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Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties

Note by the Secretariat

1. In its resolution 2017/2, the Economic and Social Council recognized the progress made by the Financing for Sustainable Development Office of the Department of Economic and Social Affairs of the Secretariat in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in that area and to further develop its activities, including relevant practical tools.

2. One of the areas of focus of the above-mentioned programme is on strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. The main tools developed in this area are: (a) the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*; and (b) a series of practical portfolios on protecting the tax base of developing countries.

* E/C.18/2018/8.

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3. The practical portfolios aim to complement and operationalize the guidelines contained in the handbook through more in-depth and hands-on practical guidance tailored to developing countries for dealing with various aspects of tax base erosion. To date, three practical portfolios have been completed and are available in digital format on the website of the Financing for Sustainable Development Office.[1]

4. The paper contained in the annex to the present note is a summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties, which focuses on the tax treatment of rent and royalties under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit shifting.

5. The practical portfolio on rent and royalties is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties dealing with rent and royalties in order to identify the major risks of base erosion and the countermeasures that these countries can take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuses with respect to cross-border payments of rent and royalties between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the practical portfolios because the topic is covered in the United Nations Practical Manual on Transfer Pricing for Developing Countries. Instead, the practical portfolio on rent and royalties presents a comprehensive identification of the risks of base erosion with respect to the deduction and taxation of rent and royalty payments and the possible countermeasures to those risks in recognition of the widely varying experiences of developing countries and in order to provide tax officials from developing countries with as much information as possible. In the summary contained in the annex, however, only the most important risks of base erosion with respect to rent and royalties are dealt with.

7. Neither the practical portfolio on rent and royalties nor the summary contained in the annex deals with the domestic laws or tax treaties of particular countries. Instead, they deal with the basic patterns of taxation with respect to rent and royalties that are commonly found in the domestic laws and tax treaties of developing countries. Thus, tax officials from developing countries should adapt the materials to their particular situation.

8. The practical portfolio on rent and royalties contains four parts. Part 1 consists of a general introduction. Part 2 provides an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the deduction and taxation of rent and royalties, the risks of base erosion with respect to such payments and the possible countermeasures. Part 3 provides guidance for tax officials from developing countries in designing and drafting domestic legislation and in negotiating tax treaties to counter base erosion. Part 4 provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with rent and royalties.

9. The practical portfolio on rent and royalties is available only in English. The summary contained in the annex to this note is intended to provide access to the basic contents of the portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the portfolio, and readers are encouraged to consult the full portfolio for more detailed information.

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[1] United Nations, Department of Economic and Social Affairs, *Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services* (New York, 2017), *Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses* (New York, 2017) and *Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties* (New York, 2017), available from www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html.

Annex

Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties*

A. Major risks of base erosion with respect to rent and royalties under domestic law

Introduction

1. Although all deductible payments of rent and royalties erode a country's tax base, most payments of rent and royalties for the use of tangible and intangible property are legitimate costs of earning income. However, developing countries may have serious concerns about the inappropriate erosion of their tax base where:

(a) Deductible payments of rent or royalties are made to a related person in excess of the amount that would have been paid if the parties were dealing at arm's length;

(b) Residents of a country, or non-residents who are taxable on a net basis in that country, make deductible payments of rent and royalties to non-residents and those non-residents are not subject to tax by that country on such payments or are subject to tax at a reduced rate;

(c) Residents of a country derive rent and royalties from foreign sources that are not subject to tax by that country or are subject to a preferential rate of tax;

(d) Residents of a country incur deductible rent and royalty expenses to earn foreign-source income that is exempt or subject to a preferential rate of tax by that country;

(e) Residents are allowed to claim generous research and development deductions and then transfer the intellectual property that is created to a related non-resident.

2. The risks of base erosion with respect to rent and royalties are significantly more serious for developing countries where deductible rent or royalties are paid to a non-resident, since developing countries are typically importers of technology and equipment. Accordingly, this summary focuses primarily on rent and royalties paid to non-residents and only briefly discusses the risks of base erosion with respect to residents of a developing country.

Basic concepts

3. In this summary, the term "rent" is used to describe payments for the use, including temporary and non-exclusive use, of tangible property under a legal transaction usually referred to as a "lease"; the term "royalties" is used to describe payments for the use of intangible property under a transaction usually referred to as a "licence." However, in the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention), the term "royalties" is used to include both rent for the use of certain equipment and royalties for the use of intangible property.

* The summary has been prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada. The full text of the practical portfolio is available at www.un.org/esa/ffd/wp-content/uploads/2017/05/PP_Rents-Royalties.pdf.

