



## Analysis of the treatment of rent and royalty payments under the provisions of tax treaties

Tuesday, 7 November 2017  
(Session 2)

Capacity Building Unit  
Financing for Development Office  
Department of Economic and Social Affairs

<http://www.un.org/esa/ffd/>

## Overview

- Provisions of the UN and OECD Models dealing with the taxation of rent and royalties
- Provisions of the UN and OECD Models that are relevant to the question of deductions for rent and royalty payments
- Other bilateral treaty provisions that deal with rent and royalties

2

## Provisions of the UN / OECD Models dealing with the taxation of rent/royalties

- Treaty provisions that may be relevant where non-resident derives rent and royalty income:
  - Art. 6 (Income from immovable property)
  - Art. 7 (Business profits)
  - Art. 8 (International Transport)
  - Art. 12 (Royalties)
  - Art. 21 (Other income)

3

## Art. 6

### **Art. 6(1)**

Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

### **Art. 6(3)**

The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.

4

## Meaning of income “from” immovable property

- Article 6 (1) and (3) of the UN and OECD models permit a State to tax income from “direct use” (e.g. rental value of owner-occupied house) and “letting or use in any form” (e.g. rental income) of immovable property situated in the State
- Important to distinguish between income derived “from” immovable property and income derived “using” immovable property

5

## Definition of immovable property

### **Art. 6(2)**

The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

6

## Computation of income and rate of tax

- Art. 6 does not provide rules for the calculation of income from immovable property or the applicable tax rate on such income: these are matters of domestic law
- Para 2 of the Comm. on Art. 6 (2) UN Model suggests that “[i]n taxing income from immovable property, the object should be the taxation of profits rather than gross income; the expenses incurred in earning income from immovable [real] property ... should be taken into account”
- Non-residents who owns immovable property may have substantial expenses connected with the renting of such property (for example, repairs, interest on funds used to buy the property, local taxes on immovable property)

7

## Computation of income and rate of tax

- Art. 6 does not provide rules for the calculation of income from immovable property or the applicable tax rate on such income: these are matters of domestic law
- Para 2 of the Comm. on Art. 6 (2) UN Model suggests that “[i]n taxing income from immovable property, the object should be the taxation of profits rather than gross income; the expenses incurred in earning income from immovable [real] property ... should be taken into account”
- Non-residents who owns immovable property may have substantial expenses connected with the renting of such property (for example, repairs, interest on funds used to buy the property, local taxes on immovable property)

8

## Example

- State A has tax rate of 30%
- Resident company has rental income of 100 and associated expenses of 50:  
 $100 - 50 \times 30\% = 15$  tax
- If State A has a 30% withholding tax on gross rent paid to non-residents, the tax would be 30 if the same rent is paid to a non-resident company
- Possible concerns applicable to expenses paid abroad or paid to related parties: same concerns for resident and non-resident owners

9

## Tax on gross or net?

- Withholding tax on gross rent should try to approximate tax on net income
- Could have elective system permitting non-resident to elect to have the income from the immovable property taxed on a net basis
- Risk of unpaid tax on rent from immovable property is very limited as property acts as security for payment of tax

10

## Art. 7

### **Art. 7(1) UN Model**

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

11

## Application of Art. 7

- Applicable if movable property rent or royalties are attributable to a PE (whether or not they are derived from a business: see Art. 21(2))
- rent for immovable property and resource royalties earned in the course of a business: Art. 6 applies by reason of Art. 6(4)
- Taxation on a net basis
- Same tax treatment as a local enterprise: Art. 21(3)

12

## Art. 8

### **Art. 8(1)**

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

### Commentary of UN/OECD Model:

- Art. 8 applies to so-called “wet” leases (leases under which the owner/lessor provides the crew with aircraft or ship) as well as “bare boat” leases that are ancillary to the operation of aircraft or ship
- Art. 8 applies to income from the lease of containers that is either directly connected or ancillary to the enterprise’s international traffic operations
- Other leases: Art. 7 (OECD) or Art. 12 (UN)

13

## Art. 12

### **Art. 12(2)**

However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed \_\_\_ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

### **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 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.

14

## Withholding tax on royalties

- A withholding tax at a low rate on gross rental payments for equipment may be excessive if the taxpayer incurs significant expenses in earning the income
- Withholding rates should usually take into account a presumptive profit margin
- Option to impose an interim withholding tax and permit the non-resident to file a return and pay tax on a net basis
- Non-resident lessors will often require residents to bear the costs of the withholding tax by grossing up the amount of the payment

15

## Example

- ACo, a State A resident, wishes to lease industrial machinery from BCo, a State B resident, at a price of 1,000
- BCo wishes a 10% return on its cost
- If BCo’s costs 910 and it charges rent of 1,000, BCo will earn a net return of 90
- If a withholding tax of 10 per cent is applied, BCo will obtain only 900, which does not even cover its costs
- BCo will be unwilling to lease the equipment to ACo on this basis.

