Negotiation of tax treaties to prevent base erosion with respect to rent and royalties (I)

Wednesday, 8 November 2017
(Session 3)

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

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

Overview

- Introduction
- Preserving domestic law restrictions on the deduction of rent or royalties paid to non-residents
- Preserving domestic law restrictions on the deduction of rent or royalties by non-residents carrying on business in the country through a PE
- Elimination of double taxation issues
- Rent and royalties paid to a PE in a third State

Introduction

- States that want to combat base erosion by non-residents through payments of rent and royalties should ensure that their treaties allow them to restrict the deduction, and tax, these payments ***in certain circumstances***
- Possible to include safeguards in treaties but difficult to reach agreement on provisions that are not in OECD/UN models
- BEPS treaty-changes will deal with some abuses (especially treaty shopping)
- Also, need to ensure that taxing rights secured through tax treaties are enforceable under domestic law

Preserving domestic law restrictions on the deduction of rent or royalties

- Whether or not an expense is deductible is a matter of domestic law
- Tax treaties do not generally deal with the deduction of amounts of rent or royalties paid by residents to non-residents ***but***
  - Art. 24(4) requires a country to allow the deduction of rent or royalties paid by its resident enterprises to residents of the other contracting State under the same conditions that would apply if the payments were made to its own residents
  - Art. 24(5) prevents a country from imposing taxes on its resident enterprises owned or controlled by residents of the other contracting State that are different from or more burdensome than the taxes imposed on similar resident enterprises

Preserving domestic law restrictions on the deduction of rent or royalties

- Art. 24(4) and 24(5) may prevent the application of certain domestic restrictions on the deduction of payments of rent and royalties (e.g. if royalties paid to non-residents are not deductible to the extent that they exceed 30% of gross profits ⟹ violation of Art. 24(4))
- Art. 24(4) and 24(5) do not prevent the application of a country's transfer pricing rules to adjust the amount of rent or royalties charged between associated enterprises
- In addition, Art. 24 (4) and (5) do not prevent a country from taxing any excessive royalty payments resulting from a special relationship between the payer and the beneficial owner of the royalty payments as provided in Art. 12(6)

5

Preserving domestic law restrictions on the deduction of rent or royalties

- A State that has domestic law restrictions that would otherwise violate Art. 24(4) or Art. 24(5) could attempt to negotiate exceptions to these provisions or try to exclude these provisions from its treaties ***but*** it is often difficult to reach agreement on such departures

6

Preserving domestic law restrictions on the deduction of rent or royalties by PEs

- Under Art. 7(3), in determining the profits of the PE, the State of source must allow the deduction of expenses incurred for a PE in determining the profits of the PE (same rule for fixed base)
- Art. 7(3) does not mean that all rent and royalties incurred for the purposes of a PE or fixed base must be deductible for the purposes of computing ***taxable income***
- Under Art. 24(3), however, PE must be allowed the same deductions as those allowed to a local company carrying on similar activities (no equivalent for fixed base)
- Also, Art. 24(4) prevents restrictions on the deduction of rent/royalties that would apply only to payments to non-residents

7

Preserving domestic law restrictions on the deduction of rent or royalties by PEs

Possible approaches if a country wants to preserve domestic restrictions as regards PEs

- Not agreeing to include Article 24(3) in its treaties
- Including a most-favoured-nation (MFN) version of Art. 24(3), so that PEs of residents of the other State would be treated no less favourably than the PEs of residents of any other third State:

  (3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of a third State carrying on the same activities … .

8

Preserving domestic law restrictions on the deduction of rent or royalties by PEs

Possible approaches if a country wants to preserve domestic restrictions as regards PEs

- Including a specific exception in Art. 24(3) for any restrictions on the deduction of rent and royalties by non-residents under the country's domestic law:

  (3.1) Notwithstanding paragraph (3), a Contracting State shall be entitled to apply any provision of the taxation laws of that State relating to the deductibility of rent or royalties and which is in force on the date of signature of the Convention or which is adopted after that date as long as such subsequent provision does not change the general nature of the provision in effect at the date of signature of the Convention.

Elimination of double taxation issues

- Tax treaty between State R and State S does not authorize State S to tax royalties paid by a resident of State S but borne by a PE in State R: in that case the royalties are sourced in State R under Art. 12(5): no relief of double taxation needed
- Tax treaty between State R and State E (a State where a resident of State R has a PE) authorizes State E to tax rent and royalties (other than from immovable property situated in State R) arising in State R in that case:
  - State R should give relief for the tax levied in State E but
  - State E should give relief for the State R tax based on Art. 24(3) if its domestic law would grant a credit for the State R tax if the PE were a resident company

Elimination of double taxation issues

- Tax treaty between State R and State S applies to restrict State S right to tax rent/royalties attributable to PE of an enterprise of State S situated in State C
- In that case, risks of reduced or non-taxation resulting from the exemption method raise concerns for both
  - The State of residence, which may not want to exempt income that the other State does not tax, or taxes at a low rate, under its domestic law or under its interpretation of the facts or of the treaty
  - The State of source, which may not want to reduce its tax with respect to income that the State of residence must exempt under the provisions of the treaty

Addressing the concerns of the State of residence

- Art. 23A(4) is a general "switch-over" clause intended to deal with such cases of non-taxation or low taxation from the perspective of the State of residence:

  The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

- The reference to "paragraph 2 of Article 10 or 11" should be extended to all treaty provisions that limit the source State tax, such as paragraph 2 of Articles 12 and 12A UN Model

Addressing the concerns of the State of source

- The Commentary of the OECD and UN models refers to potential abuses that may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to the income from such assets
- Where the State of residence exempts profits of such a permanent establishment situated in a third State, the State of source should be concerned about having to grant treaty benefits with respect to the income derived from its territory and attributable to that permanent establishment

13

Provision on rent and royalties paid to a PE in a third State

- As a result of the work on BEPS Action 6, a new anti-abuse rule provision has been included in the OECD and UN models in order to protect the State of source from having to grant treaty benefits where income obtained by a permanent establishment situated in a third State is exempt by the State of residence
- That provision is Art. 29(8)
- An alternative provision included in the Commentary goes further

14

New Art. 29(8)

8. a) Where

(i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and

(ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State,

the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

15

New Art. 29(8)

b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).

16

New Art. 29(8)

c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

Alternative included in the Commentary

Where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned Contracting State treats that income as profits attributable to a permanent establishment situated in a third jurisdiction, the benefits of this Convention shall not apply to that income if that income is subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the jurisdiction in which the permanent establishment is situated that is less than the lesser of [*rate to be determined bilaterally*] or 60 per cent of the general statutory rate of company tax applicable in the first-mentioned Contracting State. …

Alternative included in the Commentary

…If benefits under this Convention are denied pursuant to the preceding sentence with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

Thank you

TaxffdCapDev@un.org

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