4. Rent and royalties are payments for the use or the right to use property; they are fundamentally different from payments for the transfer of the ownership of property (sales) and payments in consideration for services, although it may be difficult to distinguish between them in some circumstances (for example, in so-called mixed contracts under which one person sells, leases or licenses property to another person and also provides services to that person). For domestic tax purposes, the distinction between the various types of payments is made in accordance with each country's domestic law and these laws may differ significantly. In the context of the United Nations Model Convention and the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital (OECD Model Convention), however, the treaty characterization of these payments is made in accordance with the relevant treaty definitions and the substance of these payments regardless of the domestic law. Developing countries can minimize the tax avoidance opportunities arising from the distinction between rent, royalties and fees for services by treating such payments similarly for domestic tax purposes.

5. Depending on the facts, rent and royalties may be characterized as either passive investment income or active business income under a country's domestic law. In contrast, under the United Nations Model Convention, the tax treatment of rent and royalties depends on whether a resident of one contracting state carries on business in the other State through a permanent establishment or fixed base in that State; otherwise, rent and royalties received by a non-resident will usually be subject to a withholding tax.

6. In general, rent and royalties are paid with respect to three basic types of property:

(a) Immovable property, which generally includes land, buildings and other structures affixed to land, and may also include standing timber and other natural resources;

(b) Movable property, which includes machinery and equipment and other tangible property;

(c) Intangible property, which includes patents, trademarks, copyright and know-how, and may even include technical assistance and services in some cases.

7. It is often necessary for taxpayers and developing countries to allocate rent or royalties to income-earning activities, non-income-earning activities and domestic or foreign sources. This allocation can be done on the basis of tracing or apportionment. Tracing involves determining, on the basis of the facts and circumstances, the income or activities to which specific payments of rent or royalties are connected. Apportionment involves allocating rent or royalties expenses to income by reference to the cost or value of assets, gross revenue, turnover or some other factor. Most countries use both tracing and apportionment because, although tracing is easier, it is impossible to apply in certain circumstances.

8. Payments for the use or exploitation of natural resources are often referred to as royalties; however, such payments are similar to user fees and are not usually treated as royalties for tax purposes.

Taxation of residents

9. The risks of base erosion from base-eroding payments of rent and royalties are less serious with respect to residents of a developing country than non-residents. The major risks of base erosion with respect to residents are:

(a) The developing country does not tax rent and royalties derived from foreign countries, either because it does not tax foreign-source income generally (so-called “territorial taxation”) or it does not tax certain foreign-source rent or royalties. In this situation, the country’s rules for determining the source of rent and royalties (typically the place of use of the property or the residence of the payer) may be manipulated by taxpayers to avoid tax;

(b) Where a developing country does not tax foreign-source income, any deductible rent or royalty expenses incurred by a resident to earn that exempt income will erode the country’s tax base;

(c) Where a developing country taxes foreign-source income earned by residents (so-called “worldwide” taxation), it has an obligation to provide relief from double taxation by granting a credit against that country’s tax for the foreign tax on the foreign-source income. The foreign tax credit should be limited to the developing country’s own tax on the foreign-source income. Any rent and royalties incurred by a resident to earn that income should be allocated to that income for purposes of calculating this limitation on the foreign tax credit; otherwise, the foreign tax credit will be overstated and reduce the developing country’s tax on its domestic income;

(d) Where developing countries provide generous tax incentives for research and development or preferential taxation of income derived from certain intellectual property in order to encourage research and development activities in the country (so-called “patent box” regimes), these tax incentives will reduce the country’s tax base and may be subject to abuse;

(e) Where a resident of a developing country transfers property that produces rent or royalties to a related non-resident (a controlled foreign corporation, group company or even a permanent establishment — assuming that the country exempts income attributable to a foreign permanent establishment), the country will no longer be able to tax any rent or royalty income generated by that property. Even if the country taxes any gain realized on the transfer of the property, the price for the property may be set at an artificially low amount to reduce the amount of the gain.

Taxation of non-residents earning income that is taxable on a net basis

10. Some developing countries impose tax on the net income derived by non-residents from their countries. Typically, such net basis taxation is applicable only where the non-resident’s activities in a developing country are substantial — for example, a business is carried on through a permanent establishment or fixed base or the non-resident is present in the developing country for a significant period of time. Some developing countries may also tax non-residents owning immovable property in their countries on a net basis. In these circumstances, non-residents are entitled to deduct expenses, including rent and royalties, incurred to earn the income subject to tax by the developing country.

11. The deduction of rent and royalties by non-residents in these circumstances may result in base erosion where an excessive amount of rent or royalties incurred by a non-resident is allocated to the income earned in the developing country and deducted in computing the non-resident’s income subject to tax. For this purpose, the rent and royalties incurred by the non-resident must be allocated between the non-resident’s income-earning activities in the source country and its activities outside the source country; however, it is difficult for the tax authorities to determine the proper share of a non-resident’s rent or royalties attributable to the income earned in the source country, especially with respect to intangible property. Similar issues arise in connection with the computation of profits attributable to a permanent establishment or fixed base under article 7 of the United Nations Model Convention.

