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

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Overview

- Withholding tax on rent for immovable property
- Withholding tax on royalties
  - The definition of royalties
  - The treatment of payments for the use of equipment
  - Rate of tax allowed by treaty
- Administrative aspects

Withholding tax on rent for immovable property

- Under almost all treaties, rent for immovable property are taxable without any restriction by the State in which the immovable property is located
- Most countries provide for a withholding tax on gross payments of rent and payments of resource royalties to non-residents
- Domestic law provisions may, however, provide for a deduction of expenses in the case of some types of immovable property

Withholding tax on rent for immovable property

- Also, a few treaties include an elective provision for net taxation, e.g. United States 2006 Model:

  "A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election."

Withholding tax on rent for immovable property

- Such domestic law and treaty provisions that allow the deduction of expenses might raise some base erosion concerns, e.g.
  - mortgage interest that would be paid abroad would be deductible but would not be sourced in the State where the immovable property is located (unless Art. 11(5) is made applicable to such interest)
  - branch tax that might be applicable to PE profits (if allowed by the treaty) would not seem to be applicable to such net immovable property income
- Base erosion concerns may also arise in the case of REITs domestic tax regimes that treat REIT distributions as dividends for treaty purposes

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Withholding tax on rent for immovable property

- Although the second sentence of Art. 7(3) refers to royalties and interest but not to rent for immovable property, no deduction in the form a "notional rent" for immovable property should be allowed in computing the business profits of a PE since such "notional rent" would not be income from immovable property under Art. 6 and would therefore not be taxable

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Example

- PCo is a company resident of State R that owns a building situated in State S
- From 2010 to 2015, the building was rented by SCo, a company resident of State S that was a subsidiary of PCo. SCo used the building as a manufacturing plant
- During these years, an arm's length rent was paid by SCo to PCo
- In 2016, SCo is liquidated and PCo starts operating the the manufacturing plant directly. The plant constitutes a PE of PCo
- PCo claims that under Art. 7(2), the PE should be allowed to deduct the same amount of rent that was previously paid by SCo

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Withholding tax on royalties

- Most treaties concluded by developing countries provide for the source taxation of royalties
- Since royalties constitute base-eroding payments, withholding taxes on such payments are generally considered necessary
- However, withholding taxes on royalty payments made to unrelated parties are typically added to the amount payable; in such cases, the cost of the withholding tax is borne by the local enterprises and may make foreign technology/intellectual property more expensive
- This issue may be less of a concern with respect to payments for the right to use trade marks and trade names (often made as part of franchise agreements) and for rent for ICS equipment

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Withholding tax on royalties

- Para 21 of the Commentary on Art. 12 UN Model:
  "… some members pointed out that there are artificial devices entered into by persons to take advantage of the provisions of Article 12 through, inter alia, creation or assignment of agreements for the use, right or information with respect to intangible assets for which royalties are charged. While substance over form rules, abuse of rights principles or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties … [*limited PPT rule*]"
- See also para 8.2 of the OECD Commentary dealing with transfers of ownership of certain rights

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The definition of royalties

UN Model definition:

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.

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The definition of royalties

- As previously discussed, the application of the definition raises a number of issues
  - Distinction with payments for the acquisition of property, such as software and time-limited or geographically-limited rights
  - Distinction with payments for services
- Should the definition be amended and if yes, how?

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The treatment of payments for the use of equipment

"Payments … as a consideration … for the use of, or the right to use, industrial, commercial or scientific equipment"

- In the UN Model but not in the OECD Model
- New clarification (Commentary on 2017 UN Model)

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New UN Commentary on payments for the use of ICS equipment

- "Equipment" is not defined so domestic law meaning under Art. 3(2) but

  "A feature that is always present is that the equipment will be used in the performance of a task. It is a tool used by a business in the sense that it is not enjoyed for its own sake. Thus, for example, a car rented by a tourist will not be considered to be 'equipment'. Neither can equipment include intellectual property, immovable property covered by Article 6, or property covered by Article 8. Industrial, commercial or scientific equipment is clearly a subset of equipment and may, outside of a consumer context, include (not an exhaustive list) ships, aircraft, cars and other vehicles, cranes, containers, satellites, pipelines and cables etc."

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New UN Commentary on payments for the use of ICS equipment

- Need to distinguish between payments for the sale of equipment
- Financial leases: "…the instalments paid by the purchaser / hirer do not, in principle, constitute royalties" [*Commentary includes a number of factors that would indicate a finance lease rather than an operating lease*]
- Satellite payments: some members view them as payments for services; others consider that it could be payments made for the leasing of ICS equipment

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Rate of tax allowed by treaty

- Rate of source tax on royalties allowed by treaties vary considerably; 10%-15% seem to be the rates most frequently used nowadays
- Some treaties have different rates for different types of royalties
- Some treaties exempt copyright royalties from source taxation in order to promote cultural exchanges; important to ensure that these exceptions are fairly narrow

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Administrative issues related to treaty provisions for taxing rent/royalties

1. Need to identify a non-resident who derives rent or royalties from the State of source
2. Is the non-resident entitled to a reduction/exemption under a tax treaty and, if so, how are the provisions of the treaty applied by the tax authorities of the source country?
3. Is the non-resident carrying on business in the State of source through a PE or fixed base entitled to deduct any rent or royalty expenses?
4. Are residents of a country entitled, under the provisions of a tax treaty, to deduct rent or royalties paid to residents of the other contracting State?

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Is the non-resident entitled to a reduction/exemption under a tax treaty?

- Identification of the State of residence of the recipient:
  - Application of Art. 4
  - Certificates of residence: practical issues
  - Other administrative approaches
  - Dual residence issues
- Denial of benefits in treaty shopping situations
  - LOB and GAAR provisions
- Identification of the applicable provisions of the relevant tax treaty

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Identification of the applicable provisions of the relevant tax treaty

- Does the right to the payment constitute immovable property? ⇨ Art. 6
- Does the non-resident carry on business in the country through a PE (or fixed base) to which the underlying property is effectively connected with the PE so that the royalties are attributable to the PE/fixed base? ⇨ Art. 7 or 14
- Is the payment covered by Art. 8?
- Does the payment constitute a royalty covered by Art. 12? Is the recipient the beneficial owner?

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Application of Art. 7 or 14

- Is the non-resident a resident of the other State entitled to treaty benefits?
- Is there a PE or fixed base in the State of source?
  - Does domestic law require registration of PEs?
  - Does the domestic law require the filing of tax return for the PE profits?
- Are the royalties derived by the non-resident attributable to the PE /fixed base in the State of source?
- What are the domestic rules for the computation of the profits of a non-resident who operates a business in the State of source?
- To what extent are these rules modified by the treaty?

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Application of Art. 12

- Is the non-resident a resident of the other State entitled to treaty benefits?
- Are the royalties paid by a resident of the State of source or a non-resident with a PE or fixed base in the State of source country?
- Is the non-resident the beneficial owner of the royalties? (particularly important to consider whether there are back-to-back arrangements that should be disregarded)
- Does the non-resident carry on business through a PE or fixed base in the source country and are the royalties attributable to the PE or fixed base?
- Are the royalties paid excessive because of a special relationship between the payer and the payee?

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Deduction of expenses in the form of rent and royalties

- Application of Art. 7, Art. 9 and Art. 24 in the case of deductions of rent and royalties by resident enterprises and domestic PEs

Thank you

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