United Nations Practical Portfolio

Protecting the Tax Base

of Developing Countries against Base-eroding Payments: Rent and Royalties

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

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Part 1
Introduction

1.1 Background

In 2012, the Organisation for Economic Co-operation and Development (OECD) began working on the problem of base erosion and profit shifting (BEPS). The work on BEPS was a natural outgrowth of the work of the OECD on exchange of information as a means of countering international tax avoidance and evasion. In their June 2012 meeting, the G20 finance ministers emphasized "the need to prevent base erosion and profit shifting". In February 2013, in response to the G20, the OECD issued a short report on *Addressing Base Erosion and Profit Shifting*[1] that identified several areas for action and deadlines for the implementation of those actions. On 19 July 2013 the OECD released an *Action Plan on Base Erosion and Profit Shifting*.[2] This action plan set out an ambitious agenda with 15 specific action items, some of which were completed in September 2014 and the rest in October 2015. The Final Reports on BEPS were issued in November 2015.

Early in the BEPS project, the OECD recognized the importance of involving developing countries, since their tax systems are probably more susceptible to BEPS than those of developed countries. In general, revenue from corporate taxes forms a larger part of the total tax revenues of developing countries than that of developed countries, and the tax authorities of developing countries generally have fewer administrative resources than developed countries to combat international tax avoidance and evasion and to prevent BEPS.

The United Nations has been active in assisting developing countries to protect their tax bases against BEPS. Some of these actions predate the OECD/G20 BEPS project. In 2013, the United Nations Committee of Experts on International Cooperation in Tax Matters

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[1] Organisation for Economic Co-operation and Development (OECD), *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/tax/beps-reports.htm.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/ctp/BEPSActionPlan.pdf.

established a Subcommittee on Base Erosion and Profit Shifting for Developing Countries with a mandate to consider the implications of BEPS for developing countries and recommend changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[3] to deal with BEPS. In addition, the Subcommittee on Transfer Pricing is engaged in work with respect to the effects of the transfer pricing aspects of BEPS on developing countries.

In early 2014, the Capacity Development Unit of the United Nations Financing for Development Office launched a project to assist developing countries in identifying the major risks of BEPS in their domestic tax laws and tax treaties. This project resulted in a book of 10 chapters dealing with six of the OECD/G20 BEPS action items (other than transfer pricing) that are considered to be most important by developing countries — hybrid entities and instruments, the avoidance of permanent establishment (PE) status, interest and other financing expenses, the digital economy, treaty abuse, and disclosure of aggressive international tax planning — and three additional chapters dealing with tax incentives, income from services and capital gains, plus an introductory overview.[4]

Part 2 of the September 2014 Report to the G20 Development Working Group (DWG) on the Impact of BEPS on Low Income Countries requested the OECD, the International Monetary Fund (IMF), the United Nations, the World Bank Group (WBG) and regional organizations to assess how practical toolkits could be developed to assist developing countries in implementing rules to deal

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[4] See United Nations, Department of Economic and Social Affairs, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015) (hereinafter referred to as "*Protecting the Tax Base of Developing Countries*"), available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf. A second edition of the *Handbook* is currently being revised to reflect the 2015 OECD/G20 BEPS Final Reports and will include a new chapter dealing with base-eroding payments of rent and royalties.

with base-eroding payments. The DWG Report suggested that such a toolkit could consist of:

- An explanatory note to identify the risks of base-eroding payments
- A paper on tax policy considerations related to countermeasures to such base-eroding payments
- An analysis of the advantages and disadvantages of the various options to deal with base-eroding payments
- Model legislation and explanatory notes
- Administrative guidance and practical auditing techniques
- Training materials

In response to the recommendation of the DWG Report, the Capacity Development Unit of the Financing for Development Office embarked on a project to produce a series of practical portfolios to assist developing countries in protecting their domestic tax bases against BEPS. The present *Portfolio*, dealing with the deduction of rent and royalties, is the third in a series of similar portfolios providing practical guidance to developing countries to assist them in combating base erosion in various situations, such as base-eroding payments involving fees for services, interest and other financing expenses, rent, royalties, capital gains and tax incentives.

In April 2016, the United Nations, OECD, IMF and WBG formed "The Platform for Collaboration on Tax" as the institutional framework for enhanced cooperation in delivering assistance to developing countries to strengthen their tax systems. The work programme of the Platform encompasses a variety of activities, including the development of toolkits. As part of its contribution to the Platform, the United Nations Capacity Development Unit of the Financing for Development Office undertook to prepare a series of practical portfolios (toolkits) to assist developing countries in identifying risks of base erosion and possible responses to those risks. Drafts of the first two *Practical Portfolios*, dealing with base-eroding payments for services and base-eroding payments of interest, were issued in 2016.

In February 2016 the OECD established an "Inclusive Framework" in response to the G20 request for the timely implementation of the BEPS countermeasures. The functions of the Inclusive

Framework are to monitor and support the implementation phase of the BEPS project; it is open to all countries that are prepared to commit to the BEPS minimum standards. Developing countries can participate in the Inclusive Framework as equals and are entitled to receive capacity-building assistance from international organizations, which will allow them to implement BEPS countermeasures effectively.

The Platform and the Inclusive Framework are intended to work in close cooperation. The activities of the Inclusive Framework will inform the work of the Platform, and the Platform will bring issues arising from its work to the attention of the Inclusive Framework.

This *Practical Portfolio* is intended for the use of tax officials from developing countries. It is intended to assist these tax officials in identifying the risks of BEPS with respect to base eroding payments of rent and royalties, understanding the causes of such BEPS and assessing the options for countering such BEPS. The material in the present *Portfolio* is not aimed at any particular country or group of countries, but is intended for use by a wide range of developing countries with different tax systems and different levels of economic development. Therefore, the guidance provided in this *Portfolio* must be adapted to the particular needs and circumstances of each country.

This *Practical Portfolio* focuses on the tax treatment of rent and royalties under a developing country's domestic law and its tax treaties from the perspective of potential BEPS; it does not provide a comprehensive examination of the tax policy aspects of the deductibility of rent and royalties or the taxation of cross-border payments of rent and royalties. Therefore, any decisions by a particular country about the adoption of measures to counter BEPS with respect to cross-border payments of rent and royalties should take into account many aspects that are not dealt with, or are dealt with only briefly, in this *Portfolio*. For example, some measures may be effective in countering BEPS but may have the effect of discouraging non-residents from providing leasing or licensing property to residents of developing countries. Further, some countermeasures may be difficult for tax officials in developing countries to administer and enforce effectively.

It is worth emphasizing that any country concerned about BEPS should first review the provisions of its domestic tax system to determine whether it is imposing tax and allowing the deduction of rent and royalties in all the situations in which the country considers that it is appropriate and feasible to do so. Second, the country must review the operation of the rules of its tax system to determine whether those rules are operating as intended or whether they are allowing or facilitating BEPS. Third, if the existing rules are allowing or facilitating BEPS in certain circumstances, the country should consider what types of action it might take to prevent it.

This *Practical Portfolio* contains four parts, including this introduction. Part 2 is a Tax Policy Assessment Manual consisting of:

- An analysis of the provisions of the domestic law of developing countries dealing with the deductibility of rent and royalties and the taxation of rent and royalties
- An analysis of the provisions of the tax treaties of developing countries dealing with the treatment of cross-border payments of rent and royalties
- A description of the information that is necessary or desirable for the tax officials of developing countries to gather in order to formulate tax policy with respect to the deductibility of rent and royalties appropriately
- The identification of the risks of BEPS with respect to the deductibility of rent and royalties and the options for countering such risks, and
- A checklist of the tax policy considerations that should be taken into account by tax officials of developing countries in adopting provisions of domestic law and negotiating provisions of tax treaties dealing with rent and royalties

This Tax Policy Assessment Manual does not deal with the domestic laws or tax treaties of particular countries. Instead, it deals with the basic patterns of dealing with the deductibility of rent and royalties and the treatment of cross-border payments of rent and royalties that are commonly found in many countries' domestic laws and tax treaties. Tax officials from developing countries will find it necessary to adapt the material in the Manual to the particular situation in their countries.

Part 3 of the *Portfolio* provides guidance for tax officials from developing countries in designing and drafting domestic legislation to counter BEPS and in negotiating tax treaties to counter BEPS with respect to base-eroding payments of rent and royalties. Part 4 is a Tax Administration Manual, which provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with rent and royalties.

1.2 How to use the *Portfolio*

Tax officials from developing countries can use this *Practical Portfolio* in a variety of ways. First, it can be used to obtain a general understanding of the tax treatment of cross-border payments of rent and royalties under domestic law and tax treaties. If this is the goal, chapters 1 (Tax policy analysis of the provisions of a country's domestic law dealing with the tax treatment of rent and royalties) and 2 (Analysis of the treatment of rent and royalty payments under the provisions of tax treaties) of part 2 should be the principal focus. Second, the *Portfolio* can be used as a guide for analysing the provisions of a country's domestic law and tax treaties that deal with cross-border payments of rent and royalties in terms of their effectiveness in preventing BEPS. In this case, chapters 1 and 2 should be read carefully with a view to comparing the particular country's rules to the general patterns of taxation of cross-border payments of rent and royalties that are commonly used worldwide, and comparing the provisions of the country's tax treaties dealing with rent and royalties to the equivalent provisions of the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital (OECD Model Convention).[5] Third, the *Portfolio* can be used to investigate the treatment of a particular type of cross-border payment of rent or royalties. The table of contents will be useful for this purpose, in directing readers to the relevant sections of parts 2, 3 and 4 dealing with that type of payment. Fourth, tax officials with a good understanding of a country's rules and tax treaties for dealing with cross-border rent and royalties can focus primarily on chapter 4 of part 2 dealing with the risks of base erosion and possible measures that countries can adopt to counter such risks.

[5] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Part 2

Tax Policy Assessment Manual

Chapter 1

Tax policy analysis of the provisions of a country's domestic law dealing with the tax treatment of rent and royalties

1.1 Introduction

A country's tax base may be eroded by payments of rent and royalties in many ways. The present *Portfolio* takes a comprehensive approach to the examination of base-eroding payments of rent and royalties. It provides a framework to identify all the circumstances in which payments of rent and royalties erode a country's tax base; it evaluates the seriousness of the risks of base erosion in those circumstances; and it outlines the possible responses that developing countries might consider adopting in order to prevent such base erosion.

Developing countries are usually confronted with the difficult task of balancing competing objectives: the need to attract investment from non-residents and the need to protect the tax base. Although all deductible payments of rent and royalties erode a country's tax base, denying the deduction of all such payments to non-residents is probably too drastic. Business enterprises require the use of immovable property, movable property and intangible property, and acquiring the use of such property through leasing and licensing arrangements is commercially legitimate. Therefore, the deduction of payments of rent and royalties for the use of tangible and intangible property for income-earning purposes is appropriate in most circumstances as a cost of earning income. However, in some circumstances, developing countries may be justified in considering deductions for payments of rent and royalties to be inappropriate. This *Portfolio* is intended to provide guidance to developing countries in identifying the circumstances in which base erosion through payments of rent and royalties is inappropriate and the possible responses to such base erosion.