Taxation of non-residents receiving rent and royalties — withholding tax

12. Where a resident of a developing country or a non-resident taxable on a net basis in a developing country pays rent or royalties to a non-resident, the payments will usually be deductible against the developing country's tax base. Although all deductions of rent and royalties erode a developing country's tax base, it would be inappropriate for the country to deny those deductions where the rent and royalties are legitimate expenses incurred to earn income. However, if the deductible payments of rent or royalties to non-residents are not subject to tax by the developing country, the risk of base erosion is more serious. Typically, developing countries impose withholding tax on rent and royalties paid to non-residents. Even where withholding tax is imposed on rent and royalties, risks of base erosion occur where:

(a) The tax saving from the deduction of the rent or royalties is greater than the withholding tax. For example, if a developing country has a corporate tax rate of 30 percent but imposes withholding tax on rent and royalties at a rate of only 20 per cent, the country's tax base will be eroded by 10 per cent of the amount of the rent or royalties paid. Establishing the rate of withholding tax on rent and royalties is a difficult balancing act between protecting a developing country's tax base and not discouraging non-residents from leasing and licensing property to residents of the developing country;

(b) Certain rent or royalties are exempt or subject to reduced rates of withholding tax;

(c) Rent or royalties for the use of various types of property are subject to different rates of withholding tax;

(d) The amount of rent or royalties received by a non-resident from a related party is more or less than the amount that would have been paid if they had been dealing at arm's length;

(e) The rent and royalty payments may not be related to the effective use of a right or asset. Where the payments are not incurred for the purpose of earning income or do not produce any benefit for the payer, the deduction of those payments erodes a country's tax base.

13. Where rent is paid to a non-resident for the use of immovable property located in a developing country, it is relatively easy for the country in which the property is located to impose withholding tax on the rent even where the rent is paid by a non-resident (for example, where that non-resident payer carries on business in that immovable property). However, where rent or royalties are paid to a non-resident for the use of movable or intangible property, it may be more difficult for developing countries to determine whether to impose withholding tax on those payments. For example, where a resident of a developing country pays rent or royalties for the use of property outside the developing country, it may be difficult or inappropriate to impose withholding tax on such payments. A rule that combines the place where the property or right is used and the country of residence of the payer may be the most efficient rule.

14. Developing countries could impose withholding tax on all payments of rent or royalties by residents or non-residents with a permanent establishment or fixed base in the country (or non-residents using property within the country if the place of use source rule is used) for the use of movable or intangible property; such a broad tax, however, would be difficult to enforce, especially where payments are made by individuals. Accordingly, an alternative would be to impose withholding tax only if the payments are deductible in computing income subject to tax by the developing

country; under this alternative, non-deductible payments of rent or royalties would not be subject to tax.

B. Major risks of base erosion with respect to rent and royalties under tax treaties

Introduction

15. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to rent and royalty expenses because tax treaties limit the taxes imposed by one contracting State on residents of the other contracting State. For any particular developing country, the extent to which its tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

16. In general, tax treaties are based on either the United Nations Model Convention or the OECD Model Convention. Many developing countries negotiate the provisions of their tax treaties on the basis of the United Nations Model Convention because it provides greater taxing rights for source countries.

17. Tax treaties do not generally impose tax; tax is imposed pursuant to a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, it is irrelevant whether the country has the right to tax the amount under the provisions of an applicable tax treaty.

Restrictions on the taxation of residents under tax treaties

18. Although tax treaties do not generally limit the power of a country to tax its own residents, a principle which is now expressly stated in article 1(3) of the United Nations and OECD model conventions, there are a few exceptions to this general principle that are relevant with respect to rent and royalties.

19. First, under article 23 of both model conventions, the residence country is under an obligation to provide relief from double taxation with respect to an item of income that is taxable by the source country in accordance with the provisions of the treaty. This obligation must be met by exempting that income from residence country tax or by granting a credit against the residence country's tax for the foreign tax paid on that income. As explained above, in principle, any rent or royalty expenses incurred by a resident of a country to earn foreign-source income that is exempt from residence country tax would not be deductible; also, where foreign-source income is taxable by the residence country, any such expenses incurred to earn that income would be deductible but would be allocated to that income for purposes of computing the limitation on the foreign tax credit.

20. Second, article 24(4) of both model conventions requires a contracting State to allow the deduction of rent and royalties (and other payments) paid by an enterprise of that State to a resident of the other contracting State under the same conditions as if the amounts had been paid to a resident of the first State. This provision does not apply to excessive payments of royalties under article 9 or article 12(6). For example, article 24(4) would prevent a country from denying the deduction of rent or royalties paid by a resident to a non-resident where a deduction would be allowed for a similar payment made to a resident.

