



Major design elements in drafting domestic legislation to counter base erosion related to rent and royalties

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Introduction

- The concerns analyzed during the previous session generally require different responses in order to prevent base erosion effectively:
 - **deductible payments of rent and royalties that are subject to no or low foreign tax:** some countries consider restrictions on the deductions of such payments to be appropriate
 - **withholding taxes on rent and royalties:** goal is to collect tax from non-resident recipients in order to offset the reduction of tax resulting from the deductions or to ensure that non-residents that are engaged in substantial business activities in a country are subject to tax even if the amounts are not deductible

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Introduction

- **rent or royalties paid to earn income that is deferred, exempt or favourably taxed:** the goal is to match the level and timing of deductions of rent and royalties to the level of domestic tax imposed on the associated income
- **Intellectual property transferred offshore:** goal is to recapture some or all of the tax incentives provided to the taxpayer for the creation or development of the property and/or to impose tax on any appreciation in the value of the property at the time that it is transferred offshore

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Restrictions on the deduction of rent and royalties paid to non-residents

- Tax rules that disallow the deduction of payments of rent or royalties paid to non-residents if the non-resident recipients are not subject to tax or are subject to tax at a low rate (e.g. a rate that is less than a specified percentage) on those payments
 - Relatively easy to draft such legislation **but**
 - Such subject-to-tax rules present significant interpretive and administrative difficulties for the tax authorities (e.g. tax authorities must determine the tax consequences under another country's tax system, which requires access information about the non-resident and about the foreign tax system)

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Restrictions on the deduction of rent and royalties paid to non-residents

- Because of the interpretive and administrative difficulties of subject-to-tax rules, some countries use a proxy and deny the deduction of rent and royalties paid to residents of tax havens or low-tax countries
- Difficult to define a tax haven or low-tax country
 - Could be determined by comparing the tax rates of the source and residence States **but**
 - If based on nominal tax rates, it will not ensure that the rent or royalties are actually subject to a reasonable amount of foreign tax
 - Seems preferable to compare effective tax rates (e.g. will ensure that any special low-tax regimes for royalties, such as patent boxes, are taken into account).

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Restrictions on the deduction of rent and royalties paid to non-residents

- Some countries use a list of countries that are considered to be tax havens or low-tax countries
 - Deciding which countries to put on such a list is a difficult task and may create political issues
 - List requires periodic monitoring in order to keep it reasonably up to date
 - European Union (EU) is in the process of preparing such a list (the EU list of non-cooperative jurisdictions should be endorsed by the Council by the end of 2017)
- Some developing countries might prefer to deal with problems related to deductible payments of rent and royalties that are subject to no or low foreign tax on a case-by-case basis through specific or general anti-avoidance rules or by applying broad withholding taxes,

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Withholding taxes on rent and royalties

- Withholding tax will not completely offset the tax savings from the deduction of the rent or royalties unless it is imposed at the country's applicable general tax rate
- Should apply not only to rent and royalties, but also to amounts paid in lieu of or in substitution for rent or royalties
- Recipient will typically seek to require payor to bear any withholding tax imposed on payments of rent and royalties (gross-up)
 - Will increase the cost of renting movable property or equipment or licensing intellectual property for residents
 - This effect can be minimized by exempting, or reducing the rate for, certain rent or royalties

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Withholding taxes on rent and royalties

- Withholding tax on payments of rent and royalties should be designed in the context of the country's withholding taxes on other amounts paid to non-residents
 - If the rates are identical, the withholding taxes are easier for payers/withholding agents to comply with and for the tax authorities to administer
 - Also, costs of compliance and administration are increased to the extent that amounts are exempt from withholding tax (under domestic law or the country's tax treaties)
 - Different rates and exemptions also create opportunities for tax arbitrage

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Withholding taxes on rent and royalties

- Withholding tax on payments of rent and royalties may also cover payments that are not deductible by the resident payers (e.g. individuals who pay rent or royalties to non-residents for the personal use of property)
 - Some non-resident enterprises may derive substantial revenue from rents and royalties paid by resident individual consumers
 - **But** difficult to effectively enforce withholding obligations on individuals, especially with respect to small amounts
- Withholding tax should also apply to payments of rent or royalties by non-residents if those payments are deductible in computing the non-residents' profits subject to tax by a country (e.g. non-resident has a PE)
- Failure to withhold tax may trigger denial of deduction in addition to other penalties

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Rent and royalty expenses incurred by residents to earn exempt or preferentially taxed income

