.

DTCs following the OECD MC allocate business profits, royalties, capital gains, services and other income to the State of Residence. Under the UN MC royalty income is also allocated to the State of

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Convention, be taxed with or without limitation in the State of source or situs, the State of residence has the obligation to eliminate double taxation. This can be accomplished by one of the following two methods:

- exemption method: income or capital that is taxable in the State of source or situs is exempted in the State of residence, but it may be taken into account in determining the rate of tax applicable to the taxpayer's remaining income or capital;
- credit method: income or capital that is taxable in the State of source or situs is subject to tax in the State of residence, but the tax levied in the State of source or situs is credited against the tax levied by the State of residence on such income or capital. See ORGANIZATION FOR THE ECONOMIC COOPERATION AND DEVELOPMENT. OECD Model Tax Convention, Paris, 2008, p.13.

<sup>15</sup> See ESPERANZA BUITRAGO DÍAZ, *La convención multilateral UNESCO - OMPI para evitar la doble tributación de las regalías por derechos de autor*, In Estudios de Derecho Internacional Tributario: Los Convenios de Doble Imposición, ICDT/ LEGIS, Colombia, 2006.

<sup>16</sup> According to the definition included in the 2008 OECD MC, article 12, paragraph 2.

Residence. However, the latter MC also limits such taxing rights, by suggesting that taxation at source shall not exceed a rate to be established by the contracting parties.<sup>17</sup> Whilst developed countries tend to follow the OECD MC, developing countries tend to negotiate on the basis of the UN MC. This seems to be a solution of compromise in a polarized discussion.<sup>18</sup> In the early forties and seventies proposals to address this controversy were put forward by the participating countries in the League of Nations during a meeting held in Mexico (mainly Latin American countries). The Andean Pact members (Bolivia, Colombia, Ecuador, Peru and Venezuela) also approved measures towards taxation at source in that time. Both efforts remained unsuccessful. Indeed, virtually all countries are reluctant to renounce their 'right' to tax revenue derived from royalty payments. This income is usually taxed on source basis and for DTC purposes need to be allocated. The controversy is especially relevant in the relationship between developed and developing countries. This is based on the strong believe that the origin of this income belongs just to one of them.<sup>19</sup>

DTCs following the UN MC sometimes establish a fixed withholding tax rate, but in many cases the rate varies depending on the nature of the goods or rights for which the payments are made.<sup>20</sup> It is worth mentioning that the distribution of royalty income between the country of source and the country of residence, as the UN MC proposes, has created many problems in the characterisation of royalty income. These are the results of the establishment of variable limits, conditioned to the nature of the work or kind of Intellectual property or knowledge involved. The application of the US-Spanish DTC is a good example of the difficulties originating from this kind of income

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<sup>17</sup> UNITED NATIONS, DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, *United Nations Model Double Taxation Convention between Developed and Developing Countries*, New York, 2001, art. 12, paragraphs 1 y 2.

<sup>18</sup> Many DTCs do not follow the OECD or the US MC. The US Model attributes tax jurisdiction to the State of the beneficial owner's residence, but many treaties allow taxation at source reduced to a rate of the income, Vide BORIS BITTKER, LAWRENCE LOKKEN, *Fundamentals of International Taxation. U.S. Taxation of Foreign Income and Foreign Taxpayers*, 2<sup>a</sup> ed., Warren, Gorham & Lamont: Boston, 1997, 66.2.7. pp 66-25/6.

<sup>19</sup> On this specific topic, see GERD MORGENTHALER, *Die Lizenzgebühren in System des internationalen Einkommensteuerrechts*, C.F. Müller Juristischer Verlag GmbH: Heidelberg, 1992; Kemmeren, *Principle of Origin...*, 2001; ASOCIACIÓN ESPAÑOLA DE ASESORES FISCALES, SECCIÓN DE FISCALIDAD INTERNACIONAL, *Fiscalidad Internacional Convenios de Doble Imposición. Doctrina y Jurisprudencia de los Tribunales Españoles (Años 1996-1997)*, Aranzadi - Asociación Española de Asesores Fiscales: Navarra, 2000, p 181.