21. Third, under article 24(5) of both model conventions, resident enterprises of one State owned or controlled by residents of the other State must not be subjected to taxation or any connected requirement that is different from or more burdensome than

the treatment of similar resident enterprises. For example, article 24(5) would prohibit the application of rules for the deduction of rent or royalties by a resident company owned or controlled by non-residents that are less favourable than the rules for the deduction of similar payments of rents or royalties made by other resident companies owned by residents.

Restrictions on the taxation of non-residents under tax treaties

22. There are two major questions with respect to the treatment of rent and royalties paid or received by non-residents under tax treaties. First, do tax treaties restrict a country's authority to impose withholding tax on rent and royalty payments made to residents of the other contracting State under its domestic law? Second, do tax treaties require a country to allow the deduction of rent and royalties by residents of the other contracting State in circumstances where no deduction would be allowed under domestic law?

23. If non-residents derive rent and royalty payments from a country, the provisions of article 6, 7, 8, 12 or 21 of the model conventions may apply. If a non-resident has a permanent establishment in the country and the underlying property in respect of which the rent or royalties are paid is effectively connected with the activity of that permanent establishment, ordinarily, the non-resident is taxable by the country in which the permanent establishment is located on a net basis under article 7, which contains provisions dealing with the deduction of rent and royalties (and other expenses) incurred in earning income. Otherwise, the gross amount of rent and royalties received by a non-resident is subject to withholding tax (at a rate limited by article 12 in the case of payments taxable under that article).

Withholding tax on rent and royalties

24. Article 6 of both model conventions permits developing countries to tax income from a letting (lease) of immovable property located in that country derived by a resident of the other country without any limitations. Thus, developing countries can tax rent for the use of immovable property on a net or gross basis at any rate. Where a developing country allows the deduction of expenses in computing a non-resident's income from immovable property located in the country, it should ensure that the deductions are legitimate and, in the case of non-arm's length payments, are not in excess of the arm's-length amount. If a gross-based withholding tax is imposed on rent for the use of immovable property, the rate could be established so that the tax is a reasonable proxy for a tax on net income.

25. Article 6(2) defines the term "immovable property" by reference to its meaning under the domestic law of the country in which the property is located and also includes livestock, equipment used in agriculture and forestry and licenses for the right to exploit mines and other natural resources.

26. Under article 8 of both model conventions, profits from the operation of ships and aircraft in international traffic are generally taxable exclusively by the country of residence. Thus, rental payments for ships and aircraft leased by a foreign airline or shipping company to a domestic airline or shipping company that are covered by article 8 may result in base erosion where the payments are deductible against the country in which the payer is resident and that country is prevented from imposing withholding tax on the payments.

27. Under article 12 of the United Nations Model Convention, a developing country is entitled to impose withholding tax at a maximum agreed rate on rent for the use of industrial, commercial or scientific equipment arising in the developing country and paid to a resident of the other country. The expression "industrial, commercial or scientific equipment" is not defined in the treaty and, as explained in paragraph 13.2

of the commentary on the United Nations Model Convention, has the meaning that it has under domestic law unless the context requires a different meaning. Rent is deemed to arise in a country where the payer is a resident of that country or where a non-resident has a permanent establishment or fixed base in that country, the obligation to pay rent is connected to the permanent establishment or fixed base and the rent is deductible in computing the profits attributable to the permanent establishment or fixed base. In contrast, article 12 of the OECD Model Convention does not apply to rent for the use of such equipment; instead, such rent is covered by article 7, which means that a developing country in which rent for the use of such equipment arises would be prevented from taxing the rent unless the non-resident has a permanent establishment in the country and that rent is attributable to the permanent establishment.

28. Where a developing country chooses to impose withholding tax on rent for the use of equipment, it should carefully consider that some non-resident lessors may require lessees resident in the developing country to gross up the rent to reflect the withholding tax, with the result that the tax is shifted to the resident lessees and the cost for residents to lease equipment from non-residents will be increased.

29. Article 12 of the United Nations Model Convention also allows the country in which royalties for the use or the right to use intangible property arise to tax those royalties at a rate agreed between the contracting States. Article 12(3) defines such royalties broadly as payments for the use or the right to use copyright of literary, artistic or scientific work, patents, trademarks, plans, designs or models, secret formulas or processes as well as know-how; however, fees for technical services are not royalties and are taxable in accordance with article 12A of the United Nations Model Convention. Royalties are deemed to arise in a country where the payer is a resident of that country or where a non-resident has a permanent establishment or fixed base in that country, the obligation to pay royalties is connected to the permanent establishment or fixed base and the royalties are deductible in computing the profits attributable to the permanent establishment or fixed base. Under the United Nations Model Convention, the place where property is used is irrelevant for purposes of determining where rent or royalties arise. Under article 12 of the OECD Model Convention, royalties are taxable exclusively by the country in which the recipient is resident.