- The design of legislation to deny or limit the deduction of rent and royalties incurred to earn income that is exempt or subject to low tax is relatively simple:
 - Deduction of rent and royalties to earn exempt income should be disallowed
 - If income is subject to tax at a preferential rate, the deduction of any rent or royalties to earn such income should be limited proportionately. (e.g. if only 50 per cent of the income is subject to tax, only 50 per cent of the rent/royalties should be deductible)
 - If the income is deferred, the deduction of any rent or royalties should also be deferred
 - Similar considerations apply with respect to residents earning rent and royalties from foreign sources

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Research and development costs

- Two major legislative responses may be used to counter the risk of base erosion where generous deductions are given for the costs of R&D but the resulting intellectual property is transferred to a non-resident
 - Rules that impose tax on the gain on any transfer of intellectual property to a non-resident if the R&D costs of the property have been deducted against the country's tax base
 - Rules to recapture any prior deductions for the costs of R&D of intellectual property if the property is transferred to a non-resident

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Research and development costs

- Taxing gains realized on the transfer of intellectual property transferred to non-residents:
 - Should any gain on the transfer of intellectual property be entitled to any preferential treatment generally applicable to capital gains?
 - General statutory provision taxing gains realized on the transfer of intellectual property to non-residents may apply to all transfers of property or be more narrowly targeted

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Research and development costs

- Taxing gains realized on the transfer of intellectual property transferred to non-residents:
 - Transfers to non-arm's length non-residents require deeming transfer at fair market value of the property at the time of the transfer **but** difficult for the tax authorities to determine the fair market value of intellectual property accurately
 - Should relief be allowed or restricted in the case of a loss on a transfer of intellectual property to a non-resident?

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Research and development costs

- Recapture of prior deductions for the costs of R&D of intellectual property require
 - Rules to determine the costs that are recaptured and the transfers of intellectual property covered
 - Rules to allocate the relevant costs to any transferred property
 - Rules to determine how the amount recaptured should be characterized for tax purposes
 - Determining whether some relief should be allowed to alleviate the impact of the inclusion of the recapture
 - Balancing the compliance burden on taxpayers and the administrative burden on the tax authorities against the need to protect the tax base

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Sample withholding tax provision

- The following are the portfolio's sample legislative provisions dealing with withholding taxes on rent and royalties paid to non-residents
- These provisions deal only with situations in which the risks of base erosion are considered to be most serious
- The portfolio also includes explanatory notes on these sample provisions
- ***These sample provisions are not intended to be included in any country's domestic law as drafted below; they are provided for guidance only***

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Sample withholding tax provision

1. Any person not resident in Country X shall pay tax of ___ per cent of the following amounts that a person resident in Country X pays or credits, or is deemed by the provisions of this Act to pay or credit, to the non-resident person as, on account of, or in lieu of:

- (a) Any payment [any rent, royalty or other similar payment] for the use of or the right to use any immovable property located in Country X;
- (b) Any payment for the use of or the right to use in Country X any property, including any industrial, commercial or scientific equipment, (other than immovable property located in Country X), any copyright, or related right, patent, trademark, design or model, plan, secret formula or process, or any other similar property or right;

...

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Sample withholding tax provision

...

- (c) Any payment for the use of or the right to use any information concerning industrial, commercial or scientific experience;
- (d) Any payment for an agreement by the non-resident person not to use or to allow any other person to use property described in subparagraph (a) or (b) or information described in subparagraph (c);

...

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Sample withholding tax provision

...

- (e) Any payment that is dependent on the use of or the production from property;
- (f) Any payment for the use of or the right to use in Country X any motion picture film, or any film, video tape, or other means of reproduction for the purpose of a television broadcast; and
- (g) Any payment for the use of or the right to use in Country X any tape or other means of reproduction for the purpose of radio broadcasting.

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Sample withholding tax provision

2. For the purposes of this paragraph,

- (a) "Immovable property" includes property accessory to immovable property, livestock and equipment used in agriculture and forestry, usufruct of immovable property, rights to cut timber, rights to variable or fixed payments for the working of or the right to work mineral deposits, sources and other natural resources, and shares or interests in the capital stock of any corporation, partnership, trust or other entity, which entitles the owner of the shares or interests to the use of immovable property, but does not include ships, boats or aircraft;
- (b) "Industrial, commercial or scientific equipment" includes...

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Sample withholding tax provision

3. A person resident in Country X that pays any amount described in paragraph 1 to a non-resident person shall withhold tax on behalf of such non-resident person at the rate of ___ per cent of the gross amount paid and remit that amount to _____ within ___ days of the end of the month in which the amount is paid.
4. If a person resident in Country X fails to withhold tax as required by paragraph 2 on an amount paid to a non-resident person, that person shall be liable, together with that non-resident person, for the tax payable by the non-resident person under paragraph 1.
5. If a person resident in Country X fails to withhold tax as required by paragraph 2, that person shall not be entitled to deduct the amount paid to the non-resident person in computing the person's income subject to tax under this Act.