<sup>20</sup> E.g., a maximum of 10% of the [gross] income, or 5% on literary works, 8% on scientific works and 10% on the other cases. In many cases it is not mentioned if it applies to the gross or the net income.

distribution. The characterisation of income derived from computer software depending on its literary,<sup>21</sup> or scientific character<sup>22</sup> exemplifies the situation. It creates serious problems of interpretation. I believe that, from a tax policy perspective, and considering the huge differences in its interpretation, a distribution of royalty income should not be linked to the nature of the work, especially if it depends on the characterisation as literary, artistic, scientific or technical works.

From a tax treaty policy perspective, a country should be aware of the consequences of taxing royalty income on source or residence basis. Indeed, this problem has to be addressed by the DTCs. Due to the absence of agreement between developed and developing countries regarding the allocation rule<sup>23</sup>, the main remaining question seems to be which country is willing to renounce its taxation right<sup>24</sup> and what economic impact such position will have on the countries involved. The international scenario described in section 1 of this article proves the importance of defining the policies governing the taxation of IP, not only for tax treaty purposes.

Tax treaties play an important role in the avoidance of an excessive/ double taxation. Developed countries usually have treaty networks exceeding 50 DTC. In Latin America the problem is that the treaty network is in general limited. Mexico has about 38 DTCs,

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<sup>21</sup> E.g., Spanish Supreme Court, sentence of 9.10, 2001, RJ 2001\6042, Administración General del Estado contra International Business Machines, SAE e International Business Machines Corporation; Spanish Supreme Court, sentence of 9.05, 2001, RJ 2001\5370, Administración General del Estado contra International Business Machines, SAE e International Business Machines Corporation; Spanish Supreme Court, sentence of 28.04, 2001, RJ 2001\5361, Administración General del Estado contra International Business Machines, SAE e International Business Machines Corporation; Spanish Supreme Court, sentence of 11.06, 2001, RJ 2001\5374, Administración General del Estado contra International Business Machines, SAE; Vogel: *Interpretation of double taxation treaties in particular the problem of "qualification"*, in Rassegna Tributaria, No. 11, gennaio, 1988.

<sup>22</sup> See, HANNEMAN, H.W.A.M.: *The Patentability of Computer Software. An international guide to the protection of computer-related inventions*, Kluwer Law and Taxation Publishers: Deventer/Netherlands/Antwerp-Boston-London-Frankfurt, 1985; Propuesta de Directiva del Parlamento Europeo y del Consejo sobre la Patentabilidad de las Invencciones Implementadas en ordenadores, 20 de febrero, 2002, UE, DO, nº C 151 E de 25.6.2002, p 0129-0131.

<sup>23</sup> Especially remarked in the second meeting of the Fiscal Committee of the League of Nations in Mexico, Vide SOCIÉTÉ DES NATIONS/COMITÉ FISCAL, *Modèles de conventions bilaterales tendant à éviter, dans le domaine international, les doubles impositions et l'évasion fiscale*, in Deuxième Conférence fiscale régionale, Mexico D.F.: du 19 au 29 juillet, 1943, C.2.M.2.1945.II.A.3, publ. SN: Geneva, pp 6 ff. Also in the Model Convention prepared by the Andean Countries in 1970 and United Nations in 1980.

<sup>24</sup> According to Vogel, the conflict on income allocation between the States of residence and source is a "special mode of compromise," Vide KLAUS VOGEL, MORIS LEHNER, *Doppelbesteuerungsabkommen: DBA der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen. Kommentar auf der Grundlage der Musterabkommen*, 4<sup>a</sup> ed., C. H. Beck: München, 2003, article 10-12, nm 3, p 892.