Deduction of rent and royalty payments by non-residents

30. In general, the deduction of expenses in computing income is a matter of domestic law, although article 7 of the United Nations Model Convention provides some general rules about deductions for the purposes of determining the profits attributable to a permanent establishment. In addition, article 24(3) precludes a country from discriminating against a resident of the other contracting State carrying on business in the country through a permanent establishment (but not through a fixed base). Article 7(3) provides that expenses incurred for the purposes of the business of the permanent establishment "shall be allowed as deductions" and that those deductions must be allowed irrespective of where the expenses are incurred (that is, in the country where the permanent establishment is located or elsewhere) and irrespective of whether the expenses are incurred wholly or partly for purposes of the permanent establishment. Although article 14 does not contain rules similar to those in article 7(3), paragraph 10 of the commentary on article 14 indicates that the same principles should apply for purposes of computing the income attributable to a fixed base. Thus, any rent or royalty expenses incurred for the purposes of a permanent establishment or fixed base are deductible in computing the profits attributable to the permanent establishment for the purposes of the application of article 7.

31. Movable and intellectual property owned by a non-resident enterprise may be used for the benefit of the entire enterprise rather than solely for the benefit of a permanent establishment or fixed base. For example, the property may be used for purposes of one part of an enterprise for a period of time and then for a different part of the enterprise for the balance of the year; and intellectual property may be used simultaneously for the benefit of different parts of the enterprise. Therefore, it is necessary to allocate the appropriate portion of rent or royalty expenses incurred by a non-resident to a permanent establishment or fixed base. As discussed above, this allocation can be done on the basis of factually tracing the use of property (for example, by reference to the number of hours or days used) or by apportioning the expenses on the basis of factors such as revenue, sales, assets, employees, etc.

32. Only actual rent or royalty expenses incurred by a non-resident enterprise for the purposes of a permanent establishment or fixed base are deductible for purposes of computing profits of the permanent establishment or fixed base. The deduction of notional rent or royalties charged by the head office (or another part of an enterprise) to a permanent establishment in a developing country for the use of industrial, commercial or scientific equipment or intellectual property owned by an enterprise is explicitly prohibited by article 7(3) of the United Nations Model Convention. In contrast, under article 7 of the OECD Model Convention, notional rent and royalties for such property may be deductible. Under the provisions of both model conventions, if a developing country allows the deduction of notional rent or royalties in computing the profits of a permanent establishment or fixed base, its tax base will be eroded and it will be unable to impose any withholding tax on such notional amounts. However, under the provisions of both model conventions, a developing country is entitled to impose withholding tax on actual rent and royalty payments made by a non-resident with a permanent establishment or fixed base in the developing country to another non-resident if the payments are deductible in computing the profits attributable to the permanent establishment or fixed base, since such payments are deemed to arise in the country.

33. Under article 24(3) of both model conventions, a contracting State is prohibited from taxing a permanent establishment of a resident of the other State less favourably than it taxes its own residents carrying on similar activities. Thus, if resident enterprises are taxable on their profits on a net basis, non-residents carrying on business through a permanent establishment must be similarly taxable on a net basis and must be allowed to deduct rent and royalty expenses in the same manner as resident enterprises. For example, article 24(3) would prevent a developing country from imposing a final withholding tax on rent or royalties received by a non-resident with a permanent establishment in the country where the underlying property (immovable property, equipment or intangible property) is effectively connected to the permanent establishment unless rent or royalties paid to residents are also subject to such a final withholding tax. However, article 24(3) would not apply to a branch-level tax on any rent or royalties deductible in computing the profits of a permanent establishment because such a tax is levied on the non-resident recipient of the rent or royalties and not on the permanent establishment.

34. Article 24(3) refers only to the taxation of the profits of a permanent establishment and not to connected requirements. Thus, article 24(3) does not prevent a country from imposing information-reporting requirements, penalties and other administrative rules with respect to the taxation of non-residents carrying on business through a permanent establishment that are different from those imposed on residents carrying on similar activities.

C. Countermeasures to prevent base erosion with respect to rent and royalties

Introduction

35. Three basic responses are available for developing countries to deal with cross-border base erosion through payments of rent and royalties: (a) restrictions on the deduction of rent and royalties; (b) the imposition of withholding taxes on payments of rent and royalties to non-residents; and (c) the application of rules, including transfer pricing rules and anti-avoidance rules, to prevent excessive deductible payments of rent and royalties.

