



## Analysis of the tax treatment of rents and royalties under domestic law

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## Overview

- Introduction and basic concepts
- Taxation of residents and non-residents on rent and royalty income
- Transfer pricing issues related to rents and royalties
- Information concerning rent and royalty income and payments

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## Introduction and basic concepts

### *Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties*

- Provides a framework to identify all the circumstances in which payments of rent and royalties erode a country's tax base
- Evaluates the seriousness of the risks of base erosion in those circumstances
- Outlines the possible responses that might be considered to prevent such base erosion

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### Risks of cross-border base erosion as a result of deductible payments of rent and royalties

Payer	Recipient	Risk
Resident	Non-resident	1. Income of resident payer is subject to preferential taxation
		2. Rent or royalties are exempt from or subject to reduced withholding tax
		3. Rent or royalties are exempt from or subject to reduced withholding tax
	Related non-resident	1. Rent or royalty payments are excessive: transfer pricing issues

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**Risks of cross-border base erosion as a result of deductible payments of rent and royalties**

Payer	Recipient	Risk
Non-resident carrying on business in residence country	Resident	1. Income of non-resident payer is subject to preferential taxation
	Related resident	1. Rent or royalty payments are excessive: transfer pricing issues
	Non-resident	1. Income of non-resident payer is subject to preferential taxation
		2. Payments of rent or royalties are exempt from or subject to reduced withholding tax
	3. Income of non-resident is subject to preferential taxation and rent or royalties are exempt from or subject to reduced withholding tax	
	4. Payments of rent or royalties are excessive: transfer pricing issues	

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**Risks of base erosion with respect to the deductibility of the costs of research and development where the property is transferred to a non-resident**

Transferor	Transferee	Risk
Resident	Arm's length non-resident	Gain on the transfer is exempt or subject to preferential tax
Resident	Related non-resident	Sale price is less than the fair market value of the property
Non-resident	Arm's length non-resident	Gain on the transfer is exempt or subject to preferential tax
Non-resident	Related non-resident	Sale price is less than the fair market value of the property

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**Basic concepts**

- **Lease** (“letting” and “hire”): transactions in which the owner of tangible property provides the use of that property to another person in consideration for payments generally called **“rent”**
- **Licenses**: transactions involving the use of intangible property are generally referred to as “licences” and the payments for the use of such intangible property are generally called **“royalties”**

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**Basic concepts**

- Payment of “rent” or “royalty”: fixed or variable; lump-sum payment at the beginning or the end of the period of use of the asset; situations where there is no payment
- “Mixed contracts” (e.g. contracts under which one person provides both the right to use property and services to the other person)

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## Basic concepts

- The concept of “rent”
  - Rent from immovable property
  - Rent from movable property
- The concept of royalties
  - The definition of royalties
    - Copyright royalties
    - Industrial property royalties with respect to *patents, trademarks, designs or models, plans, secret formulas or processes, or for information concerning industrial, commercial or scientific experience*
    - Rent for the use of industrial, commercial and scientific equipment

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## Basic concepts

- Geographical source of rent and royalties:
  - Rent and royalty payments related to immovable property: usually where the property is located
  - Two typical rules for rent and royalty payments for the use of movable property:
    - where the property is used
    - State of residence of the payer
- Allocation of rent and royalties to income
  - Need for rules to allocate rent and royalty expenses to non-taxable activities, activities taxable at ordinary rates, activities taxed at reduced or preferential rates
  - Main methods: direct tracing and apportionment

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## Basic concepts

- Payments of rent and royalties to related persons
- Payments for the use and exploitation of natural resources
- Back-to-back arrangements

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## Taxation of residents and non-residents on rent and royalty income

- Deduction of rent and royalty expenses against a country's tax base without any corresponding tax on the recipient typically arise in two cases:
  - A non-resident carries on business through a fixed base or PE and rent and royalty expenses are deductible in computing the profits attributable to the fixed base or PE
  - A non-resident receives rent and royalties from a related or unrelated payer who deducts the payments in its country of residence whether or not the non-resident is subject to tax on the rent or royalty income in its country of residence

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## Non-residents with a permanent establishment or fixed base

- May be difficult to determine the share of the total rent or royalty expenses incurred by a non-resident that should be allocated to a PE or fixed base
- Para 3 of the Comm. on Art. 7 UN Model: the PE (or fixed base) should be allowed a deduction of its “allocable share” of royalty expenses paid to third parties:
  - Royalties paid by the enterprise for the benefit of its different parts should be allocated and apportioned between these parts
  - Royalty payment should be allocated exclusively to a PE or fixed base if incurred exclusively for the benefit of the PE or fixed base

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## Non-residents with a permanent establishment or fixed base