Venezuela 31, Brasil 29, Chile 21 and Argentina 20. Whilst Brazil has a moderate withholding tax of 15% and more than 28 DTCs, in the Andean community the rates are generally quite high. Colombia has the highest rate and no more than 4 DTCs with only one in force. Peru levies a 30% withholding on royalties, limited to 15% in its DTCs with Chile and Canada. In Ecuador, the rate is 25% (as well as for technical assistance and technical services) and by virtue of its 11 CDIs may be limited to 5%, 10% or 15% depending on the country. Bolivia offers the more competitive rate: 12.5% limited in its DTCs with Argentina, Germany, Spain, France, UK and Sweden. In Venezuela, although the withholding tax rate is 30.60%, DTCs lower it to rates between 5% to 20%.

In South America there are a quite painful experiences. For example, Colombia kept a 35% withholding tax on the “exploitation”<sup>25</sup> of IP rights plus a 7% remittance tax until four years ago. The effective tax rate was 39,55%. Although the remittance tax has been abolished since 2007, the withholding rate is still (too) high. Income tax treaties have been negotiated only in the last five years and only one is in force. Even more, the 33% withholding tax rate is the same as for payments made to tax paradises<sup>26</sup>. The difference with the latter is the possibility to deduct royalty payments if major requirements are met: 1) the withholding on the payments<sup>27</sup> and 2) the fulfilment of the requirements stated by the Exchange Regime (mainly registration of the contracts related to technology licensing, technical services, basic engineering and detail and other technology contracts due to the necessity of the Andean Community (AC Member States to assess the contribution of the technology to the importing country <sup>28</sup>. According to tax experts, such measures have to be amended because they make the Colombian tax system not competitive<sup>29</sup>, and IP imports

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<sup>25</sup> Proceeds received by non-residents from the exploitation of intangible goods within the Colombian territory are subject to tax in Colombia. The same applies to the benefits or royalties of any kind derived from the exploitation of any copyright, industrial property and know-how. The main question is whether the term «exploitation» covers outright sale and licensing. If the answer is yes, then both payments are subject to a withholding tax ranging from ...to 33%. The Colombian tax administration is keen on the «yes» approach. See CATALINA HOYOS JIMÉNEZ, *Tributación de Intangibles en Colombia*, Memorias XXIX Jornadas Colombianas de Derecho Tributario, ICDT, Cartagena de Indias, 2005.

<sup>26</sup> Colombian Tax Law Statute “Decreto 624 de 30 de marzo de 1989” its addendums and reforms, articles 24, 408, paragraph 2.

<sup>27</sup> *Ibid*, art.124.

<sup>28</sup> *Ibid*, art.123. Also AC, Decisión 291 de la Comisión del Acuerdo de Cartagena sobre “Régimen Común de Tratamiento a los Capitales Extranjeros y sobre Marcas, Patentes, Licencias y Regalías”, in *Gaceta Oficial del Acuerdo de Cartagena*, nº. 80, (1991), art.12.

<sup>29</sup> JOSÉ VICENTE TROYA, in: Byrne, Peter/González Bendixsen, Jaime: *Tributación Internacional y Precios de Transferencia. Intervenciones*, in *Memoria XXII. Jornadas Colombianas de Derecho Tributario*, Tomo II,

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In addition to the above mentioned regarding DTC, Community law has also addressed the issue of the allocation of royalty income. This is the case of the AC and the European Union. The “Decision 578” governs the relationship between AC Member States. According to this Decision, the right to tax royalty income belongs to the country having its “producing source” (“fuente productora”),<sup>30</sup> precluding other AC Member States from taxing the same income, with few exceptions.<sup>31</sup> The allocation rule of royalty payments has not suffered any change,<sup>32</sup> compared to the Decision 40. It seems to me that AC law followed the recommendation made by legal scholars in the session of the ILADT in Montevideo in 1996, proposing to follow taxation at source in every integration zone,<sup>33</sup> in order to avoid distortions, eliminate double taxation and simplify the tax systems.<sup>34</sup> A similar criterion was proposed by the ILADT for its Model Tax Convention in 2010<sup>35</sup>.