Countermeasures under domestic law

Restrictions on the deduction of rent and royalties by residents and non-residents

36. Although all deductions of rent and royalties reduce a developing country's tax base, it would be inappropriate to deny the deduction of rent and royalties where such expenses represent legitimate costs of earning income. The risks of base erosion with respect to deductible payments of rent and royalties are greater where the payments are made to non-residents and are excessive and/or are not subject to tax by the developing country or are subject to a reduced rate of tax. As discussed below, developing countries may wish to ensure that rent and royalties paid to non-residents are subject to withholding tax.

37. Payments of rent or royalties to non-residents may be excessive where the payer and the recipient of the payments are related or do not deal at arm's length. Developing countries may want to consider the adoption of robust transfer pricing rules to prevent base erosion through excessive rent and royalties paid to related non-residents; they may also want to consider enacting similar anti-avoidance rules to prevent the deduction of excessive payments of rent and royalties between related individuals.

38. Non-residents who are taxable by developing countries on a net basis (for example, where they have a permanent establishment in that country) may allocate disproportionate amounts of rent or royalties to their income-earning activities in such developing countries and deduct those amounts in computing their income. To prevent this result, developing countries may want to enact clear rules for allocating rent and royalties incurred by a non-resident to the income from the business carried on by the non-resident in their countries, and the tax authorities should be vigilant in applying those rules.

Withholding tax on rent and royalties

39. Although payments of rent and royalties to non-residents erode a developing country's tax base, that base erosion can be offset if the country imposes tax on the payments. Usually, such a tax is imposed as a flat-rate withholding tax on the gross amount of the payments and the rate is established as a proxy for a tax on the non-resident's net income. A developing country's tax base will still be eroded to the extent that any rent or royalties paid to non-residents are exempt from tax or the rate of withholding tax is less than the tax saving from the deduction of the rent and royalties by the payer. Because high rates of withholding tax on rent or royalties may have the effect of limiting access by residents of a developing country to equipment and technology, developing countries often agree to exemptions or reduced rates of withholding tax on royalties in their tax treaties. However, it is important that any such exemptions or reduced rates be carefully reviewed to ensure that they are

justified. Sample legislation imposing withholding tax on rent and royalties with explanatory notes is provided in the practical portfolio on rent and royalties.

40. If a developing country has different rates of withholding tax on payments of rent and royalties and other payments to non-residents, such as interest and fees for services, taxpayers may manipulate transactions in order to avoid or minimize withholding taxes by altering the character of payments. Developing countries can minimize this risk of base erosion by maintaining consistent rates of withholding under their domestic law and their tax treaties on all payments to non-residents.

41. Where non-residents are taxable on a net basis and deduct payments of rent and royalties against a country's tax base, that country's tax base will be eroded by the deductions except to the extent that such payments are subject to withholding tax.

42. Non-residents may enter into back-to-back arrangements to avoid withholding tax on rent or royalties. To prevent this type of tax avoidance, developing countries can either adopt specific anti-avoidance rules to deal with abusive back-to-back arrangements or, if they have a general anti-avoidance rule, apply that rule to such arrangements.

43. If a developing country imposes withholding tax on rent paid to non-residents for the use of immovable property located in the country, it could consider ensuring that its domestic-law meanings of "immovable property" and "income from" such property are sufficiently broad for this purpose. For example, those meanings might include payments for the use of natural resources — mines, agricultural property, timber – and for the use of property affixed to immovable property, such as pipelines.

44. Similarly, a developing country may find it helpful to review the meanings of "rent" and "royalties" under its domestic law to ensure that they are sufficiently broad to cover all payments for the use of property, that any exemptions are justified and that the meanings are consistent with the meaning of royalties in its tax treaties.

45. 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 permanent establishment or fixed base in the country. This type of tax avoidance is not limited to rent and royalties, but may occur with respect to a variety of businesses, including the provision of digital goods and services. The imposition of a withholding tax on all rent and royalties paid to non-residents is unlikely to be an effective response to this type of base erosion since such a tax is difficult to collect from individual consumers. Some countries have enacted special anti-avoidance rules or adopted rules to tax non-residents if they have substantial supplies of digital goods and services in a country.

Taxation of residents

46. Where residents of a developing country incur rent or royalties to earn exempt income from foreign sources, in principle, those expenses should not be deductible. Where such expenses are incurred to earn taxable foreign-source income, they are generally deductible, but should in principle be allocated to, and reduce, the foreign income for purposes of the limitation on any foreign tax credit allowed by the developing country. http://www.un.org/esa/ffd/wp-content/uploads/2017/05/PP_Rents-Royalties.pdf.