The framework of analysis used in this *Portfolio* is based on the residence of the payers and recipients of payments of rent and royalties, the type of property in respect of which the payments are made, and the consequences of the tax treatment of those payments. There are five possibilities with respect to the residence of the payers and recipients of rent and royalties:

(a) A resident of a country pays deductible rent or royalties to another resident of the same country (as explained below, this type of domestic base erosion is not dealt with in this *Portfolio*);

(b) A resident of a country pays deductible rent or royalties to a non-resident;

(c) A non-resident pays rent or royalties that are deductible against a country's tax base to a resident of that country;

(d) A non-resident pays rent or royalties that is deductible against a country's tax base to another non-resident; and

(e) A resident of a country derives rent or royalties from foreign sources.

In general, rent and royalties paid by a non-resident are deductible against a country's tax base only if the non-resident is subject to tax on a net basis in that country (which is ordinarily the case where the non-resident is carrying on business in that country) and, if a tax treaty applies, where the non-resident carries on business through a permanent establishment (PE) or fixed base in that country.

In general, there are three basic types of property in respect of which payments of rent and royalties are made:

- Immovable property, which generally includes land, buildings and other structures affixed to land, and may also include timber and other natural resources
- Movable property, which includes machinery and equipment and other tangible property
- Intangible property, which includes patents, trademarks, copyright, and know-how, and may even include technical assistance and services in some cases

The precise meaning of each type of property is determined in accordance with each country's domestic law, although special meanings may apply for purposes of tax treaties (see section 1.2 below).

With respect to the tax treatment of payments of rent and royalties, base erosion occurs only if either the payments are deductible or are not taxable, or both. Where payments of rent or royalties are not deductible against a country's tax base, erosion of that country's tax base occurs only if the payments are not subject to tax by that country. For example, if an individual pays rent to a non-resident for property that is used for personal purposes, the rent is unlikely to be deductible. Therefore, the only issue is whether the non-resident owner of the property is subject to tax on the rent by the country in which the payer is resident. It may be questionable whether such a situation should be considered to constitute base erosion. Even if it is considered to be base erosion, it is less serious than the base erosion that results from deductible payments of rent and royalties. Therefore, the taxation of non-residents on payments of rent or royalties that are not deductible by the payer is discussed only briefly in this *Portfolio* as a separate category of base erosion; it is, however, discussed as part of the taxation of non-residents on deductible payments of rent and royalties, since many developing countries impose withholding tax on payments of rent and royalties to non-residents irrespective of whether the payments are deductible by the payers (for example, the use of intangible property, such as video games, music and movies, by individuals consumers).

Deductible payments of rent and royalties result in base erosion in the following situations, where:

(a) The payments are made to related persons and are in excess of the amounts that would have been paid if the parties were dealing with one another at arm's length;

(b) The payments are not taxable or taxable at a reduced rate (by the country in which the payer is resident or carrying on business)[1] in the hands of the recipient;

[1] From the perspective of the country that allows the deduction of rent and royalties, base erosion occurs irrespective of whether or not the payments are subject to tax by the country in which the recipient of the payments is resident. From a global perspective, however, if rent and royalties are deductible in one country but taxable in another country at the same rate,

(c) Any income earned from the use of the property in respect of which rent or royalties are paid is not subject to tax or is taxed at a preferential rate (by the country in which the payer is resident or carrying on business);

(d) Any combination of the preceding three situations occurs.

Base erosion may also arise where a country allows deductions for the costs of research and development (R&D) of intellectual property and the property is subsequently transferred to a non-resident. Where the property is transferred to an arm's length non-resident, the gain realized by the transferor may be subject to tax by the country in which the property was created and developed; however, the gain may be exempt from tax (because the country does not tax capital gains) or may be taxable at a preferential rate. Thus, a country's tax on the gain from the offshore transfer of intellectual property may not fully offset the reduction in the country's tax base from the deductions for the R&D of the property. Where the property is transferred to a non-arm's length non-resident, there is an additional risk that the sale price of the property may be less than its fair market value. In addition, intellectual property that is created in a country and then transferred to a non-resident may be licensed by the non-resident to residents of the country in which it was created. In this situation, the risks of base erosion with respect to deductible royalties described above also apply.

This *Portfolio* deals exclusively with cross-border base erosion through payments of rent and royalties. Base erosion may also occur in an exclusively domestic situation where there is no cross-border element. For example, where a resident entity makes deductible payments of rent or royalties to a domestic tax-exempt entity, there is no domestic tax on the recipient to offset the reduction in the country's tax base as a result of the deduction of the payments. The base erosion in this situation is similar to the base erosion that occurs where a resident entity pays deductible rent or royalties to a non-resident that are exempt from residence country withholding tax. A country can prevent domestic base erosion as a result of deductible payments of rent or royalties by one resident to another resident by taxing the recipient on the payments, by denying the deduction of the payments

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there is no base erosion. This *Portfolio* does not deal with the treatment of rent and royalties in the country in which the recipient is resident.

by the payer or by applying anti-avoidance rules. This type of domestic base erosion through payments of rent or royalties is not discussed in this *Portfolio*.

Although all deductions, including deductions for rent and royalties, reduce a country's tax base, it should be recognized that most payments of rent and royalties represent legitimate expenses incurred for the purpose of earning income. Where payments of rent and royalties are reasonable, are subject to withholding tax, and the income earned by the payer from the use of the property is subject to tax, the deductions claimed for the rent and royalties should not be considered to give rise to improper base erosion. However, where the payments are excessive or are exempt from or subject to reduced withholding tax, or where the related income is not subject to tax or subject to preferential tax, a country's tax base is improperly eroded and countermeasures to prevent such base erosion may be appropriate. The base erosion is clearly most serious where all three base-eroding effects occur: the deductible payments of rent or royalties are excessive, the payments are not subject to withholding tax and any related income is not subject to tax.

Table 1 below shows the risks of cross-border base erosion through deductible payments of rent and royalties in the various circumstances involving resident and non-resident payers and resident and non-resident recipients, and provides references to the section of part 2 of the *Portfolio* in which each particular type of base erosion is discussed. Table 2 shows the additional risks of base erosion where the costs of R&D of intellectual property are deductible and the property is transferred to a non-resident.

Table 1
Risks of cross-border base erosion as a result of deductible payments of rent and royalties

Payer	Recipient	Risk	Reference
Resident	Non-resident	1. Income of resident payer is subject to preferential taxation	1. Chapter 1, section 1.4
		2. Rent or royalties are exempt from or subject to reduced withholding tax	2. Chapter 2, section 2.3.1.2

Table 1 (cont'd)

Payer	Recipient	Risk	Reference
		3. Income of resident is subject to preferential taxation and rent or royalties are exempt from or subject to reduced withholding tax	3. Chapter 1, section 1.4, and chapter 2, section 2.3.1.2
	Related non-resident	1. Rent or royalty payments are excessive: transfer pricing issues	1. Chapter 1, section 1.5, and chapter 2, section 2.3.3
Non-resident carrying on business in residence country	Resident	1. Income of non-resident payer is subject to preferential taxation	1. Chapter 2, section 2.3.1.3
	Related resident	1 Rent or royalty payments are excessive: transfer pricing issues	1. Chapter 1, section 1.5, and chapter 2, section 2.3.3
	Non-resident	1. Income of non-resident payer is subject to preferential taxation	1. Chapter 2, section 2.3.1.3
		2. Payments of rent or royalties are exempt from or subject to reduced withholding tax	2. Chapter 2, section 2.3.1.2
		3. Income of non-resident is subject to preferential taxation and rent or royalties are exempt from or subject to reduced withholding tax	3. Chapter 2, section 2.3.1.2
		4. Payments of rent or royalties are excessive: transfer pricing issues	4. Chapter 1, section 1.5, and chapter 2, section 2.3.3

Some general observations may be made on the basis of table 1:

(a) Where deductible rent or royalties are paid by a resident or a non-resident of a country, base erosion occurs if the related income is not taxed by the country or is subject to preferential tax.

(b) Where deductible rent or royalties are paid by a resident or a non-resident of a country to a non-resident, base erosion always occurs, but may be exacerbated if the related income is not taxed by the country or is subject to preferential tax.

(c) Where rent or royalties are paid by residents of a country or non-residents carrying on business in that country to non-residents of the country, an additional base erosion concern arises related to withholding tax on the rent or royalty. The payments of rent or royalties are usually deductible by the payer against the country's tax base. Withholding tax on the payment serves to offset the effect of the deduction of the rent or royalty, but may not offset that effect completely, especially where the rent or royalty is exempt from withholding tax or is subject to a reduced rate of withholding tax pursuant to a tax treaty.

(d) The risks of base erosion are exacerbated where rent or royalties are paid by a resident to a related non-resident or by a non-resident to a related resident. Where the payer and recipient are related, the amount of rent or royalties charged may be higher or lower than the amount of rent or royalties that parties dealing at arm's length would charge. One obvious response to this type of base erosion is the application of transfer pricing rules. However, transfer pricing rules are not dealt with in detail in this *Portfolio*.

Base erosion is also a concern where a taxpayer transfers tangible or intangible property to a non-resident. As long as the property is owned by a resident, any rent or royalties generated by the property are subject to tax by the country in which the taxpayer is resident. However, once the property is transferred to a non-resident (or a foreign PE if the income of the PE is exempt from tax in the residence country), the rent or royalties may cease to be taxable by the residence country or may be subject to tax at a lower rate. Moreover, where the transferor and the transferee are related, there is a risk that the property may be transferred for less than its fair market value in order to avoid or reduce the tax on any gain realized by the transferor. Also, any gain realized by the non-resident transferee on a subsequent disposition of the property may not be subject to tax by the country in which the property is used. In some cases, the country in which the transferor of property is resident may have allowed generous tax deductions for the R&D costs with respect to the property. In principle, the deduction of these costs should be offset by tax revenues on the future income generated by the property; however, if the property is transferred to a related non-resident, the future profits from the property may not be subject to tax by the country that supported its creation and development. Although a detailed discussion of these issues is beyond the scope of this *Portfolio*, they are discussed briefly.[2]

Where intellectual property is created and developed in a country but transferred to a non-resident, the risks of base erosion are summarized in table 2 below.

Table 2
Risks of base erosion with respect to the deductibility of the costs of research and development where the property is transferred to a non-resident

Transferor	Transferee	Risk
Resident	Arm's length non-resident	Gain on the transfer is exempt or subject to preferential tax
Resident	Related non-resident	Sale price is less than the fair market value of the property
Non-resident	Arm's length non-resident	Gain on the transfer is exempt or subject to preferential tax
Non-resident	Related non-resident	Sale price is less than the fair market value of the property

[2] See Organisation for Economic Cooperation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (Paris: OECD, 2010), chapter VI, available from http://www.oecd-ilibrary.org/docserver/download/2310091e.pdf?expires=1487955911&id=id&accname=ocid195767&checksum=CB1D33377B58D3E37692723A73B55413.

The present chapter begins with a discussion of some basic issues concerning the tax treatment of payments of rent and royalties. These concepts — the definition of rent and royalties for tax purposes; the distinction between royalties and other payments, especially sales and services; the problems of mixed contracts; the geographical source of rent and royalties; the allocation of rent and royalties to income; payments of rent and royalties to related persons; and back-to-back arrangements — permeate the discussion of base erosion caused by payments of rent and royalties throughout this *Portfolio*. The chapter then provides an analysis of the tax policy considerations in the situations involving base-eroding payments of rent and royalties identified above: first, the tax treatment of rent and royalties received or paid by non-residents (section 1.3); and second, the tax treatment of rent and royalties earned or paid by residents (section 1.4). The chapter ends with a brief analysis of transfer pricing issues with respect to payments of rent and royalties (section 1.5).