Annex II of Decision 40 rules the relations between AC Member States and third countries. In this case, AC Member States shall also follow the principle of taxation at source.<sup>36</sup> It applies to payments of royalties, services, professional services and technical assistance.<sup>37</sup> The allocation of this income has been highly criticised for repeating the AC

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Instituto Colombiano de Derecho Tributario: Cartagena de Indias, 1998, pp. 67. Also Rodríguez Piedrahíta, Adrian: *Doble imposición internacional en la Comunidad Andina y la Decisión 40 de 1971 de la Comisión del Acuerdo de Cartagena*, in *Impuestos. Revista de Orientación Tributaria*, No. 94, 1999, p. 26.

<sup>30</sup> A definition in Decisión 578 “Régimen para evitar la doble tributación y prevenir la evasión fiscal”, 4 de mayo, 2004, Gaceta Oficial del Acuerdo de Cartagena, n° 1063, available at <http://www.comunidadandina.org/normativa/dec/D578.htm>, Article 3.

<sup>31</sup> As e.g. profits derived by transportation enterprises and for capital gains from ships, aircrafts, buses and other means of transportation, as well as commercial papers, shares and other securities, see AC Decisión 578, “Régimen para evitar la doble tributación y prevenir la evasión fiscal,” may 4, 2004, Official Journal n° 1063, available at <http://www.comunidadandina.org>, article 3.

<sup>32</sup> Decisión 578, Régimen para evitar la doble tributación y prevenir la evasión fiscal, en: Gaceta Oficial del Acuerdo de Cartagena, n°. 1063, 2004 <http://www.comunidadandina.org/normativa/dec/D578.htm>, article 9.

<sup>33</sup> The most known in Latin America are CARICOM, MERCOSUR and the Andean Community. The criteria to be followed by the new South American Community is unknown.

<sup>34</sup> The Recommendation is available at: [http://www.iladt.org/documentos/detalle\\_doc.asp?id=380](http://www.iladt.org/documentos/detalle_doc.asp?id=380), 3rd Recommendation.

<sup>35</sup> Article 9 Model Tax Convention for Latin America, as presented in the “XXV Jornadas Latinoamericanas de Derecho Tributario”, Cartagena de Indias, February, 2010.

<sup>36</sup> In the «producing source». See, Decisión 40: Aprobación del Convenio para evitar la doble tributación entre los Países Miembros y del Convenio Tipo para la celebración de acuerdos sobre doble tributación entre los Países Miembros y otros Estados ajenos a la Subregión, November 8 to 16, 1971, available at <http://www.comunidadandina.org>.

<sup>37</sup> According to the MC approved by the Decision 40.

law. The influence exercised by AC law in the past seems to be the reason for the absence of tax treaties to avoid the harmful effects of double taxation in countries like Colombia,<sup>38</sup> or their slow implementation in the other AC Member States. Actually the net of tax treaties is not really extensive.

The AC Model has not been followed by the AC Member States in their relation with third countries. Although Venezuela is no longer an AC member State, DTC signed by the time it was did not follow AC policies. The DTC between Venezuela and the USA follows the US Model, and tax treaties with France, Italy, the Netherlands and the UK follow the OECD Model.<sup>39</sup> Tax treaties signed by other EU Member States follow the OECD MC, the UN MC or the US MC. From the analysis of the DTCs of AC Member States one can conclude that the tax treaty policy adopted by AC law is no longer important.

In the EU the taxation of royalties varies in each of the twenty-five Member States. Several EU countries do not impose any withholding tax on outbound royalty payments (Netherlands, Norway, Luxemburg). It is also noteworthy that most EU Member States have a relatively large net of DTCs between them and third countries. In addition, Directive 2003/49/CE governs certain aspect of the taxation of royalties within the EU. Although there is no specific community tax rule governing the relations between EU Member States and third countries, the influence of EC law in the DTCs is subject to important discussions, due to the unknown limits of what is called “negative integration”<sup>40</sup>.