47. To counter the risks of base erosion where a resident of a developing country transfers intangible property to a non-resident, the developing country might consider taxing any gain realized on the transfer. Where the property is transferred to a related non-resident, there is a risk that the sale price of the property may be less than its fair market value in order to minimize the amount of the gain subject to tax. Developing countries may want to consider including provisions in their domestic law to deem

the proceeds of sale to be equal to the fair market value of the property with respect to such related party sales and may even consider using hindsight for the purpose of determining the value of such property. They should also ensure that they allocate sufficient resources to enforce such provisions effectively.

Countermeasures under tax treaties

48. A developing country's tax treaties may prevent it from imposing withholding tax on certain payments of rent or royalties to residents of its treaty partners, or may require it to reduce its rate of withholding tax on such payments. Developing countries could insist on maintaining reasonable rates of withholding tax on rent and royalties — such as 10 or 15 per cent — in their treaties, which would reduce the extent of any base erosion through deductible payments of rent and royalties. However, as noted above, non-resident owners of intellectual property may require resident licensees to bear the cost of any withholding tax by grossing up the royalty payments. Developing countries may also want to ensure that any exemptions from withholding tax on rent and royalties are clearly justified and, to the extent possible, should consider ensuring that the rates of withholding tax on various types of royalties and other payments, such as interest and fees for services, are consistent.

49. Developing countries should ensure that their tax treaties include provisions similar to article 6 of the United Nations Model Convention and, as noted above, they should consider imposing tax under domestic law on all income from immovable property that it is entitled to tax under article 6.

50. Where developing countries agree to include article 12(3) of the OECD Model Convention in their tax treaties, they will be unable to tax rent for the use of industrial, commercial and scientific equipment unless the non-resident lessor has a permanent establishment in their country and the equipment is effectively connected to the permanent establishment. In contrast, if developing countries include article 12(3) of the United Nations Model Convention in their tax treaties, they will be able to impose withholding tax at an agreed rate on rent for the use of such equipment.

51. With respect to royalties for the use of intangible property, developing countries may want to ensure that any payments that are subject to withholding tax under domestic law are also taxable under article 12(3) and that any exemptions from withholding tax under article 12 are clearly justified.

52. To the extent that a country has entered into tax treaties that contain a non-discrimination provision similar to article 24(3) of the United Nations Model Convention, those treaties will prevent the country from denying the deduction of rent and royalties by non-residents carrying on business in the country through a permanent establishment (although not through a fixed base) unless residents of the country are not allowed to deduct similar payments. Although tax treaties generally require countries in which a permanent establishment is located to allow the deduction of rent and royalties that are properly attributable to the permanent establishment, the tax authorities of developing countries should be careful not to allow non-residents to deduct disproportionate amounts. Developing countries should consider not adopting article 7 of the current OECD Model Convention in their treaties because that article may require them to allow deductions for notional rent and royalties in computing the profits attributable to a permanent establishment without being able to collect a withholding tax on such notional payments.

53. Tax treaties entered into by a country that contain provisions similar to articles 24(4) and (5) of both model conventions may prevent that country from restricting the deduction of rent or royalties in certain cases. To avoid this result in cases where a country considers that such restrictions are justified and essential, a country might:

(a) Decline to enter into tax treaties;

(b) Refuse to agree to the inclusion of articles 24(4) and (5) in its tax treaties;

(c) Apply any restrictions on the deduction of rent and royalties by non-residents also to payments of rent and royalties by residents;

(d) Insist on expressly excluding any restrictions on the deduction of rent and royalties to non-residents from articles 24(4) and (5); or

(e) Insist on limiting articles 24(4) and (5) to most-favoured-nation treatment rather than national treatment.

D. Tax administration issues

63. In general, non-residents may be taxable on rent or royalties as part of their net income in the same manner as residents or on the gross rent and royalties they receive without any deductions. Where non-residents are subject to tax on their net income, they are usually required to file tax returns showing their income subject to tax and the tax payable. Although the payments of domestic-source rent and royalties that such non-residents receive in these circumstances may be subject to withholding, such withholding is provisional; it represents payments on account of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. Where non-residents are subject to withholding taxes on the gross payments they receive, the tax withheld is usually the final tax. The non-resident is not allowed to pay tax on a net basis, although in some circumstances a non-resident may be allowed to file a tax return and claim a refund for excessive tax withheld.

64. Where non-residents are taxable by assessment, the tax authorities face the difficult task of identifying non-residents who are required to file tax returns, verifying that their income has been computed accurately and collecting tax payable. These difficulties can be minimized if non-residents are subject to interim or final withholding. To the extent that non-residents are subject to withholding, the obligations to identify non-residents subject to tax and to determine the amount of the tax are effectively shifted to withholding agents.