1.2 Basic concepts

1.2.1 Introduction

Several different English terms are commonly used to describe legal transactions involving the use of property. The terms "lease", "letting" and "hire" are all used to describe transactions in which the owner of tangible property provides the use of that property to another person in consideration for payments generally called "rent". In this *Portfolio*, the term "lease" is used to refer to these transactions. Transactions involving the use of intangible property are generally referred to as "licences" and the payments for the use of such intangible property are generally called "royalties".

Domestic laws often do not differentiate between rent and royalties. Usually, they distinguish only between "active income" from the conduct of a trade or business and "passive income" from the ownership of property. Even in countries where the terms "rent" and "royalties" are used, they are usually used in the context of a distinction between business income and non-business or passive income. However, the distinction between rent or royalties as business income and rent or royalties as passive income is usually irrelevant for purposes of tax treaties. For example, as discussed in chapter 2, section 2.3.1.2.4, below, rent and royalties are dealt with in Article 12 whether or not they are characterized as business income under domestic law.

In this *Portfolio*, the terms “rent” and “royalties” refer to both business and non-business income from the perspective of the recipient of the rent or royalty. From the perspective of the payer, rent and royalties paid in the course of a business are usually deductible, resulting in risks of base erosion. If the payer does not carry on a business, income in the form of rent or royalties received by the owner of the property may not be subject to tax in the payer’s country of residence. In this case, the base erosion is not as serious because the payments of rent and royalties are not deductible.

In the domestic law of most countries, the term “rent” usually refers to payments for the use of movable or immovable property, including rights for either the non-exclusive or temporary use of a property (for example, usufructs or time-sharing payments to enjoy the use of a house for, say, two weeks per year). In contrast, the term “royalties” is generally used to describe payments for the use of intangible property. The provisions of the United Nations and the Organisation for Economic Cooperation and Development (OECD) Model Conventions[3] do not use the term “rent”. Under the United Nations Model Convention, it is necessary to distinguish between income from immovable property (Article 6), payments for the use of industrial, commercial or scientific equipment (Article 12 (3)) and payments for the use of other movable property that is within the scope of either business profits (Article 7) or other income (Article 21) in tax treaties. The term “royalties” is used in Article 12 (3) to describe payments for the use of both certain equipment and intangible property.

Rent and royalties are different from income from sales or services. The distinctive feature of payments of rent and royalties is that they are consideration for the use of or the right to use tangible or intangible property. In contrast, proceeds from the sale of

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

property represent consideration received for the transfer of ownership of the property itself, and not just the right to use the property. Similarly, rent and royalties are different from services, which involve the performance of work by one person for another for consideration, and interest, which represents consideration for the use of money. Under most countries' domestic tax law, payments of rent and royalties to non-residents are usually subject to withholding tax. In contrast, business profits derived by non-residents are usually taxable only if the non-residents carry on business activities in a country and meet a threshold requirement such as a PE or fixed base. Capital gains from the disposition of property by a non-resident may be taxable by a country in certain circumstances, depending on the nature and location of the property (for example, gains from the sale of immovable property located in the country).

In practice, contractual arrangements often involve so-called mixed contracts, under which one person provides both the right to use property and services to the other person. However, such arrangements may provide for a single payment that covers both rent or royalties for the use of property and compensation for services. In these cases, it is necessary to determine whether all the consideration under the contract should be treated in accordance with the principal part of the contract or whether the consideration should be allocated to each of the elements of the contract.

Rent and royalties involve payments by one person to another person for the use of property. If there is no payment for the use of the property, there is usually no rent or royalty, except where a person allows a related or associated person to use property without any payment, in which case payment equal to the fair market value of the use of the property should be deemed to be made.

The form of payment is not usually relevant for the purpose of determining the underlying nature of a transaction or contract, even if it is relevant for the purpose of determining what the parties to the transaction or contract really intended to achieve. Thus, the nature of contracts that give rise to rent or royalty payments is not affected by how the payments are made or calculated (for example, fixed or variable, a lump-sum payment at the beginning or the end of the period of use of the asset). Specific issues may arise with respect to the form of payments between related parties (see section 1.5 below).

1.2.2 Distinction between rent or royalties and proceeds of sale

For income tax purposes, it is important to distinguish between payments for the "use or right to use" property and proceeds from the sale or transfer of property. In general, the former payments are rent or royalties, while the latter are business profits or capital gains.

The distinction between sales and leases or licences of movable, immovable or other property or rights is usually found in a country's domestic civil or commercial law. Not surprisingly, domestic law in this regard, especially with respect to intellectual or intangible property law and leasing, differ significantly. For example, some countries may not permit the sale of certain things, such as software or "know-how", while others may permit the alienation of any right or property. Civil law countries often give pre-eminence to the right of authors, whose personal rights can never be alienated. In contrast, in common law countries, the rights of persons who commercialize ideas or texts are often given more weight.

Countries should be aware that countries' domestic laws may characterize transactions differently, including the underlying property rights, for the purpose of characterizing payments as rent or royalties or as proceeds of sale. In any particular case, it must be determined which country's law should apply to determine the fundamental nature of the transactions, the rights and obligations of the parties and the character of any payments made. It is not uncommon for parties to stipulate in their contracts that the rights and obligations are to be determined in accordance with the laws of a particular country, which may not be the country of residence of any of the parties to the contract.

In the context of tax treaties, however, the Commentaries to the United Nations and OECD Model Conventions have evolved from their original position that recognized the application of domestic laws to define "use" or "sale" to an approach that characterizes transactions in accordance with their substance, regardless of domestic law. Therefore, for example, if a contract has the features of a sale, as determined in accordance with the Commentary, it will be regarded as a sale regardless of the domestic law applicable. This approach was first applied by the OECD in 1977 with respect to the distinction between sales and leases of equipment; then in 1992 to computer software and digital products in general (rights to "use" a program are equivalent to a sale, but rights to exploit or modify a program are "royalties"); and finally, it was generally applied. This approach is also accepted in the Commentary to Article 12 of the United Nations Model Convention. For example, if a purchase of a licence to use a computer software program is characterized as a sale, the country in which the payer is resident will not usually tax the profit from the sale. On the other hand, if the right to use the program is regarded as a licence, the payments for the use of the program will be characterized as royalties and withholding taxes will usually apply. In either case, the payer will usually be allowed to deduct the payments as the cost of property acquired, in the case of a purchase and sale, or as a royalty, in the case of a licence.

From a base-erosion perspective, the most worrying outcome occurs where the payments are deductible in the source country and no tax is imposed on the non-resident recipient of the payments. Countries should be aware that rights for the use of property (tangible and intangible) can be disguised as partial sales of property rights in order to avoid withholding taxes at source.

Example 1

Mr. A, a resident of Country A, owns the copyright in a literary work and wishes to grant to Ms. S, a resident of Country S, the right to translate and reproduce that work in Country S in consideration for royalty payments based on the sales of the translated work. Instead of granting a licence to Ms. S, Mr. A enters into an agreement of sale under which all rights related to the translated version of the work in Country S are transferred to and acquired by Ms S. The contract further provides that Mr. A has the option to reacquire the rights after a period of five years. Based on these facts, Country S could apply its domestic anti-abuse rules to treat the proceeds of sale as royalties subject to withholding tax (see paragraph 91 of the Commentary to Article 1 of the United Nations Model Convention).

Similar results can be achieved with tangible assets; for example, the sale or transfer of rights to use property (for instance, sales of goods that hide rights of use of industrial property or sale of property for a limited period of time, such as two weeks per year).

On the other hand, sometimes outright sales of property with intangible components (for example, the purchase of a car or a computer with embedded software) are real sales without any right to use the embedded intangibles. It is probably inappropriate to apply withholding tax on royalties on the amount of the sales proceeds attributable to such embedded intangibles.

The facts and circumstances of each case must be carefully studied in order to determine whether the transaction is in essence a sale or a lease of an asset, and whether the payments are sale proceeds or rent or royalties. The name used in the documents to describe the transaction should not be determinative of the nature of the transaction and the payments for tax purposes.

1.2.3 Distinction between rent or royalties and fees for services

Rent and royalties may be considered to be services if the term services is given a broad meaning. However, rent and royalties are different from most services. Rent and royalties involve payments for the right to use property for a period of time, whereas payments for most services involve consideration for activities performed by the service provider and responsibility for the results of the services without any right to use any property of the service provider.

Domestic law usually applies to determine whether payments are for the right to use tangible or intangible property or for a service, and the characterization of the payments may have different commercial and tax consequences. For instance, if a conductor or singer agrees with a company to record music, and under the applicable domestic law the artiste's rights with respect to the final product are recognized, the payments would be characterized as royalties. However, if domestic law does not recognize the artiste's rights, the owner of the recording will be the company and payments to the artiste may be characterized as fees for services. Countries often characterize payments differently. The tax consequences of such conflicts of characterization can be minimized if payments of rent and royalties and fees for technical services are treated similarly.

In a cross-border context, from a domestic law perspective, the distinction between payments for services and rent and royalties may be relevant if different source rules are used for the two types of payments. Many countries consider the source of rent or royalties to be where the payer is resident. In contrast, fees for services are considered to arise either where the services are performed or where they are used or consumed, which is usually where the payer is resident.

Under tax treaties, income from services is usually characterized as business profits (Article 7 of the United Nations Model Convention) or independent personal services (Article 14 of the United Nations Model Convention), whereas payments of rent and royalties are subject to withholding taxes (Article 12 of the United Nations Model Convention).

The distinction between fees for services and rent or royalties is problematic for several reasons. First, intangible property or rights are often used in the provision of services. In these cases, the use of the intangible property should be distinguished from the main goal of the contract, which is the provision of services.

Example 2

An engineer, architect, lawyer, doctor or other professional may use know-know to perform services under a contract for a client. In these circumstances, the client does not usually expect to acquire a right to use the professional's know-how, but expects an outcome that is the object of the contract (for example, building a bridge in the case of the engineer, a house in the case of the architect, legal advice from the lawyer, and medical advice or treatment from the doctor). There is no transfer of know-how to the client in any of these cases.

Second, there is usually a difference between simply leasing property to a client for use by the client and a service provider using property for the purpose of providing services to a client. Determining who controls, manages and operates the property is crucial in these cases for the purpose of characterizing the transaction as a lease or the provision of services. For example, a company may lease a crane to be operated by the company's employees for purposes of a construction project carried out by the company, in which case the payments should be characterized as rent. Alternatively, the company may enter into a contract for the owner of the crane to perform services related to the construction project, in which case the crane would be operated by the employees of the owner of the crane and the payments should be fees for services.

Third, contracts often combine different elements (for example, sales and services, sales and know-how, services and royalties, franchising agreements), as discussed in section 1.2.4 below.