Royalties are normally subject to direct taxation. The Member States, and not the EC as such, have competence over direct taxation. However, the European Court of Justice (ECJ) has emphasised that this lack of competence does not relieve the Member States from complying with their obligations under EC law, especially, according to the fundamental freedoms recognised by the EC Treaty.<sup>41</sup> This

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<sup>38</sup> For future prospectives, see DEL CASTILLO et al.: Taking advantage of tax treaties in Latin America, in *International Tax Review*, March, 2003, p 29. On May 31 2005, Colombia has signed a tax treaty with Spain. At the moment is not in force.

<sup>39</sup> Ibid, p 30.

<sup>40</sup> See, LUC HINNEKENS, Compatibility of bilateral tax treaties with European Community law. The rules, in *EC Tax Review*, No. 4, 1994; MORIS LEHNER, *EC Law and the Competence to abolish Double Taxation, in Tax treaties and EC law*, edit. Gassner/Lang/Lechner, Kluwer: London, 1996; VOGEL et al., *Doppelbesteuerungsabkommen*, op cit. There are also authors referring to the disintegration of the domestic law, see WATHELET: Direct taxation and EU law: integration or desintegration?, in *EC Tax Review*; vol. XIII, No. 1, 2004, p 3.

<sup>41</sup> See, ECJ 14.02.1995 Case 279/93, Schumacker; ECJ 29.01.1999 Case C-18/95, Terhoeve; ECJ Case C-307/97, Saint Gobain; ECJ 12.12, 2002 Case C-385/00, de Groot; ECJ 28.01.1986 Case 270/83,

rationale has influenced some political decisions on the IP tax field at the domestic level. For example, in 2007, the EU Commission referred to a tax incentive granted by Section 243 of Ireland's Taxes Consolidation Act 1997. The incentive regarded the exemption of patent royalties from taxation as long as the research leading to the patent was carried out in Ireland. The Commission found it discriminatory and incompatible with EU rules on freedom of establishment and the free movement of services. Even more, according to the EU Commission Ireland had to change such taxation on patent royalties or face legal action before the European Court of Justice. Under the pressure, Ireland extended its exemption on patent royalty income to include royalties received in respect of non-Irish patents granted after 1 January 2008.

The EU has also taken some measures on certain aspects of the double taxation within the Community, which very early had been identified as a serious problem<sup>42</sup>. For royalty payments, the main disadvantage observed was the effect of the withholding tax in the source country. Legal scholars<sup>43</sup> and the European Commission proposed the reduction or abolition of the withholding tax on royalties within the EU, pondering the distortions on the financial and commercial transactions within the EU. Until today, the problems related to the EU internal taxation system have been partially resolved with the approval of the Directive 2003/49/EC and its amendments, forcing the Member States to introduce some changes.

According to the Directive 2003/49/EC the proper way to ensure equality of tax treatment between national and cross-border transactions is the abolition of taxation on royalty payments in the EU Member State where royalties arise.<sup>44</sup> As a consequence, the method approved for the avoidance of double taxation is the exclusive taxation of royalties in the country of residence of the beneficial owner. However, there are some exceptions, justified for budgetary reasons, or by the differences of technological development among member

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Avoir fiscal. As to legal scholars, see: Lehner: Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty, in *International Tax Review «Intertax»*; vol. IX, No. 1, 2000, p 7; Rädler: Most-Favourite-Nation- Treatment in Direct Taxation - Some New Aspects, in *SWI - Steuer & Wirtschaft International*; vol. XIII, No. 8, 2003, pp 361-362.

<sup>42</sup>See, the Report of the Neumark Committee in 1962.

<sup>43</sup> See, MORIS LEHNER, *EC Law*, op cit, p 9ff.

<sup>44</sup> See, Directiva 2003/49/CE del Consejo de 3 de junio de 2003 relativa a un régimen fiscal común aplicable a los pagos de intereses y cánones efectuados entre sociedades asociadas de diferentes Estados miembros, 2003, *Diario Oficial de las Comunidades Europeas*, n° L 157 de 26.6.<http://europa.eu.int>, art. 2(b), motive 4.

