



Characterization issues under domestic law and treaties

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Overview

- Characterization issues under domestic law
- Characterization issues under treaties
- Distinction between rents and royalties and proceeds of sale
- Distinction between rents and payments for services
- Distinction between royalties and payments for services
- Treatment of payment for software
- Treatment of various digital economy payments
- Treatment of broadcasting payments

2

Characterization issues under domestic law

- Need to characterize different types of payments under domestic law often depends on:
 - Whether capital gains are treated differently from other income
 - Whether rent / royalties are business income or are treated differently
 - Which payments to non-residents are subject to withholding tax and at what rate
 - The distinctions that exist for VAT purposes concerning:
 - Taxable and exempt supplies
 - Place of supply rules

3

Characterization issues under treaties

- Need to characterize different types of payments under treaties arises from the schedular nature of treaties which have different rules for
 - Business profits (Art. 7)
 - Royalties (Art. 12)
 - Payments for certain services (Art. 12A)
 - Capital gains (Art. 13)
 - Income from independent personal services (Art. 14)
 - Entertainers and Artistes (Art. 17)
 - Other income (Art. 21)

4

Distinction between rents and royalties and proceeds of sale

- Rent and royalties are consideration for the use of or the right to use tangible or intangible property
- Proceeds from the sale of property are consideration received for the transfer of ownership of the property itself, not just the right to use the property
- Under most countries' domestic tax law and under treaties, proceeds from the sale of movable property are only taxable only if the non-resident carries on business activities in a country and meet a threshold requirement such as a PE or fixed base (proceeds from sale of immovable property, however, are usually taxable)

5

Distinction between rents and royalties and proceeds of sale

- The distinction between sales and leases or licences of movable, immovable or other property or rights is usually found in a country's domestic civil or commercial law
- In any particular case, it must be determined which country's law should apply to determine the fundamental nature of the transactions, the rights and obligations of the parties and the character of any payments made
- The distinction is important for tax treaties because source taxation will often be allowed for rents and royalties but not for proceeds of sale

6

Distinction between rents and royalties and proceeds of sale

- From a base-erosion perspective, the most worrying outcome occurs where the payments are deductible in the source country and no tax is imposed on the non-resident recipient of the payments
- Countries should be aware that rights for the use of property (tangible and intangible) can be disguised as partial sales of property rights in order to avoid withholding taxes at source
- These results can be achieved with intangible property (e.g. sale of the exclusive right to use a trade mark for 10 years in a given country) or tangible property (e.g. sale of property for a limited period of time, such as two weeks per year).

7

Distinction between rents and payments for services

- Rent and royalties involve payments for the right to use existing property for a period of time, whereas payments for most services involve consideration for activities performed by the service provider
- Domestic law usually applies to determine whether payments are for the right to use tangible or intangible property or for a service; countries may therefore characterize the same payment differently (e.g. *Pierre Boulez* decision of the US Tax Court)

8

Distinction between rents and payments for services

- The distinction between rents and royalties and payments for services is particularly problematic under treaties that do not include provisions similar the new Art. 12A on fees for technical services:
 - Intangible property or rights are often used in the provision of services. In these cases, the contract is the provision of services (e.g. engineer uses know-know or secret formula to perform services under a contract for a client; the know-how and secret formula are not used by the client)
 - Leasing property to a client for the client's use is different from a service provider using property for the purpose of providing services to a client (e.g. a company may lease a crane that it will operate or contract with the owner/operator of the crane for digging services)

9

Mixed contracts

- Many contracts involve a combination of different elements:
 - sales combined with the use of tangible or intangible assets
 - services combined with the use of equipment
 - rentals of immovable property (for example, land, farms, houses, hotels) combined with rentals of movable property (for example, equipment, furniture, animals)
- If the different elements of a mixed contract are treated differently under domestic law or tax treaties, it is necessary to determine the part of the payments that are properly attributable to each of the elements

10

Mixed contracts

- The parties to the contract, whether related or not, may attempt to allocate the overall contract price to its several elements in a manner that avoids or reduces tax
- Tax authorities need to identify the various elements of a mixed contract and ensure that the price for each element is appropriate
- UN Commentary suggests that mixed contracts must be broken down into their different parts and the consideration apportioned among those parts based on the information in the contract or on some reasonable basis. However, if one part is by far the principal purpose of the contract, the treatment applicable to the principal part should generally be applied to the entire consideration

11

Mixed contracts: example

- RCo, a resident of Country R, agrees with SCo, a resident of Country S, to provide syrup and other ingredients to bottle and sell flavoured soda water in Country S
- The contract also gives SCo the right to use the trademark for an internationally renowned soda owned by RCo
- The contract requires that SCo must pay for the syrup and other ingredients, but does not require any payment for the use of the trademark
- RCo and SCo are not related parties

12

Treatment of payments for software

- Has long been a contentious issue
- OECD Commentary distinguishes between payments for the use of the software and payments for the use of the copyright that protects the software
- 2017 UN Model reproduces relevant part of OECD Commentary but adds that “Some members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD Commentary extracted above may constitute royalties”

13

Treatment of various digital economy payments

- Downloading of software, apps, music, e-books, pictures or movies
- Remote access to such products for a single use
- Application hosting / data warehousing (cloud transactions)
- Data search and retrieval
- Subscription based interactive sites
- Others?

14

Treatment of broadcasting payments

- State S has been awarded the organisation of the 2013 tournament of WIFAA, an international federation established in State R which is the world governing body for a major sport
- WIF-TV (also a resident of State R) is the wholly-owned broadcasting subsidiary of WIFAA. It sold the rights to broadcast the tournament matches in State S to SCC, a company resident of State S
- In consideration for these rights, SCC will pay WIF-TV a significant lump-sum amount and will provide, free of charge to WIFAA and LOC, 500 advertising slots for WIFAA events and the tournament

15

Treatment of broadcasting payments

- WIF-TV has entered into similar contracts with broadcasters in a number of different countries; these agreements provide that the live feed for each match of the tournament will be provided by WIF-TV through its host broadcaster
- TBC, a resident of State T that is a broadcaster in that country, will pay XCO, which is a company resident of State X that operates a satellite, for the broadcasting of some of the matches over the territory of State T
- Around 50% of the money derived by WIF-TV from the granting of the broadcasting rights will be distributed to the teams that will compete in the tournament and 30% will go to the local organising committee

16



Thank you

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