1.2.4 Mixed contracts

Many contractual arrangements involve a combination of different elements: sales combined with the use of tangible or intangible assets, services combined with the use of equipment, and rentals of immovable property (for example, land, farms, houses, hotels) combined with rentals of movable property (for example, equipment, furniture, animals). If the different elements of a mixed contract are treated differently under domestic law or tax treaties, it will be necessary for the tax authorities to determine the amount of the payments under the contract that are properly attributable to each of the elements. Moreover, the parties to the contract, regardless of whether they are related or not, may be tempted to split the contract into several elements or to price some of the elements in order to avoid or reduce tax. Therefore, it is important for the tax authorities to identify the various elements of a mixed contract and ensure that the price for each element is correct.

Mixed contracts present different problems than structures that erode a country's tax base through payments of rent or royalties or payments for goods or services (for example, a company in one country that pays deductible rent or royalties to a related company in another country).[4]

The rules for mixed contracts vary considerably under countries' domestic laws and tax treaties. The United Nations Model Convention suggests that mixed contracts must be broken down into their different parts and the stipulated consideration should be apportioned among those parts based on the information in the contract or

[4] See Peter Harris, "Taxation of rents and royalties", in *Protecting the Tax Base of Developing Countries* (New York: United Nations, 2017), chapter XI, section 2.1.

on some reasonable basis.[5] However, if one part is by far the principal purpose of the contract and other parts are ancillary and largely unimportant, the treatment applicable to the principal part should generally be applied to the entire consideration. The Commentary does not provide any guidance on how to break down contracts or when to aggregate transactions.[6]

The approach adopted in the Commentary to Article 12 for dealing with mixed contracts is not accepted by all countries. Therefore, in some countries mixed contracts may result in base erosion through the reduction of withholding taxes imposed by a country on payments to non-residents. The approach in the Commentary may lead taxpayers to fragment contracts with regard to intangible assets (including know-how) that often involve technical assistance into two parts, one dealing with services and the other with royalties. Where withholding taxes are applied only on royalties, this fragmentation will avoid withholding taxes on the fees for services. Therefore, countries should consider whether, in these cases, services linked with licences of assets should be given the same treatment as rent or royalty payments or whether they should accept the fragmentation of contracts. It is the practice of some countries to assimilate the tax treatment of the use of intangibles and technical assistance connected with the granting of the right to use the intangibles, so that any fees for technical assistance are treated the same as the royalties.

Example 3

SCo, a resident of Country S, enters into a contract whereby it acquires the right to use a patent registered by RCo, a resident of Country R. The contract also requires the presence of technical employees of RCo in Country S for two months to show employees of SCo how to apply, use and commercialize that patent. After two months, the employees of RCo are required to assist the employees of SCo by phone or e-mail for an additional 12 months.

[5] Paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention.

[6] Some guidance on this matter can be found in OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, supra note 2, chapter VI, on intangibles).

The total price paid by SCo to RCo under the contract is 200. Depending on the approach to mixed contracts used by Country S, the taxpayer might allocate the price of the contract to the different components to avoid withholding taxes on royalties. For example, 120 could be allocated for the use of the patent, 50 for technical assistance and 30 for remote services. If the approach in the Commentary to Article 12 of the United Nations and OECD Model Conventions is followed, only 120 would be subject to withholding tax on royalties; payments for technical assistance and remote services would escape that withholding tax. If, however, the payments for technical assistance and remote services are intrinsically linked to the contract for the use of the patent, the full amount of 200 can be subject to withholding tax.

Example 4

RCo, a resident of Country R, agrees with SCo, a resident of Country S, to provide syrup and other ingredients to bottle and sell flavoured soda water in Country S. The contract also gives SCo the right to use the trademark for an internationally renowned soda owned by RCo. The contract requires that SCo must pay for the syrup and other ingredients, but does not require any payment for the use of the trademark. If payments for the syrup are not subject to withholding tax by Country S but royalties for the use of the trademark are subject to withholding tax, the payments for the syrup may reflect payments for the use of a trademark as well. If so, the two elements of the contract (purchase of goods and use of a trademark) must be broken down or disaggregated so that each part is treated appropriately. In this example, identifying the amount of the payment for the use of the trademark will allow Country S to impose withholding tax on that amount.

Countries may apply general anti-avoidance rules and transfer pricing rules to deal with mixed contracts. It is also important for the tax authorities to engage in a careful and thorough consideration of the facts and circumstances of each case.

1.2.5 The concept of rent

1.2.5.1 Introduction

The term "rent" refers to payments (periodical or not) made by one person to another for the use of movable or immovable property. As mentioned above, these types of payments are often associated with passive income in domestic tax systems, whereas in international tax treaties the taxation of these payments does not usually depend upon whether the renting activity constitutes a business carried on by the recipient. In other words, rental payments can refer to payments for use of property regardless of whether the main activity of the lessor is the leasing of property.

Under some tax treaties, some rental payments (that is, those for the use of industrial, commercial and scientific equipment) are characterized as royalties. These types of payments are discussed in section 1.2.6.2.4 below.

1.2.5.2 Rent from immovable property

The concept of immovable property usually depends on the law (often private law rather than tax law) of the country where the property is located. Although some countries may not have clear definitions of immovable property in their domestic law, immovable property should have a meaning under all countries' laws. In most countries, immovable property has a broad meaning that covers not only land and buildings, but also:

- Trees, plants, structures, paintings, statues, machinery, and pipelines that are attached to immovable property
- Mines and quarries, as well as minerals as long as they remain attached to the land
- Dykes and dams, and floating structures that are in a fixed place in the water
- Waters (especially internal waters or waters within the economic exclusive zone)
- Rights of way over private or public lands and rights with respect to immovable property (for example, usufruct, surface rights, time-sharing rights)
- Property, livestock and equipment used in a business, such as agriculture and forestry, or accessory to any business that is mainly based on the use of immovable property (for example, hotels, wind and solar farms).

Some countries also treat shares or any other rights as immovable property where the ownership of such shares or rights entitles the holder to the enjoyment of immovable property located in the country.

Article 6 (2) of both the United Nations and OECD Model Conventions provides that the term “immovable property” has the meaning that it has under the domestic law of the country in which the property is located; it also includes “property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources”. Ships, boats and aircraft are expressly excluded from the definition of immovable property.

The concept of rent includes payments made for the use of or right to use immovable property. Under Article 6 of the United Nations and OECD Model Conventions, rental income derived from immovable property is treated the same as any other income from such property: the country in which immovable property is located is entitled to tax any income, including rent derived from the property, without any limits.

While it might be thought that the risks of base erosion are less in the case of rent for immovable property, there are also techniques that can be used to reduce the tax base in the country where the property is located. These techniques include the use of foreign, often related, companies that either increase deductible expenses in the country where the property is located or decrease income taxable in the country.

Example 5

A Corporation, a resident of Country A, rents a building or land for use in carrying on its own business. If a non-resident associated company provides some services linked with the rental (for example, a commission for finding the property or maintenance), the deductible expenses will include the rent and the fees for the services. If the fees for the services are not subject to tax in Country A, the corporate tax base of Country

A is eroded by the deductible expenses without any tax on the fees for services. Transfer pricing rules may limit the amount of the deduction or may even be used to eliminate the deduction of the payment, depending on the facts and circumstances.

Example 6

Corporation A owns a hotel and an apartment building in Country A. It commercializes rooms in the hotel and time-sharing rights in the apartments through a non-resident related company so that Corporation A receives amounts from that company that are less than the prices charged to the client for the right to use the rooms or apartments. Therefore, income attributable to the property located in Country A is split in two parts, part accruing to Corporation A and part accruing to the non-resident commercializer of the rooms or rights. The non-resident related company may not be taxable in Country A, since it will not have a PE in Country A. If a developing country wants to tax the payments made to the non-resident related company in these types of circumstances, it needs to have provisions in its domestic law that allow it to impose withholding tax on the fees for services. A broad definition of immovable property may also help to attribute Country A rights of taxation on the income obtained by the commercializer.

1.2.5.3 Rent from movable property

Movable property is anything that is not immovable property. Therefore, the concept of movable property depends upon the (broad or narrow) definition of immovable property under a country's domestic law. Rent from movable property includes payments for the use of property that is not immovable property.

Under the provisions of the United Nations and OECD Model Conventions, rent from movable property, which includes ships, boats and aircraft, will usually be treated as business profits under Article 7, or other income under Article 21. Thus, if rent is received by an enterprise in the normal course of its business activities, the rent is not taxable by any country other than the country in which the enterprise is resident, unless the enterprise has a PE in a country and the rent is attributable to the PE. Under Article 21 (2) of the United Nations Model Convention, a country is entitled to tax rent from movable property if the rent arises within the territory of the country, provided that the owner of the property does not carry on a business activity through a PE or fixed base in the source country. As discussed below in section 1.2.6.2.4, there may be some overlap between rent from movable property and royalties as a result of the inclusion of payments for the use of "industrial, commercial or scientific equipment" in the definition of royalties under Article 12 (3) of the United Nations Model Convention.

1.2.6 The concept of royalties

1.2.6.1 Introduction

Some countries may not have a definition of the term "royalty" or "royalties" under their domestic law—they may simply impose withholding tax on certain payments that are commonly referred to as royalties. In some cases, only deductible payments may be subject to withholding tax.

The definition of royalties in Article 12 (3) of the United Nations and OECD Model Conventions may be narrower than the definition under domestic law or the scope of the payments subject to withholding tax under domestic law. In addition, as discussed in section 1.2.3 above, some countries may treat certain payments as royalties, while other countries may treat the same payments as fees for services.

A definition of royalties may be either exclusive or closed ("royalties means …") or inclusive or open ("royalties includes …") or both ("royalties means … and includes …"). Although inclusive/open definitions give flexibility to tax administrations, they create uncertainty. Therefore, it may be preferable to list the payments that a country wishes to characterize as royalties exhaustively. The definition of royalties in both the United Nations and OECD Model Conventions is exclusive/closed. However, the categories of underlying property in the definition of royalties (for example, copyrights, patents, trademarks) in respect of which payments are made are not usually defined. Therefore, such underlying property must be defined by reference to the applicable domestic law (which may or may not be the law of the country in which the payer is resident), and to the Commentary to Article 12 of the United Nations or OECD Model Convention if relevant. The

Commentary clarifies the meaning of some of the terms in the definition of royalties. In some cases, the meaning in the Commentary may not be the same as the meaning under domestic law (for example, payments for computer software (see section 1.2.6.2.2 below)). The various types of underlying property referred to in the definition of royalties under Article 12 (3) of the United Nations Model Convention are discussed in detail in section 1.2.6.2 below.

In principle, payments for the exclusive right to distribute a product or service, including software, within a particular territory (without the right to reproduce the property) are not rent or royalties,[7] since such payments do not give the payer the use of or the right to use any property. However, payments for the exclusive use of information or property covered in the definition of royalties are considered to be royalties under the OECD Model Convention.[8] Such payments are not dealt with in the Commentary to Article 12 of the United Nations Model Convention. In any particular situation, it may be difficult to determine whether payments are royalties for the use of property or the purchase price of property. See section 1.2.2 above.

Example 7

If SCo, a resident of Country S, purchases the right to distribute television sets under the brand name of TCo, a resident of Country T, SCo does not acquire any right to use the TCo brand name; it acquires only the right to sell television sets with the TCo brand name. However, if SCo also acquires the right to use the TCo brand name to sell television sets that it manufactures or the exclusive right to use the brand name for the sale of television sets in Country S, the payments would usually be royalties.