16

## Example

- Bco will instead require ACo to bear the cost of the State A withholding tax
- This will be accomplished by grossing up (increasing) the amount of the rent paid by ACo so that BCo receives 1,000 after Country A withholding tax (that is, an amount equal to the costs of BCo attributable to the transaction plus the 10 per cent profit):

Grossed-up payment	1,111
Withholding tax (10 per cent)	<u>111</u>
Net amount	1,000

- The cost of the leasing of the machinery, therefore, increases for ACo (1,111 instead of 1,000).

17

## Source rule for royalties

- The treaty source rule for royalties is residence of the payer unless the royalties are incurred for, and borne by a PE or fixed base
- May differ from a “place-of-use” domestic rule
- Royalties may be sourced in two States under two treaties:

ACo, resident of State A, has a PE in State B. ACo rent equipment from a company resident of State C to be used exclusively by the PE in State B.

- A-C treaty: sourced in State A
- B-C treaty: sourced in State B

18

## Definition of royalties

### **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 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.

- Does not cover resource royalties, which are covered by the definition of immovable property in Art. 6(2)
- Definition raises a number of characterization issues

19

## Art. 21(3) UN Model

### **Art. 21(3)**

Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

- Applies to rent and royalties that are not attributable to a business and not attributable to a PE
- Would cover non-business movable property rent (i.e. yacht) received by an individual
- Unlikely to be a serious risk of base erosion

20

## Provisions of the UN / OECD Models relevant to deductions for rent/royalties

- Relevant provisions:
  - Art. 7(2)
  - Art. 7(3)
  - Art. 14
  - Art. 24(3)
  - Art. 24(4)

21

## Art. 7

- Effect of Art. 7(2) and 7(3) UN Model:
  - In determining profits attributable to the PE, expenses, wherever incurred, must be allowed as deductions (direct or indirect allocation)
  - Art. 7(3) UN Model: actual expenses, not notional expenses
  - Whether expense is deductible and how are matters of domestic law (subject to Art. 24)
- Since 2010, OECD Model would recognize the deduction of notional royalties (depends whether economic ownership of the intangible is allocated to head office)

22

## Art. 14

- Para 10 of the Comm. on Article 14: “expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment”

23

## Art. 24

- Art. 24(3) ensures that taxation of a PE is “not less favourably levied” than taxation of a domestic company (e.g. expenses allowed in the computation of the taxable income of a domestic company must also be allowed to a PE)
- Art. 24(4) ensures that interest, royalties and other disbursements (which includes rent) paid by an enterprise of State A to a resident of State B are deductible under the same conditions as if paid to a resident of State A

24

## Other bilateral treaty provisions dealing with rent and royalties<sup>3</sup>

### **Australia-Turkey 2010**

The term "royalties" in this Article means credits or payments of any kind, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:

- (a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right; or
- (b) the use of, or the right to use, any industrial, commercial or scientific equipment; or
- (c) the supply of scientific, technical, industrial or commercial knowledge or information; or
- (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in subparagraph (a), any such equipment as is mentioned in subparagraph (b) or any such knowledge or information as is mentioned in subparagraph (c); or

25

## Other bilateral treaty provisions dealing with rent and royalties<sup>3</sup>

### **Australia-Turkey 2010 (cont.)**

- (e) the use of, or the right to use:
  - (i) motion picture films; or
  - (ii) films or audio or video tapes or disks, or any other means of image or sound reproduction or transmission for use in connection with television, radio or other broadcasting; or
- (f) the use of, or the right to use, some or all of the part of the radiofrequency spectrum specified in a relevant licence; or
- (g) total or partial forbearance in respect of the use or supply of any property or right referred to in this paragraph.

26

## Other bilateral treaty provisions dealing with rent and royalties

### **India-Malaysia 2001**

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 patent, trade mark, design or model, plan, know-how, **computer software programme**, secret formula or process...

### **India-Croatia 2014**

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 ... **satellite or cable transmission for broadcasting to the general public through any form of electronic media**, ... any patent, trade mark, design or model, plan, secret formula or process ...

27

## Other bilateral treaty provisions dealing with rent and royalties

### **United States (2006 Model)**

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.

### **United States (2016 Model)**

Royalties shall be deemed to arise in a Contracting State when they are in consideration for the use of, or the right to use, property, information or experience in that Contracting State.

28



**Thank you**

**TaxffdCapDev@un.org**

<http://www.un.org/esa/ffd/>