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Sample withholding tax provision

6. For the purposes of paragraph 1, if a person who is not resident in Country X (referred to in this section as the "first person") pays or credits an amount to another person who is not resident in Country X, the first person is deemed to be a person resident in Country X to the extent that the amount paid or credited is deductible in computing the first person's income subject to tax under this Act.
7. For the purposes of paragraph 1, if a partnership in which a person resident in Country X is a partner pays or credits an amount to a person who is not resident in Country X, the partnership shall be deemed to be a person resident in Country X.
8. For purposes of paragraph 1, if a partnership in which a non-resident person is a partner receives an amount described in paragraph 1 that is paid or credited by a person resident in Country X, the partnership shall be deemed to be a person who is not resident in Country X.

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Sample withholding tax provision

9. Paragraph 1 does not apply to any payment in respect of:
 - (a) Any copyright of a literary, dramatic, musical or artistic work;
 - (b) Any payment to a non-resident person where the payment is deductible in computing the profits of the payer from a business carried on by the payer [through a PE or fixed base] outside Country X;
 - (c) Any payment for computer software that gives the payer the right to copy or download the software for the payer's use, but does not give the payer the right to copy the software for any other purpose; or
 - (d) Any payment for services subject to tax under paragraph ___.

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Administrative aspects: checklist related to the deductibility of rent and royalties

1. Restrictions on deductions for rent or royalties:
 - If the country has rules that deny or limit the deduction of rent or royalties, verify that the rules have been applied properly
2. Related-party transactions:
 - Verify that any payments of rent or royalties by residents to related non-residents are not more or less than the arm's length amount
 - Apply the country's transfer pricing rules
3. Withholding taxes on payments of rent or royalties:
 - Verify that tax on any rent or royalties paid to non-residents has been withheld by the withholding agents properly (see section 3.5 below)

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Administrative aspects: checklist related to the deductibility of rent and royalties

4. If income from rent and royalties from foreign sources is taxable:

- Verify the amount of foreign source income earned in each foreign country from a resident's tax return, supporting books and records and foreign tax return
- If the country uses a per country limitation on the foreign tax credit, verify the amount of foreign tax paid to each foreign country on the income earned in that country from its foreign tax return
- If the country uses an overall limitation on the foreign tax credit, verify the total amount of foreign source income from a resident's tax return, supporting books and records and foreign tax returns
- Verify that the limitation on the foreign tax credit is properly computed (rent and royalty expenses should be allocated to foreign source income properly)

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Administrative aspects: checklist related to the deductibility of rent and royalties

5. If income from rent and royalties from foreign sources is exempt:

- Verify the amount of foreign income qualifying for exemption from a resident's tax return, supporting schedules and foreign tax returns (if the foreign income is taken into account to determine a resident's tax rate, verify that the rate is calculated properly)
- Verify that any rent or royalty expenses allocated to exempt foreign income are not deductible against the country's tax base (assuming, of course, that expenses incurred to earn exempt income are not deductible under the country's domestic law)

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Administrative aspects: checklist related to the taxation of rent and royalties

1. If non-residents are subject to tax on rent or royalties on a net basis (e.g. PE situations):

- Identify the non-resident recipients of rent or royalties paid by a non-resident (if payments of rent or royalties to non-residents are subject to provisional withholding, verify that payers are withholding properly on the basis of withholding information returns, payers' tax returns and other information)
- Determine whether any threshold is met (PE, fixed base, presence for a minimum number of days, or other domestic threshold)
- Verify that non-residents are not improperly avoiding any threshold requirement
- Verify the amount of income subject to tax from tax returns, supporting books and records and third-party information returns
- If any restrictions on the deduction of rent or royalties apply to non-residents, ensure that the restrictions are applied properly

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Administrative aspects: checklist related to the taxation of rent and royalties

2. If non-residents are subject to tax on rent or royalties on a withholding basis:

- Verify that payers (residents and non-residents with a PE or fixed base in the country) are withholding tax properly on the basis of withholding information returns, payers' tax returns, books and records and other information
- Cross-check against the deduction of rent and royalties paid to non-residents by residents and non-residents with a PE or fixed base in the country

3. Payments of rent or royalties to related non-residents:

- Verify that any payments of rent or royalties by residents to related non-residents are equal to the arm's length amount (apply transfer pricing rules and any similar rules applicable to payments by or to individuals)

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Thank you

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