65. In order to effectively administer the provisions of domestic law and tax treaties, the tax authorities require the power to gather the necessary information from the taxpayer and other persons, such as financial institutions and withholding agents, and to audit and verify that the provisions of domestic law have been complied with. Therefore, developing countries may want to consider whether the disclosure and information-reporting requirements under their domestic law and the resources devoted to audit and verification activities are adequate for this purpose.

66. The tax authorities of a developing country also need to apply the provisions of its tax treaties with respect to rent and royalties. The application of the provisions of tax treaties with respect to rent and royalties involves the determination of:

(a) The residence of a non-resident recipient of rent or royalties (often, certificates of residence from the foreign tax authorities are required for this purpose);

(b) The applicable article of the treaty (for example, article 6, 7, 8, 12 or 21);

(c) Whether the non-resident qualifies for the benefits of the particular article of the treaty;

(d) Where a non-resident is taxable in accordance with the provisions of article 7 or article 14, whether rent or royalty expenses are deductible in computing the profits attributable to the permanent establishment or fixed base;

(e) Whether the rent or royalty payments to associated non-residents conform to arm's-length amounts for purposes of articles 9 and 12(6) of the United Nations Model Convention;

(f) Whether the proper amount of withholding tax has been withheld in accordance with the relevant article of the treaty and whether any excess must be refunded.

Appendix

Checklist of the major risks of base erosion and possible countermeasures

Risk	Countermeasures
Deductions of rent and royalties	
• Payments of rent or royalties to related non-residents in excess of arm's-length amounts	• Apply transfer pricing rules
• Provisions of tax treaties (article 24(4) or (5)) may prevent application of legitimate and essential restrictions on deductions of rent or royalties	• Don't enter into tax treaties • Don't agree to include article 24(4) or (5) • Apply restrictions on deductions of rent or royalties to both residents and non-residents • Exclude any restrictions on deductions of rent or royalties from article 24(4) and (5) • Limit article 24(4) and (5) to most-favoured-nation treatment
• Non-residents subject to net-basis tax may claim excessive deductions of rent or royalties	• Apply restrictions on deductions of rent or royalties to non-residents • Apply robust rules for allocating rent or royalty expenses to income earned by non-residents • Ensure that notional rent and royalties are not deductible and no mark-up on rent or royalty expenses is allowed
• Provisions of tax treaties (article 24(3)) may prevent application of rules to disallow excessive deductions of rent or royalties for permanent establishment	• Don't enter into treaties • Don't agree to include article 24(3) • Apply any restrictions on deductions of rent or royalties to both permanent establishment and resident enterprises • Exclude any restrictions on deductions of rent or royalties from article 24(3) • Limit article 24(3) to most-favoured-nation treatment
Withholding taxes	
• No or reduced withholding tax on rent or royalties paid to non-residents under tax treaties	• Maintain reasonable rates of withholding tax on rent and royalties paid to non-residents • Ensure that any exemptions are clearly justified
• Withholding tax imposed at different rates on royalties and other amounts, such as interest and services	• Ensure that consistent rates of withholding tax are imposed under domestic law and tax treaties
• No withholding tax on payments of deductible rent	• Ensure that withholding tax on rent and royalties applies to payments of rent or royalties by non-residents that are

or royalties by non-residents	deductible in computing their income earned in the source country
• Non-residents claim benefit of reduced rate of withholding under tax treaties	• Ensure that non-residents are entitled to treaty benefits under article 12
• Taxpayers may enter into back-to-back arrangements to avoid or reduce withholding tax	• Adopt specific anti-avoidance rules to prevent abusive back-to-back arrangements • Apply general anti-avoidance rule to abusive back-to-back arrangements
• No withholding tax on rent for the use of equipment under article 12 of tax treaties	• Ensure that tax treaties contain a provision similar to article 12 of the United Nations Model Convention, which allows withholding tax on rent for the use of equipment
• Meaning of immovable property and income from immovable property under domestic law may be too narrow	• Ensure that the meaning of immovable property is at least as broad as the definition in article 6 of the United Nations Model Convention and that the meaning of income from immovable property covers all types of income
• The definition of royalties under domestic law may be too narrow or inconsistent with the definition under tax treaties	• Review royalty payments subject to withholding tax under domestic law • Ensure that any exemptions from withholding tax are justified • Compare withholding tax under domestic law and tax treaties and ensure that tax treaties do not limit domestic withholding tax inappropriately • Apply anti-abuse rules to prevent arrangements from avoiding withholding tax on royalties
Special risks of base erosion	
• Intangible property is transferred by a resident to a related non-resident and perhaps leased back to the resident	• Impose tax on gain; ensure that property is deemed to be transferred for its fair market value (perhaps use hindsight to determine fair market value) • If residence country allowed special deductions for research and development expenses, recapture deductions when the property is transferred to a non-resident • Apply a general anti-avoidance rule, if available, in abusive cases