States.<sup>45</sup> The Czech Republic, Greece, Latvia, Lithuania, Poland, Portugal, Slovakia and Spain are allowed to a limited taxation at source for a limited period of time.<sup>46</sup>

As far as third countries are concerned, the situation regarding the interaction between EC law and tax treaties is still rather vague. In this context, the discussion regarding the influence of EC Law in tax treaties arises<sup>47</sup>. Taking a closer look at the extensive net of DTCs signed by EU Member States one has to acknowledge that taxation at source is not disregarded. This is observed in the DTCs with third countries. DTCs are negotiated on different premises, depending on the interests of both contracting states. In some cases the countries are used to following either one of the versions of the OECD MC, the US MC or the UN MC.

#### **4. Challenges posed by tax expenditure**

Finally, it is also noteworthy that tax expenditures such as exemptions, including the ones mentioned in section 1, allowances, credits, rate relief or deferrals are an alternative tool for achieving public policies. Developed and developing countries seem to have a different approach to tax expenditure especially when it comes to IPR<sup>48</sup>. Tax regulations seem to show more attention to IPR leading to technology developments and innovation and/or to certain industries such as software or film industries.

The results achieved by tax expenditures approved by OECD Member States suggest that they are sufficiently satisfactory to otherwise take action. It is important to note that OECD Member States possess a good level of economic and technological development and direct investment in R&D. However, not all OECD Member States grant tax incentives for R&D, as it is the case of

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<sup>45</sup> See, Directive 2003/49/CE, *ibid*, recitals 4, 7 and 8.

<sup>46</sup> Council Directive 2004/76/EC of 29.4.2004 amending Directive 2003/49/EC as regards the possibility for certain Member States to apply transitional periods for the application of a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Official Journal L157/106, 30/04/2004, Article 1, p 5.

<sup>47</sup> For the controversy, see ESPERANZA BUITRAGO, Royalties taxation and economic globalisation. A comparative view in the USA, the European and the Andean Community. Domestic, Community and double taxation treaty policy. *Financial and Economic Law Review*, Peking University, September 2005.

<sup>48</sup> INTERAMERICAN DEVELOPMENT BANK. Villela Luis, Lemgruber Andrea, Jorrat Michael. Tax Expenditure Budgets. Concepts and challenges for implementation, IDB working paper series IDB-WP-131, New York, 2010.

Germany, Finland, Island and Sweeden<sup>49</sup>.

The effect of tax incentives for R&D in developing countries has not been subject of further study<sup>50</sup>. However, outside the Western world, including Latin America, in countries like China, India, Singapore and Korea, tax incentives appear to play an important role in attracting capital and promoting R&D. Statistics regarding the results of tax incentives are unknown however<sup>51</sup>. In Colombia there is certain criticism towards the efficiency of tax incentives granted to promote R&D in particular periods and in the private sector.<sup>52</sup> It is considered that the direct benefit derived from the existing policy in this area is minimal and that incentives do not achieve the objectives pursued with them. The incentives seem complex and are criticised by not being administered by the Tax Administration (DIAN) but from COLCIENCIAS.<sup>53</sup> This includes a tax exemption of the income tax for new software products made in Colombia. Requirements to apply for the exemption include a high scientific and technological research activity performed in the country and approval by COLCIENCIAS.<sup>54</sup> Such an exemption seems to be complex and creates a kind of discrimination with other innovative – scientific products and other goods protected by IPR. According to statistics published by Mercer-Blackman, in 2004 from 20 applications, 16 were granted<sup>55</sup>.

Due to the fact that tax expenditures are a substitute for regular direct expenditure programs, another concern is that they should be subjected to the same budget control regulations as the latter<sup>56</sup>. According to the OECD the problem is to establish the efficiency of tax expenditures and its interaction with other economic tools such as subsidies<sup>57</sup>. This is not the only criticism. Since tax expenditures

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<sup>49</sup> ORGANIZATION FOR THE ECONOMIC COOPERATION AND DEVELOPMENT, “OECD Science, Technology and Industry Outlook”, OECD, Paris, 2008, p. 80.

