



## Risks of base erosion with respect to rent and royalty payments and possible countermeasures

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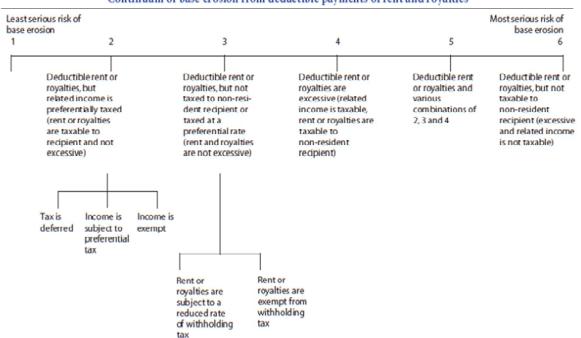
## Introduction

- Although all deductible payments of rent and royalties erode a country's tax base, not all such deductible payments should be viewed as problematic from the perspective of base erosion, because most of them represent legitimate expenses incurred in earning taxable income and should be deductible
- The risks of base erosion through deductible payments of rent and royalties can be viewed as a continuum, as shown on the following slide

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## Introduction

Table 3  
Continuum of base erosion from deductible payments of rent and royalties



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## Introduction

- Disallowing any deduction for rent and royalties would be inappropriate because
  - Rent and royalties represent legitimate expenses incurred to earn income
  - Where rent or royalties are normally taxed in the hands of the recipient (through withholding tax in the case of a payment to a non-resident; the difference in rate would not justify a general denial of deduction)
  - It would likely restrict access of a country's residents to technology and equipment
- Unlike the deduction of interest expenses, the deduction of payments of rent and royalties is usually not subject to a general restriction

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## Excessive deductions for rent and royalty payments by residents

- **Risk:** Deductible payments of rent or royalties by residents of a country to related non-residents may exceed arm's length amounts
- **Possible response:**
  - Apply transfer pricing rules to ensure that any payments of rent or royalties do not exceed an arm's length amount of such payments
  - Ensure that similar rules apply to payments of rent and royalties between related individuals and between individuals and related enterprises
  - Ensure that rules exist to deal with misallocation of prices in mixed contracts

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Where the withholding tax is less than the tax saving from the deduction allowed for rents and royalties (i.e. because the domestic rate or the treaty rate is low), base erosion will not be offset completely. This is a particular concern where certain payments of rent and royalties are exempt from withholding tax under the provisions of a country's domestic law or its tax treaties

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## Deductions for rent and royalty not offset by withholding tax

- **Possible response:**
  - Developing countries that do not impose withholding tax on rent or royalties paid to non-residents should seriously consider imposing such a tax
  - Developing countries should ensure that any domestic law exemptions from such withholding taxes and any reduced rates of withholding tax for payments of rent or royalties to non-residents are justified (withholding taxes on such payments may increase the cost for a country's residents to obtain foreign-owned equipment and technology: must balance the need to prevent base erosion against the need to allow access to such equipment and technology)

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Tax treaties may prevent the application of withholding tax on certain payments of rent or royalties or may require a reduction of such tax
- **Possible response:**
  - Not to enter into tax treaties? May be too drastic because tax treaties provide other economic benefits for developing countries
  - Refuse to agree to any reduction in their withholding taxes on rent and royalties? Unlikely to be acceptable to other countries
  - Insist on maintaining reasonable rates of withholding tax on rent and royalties—such as 10% or 15 % (but note the risk that tax will be borne by residents)
  - Ensure that any exemptions from withholding tax on royalties are well understood and clearly justified

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** If rates on rents and royalties is different from the rate on interest, services or sale of goods (in domestic law or treaties) taxpayers may manipulate transactions to benefit from the lower rate
- **Possible responses:**
  - Try to apply consistent rates of withholding tax on payments of interest and royalties and payments for services under their domestic law
  - Try to ensure that the treaty rates of withholding tax on interest, royalties and technical services are consistent
  - Transfer pricing rules, rules dealing with misallocation of prices in mixed contracts and anti-avoidance rules that allow the tax authorities to classify transactions based on their substance may help as regards arbitrage transactions involving the sale of goods

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Where non-residents carry on business in a country and deduct payments of rent and royalties against that country's tax base, any such payments made to non-residents may not be subject to withholding tax.
- **Possible responses:**
  - Ensure that deductible payments of rent and royalties made by non-residents to other non-residents are subject to withholding tax (i.e. where rent from movable or immovable property or royalties derived by non-residents are taxed on a net basis, e.g. where expenses incurred for a PE)
  - Ensure that the expense is correctly allocated to the PE and that the tax can be collected effectively (for example, through a system of interim withholding or branch level tax)

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Where payments of rent or royalties for the use of property are made to a non-resident who claims the benefit of a reduced rate of withholding tax under Art. 12 of an applicable tax treaty, there is a risk that the non-resident may not be entitled to the benefit of the treaty
- **Possible response:** The tax authorities should verify that the non-resident is entitled to the benefit of Article 12. In particular, the tax authorities should verify that the recipient of the rent is a resident of the other contracting State and the beneficial owner of the rent

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Taxpayers may enter into back-to-back arrangements to avoid or reduce withholding tax on royalties
- **Possible response:**
  - Consider adopting anti-back-to-back rules or applying a general anti-avoidance rule to back-to-back royalty arrangements
  - Verify that the recipient of royalties is the beneficial owner of the royalties
  - Consider including in treaties a general anti-abuse rule similar to the one to be added to the United Nations Model Convention in the 2017 update

