

A Decade of Case Law

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Sample excerpt

Chapter 2: Treaty issues related to the provision of know-how: Comment on a Spanish Supreme Court decision

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Executive Summary

This contribution comments on a Spanish court decision upon the definition of royalties for treaty purposes. The Spanish court decision is briefly summarized to give an overview of its background, the issues raised and the conclusions reached by the Court. Subsequently, attention is focused directly on three main issues: the definition of know-how, the difference between supply of know-how and provision of services, and mixed contracts.

1. *The definition of know-how:* This contribution compares the definitions of royalties contained in the OECD Model, UN Model and US Model, and analyses the types of information and transactions covered. It suggests that the definition of royalties should make express reference to “know-how” and that the guidance in the Commentary should be brought into agreement with a widely accepted definition in the field of international intellectual property law (such as that contained in Art. 39 of the Agreement on Trade-Related Aspects of Intellectual Property Rights). Further, it highlights a possible conflict between Arts. 12 and 13 of tax treaties.
2. *The difference between supply of know-how and provision of services:* Analysis is made of the OECD Commentary as expanded in 2003 following the recommendations of the 2001 TAG Report (based on an Australian Tax Office ruling,¹ hereinafter “ATO ruling”). It argues that the key difference between a supply of know-how and the provision of a service is that the latter does not entail transferring knowledge and experience to the other party but using it to provide the service itself. This contribution contains a very useful overview of the different treaty policies in respect of the taxation of service fees, mainly between developed and developing countries.
3. *Mixed contracts:* The third issue deals with problems that are generally encountered in practice. Difficulties that may arise with mixed contracts are related to the correct characterization not only of the different transactions

¹ See ATO Ruling, 29 November 1991, No. 2660.

underlying the mixed contract, but also to the determination of the appropriate apportionment or the principal part of the contract. It suggests a practical solution to address these.

2.1. Introduction

This contribution comments on a Spanish court decision upon the definition of royalties for treaty purposes. The Spanish court decision is briefly summarized to give an overview of its background, the issues raised and the conclusions reached by the Court. Subsequently, the attention is focused on three main issues: (i) definition of know-how; (ii) the difference between supply of know-how and provision of services; and (iii) mixed contracts.

2.2. *Electronic Data Systems Deutschland* case: A brief summary

2.2.1. Background

On 23 November 2000, the Spanish National Court issued a decision in the case of *Electronic Data Systems Deutschland GmbH v. Inspección Tributaria*.² The facts of the case are as follows: According to an agreement signed in 1987, a German resident company (*Electronic Data Systems Deutschland GmbH*) provided a Spanish resident company (*Electronic Data Systems España S.A.*) with a number of “system maintenance services and data processing services”. The taxpayer considered the payments received in relation to the mentioned agreement as remuneration for the provision of a service and, thus, no tax was paid in Spain, in accordance with Art. 7 of the 1966 Germany–Spain treaty, which allocated exclusive taxation rights to the residence state in the absence of a permanent establishment in the source state.³

The Spanish tax authorities assessed the taxpayer arguing that the payments were for a supply of know-how thus falling within the scope of the royalties article of the 1966 Germany–Spain treaty (which departs from the OECD Model and attributes limited taxing rights to the source state).

2.2. *Electronic Data Systems Deutschland* case: A brief summary

2.2.2. The issue and the court decision

The National Court ruled that the payments made to the German company were taxable in Spain under Art. 12(3) of the treaty. The decision was based on the qualification of the parties’ agreement as a supply of know-how contract, so that the consideration received by the German company was characterized as a royalty for treaty purposes. According to the court, the fact that it was a mixed contract, which

² See, Spanish National Court (Audiencia Nacional), 23 November 2000, No. 1057/1997, in *Asociación Española de Asesores Fiscales, Fiscalidad internacional. Convenios de doble imposición*, 2002, pp. 212 et seq. and in *Jurisprudencia Tributaria*, 2001, I, pp. 404 et seq.

³ See Convention between the Spanish State and the Federal Republic of Germany for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, signed on 5 December 1966 and effective as of 1 January 1968.

also included maintenance services, did not affect the qualification of the whole consideration. The court observed that the distinction between the two elements of technical assistance contracts, i.e. the supply of know-how and the rendering of services, was not always clear and gave rise to difficulties in practice. The court set out that – among other differences – contracts for the supply of know-how usually concern information that already exists, but which is not available to the public and that usually the recipient of know-how is obliged to keep confidential. This decision follows a path (certainly debatable) also validated by the Spanish Supreme Court, according to which a distinction should be made between the supply of know-how and the provision of services. Heredia summarizes the state of the art of Spanish case law as follows:⁴

[...] the predominant feature of the Spanish judgments and Resolutions on this issue, both judicial (the Spanish Supreme Court and the National Court, Audentia National) and administrative (the TEAC) is the lack of any discipline in distinguishing between contracts in respect of know-how and for the provisions of services.

Irrespective of the specific relevance of the decision taken by the Spanish National Court, the case law in question – and Spanish case law in general – touch upon several delicate treaty interpretation issues, which are analysed below.

2.3. Definition of know-how

2.3.1. Royalty definition: Comparison between OECD Model, UN Model and US Model

The royalty definitions contained in the OECD Model, UN Model and US Model are outlined below:

2005 OECD Model, Art. 12(2)

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, or for information concerning industrial, commercial or scientific experience.

Compared with the 1963 OECD Model, the only amendment is the exclusion of payments for “the use of, or the right to use, industrial, commercial or scientific equipment”. This exclusion was made in 1992 to ensure that compensation for equipment leasing fell within the scope of Art. 7 of the OECD Model.

1981 UN Model/2001 UN Model, Art. 12(3)

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, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula

⁴ See A. Garcia Heredia, “Who Knows the Riddle of Know-How? Spain Becomes Entangled in the Web of Intangibles”, *European Taxation* (2005), pp. 103–112, at 109.

or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

1996 US Model, Art. 12(2)

The term “royalties” as used in this Convention means:

- a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and
- b) gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use, or disposition of the property.

2006 US Model, Art. 12(2)

The term “royalties” as used in this Article means:

- a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and
- b) gain derived from the alienation of any property described in subparagraph a), to the extent that such gain is contingent on the productivity, use, or disposition of the property.

The definition of royalty contained in the US Models differs from that of the OECD Model in that:

- a residual catch-all category of copyrighted intangibles is added (i.e. copyright of “other work” added to literary, artistic and scientific works);
- a residual catch-all category of intangibles is added (i.e. “other like right or property” is added to patents, trademarks, designs or models, plans, secret formulas or processes); this residual category contained in the 1996 US Model was then excluded from the 2006 US Model;
- gains derived from the alienation of all intangibles that generate royalties are also characterized as a royalty to the extent these are contingent on the productivity, use, or disposition of the property.

2.3.2. Article 12(2) of the OECD Model

The definition of royalty contained in Art. 12(2) of the OECD Model can be divided into two main parts:

- (i) consideration received 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

- (ii) consideration received for information concerning industrial, commercial or scientific experience.