All the facts and circumstances, especially the terms of the distribution agreement, need to be carefully considered.

[7] See paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 14.4 of the OECD Model Convention.

[8] See paragraph 8.5 of the Commentary on Article 12 of the OECD Model Convention.

1.2.6.2 The definition of royalties

1.2.6.2.1 Introduction

Under Article 12 (3) of the United Nations Model Convention, the term "royalties" is defined to mean payments received as consideration for the use of or the right to use any:

- Copyright of literary, artistic or scientific work, including cinematographic films or tapes used for radio or television broadcasting
- Patent
- Trademark
- Design or model
- Plan
- Secret formula or process
- Information concerning industrial, commercial or scientific experience, or
- Industrial, commercial or scientific equipment

The meaning of each of these types of property is discussed below. Payments with respect to the use of other types of property are not considered to be royalties under this definition.

1.2.6.2.2 Copyright royalties

The term "copyright" and the expression "literary, artistic or scientific work" in Article 12 (3) of the United Nations Model Convention do not have the same meaning in all countries or in international agreements protecting copyright. Works protected under copyright are generally original intellectual creations, but the degree of originality required in different countries may vary and the meaning of "intellectual creations" is not clear. The meaning of the expression "literary, artistic or scientific" is also unclear and also differs from country to country (for example, is broadcasting a soccer match a "literary, artistic or scientific work"?). The World Intellectual Property Organization (WIPO) has provided guidance concerning the meaning of these terms,[9] but,

[9] The World Intellectual Property Organization (WIPO), *WIPO Intellec-*

ultimately, the meaning of the terms depends on domestic law.

Under the copyright laws of some civil law countries, the rights of authors are given pre-eminence, whereas in many common law countries, commercial rights (for example, the rights of broadcasters, performers or audiovisual producers) have priority over the rights of authors. Thus, in some legal systems the author may be the central focus of the protection of copyright laws (which may not allow the full or partial alienation of rights), even if the holders of economic rights can be recognized as having "neighbouring rights"/"droits voisins" that enjoy a similar level of protection as copyright; whereas in other legal systems copyright laws ordinarily protect the holder of

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tual Property Handbook (Geneva: WIPO, 2004), available from http://www.wipo.int/about-ip/en/iprm/, paragraphs 2.176 ff., explain what a "work" may be:

"2.176. Practically all national copyright laws provide for the protection of the following types of work:

literary works: novels, short stories, poems, dramatic works and any other writings, irrespective of their content (fiction or non-fiction), length, purpose (amusement, education, information, advertisement, propaganda, etc.), form (handwritten, typed, printed, book, pamphlet, single sheet, newspaper, magazine); whether published or unpublished; in most countries "oral works," that is, works not reduced to writing, are also protected by the copyright law;

musical works: whether serious or light; songs, choruses, operas, musicals, operettas; if for instructions, whether for one instrument (solos), a few instruments (sonatas, chamber music, etc.), or many (bands, orchestras);

artistic works: whether two-dimensional (drawings, paintings, etchings, lithographs, etc.) or three-dimensional (sculptures, architectural works), irrespective of content (representational or abstract) and destination ("pure" art, for advertisement, etc.);

maps and technical drawings;

photographic works: irrespective of the subject matter (portraits, landscapes, current events, etc.) and the purpose for which they are made;

motion pictures ("cinematographic works"): whether silent or with a soundtrack, and irrespective of their purpose (theatrical exhibition, television broadcasting, etc.), their genre (film dramas, documentaries, newsreels, etc.), length, method employed (filming "live," cartoons, etc.), or technical process used (pictures on transparent film, videotapes, DVDs, etc.);

computer programs: (either as a literary work or independently).

"2.177. Many copyright laws protect also "works of applied art" (artistic jewelry, lamps, wallpaper, furniture, etc.) and choreographic works. Some regard phonograph records, tapes and broadcasts also as works."

commercial rights.[10] In civil law systems, the author always retains certain rights with respect to the author's creations, which explains why in these systems "sales" or "full transfers" of copyrights are not usually recognized. However, in common law systems, such sales or transfers are recognized and protected.

Tax officials should have thorough knowledge of their domestic copyright laws and recognize that other countries' laws dealing with copyright may be different. However, only copyright in respect of "literary, artistic and scientific work" is recognized under Article 12 (3) of the United Nations Model Convention. If the concept of "neighbouring rights" or "droits voisins" is recognized under a country's domestic law, such rights should be referred to explicitly in both domestic legislation and the country's tax treaties, since such rights may not be included in the meaning of copyright under some countries' laws.

The domestic laws of many countries and the Commentary of the United Nations Model Convention[11] have accepted that the "use" of a digital product (image, sound or text), consisting of the downloading of the product onto a computer for the personal consumption and enjoyment of the user, is not equivalent to use of a copyright and any payments for such use will not be royalties.

Databases are often protected under copyright law explicitly or, like software, as literary, scientific or artistic works. However, protection extends only to the structure of the database or the tools used to access the database (for example, software, specific applications) and

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[10] The main "rights comprised in copyrights", as defined by WIPO in *WIPO Intellectual Property Handbook,* ibid., paragraphs 2.178 – 2.201, are: right of reproduction and related rights; performing rights; recording rights; motion picture rights; broadcasting rights; translation and adaptation rights; and moral rights. The *WIPO Intellectual Property Handbook* (paragraph 2.214) further explains that "neighbouring" or "related" rights" are the following: "rights granted in an increasing number of countries to protect the interests of performers, producers of phonograms and broadcasting organizations in relation to their activities in connection with the public use of authors' works, all kinds of artists' presentations or the communication to the public of events, information, and any sounds or images".

[11] Paragraph 12 of Article 12, quoting paragraphs 17.1 – 17.3 of the Commentary on Article 12 of the OECD Model Convention.

not the content of the database. Therefore, whether payments for the use of or subscription to a database are royalties should depend on the content of the database and the rights of the user. For instance, if the user of the database has the right only to read the contents of the database and no right to any confidential or specific know-how is transmitted to the user, the payments for the use of the database are not royalties. If, however, the database provides access to confidential information that can be used by the client, the payments would be royalties.

The legal protection for computer software varies from country to country. In some countries, it may be protected by copyright. Under the United Nations and OECD Model Conventions, a distinction is made between the use of copyrighted materials and the use of copyright: payments for the right to use a copy of a software program (licences) are not royalties, whereas payments for rights to sell, reproduce or develop the software (for example, the right to translate software into another language and sell it) would be royalties. It does not matter whether the software is used for personal enjoyment (games) or business (specific software for machinery used in industrial processes); nor is it relevant whether the software is acquired through an online download or in some physical format.

1.2.6.2.3 Industrial property royalties with respect to patents, trademarks, designs or models, plans, secret formulas or processes, or for information concerning industrial, commercial or scientific experience

Industrial property royalties usually include payments in consideration for the use or the right to use patents, trademarks, designs or models, plans, secret formulas or processes, or for information concerning industrial, commercial or scientific experience. As with copyright, countries' domestic laws with respect to patents, trademarks, and so forth, may vary significantly, although international conventions seek to achieve harmonization.[12] The Commentary to Article 12 of the United Nations and OECD Model Conventions provides guidance

[12] For further information concerning international conventions dealing with patents, trademarks and design systems, see the WIPO website at http://www.wipo.int.

as to the meaning of royalties with respect to the use of patents, trademarks and other industrial property by reference to the substance of any transaction with respect to such property, including the rights and obligations of the parties, regardless of domestic law.

The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[13] discusses the treatment of "intangible property", which is broader than the categories of property specified in the definition of royalties in Article 12 (3) of the United Nations Model Convention. In fact, for many countries, the broader concept of intangible property for transfer pricing purposes is a cause for concern in terms of base erosion, since in the post-BEPS era the parts of a multinational group that add value (that is, carry out the so-called development, enhancement, maintenance, protection and exploitation (DEMPE) functions) in connection with the intangible property are supposed to be compensated appropriately for their activity. In contrast, parts of the enterprise that simply perform routine functions should be allocated relatively little income. Therefore, countries should carefully consider DEMPE functions occurring in their territory with regard to intangible property of a multinational group. Where DEMPE functions and risks are transferred from one country to another, the tax base of the country from which the functions and risks are shifted will likely be eroded.

Developing countries should recognize that some countries use the concepts of marketing intangibles or location savings to attribute more profit to local subsidiaries and to reduce the royalties paid to non-resident companies of the same group.[14]

Payments for the use of or right to use patents are included in the definition of royalties. The term "patent" usually refers to the legal protection provided under domestic law to inventions of products and processes. Patents are usually registered. Although domestic laws with respect to patents vary, in general the requirements for

[13] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, supra note 2, chapter VI.

[14] See *United Nations Practical Manual on Transfer Pricing for Developing Countries*, chapter 10, pp. 357–415, (New York: United Nations, 2013), describing the transfer pricing laws of China and India.

patentability are: (1) industrial utility, (2) novelty, (3) non-obviousness and (4) patentable subject matter. Most countries exclude certain categories of inventions from patentability (for example, scientific theories, mathematical methods, plant or animal varieties, discoveries of natural substances, methods of medical treatment as opposed to medical products). Although some new processes or products are not patentable, payments for the use of or the right to use such processes or products may fall within another type of property in the definition of royalties (for example, secret formula or process) and give rise to a royalty if a right of use is conferred on the licensee.

Contracts for the use of patents often also provide for technical assistance, know-how, show-how or services to permit the licensee to exploit the patent fully and effectively. The problems with such mixed contracts are discussed in chapter 1, section 1.2.4, above.

According to WIPO, a trademark is generally defined as "a sign, or a combination of signs, that distinguishes the goods or services of one company from those of another".[15] Trademarks also include: (a) collective marks (used by associations and their members to identify themselves), (b) certification marks (signs of the quality or composition of a product), (c) "service marks" (used, for instance, by hotels and restaurants to identify themselves as members of a group) and (d) trade names, which can be protected within a trademark or independently. In general, payments for the use of all these signs, marks or names are included in the definition of royalties.[16] The terms "designs, models and plans" refer to types of intellectual property that are not protected as patents or trademarks but are nevertheless given legal protection and are subject to registration under domestic law. According to WIPO, the term "design" "refers to the right granted in

[15] See WIPO Publication No. 895E, *Understanding Industrial Property* (Geneva: WIPO, 2016), p. 19, available from http://www.wipo.int/edocs/pubdocs/en/wipo_pub_895_2016.pdf.

[16] With respect to use of group names and trade names, see OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD, 2015), section B.4.3, paragraphs 6.81–6.85, at 87, available at http://www.oecd-ilibrary.org/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en.

many countries, pursuant to a registration system, to protect the original, ornamental and nonfunctional features of a product resulting from design activity".[17] Only new or original designs, not those dictated by functionality, are protected. The term "model" usually means a "utility model", which is a name given to "a title of protection for certain inventions, such as inventions in the mechanical field".[18] Models are usually less complex than patents and can be registered using a simplified procedure. In some countries, integrated circuits may not be given protection either as designs, models or plans, but this does not mean that payments with respect to the use of such circuits are not royalties, since the circuits may qualify as a different type of property.