- Rental payments for immovable or movable property may be easier to allocate than royalties since attribution normally depends on who uses the rented property (direct allocation) but apportionment issues (indirect allocation) may also arise if the rented asset is used for purposes of both the head office or other parts of the enterprise
- Non-resident enterprise should not be allowed to charge the PE or fixed base a mark-up on the rent or royalty expense; also, no deduction of notional or fictitious payments of rent or royalties to head office

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## Non-residents without a PE / fixed base

- Rent for immovable property present limited risk of base erosion (unless the deduction of expenses is allowed)
- Rent for movable property and royalties present more risk
  - Need to determine the source of the rent or royalties
  - Difficult is difficult to establish an appropriate withholding tax rate that will not create an obstacle to residents obtaining the use of the property
  - Withholding tax on all payments of rent or royalties or only on payments that are deductible in the country in computing income subject to tax

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## Residents

- Risks of base erosion as regards residents
  - In relation to deductions for rents and royalties claimed by residents
  - In relation to rent and royalty income derived by residents
- Risks differ depending on whether residents are
  - Taxed on a worldwide basis
  - Taxed on a territorial basis

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## Deductions for rents and royalties claimed by residents

- Who are taxed on territorial basis
  - Since foreign source income is not taxable, rents and royalties claimed by residents for the purpose of earning such income should not be deductible **but** difficult to apply this principle in practice
- Who are taxed on a worldwide basis
  - Relief of double taxation through exemption or credit: need to determine rent and royalty expenses applicable to foreign income
  - Credit should not be given for resource royalties paid to a foreign government (these are not income taxes)
  - Foreign losses applied against domestic income
  - Rents and royalties incurred to earn exempt income (such as dividends from foreign subsidiaries)

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## Rent and royalty income derived by residents

- Who are taxed on territorial basis
  - Incentive to earn foreign rent and royalty income if these are taxed abroad at reduced rates under treaties or domestic law
  - Base erosion if domestic expenses incurred to earn foreign rent/royalty income are deductible
- Who are taxed on a worldwide basis
  - Relief of double taxation through exemption or credit: need to determine expenses applicable to foreign rent and royalty income
  - Risks associated with “Patent box” regimes

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## Rent and royalty income derived by residents

- Base erosion where residents deduct expenses (e.g. R&D) incurred in developing intangibles and
  - Give licenses to CFCs to exploit the intangibles abroad, or
  - Alienate the intangibles to CFCs

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## Transfer pricing issues related to rents and royalties

- Payments of rent and royalties to foreign related persons
  - Rent and royalty payments may not be related to the effective use of a right or asset by the payor
  - Amount of the payment may be higher than the price a third party would be willing to pay (excessive payments)

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## Transfer pricing issues related to rents and royalties

- Payments of rent or royalties to residents by related persons :
  - Rent and royalties may not be paid even where a resident has provided the use of property to a non-resident
  - Amount of the payment may be lower than the price a third party would be willing to pay (insufficient payment)
  - Where the residence country applies a patent box regime, income benefiting from that regime may be inflated
  - Expenses of an MNE group may be allocated to the country where taxes are higher

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## Transfer pricing issues related to rents and royalties

- Two cases that are especially problematic:
  - Payments for the use of property (in particular intangible property) that has been developed by the payer and is transferred to a non-resident related company that leases the property back to the payer
  - Cost-sharing arrangements and contributions to R&D activities of multinational enterprises

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## Information concerning rent and royalty income and payments

The following information (ideally collected on a country-by country basis) would be useful for purposes of tax policy analysis as regards payments of rent and royalties to non-residents and the deduction of such payments:

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## 1. Rent and royalties paid by residents to non-residents—withholding taxes

- Total amount of rent and royalties paid to non-residents
- Total amount of rent and royalties subject to withholding taxes
- Total amount of withholding taxes on rent and royalties collected
- Rent and royalties exempt from withholding taxes
- Rent and royalties paid to non-residents on a country-by-country basis
- Non-resident recipients of rent and royalties
- Resident payers
- Non-resident payers

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## 2. Deductions of rent and royalties

- Total amount of deductions for payments of rent and royalties claimed by residents
- Total amount of deductions for payments of rent and royalties claimed by non-residents
- Amount of deductions for payments of rent and royalties claimed by non-resident enterprises carrying on business in a country through a PE / fixed base
- Amount of deductions for payments of rent and royalties claimed by various types of residents and non-residents
- Amount of deductions for payments of rent and royalties claimed by resident enterprises controlled by non-residents with respect to each type of property (immovable, movable and intangible property)

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## 3. Other information

- Rent and royalties paid to related non-residents
- Gains from the disposition of tangible and intangible property
- Information on value-added tax (VAT) (or goods and services tax) related to rent and royalties

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**Thank you**

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