<sup>50</sup> ANWAR SHAH y JOHN BAFFES, *Do tax policies stimulate investment in Physical and R & D capital?*, en: *Fiscal Incentives for Investment and Innovation*, Shah Anwar (editor), Oxford University Press, 1995, p. 617. SHAH, ANWAR, *Fiscal Incentives for Investment and Innovation*, 2006, available in SSRN: <http://ssrn.com/abstract=896144>.

<sup>51</sup> Interamerican Development Bank, *Tax Expenditure Budgets*, op cit, p. 58.

<sup>52</sup> HERNANDO JARAMILLO, CARLOS POMBO y, JUAN MIGUEL GALLEGO, *Incentivos Fiscales en Ciencia, Tecnología e Innovación: Revisión y Análisis de la Experiencia Internacional*, en revista *Borradores de Investigación*, n° 29, 2002, pág. 6.

<sup>53</sup> VALERIE MERCER-BLACKMAN, *The Impact of Research and Development Tax Incentives on Colombia's Manufacturing Sector: What Difference Do They Make?*, en revista *IMF Working Papers*, 2008, p. 41.

<sup>54</sup> [http://quihicha.colciencias.gov.co/web/guest/sobrecolciencias/marco\\_legal;jsessionid=F0EDB73A4D1A16F4F582B3C8684FB1A1](http://quihicha.colciencias.gov.co/web/guest/sobrecolciencias/marco_legal;jsessionid=F0EDB73A4D1A16F4F582B3C8684FB1A1).

<sup>55</sup> VALERIE MERCER-BLACKMAN, *The Impact of Research... op cit.*, págs 11 y 41.

<sup>56</sup> *Ibid*, p. 58

<sup>57</sup> *Ibid*, p. 80.

privilege one sector of activity, the tax administration will have more volume of work to control the exceptions. In addition, there are concerns regarding the effects of an international tax competition to attract foreign investment due to the growing innovation of tax incentives and the level of sophistication that they are reaching.

## **5. Conclusions**

Law regarding the taxation of IPR income and IPR holding companies demonstrates that in the international arena tax neutrality does not exist. Moreover, excessive (double) taxation on crossborder transactions is more rule than exception. As such one should be aware of the fact that: 1) There is a severe competition between countries for IPR proceeds/assets/financial centres; 2) Tax laws and DTCs are important instruments to achieve the political objective of attracting inward investments in R&D; 3) tax expenditures less visible financial tools to further achieve technological development and innovation in some countries.

Whilst the international legal protection of IPR has been strengthened, the taxation of such proceeds has grown in importance both domestically and internationally. The taxation of IPR is not a loose wheel of the economy but on the contrary, it may influence the promotion of innovation, research and development and the creation of IPR, usually financed by direct investment.

Tax policies vary from country to country. This paper presented different trends. Some countries tend to promote domestic innovation via tax laws but at the same time impose high withholding taxes on outbound royalties. Some exempt such payment and instead promote the creation of IP holding centres in order to maximize tax efficiencies. There are different levels of taxation and different approaches to tax expenditures. Lower levels of taxation and a good number of qualified tax expenditures tend to attract more foreign investment. This influences the economic exploitation of IPR and may even determine the IP strategy.

Tax law can help to channel the income to low tax jurisdictions or tax havens. The advantages and disadvantages that arise with the creation of IP royalty routing companies and the many tax incentives should be analyzed in detail by developing countries. The analysis of such practices is crucial to determine the policy of IP taxation.

An analysis of the advantages and disadvantages of IP requires a macroeconomic analysis. It is important to distinguish between

countries with different levels of economic development and levels of innovation. Strengthening IP in both is necessary. However, a major change in the tax treatment of royalty income in tax treaties between developed and developing countries should not be expected. Without a balance in this respect we believe there is a risk of increasing the bridge between developed and developing countries.

While it is true that the need for knowledge and IPR by developing countries must be taken into account in the tax and trade agenda of intellectual property, it is also true that these countries should commit to adopt policies and specific measures towards an improvement of their innovation levels and the creation of IPR. A review of tax law in developing countries considering the international arena seems also necessary for this purpose.