If a design, model or plan results from the performance of services (the design, model or plan did not previously exist), according to paragraph 10.2 of the Commentary to Article 12 of the OECD Model Convention, payments for the use of the design, model or plan should not be treated as royalties. For example, payments by a client to an architect for the design of a house are not regarded as royalties, but as business profits earned by the architect, even if the architect retains intellectual property rights with respect to the design, model or plan. If, however, the architect gives the client rights to modify the original design, payments for those rights are royalties. However, this position has not been accepted in the Commentary to Article 12 of the United Nations Model Convention.

Countries should consider whether to adopt broad meanings of the terms "design, model or plan" under their domestic law so that services resulting in a design, model or plan are covered by those terms. This issue does not arise if the same withholding tax rates apply to both royalties and services. In addition, fees for services resulting in designs, models or plans may be considered to be royalties in the form of payments for "information concerning industrial, commercial or scientific experience".

The meaning of the terms "secret formula or process" and "industrial, commercial or scientific experience" is controversial. They include secrets of a commercial or industrial nature, as well as knowledge

[17] WIPO, *Understanding Industrial Property,* supra note 15, p. 13.

[18] Ibid., p. 12.

derived from experience that is not subject to legal protection as a patent, copyright, and so forth.

Countries interpret the expression "information concerning industrial, commercial or scientific experience" differently. Therefore, countries should consider adopting a clear meaning for this information in their domestic law and attempt to avoid conflicts about that meaning in their tax treaties. Conflicts may arise with respect to the following:

- Technical assistance (show-how or technical information conveyed through technical or consultancy services, which is usually linked with licences of other assets such as patents) may be considered by some countries to be information concerning industrial, commercial or scientific experience. However, under the Commentary to Article 12 of the United Nations and OECD Model Conventions, such technical assistance is regarded as business profits covered by Article 7. If, however, fees for technical services are subject to withholding tax at the same rate as royalties, as provided in Article 12 A of the United Nations Model Convention, the distinction between such fees and royalties should be irrelevant.
- Some countries consider that payments for brain work, technical services or any specialized knowledge conveyed in whatever form are payments for "information concerning industrial, commercial or scientific experience". Under Article 12 (3) of the United Nations Model Convention, payments for such services are excluded from the definition of royalties. However, as noted above, if fees for technical services are subject to withholding tax at the same rate as royalties, the distinction between such fees and royalties should be irrelevant.
- According to paragraph 12 of the Commentary to Article 12 of the United Nations Model Convention, information concerning industrial, commercial or scientific experience is limited to information arising from previous experience. Some countries do not accept this limitation but consider that such information can be conveyed through services provided to clients. Again, if similar withholding taxes apply to fees for technical services and royalties, this distinction should be largely irrelevant.

1.2.6.2.4 Rent for the use of industrial, commercial and scientific equipment

Payments for the use of or the right to use industrial, commercial and scientific equipment are included in the definition of royalties under Article 12 (3) of the United Nations Model Convention and are often subject to withholding tax under domestic law. However, the terms "industrial", "commercial" and "scientific" are not usually defined in tax treaties. Unlike the other intangible property referred to in the definition of royalties, "equipment" refers to tangible, movable property (for example, cars, planes, ships, industrial machinery and apparatus, and containers).

The expression "industrial, commercial and scientific equipment" is usually given a broad meaning, which, for instance, can include wax figures for a wax museum. However, payments for the use of equipment that is ancillary to immovable property should not be considered to be royalties. For instance, if a farm or other immovable property is rented with machinery used for the purposes of carrying on a business, rent for the property should probably be treated entirely as income from immovable property with ancillary movable elements, especially if the machinery represents a relatively small part of the leased property. In most cases, however, rent for equipment, such as a vessel or drilling rig, will constitute equipment on a stand-alone basis.

Industrial, commercial or scientific equipment may be used in the business of an enterprise but may also be used to earn income from the property outside the context of a business. From the perspective of the owner of such equipment (the lessor), it is irrelevant whether the leased equipment is used by the lessee for business or personal purposes. All the facts and circumstances of contracts for the use of equipment must be carefully studied in order to characterize the payments. However, under a finance lease, the nominal owner of the equipment provides funds to the lessee to acquire the equipment. The payments by the lessee under a finance lease represent payments of principal and interest as if the lessee had borrowed funds from a lender to acquire the property. It is sometimes necessary to distinguish between proceeds from operating leases and finance leases. Payments for the use of equipment under an operating lease should be treated as royalties under Article 12 (3) of the United Nations Model Convention.

In sum, to determine whether a contract is a lease or a sale of equipment, the true nature or economic substance of the transaction should be considered, taking into account all the facts and circumstances.

Example 8

SCo leases industrial machinery from FCo for a period of five years, which is the expected useful life of the machinery. At the end of the contract, SCo has an option to purchase the machinery for its residual value at that time. The monthly payments by SCo to FCo cover the amortization or depreciation of the machinery plus interest and the contract specifies that all risks and expenses linked with the machinery are assumed by SCo. This transaction has all the elements of a "finance lease", and the payments are not, in substance, royalties for the use of equipment, but blended payments of principal and interest. If, however, the useful life of the machinery is ten years or SCo does not assume any risks or expenses with respect to the use of the machinery, the payments under the contract would likely be royalties.

Leases for the use of equipment usually provide that the payer has physical possession and control of the property. As a result, payments for services — for example, payments for digital or internet services (hosting, data warehousing, and so forth), or for the use of satellites, networks, pipelines or cables — where the payer does not have any control of the equipment used are not royalties. Countries that want to tax payments arising from these types of transactions, which may be substantial, must ensure that such payments to non-residents are subject to withholding tax under domestic law; they must also ensure that they do not give up the right to tax such payments in their tax treaties (perhaps, for example, by extending Article 12 to include such payments).

Equipment leasing may result in base erosion for both source and residence countries. From the perspective of source countries, payments for the use of equipment for business purposes will often be deductible by the payer and the payments may not be subject to withholding tax, or may be taxed at a reduced rate under the provisions of tax treaties.

From the perspective of residence countries, a resident taxpayer can establish a non-resident company to earn rent for the use of equipment in the residence country. The tax base of the residence country is reduced because the payer will deduct the rental payments and the non-resident company will usually not be subject to tax on its rental income by the residence country.

1.2.7 Geographical source of rent and royalties

For purposes of taxing non-residents, and also for purposes of providing relief from double tax, it is necessary to determine the geographical source of income, including rent and royalties. Rent from immovable property is inevitably considered to be derived from the country in which the immovable property is located. This source rule applies to both passive and active income (from businesses that use immovable property, such as agriculture, farms, mines, wind farms).

For rent and royalty payments for the use of movable property, two sourcing rules are generally used: the country where the property is used and the country of residence of the payer. Both rules are useful for countries, since they capture different situations.

Example 9

ACo, a resident of Country A, rents machinery to BCo, a resident of Country B, to be used in a construction project in Country S. The construction project does not give rise to a PE (it lasts only for two months) in Country S. If Country S uses the residence of the payer as the source rule for the rental payments, the payments from BCo to ACo would not be considered to arise or have their source in Country S. However, if Country S uses the place of use of the machinery as the source rule, it could tax the payments of rent by BCo to ACo because the rent would be considered to be sourced in Country S.

Source rules should be consistent for different forms of payments. If the residence of the payer rule is used as the source rule for royalties but the place of performance for income from services, taxpayers may have an incentive to turn one category of income into another to avoid taxation in the source country.

Example 10

SCo, resident in Country S, contracts with an engineering company, TCo, resident in Country T, for know-how and technical services. Country S uses the residence of the payer rule as the source of royalties and the place of performance as the source of income from technical services. As a result, the parties may split the contract in two parts (one for know-how and the other for services) in order to avoid withholding taxes with respect to services provided by TCo. In such situations, taxpayers may tend to inflate the price for the provision of services and reduce the price for the know-how in order to avoid withholding taxes on the payments for the know-how.

Payments of rent or royalties by non-residents that are deductible in computing the profits subject to tax by a country should be considered to be sourced in that country and should be subject to withholding tax by that country. In the context of tax treaties, payments of rent or royalties are deductible by a non-resident only if the non-resident carries on business in a country through a PE or fixed base. Similarly, countries may wish to exempt from withholding tax payments of rent and royalties made by residents that are effectively connected with the income-earning activities of a foreign PE or fixed base.

Example 11

If ACo, resident in Country A, leases industrial equipment to BCo, also resident in Country A, to be used by a PE of BCo in Country C, the rental payments for the equipment would be considered to be sourced in Country A if it uses the residence of the payer as the source rule. It is also likely that Country C, where the PE is located, will impose tax on the rental payments, since they are deductible in computing the profits attributable to the PE. Thus, double taxation may be the result.

The residence of the payer rule is easier to administer than the place of performance rule, since there is no need to determine where the asset is used under the residence of the payer rule.

1.2.8 Allocation of rent and royalties to income

Payments under a lease or licence may represent expenses of the payer that relate to:

- Non-taxable activities (non-income-earning or personal) activities
- Activities taxable at ordinary rates, or
- Activities taxed at reduced or preferential rates

The particular method or methods used by a country to allocate expenses to different activities may be established in its domestic tax legislation, in the administrative practices of the tax authorities, in court cases, or in a combination of these sources. The rules for allocating rent and royalties are usually the same rules that apply to expenses generally, and the following comments should be seen in this context.

Expenses (rent and royalties) should normally be deductible only if they are incurred to earn taxable income. Thus, rent or royalties for the personal use of property should not be deductible.

Countries may establish (rebuttable or non-rebuttable) presumptions of non-deductibility with regard to expenses connected with certain types of property that are likely to be used for private purposes and not to earn income. Where only part of an asset is used to earn income (for example, an automobile that is used partly for personal purposes and partly to earn income), only the part of the rent or royalty for the use of the property for income-earning purposes should be deductible. Some countries may disallow the deduction of any portion of such expenses: in other words, they may require deductible expenses to be incurred wholly and exclusively for the purpose of earning income.

The deductibility of rent and royalties with respect to hobby activities raises difficult issues. General restrictions on the deductibility of rent and royalty expenses may be applied to prevent the deduction of personal expenses. A proper definition of "business" by reference to factors such as profitability over time, main activity, number of employees, assets, can also be useful in these cases, although it may be difficult to differentiate between a real business and a hobby in particular cases.

Example 12

Mr. A is a wealthy individual resident in Country A. Mr. A rents a horse farm (land and buildings) from a non-resident that Mr. A uses for raising, boarding and riding horses. The farm is used primarily for recreational purposes (riding with family and friends). Mr. A decides to start a horse-breeding operation at the farm. The horse-breeding operation involves substantial expenses but little income is produced from the sale of horses. Limits should be established on the deduction of the losses from the horse-breeding activities of Mr. A against his other income.

Since the horse-breeding activity produces recurring losses, it can be regarded as a non-income-earning activity. Alternatively, the losses from the horse-breeding activities of Mr. A can be ring-fenced so that those losses can be used only to offset income from those activities and not to reduce his other income.

If rented property is linked to income-earning activities, it is necessary to consider whether some income is exempt from tax or subject to tax at reduced rates. In these cases, it is also necessary to allocate the rent and royalty expenses to the exempt or preferentially taxed income to ensure that such expenses are not deducted against income taxed at ordinary rates. There are basically two systems that can be used for this purpose: direct tracing or apportionment.