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** The definition of “immovable property” under a country’s domestic law may be inappropriately narrow.
- **Possible response:** Review the definition of immovable property in their domestic law to ensure that such definition is appropriate for tax purposes, in particular as regards income derived from natural resources (Art. 6, unlike Art. 12, does not limit the rate of source taxation)

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** The domestic law concept of “**income from immovable property**” may be inappropriately narrow
- **Possible response:** Review the provisions of domestic law to ensure that non-residents cannot avoid withholding tax on rent for the use of immovable property located in a country by receiving compensation for the use of the property in a form other than rent (e.g. treatment of payments received in lieu of rent, payments dependent upon the use of or production from the property, payments based on the profits of the lessee, and gains from the disposition of the property)

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Non-residents may seek to avoid source country tax on income from immovable property through time-sharing and other arrangements, especially with related non-residents, whereby the payments of rent for the use of the property and the source country’s withholding tax are reduced
- **Possible response:** Developing countries should ensure that they have robust anti-avoidance rules to prevent taxpayers from avoiding withholding taxes on rent for the use of immovable property by structuring arrangements so that payments of the sale price of property or fees for services are substituted for payments of rent

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** Tax treaties that contain a definition of royalties that does not cover payments for the use of, or right to use, industrial, commercial or scientific equipment do not allow the taxation of rental payments for movable property
- **Possible response:** Ensure that tax treaties allow withholding tax on payments of rent for the use of movable property (e.g. use the definition in Art. 12(3) of the UN Model)

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## Deductions for rent and royalty not offset by withholding tax

- **Risk:** The definition of royalties under a country's domestic law for the purposes of withholding tax may be inappropriately narrow or inconsistent with the treaty definition of royalties in the UN Model
- **Possible response:**
  - Review the types of payments that are subject to withholding tax, compare them with Art. 12(3) of the UN Model and determine whether all payments of rent and royalties for the use of property are subject to the withholding tax
  - Review the provisions of domestic law to ensure that non-residents cannot avoid withholding tax on royalties for the use of intellectual property
  - Consider the possible application of anti-avoidance rules to prevent taxpayers from avoiding withholding taxes on royalties

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## Deductions for rents and royalties paid by non-residents taxable on a net basis

- **Risk:** Non-residents subject to net-basis taxation by a country (e.g. having a PE in that country) may claim deductions for rent or royalties in computing their income subject to tax by the country
- **Possible response:** Ensure that domestic law allows the application of withholding tax to any deductible payments of rent and royalties made by non-residents carrying on business in a country to non-residents

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## Deductions for rents and royalties paid by non-residents taxable on a net basis

- **Risk:** Non-residents may allocate and deduct disproportionate amounts of rent and royalties in computing net income earned in a country
- **Possible response:**
  - Adopt clear domestic law rules for allocating rent and royalties incurred by a non-resident to the income from the business carried on by the non-resident in a country
  - Ensure that tax authorities carefully review the deductions of rent and royalties claimed by non-residents
  - Adopt the UN Model version of Art. 7 that does not allow the deduction of notional amounts in computing the profits attributable to a PE

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## Deductions for rents and royalties paid by residents to earn exempt / low-tax income

- **Risk:** If residents of a country incur expenses for rent or royalties with respect to property that is used to earn exempt income, the deduction of the rent or royalties erodes the country's tax base and the related income is not taxable
- **Possible response:** Consider disallowing or restricting the deduction of rent and royalties incurred to earn exempt income. Similarly, consider restrictions on the deduction of rent or royalties incurred to earn preferentially taxed income

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## Deductions for rents and royalties paid by residents to earn exempt / low-tax income

- **Risk:** Where residents of a country incur expenses for rent or royalties with respect to property that is used to earn foreign source income subject to tax by that country, the foreign tax credit allowed against that country's tax for foreign taxes on the foreign source income, rent or royalties may be overstated
- **Possible response:** Any expenses, including rent or royalties, incurred by residents to earn foreign source income should be allocated to the foreign source income for purposes of the limitation on the foreign tax credit in order to ensure that the credit is limited to foreign tax on foreign source income

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## Transfers of locally developed intellectual property to non-residents

- **Risk:** Where a country provides tax support for the creation of intellectual property through R&D deductions but the resulting property is transferred to a non-resident, the country's tax base is eroded by the deductions allowed
- **Possible responses:**
  - Consider adding rules to the domestic tax law to recapture the previous deductions claimed in respect of the costs of creating the property
  - Consider adding rules to the domestic tax law to tax the gain realized on the transfer of the property to a non-resident (transfer pricing rules or other rules would also be required in order to determine a proper market value in the case of a transfer of intangibles between related parties)

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## Non-residents earning rents and royalties from resident consumers

- **Risk:** Non-resident enterprises may be able to earn substantial amounts in the form of rent or royalties from resident consumers without the need to establish a PE or fixed base in the country (e.g. sale of digital goods and services)
- **Possible responses:**
  - Although developing countries clearly have the right to tax and would like to impose tax on non-residents in these circumstances (subject to the provisions of any tax treaties), the application of withholding taxes is problematic with respect to non-deductible payments to non-residents that are made by individuals
  - The ongoing work of the EU and the OECD on the taxation of the digitalised economy should be monitored

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**Thank you**

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