Under direct tracing, all the facts and circumstances are examined in order to determine the activity to which the rental property is connected. If the property is connected with exempt income, the expense should not be deductible. Similarly, if the property is traced to an activity that is preferentially taxed, only a portion of the rent or royalty expense should be deductible.

Under an apportionment approach, rent or royalties are allocated to income by reference to the cost or value of assets, gross revenue, turnover or some other factor.

Example 13

Industrial equipment is rented by ACo to be used in two different activities, one exempt from corporate tax and the other one subject to the ordinary corporate rate. The total turnover of ACo from the exempt activity is 10 and the turnover from the fully taxed activity is 90. If the rent paid for the equipment is 50, the total deduction for the use of the equipment in the fully taxed activity should be calculated as follows:

$$\frac{\text{90 (turnover of fully taxed activity)}}{\text{100 (total turnover) x 50}} = \text{45 (amount of deduction)}$$

(amount of expense)

Most countries use both tracing and apportionment because, although tracing is easier, it is impossible to apply in certain circumstances.

1.2.9 Payments of rent and royalties to related persons

Cross-border payments of rent and royalties to related persons present specific risks of base erosion, especially if the payments are deductible and not subject to withholding taxes, or the withholding tax rate does not offset the tax savings from the deduction. When persons are considered to be related depends on domestic law. Legal entities are generally considered to be related to entities that they control and to persons that control them. Control for this purpose usually means the ownership of more than 50 per cent of the voting shares or other interests in an entity, but may also include the ownership of interests representing more than 50 per cent of the value of all the interests in an entity. In some circumstances, countries may use a threshold of 25 per cent or lower for determining when parties are related. Natural persons are generally considered to be related if they are related by means of blood relationship, marriage or adoption.

The problems of base erosion with respect to payments of rent and royalties to related parties are dealt with below in section 1.5.

1.2.10 Payments for the use and exploitation of natural resources

It is common for countries to impose tax on payments that compensate a country (or any other public entities such as subnational governments or governmental agencies) for the use and exploitation of natural resources (for example, oil, gas, minerals) as royalties. However, these payments are not characterized as royalties for purposes of tax treaties.

Payments that are intended to compensate a country for the extraction of natural resources from the public domain are similar to user fees, and are therefore expenses of the business carried on in that country. They are not usually within the scope of the distributive rules of tax treaties. Sometimes, however, resource royalties do not represent compensation for use of natural resources and, depending on how the royalties are structured, may be similar to income taxes. In these cases, the provisions of tax treaties may apply, and the difficult issue is whether the residence country must provide relief for the resource royalties paid to the source country in order to avoid double taxation.

The treatment of resource royalties is outside the scope of this *Practical Portfolio.*

1.2.11 Back-to-back arrangements

Some countries may impose withholding taxes only on payments of royalties to certain non-residents — for example, payments to non-residents with whom the payer does not deal at arm's length. Similarly, restrictions on the deduction of royalties may be imposed only on royalties paid to certain non-residents — for example, residents of a low-tax country or tax haven. Similarly, the benefits of reduced withholding tax under a tax treaty typically apply only if the recipient is the beneficial owner of the royalties. In all these cases, it is necessary to determine the identity of the recipient of royalty payments, and, as a result, taxpayers have opportunities to avoid the rules through back-to-back arrangements.

Example 14

ACo, a resident of Country A, licenses technology to its wholly owned subsidiary BCo, a resident of Country B, in consideration for an annual royalty payment of 1,000. BCo, in turn, licenses the technology on the same day to a related corporation, CCo, a resident of Country C, for an annual royalty payment of 1,000. Should the royalty payment by CCo be treated as a royalty to BCo (the nominal licensor) or as a royalty payment to ACo (the original source of the technology)?

This issue is important under treaties (as discussed in chapter 4, section 4.3.2 below), and may also be important under domestic law. In the case of treaties, identifying the owner of intellectual property is essential for determining whether the recipient of royalties is the beneficial owner of the royalties and entitled to treaty benefits, and possibly a reduced withholding tax. Under domestic law, proper identification of the owner of intellectual property and royalties can be important for information-reporting purposes as well as for withholding tax and the application of any restrictions on the deduction of royalties.

The difficulty in identifying the correct licensor in the case of back-to-back royalty arrangements is even more challenging when the intermediary is not related to the other parties. This is more likely to be the case with respect to interest than to royalties. For instance, assume that, based on the facts of the previous example, ACo licenses BCo, an arm's length company in Country B, to use technology, but on condition that the technology is licensed on the same terms to CCo in Country C. Should the royalties paid by CCo be treated by Country C as royalties paid to ACo?

This question may be easy to answer based on these simple facts, especially if, for example, royalty payments made directly from CCo to ACo are subject to a 25 per cent withholding tax but royalties paid to arm's length persons are exempt from withholding tax. However, in other situations the question may be difficult to determine. For example, what if the terms of the licence or the amounts of the royalties under the two licences are not the same? In general, the issue depends on all the facts and circumstances, including the terms of the two transactions, the royalty rates, and how closely related the two transactions are in time. If the first transaction is conditional upon the ultimate transaction, that will likely be a clear indication that the two transactions form a back-to-back arrangement.

Back-to-back arrangements may be structured in a wide variety of ways. Countries should ensure that they have effective anti-avoidance rules in order to prevent the use of back-to-back arrangements aimed at avoiding various rules dealing with deductions of rent or royalties and withholding taxes on rent or royalties, or at obtaining treaty benefits improperly.

Back-to-back arrangements are not a serious concern with respect to rent derived by non-residents from immovable property located in a country if the country imposes tax on all such rental payments.

1.3 Taxation of non-residents on rent and royalties

1.3.1 Introduction

In considering the risks of base erosion through payments of rent and royalties, the most significant issue is the deduction of rent and royalty expenses by the payer against a country's tax base without any corresponding tax on the recipient of the rental or royalty payments. This result generally occurs in two contexts:

- A non-resident invests in a country through a fixed base or PE and rent and royalty expenses are deductible in computing the profits attributable to the fixed base or PE. These issues are discussed below in section 1.3.2.
- A non-resident receives rent and royalties from a related or unrelated payer who deducts the payments in its country of residence whether or not the non-resident is subject to tax on the rent or royalty income in its country of residence. These issues are discussed in section 1.3.3.

As noted throughout this *Portfolio*, payments of rent and royalties, when connected with business activities and reasonable in amount, are legitimate business expenses that generally should be deductible in both situations.

1.3.2 Non-residents with a permanent establishment or fixed base paying rent and royalties to earn income

In the case of a fixed base or PE, there are challenges to address where rent and royalties are paid to non-residents and are deductible in computing the profits attributable to the PE or fixed base. In some cases, rental and royalty payments are incurred by a non-resident enterprise and are clearly attributable to a PE or fixed base. This category of payments is similar to payments made by a resident of a country to a non-resident, and the considerations discussed in section 1.3.3 below are equally applicable to PEs or fixed bases.

However, in some cases, it can be difficult to determine the share of the total rent or royalty incurred by a non-resident enterprise that should be allocated to the PE or fixed base. Although the PE or fixed base usually maintains books and records (in order to determine its income), it is not a legal entity separate and distinct from the enterprise of which it is a part.

The United Nations Model Convention recognizes the challenge of allocating royalty payments to a PE or fixed base. Paragraph 3 of the Commentary to Article 7 (Business profits) directs that the PE or fixed base should be allowed a deduction of its "allocable share" of royalty expenses paid to third parties. Thus, third-party royalties paid by the enterprise should be allocated and apportioned between the PE or fixed base and the rest of the enterprise. A royalty payment should be allocated exclusively to a PE or fixed base if the payment is directly connected with the activity of the PE or fixed base or is incurred exclusively for the benefit of the PE or fixed base.

Rental payments for immovable or movable property are somewhat easier to allocate than royalties in respect of intangible property, since usually the payment can be allocated to the head office or PE, depending on who uses the rented property (direct allocation). Apportionment issues may also arise in this context if the rented asset is used for purposes of both the head office or other parts of the enterprise and the PE or fixed base.

Determining the "allocable share" of rent and royalty expense that should be deductible by a fixed base or PE is not always simple. Sound legislation and administrative practices with respect to the allocation of rental and royalty payments may help to prevent base-erosion effects (see chapter 2, section 2.3.1.3.2, below, on the problems of applying Article 7 (3) of the United Nations Model Convention). Although taxpayers have a responsibility in the first instance to determine the allocation, the tax authorities must consider whether the taxpayer's method of allocation is reasonable or whether a different method of allocation should be applied.

In general, a PE or fixed base is not a separate taxable entity. Therefore, a PE or fixed base does not incur or pay rent or royalties. Instead, a non-resident enterprise with a PE or fixed base in a country is allowed to deduct actual expenses incurred by the non-resident enterprise on behalf of or for the benefit of the PE or fixed base. A PE or fixed base should not be allowed to deduct more than the actual rent or royalty expense incurred by the non-resident enterprise on its behalf (that is, the non-resident enterprise should not be allowed to charge the PE or fixed base a mark-up on the rent or royalty expense). Similarly, a PE or fixed base should not be allowed to deduct notional or fictitious payments of rent or royalties to its head office, since a country will not be able to tax those payments with withholding taxes and this will cause base erosion.[19]

[19] See also chapter 2, section 2.3.1.3.2, on these issues and how they are dealt with in Article 7 (3) of the United Nations Model Convention, which

1.3.3 Non-residents earning domestic source rent and royalty income

1.3.3.1 Introduction

In considering the challenges of base erosion through rental and royalty payments to non-residents without a PE or fixed base in the country, the main issues are:

- *Allocation of the expenses to private or business activities from the perspective of the payer:* This problem is dealt with in section 1.2.8 above. If payments of rent and royalties relate to private or personal activities, no deduction should be allowed. If the income from the activities is exempt from tax or taxed at a preferential rate or benefits from specific incentives, the rent and royalty expense should be allocated to the specific activity with which it is directly linked.
- *Avoidance of taxable presence in a country by the recipient of the payment:* If there is substantial activity by a non-resident in a country, the tax authorities should determine whether that activity is sufficiently relevant to permit taxation in full of the recipient of the rent and royalty payment. If a non-resident receives rent and royalty payments from a country, quite often it will not be taxable in that country or will be taxed at low withholding tax rates, especially if tax treaties are applicable. Therefore, the deduction of the expenses will not be matched by corresponding taxation of the person deriving the income. As a result, there is an incentive for a non-resident to claim that there is no taxable presence in the country (PE or fixed base). This risk should be addressed with special provisions in tax treaties or domestic legislation, transfer pricing or anti-abuse rules that permit a country to tax the rental or royalty payments.[20]

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does not accept the authorized OECD approach for the attribution of profits to PEs in Article 7 of the OECD Model Convention.

[20] See Adolfo Martín Jiménez, "Preventing avoidance of permanent establishment status", in *Protecting the Tax Base of Developing Countries* (New York: United Nations: 2015), chapter VII, pp. 325 – 406, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

- *Taxing payments of rent and royalties to non-residents without a PE or fixed base in the country*: This issue is addressed in the following section.

1.3.3.2 Rent and royalties derived by non-residents without a PE or fixed base

The risk of base erosion through payments of rent and royalties by residents (or non-residents with a PE or fixed base in a country) to non-residents depends on several factors:

- The type of rent and royalty payment under domestic law
- The relationship between the payer and the recipient (see section 1.5 below)
- Whether a tax treaty applies (see chapter 2 below dealing with the treatment of rent and royalties)

Rent from immovable property located in a country derived by non-residents without a PE or fixed base in that country presents limited problems in terms of base erosion (see section 1.2.5.2 above for the meaning of immovable property). Usually, the country in which the immovable property is located has the right to tax the rent (and any other income) derived from the immovable property, and most countries impose tax on such income. Therefore, the deduction of the expense by the payer is offset by tax imposed on the non-resident recipient of the payment.

The risk of base erosion may arise if a country permits the deduction of expenses related to immovable property located in the country. However, the deduction of these expenses is appropriate if a country taxes non-residents on their income from immovable property on a net basis. Developing countries that tax non-residents on income from immovable property located in the country should have domestic laws and administrative practices to ensure that the proper amount of net income derived by non-residents is subject to tax.

Rental and royalty payments to non-residents for the use of movable property or other rights included in the definition of royalties present more challenges in terms of base erosion than rent from immovable property. The risks are similar to those that arise with respect to income from services (see sections 1.2.5.3 and 1.2.6.2.4

above on the concepts of movable property and royalties). In general, countries tax non-residents on their income from rent and royalties earned in those counties. The critical question in this regard is how does a country determine the source of rent and royalties derived by non-residents? Countries tend to use different source rules. Probably, a combination of the place where the property or right is used and the country of residence of the payer is the most efficient rule, although some technical measures should accompany these sourcing rules (see section 1.2.7 above).

Since a non-resident deriving rent or royalty income from a country may not have any significant presence in the country (fixed place of business, employees or assets), the only effective way to collect tax is to impose a withholding tax on the gross amount of the payments, or perhaps deny the payer a deduction for the payments. Whether there is a net reduction of a country's tax depends on a comparison of the tax saving from the deduction of the payments and the amount of any withholding tax on the payments. For example, if the payer is subject to tax on its income at a rate of 30 per cent and the amount of the payment for the rent or royalty is 1,000, the deduction of the payment results in a tax saving for the payer of 300. If the withholding tax rate applicable to the payment for the rent or royalty is 10 per cent or 100, the country's tax base is reduced by 200 (300 – 100 = 200). This does not mean, however, that the country should impose a withholding tax at a rate of 30 per cent, since the withholding tax should be a proxy for tax at the applicable rate on the non-resident's net income.

It is difficult to establish a domestic withholding tax rate. Non-residents may often have expenses connected with the rent or royalties earned from a country. If so, gross-basis withholding taxes, even at a low level, may represent a high percentage of the net income earned by the non-resident. In these cases, non-residents will attempt to shift the burden of the withholding tax to the payer by requiring the payer to gross-up the amount paid (see example 22 in chapter 2, section 2.3.1.2.3, below). To mitigate the effects of withholding, some countries permit non-residents deriving rent and royalties to elect to be taxed on a net basis, or set a relatively low rate of withholding tax. Some countries may also apply reduced withholding tax rates on rent and royalties or exempt such payments from withholding tax in order to promote the import of certain technology or equipment into the country.

The basic patterns for the taxation of rent and royalties from movable property or rights are the following:

(a) All payments of rent or royalties by residents or non-residents with PEs or fixed bases in the country (or non-residents using property within the country if the place-of-use source rule is used) are subject to a gross-based withholding tax; such a broad tax is difficult to enforce, especially where payments are made by individuals.

(b) Payments of rent or royalties by residents or non-residents with PEs or fixed bases in the country (or non-residents using property within the country if the place-of-use source rule is used) are subject to a gross-based withholding tax only if the payments are deductible in the country in computing income subject to tax. However, under this pattern, non-deductible payments made by individuals or exempt entities are not subject to tax.

Both of these alternative patterns have advantages and disadvantages. The first pattern permits a country to tax a broader range of payments, but is more difficult to administer and enforce, especially for individuals. The second pattern seeks to tax non-residents only where there is a corresponding deduction that erodes the country's tax base. Although this pattern is easier to administer and enforce, it has a narrower tax base and some non-residents will escape taxation on rent and royalties derived from the country, which, in itself, may be regarded as a form of base erosion. This second pattern may also create more opportunities for exempt entities in a country to be used as intermediaries for leasing and rental arrangements in order to avoid withholding taxes falling on the non-resident.

Regardless of the basic pattern, some countries deny the deduction of rent and royalties if the payer has not withheld the tax applicable. Other countries impose joint liability on the withholding agent for the withholding tax due (plus interest and penalty) if the withholding agent fails to withhold the proper amount or the non-resident fails to pay the tax.

The risks of base erosion are exacerbated if tax treaties prevent a country from taxing rent and royalty income arising in its territory or substantially reduce the withholding taxes applicable to that income (see chapter 2 below on the effect of tax treaties). Some countries have implemented specific "penalty taxes" (for example, the United Kingdom Diverted Profits Tax and Australian Multinational Anti-Avoidance Law) to deal with deductions of payments to non-residents that are either not taxed or taxed at preferential rates. These taxes are aimed at capturing deductions, including deductions of rent and royalties, through payments to entities that are subject to low or no tax. These taxes may give rise to problems if applied in a treaty context.

1.4 Taxation of resident taxpayers on rent and royalties

1.4.1 Introduction

In terms of base erosion, rent and royalties can be considered from two perspectives. First, they can be expenses for residents of a country incurred to earn any type of income. Second, they can also be income derived by residents of a country. Where residents of a country earn rent or royalties sourced in that country, most countries impose tax on such rent and royalties. However, where rent or royalties are derived from foreign sources, they may be exempt from domestic tax or subject to domestic tax with a credit for any foreign tax on the rent or royalties.

There are two basic patterns for taxing income earned by residents of a country:

(a) Worldwide taxation, under which residents are taxed on their income derived from the country in which they are resident from sources outside that country (foreign source income); and

(b) Territorial taxation, under which a country taxes income only if it is earned or derived from the country, so that residents are not taxable on income earned outside the country. In effect, under territorial taxation, foreign source income is exempt from tax.

It is not necessary for a country to tax all income in accordance with one of these basic patterns. For example, a country that generally taxes on a worldwide basis may decide to exempt certain foreign source income, such as business profits earned through a foreign PE or dividends received from foreign corporations in which resident corporations own a substantial interest (generally 5 or 10 per cent or more of the shares of the foreign corporation). Similarly, a country that generally taxes on a territorial basis may tax certain types of foreign source income derived by residents of the country.

Base erosion issues are relevant for a country regardless of whether it taxes on a worldwide or territorial basis. As indicated above, for the purposes of analysis it is important to differentiate cases where a resident of a country pays rent and royalties from those where a resident receives those payments. In both cases, cross-border payments of rent and royalties are especially important from the perspective of base erosion. A third situation that may cause concern for a country in terms of base erosion arises where a resident of a country alienates assets or rights that either generate rent or royalties or have the potential to generate them.

1.4.2 Residents incurring rent and royalties to earn foreign income

1.4.2.1 Territorial taxation

If a country taxes on a territorial basis, the critical base-erosion issue is whether rent and royalties incurred by residents of the country to earn foreign source income are deductible. In theory, since foreign source income is not taxable, any expenses incurred by the taxpayer for the purpose of earning such income should not be deductible. Although this fundamental principle is clear, it is difficult to apply in practice. In particular, sometimes it is easy to establish a direct link between payments of rent or royalties and the income so that the expense is either deductible or not deductible in full.

Example 15

ACo, a resident of Country A, rents industrial machinery for a price of 100 to perform construction work in Country B for a resident of that country. Since the payment is connected with foreign income, the expense of renting the equipment should not be deductible in computing the income of ACo taxable by Country A, assuming that Country A does not impose tax on foreign source income.

However, expenses may be connected with foreign and domestic source income at the same time (for example, rent for immovable property where the office of a company is located and where both the domestic and foreign activities are managed, royalties with respect to a patent, trade mark or know-how used both domestically and abroad, rent for equipment used within the same year within and outside the country). In such cases, the portion of the expenses to be allocated to domestic and foreign source income must be determined (see section 1.2.8 above on the methods of allocation of rent and royalties to income).

In terms of the allocation of expenses, the case of rent and royalties is special because sometimes, if the rent or royalty is directly linked to foreign income, a tracing approach denying the deduction of the rent or royalty is clearly justified. On the other hand, if the rent or royalty is connected with both domestic and foreign source income or cannot be easily allocated to an income stream, an apportionment approach based on certain factors may be necessary or preferable. Both approaches for allocating rent and royalties may need to be applied by a particular taxpayer to different types of expenses, depending on the type of expense and the location of the activity. Sometimes different approaches may need to be applied to the same asset in different tax years (for example, equipment used abroad in year 1 and used both domestically and abroad in year 2).

If a country taxes on a territorial basis and allows the deduction of rent and royalties paid to earn foreign source income that is not taxable, the country's tax base is clearly eroded inappropriately. If a country denies the deduction of rent and royalties incurred to earn foreign source income, the issue is whether those rules are effective or easily avoided.

Sometimes base erosion is acceptable to countries as a method of promoting foreign investment by resident enterprises or groups of companies. Allowing the deduction of expenses incurred to earn exempt income may give resident enterprises a competitive advantage over foreign enterprises. In these situations, countries should carefully consider whether this result is reasonable. Some countries may justify the deduction of rent and royalties to earn exempt foreign source income on the basis that the rent and royalties would not be deductible in computing income in the foreign country where the income is earned.

Example 16

ACo, a resident of Country A, rents an office for 100 in Country A from which its activities in Country A and Country B are managed. Country A has to decide whether to permit ACo to deduct the rent (100) in full or to apportion it between the domestic and foreign activities. The rental payment can be linked or traced on a factual basis to both domestic and foreign income-earning activities. If an apportionment approach is adopted, the part of the rent allocated to the activities in Country B may not be deductible in Country B (for example, where Country B is a tax haven that does not impose tax). If Country B imposes income tax in this situation, it should allow a deduction for the rental expense incurred for the purposes of the activities carried on in Country B. Even if Country B does not allow a deduction for the rent in these circumstances, from a tax policy perspective, Country A should not allow the deduction of the rent attributable to the activities in Country B. However, Country A may decide in this case to permit company A to deduct 100 and not to apportion that income between foreign and domestic activities

1.4.2.2 Worldwide taxation

If a country taxes its residents on their worldwide income, any rent or royalty expenses incurred for the purpose of earning foreign source income are likely to be deductible in the same way as other expenses. Several important consequences flow from the decision to tax residents on their foreign source income.

First, if a country taxes on a worldwide basis, the income derived by its residents will often be subject to double taxation — once by the country in which the income is earned and again by the country of residence of the taxpayer. It is generally accepted that the country of residence has the obligation to eliminate double taxation and must do so by allowing a credit against its own tax for the tax paid to the foreign country or by exempting the income earned in the foreign country. Note that if a country provides relief from double taxation by exempting the foreign source income from tax in the country, in effect, it is taxing that income on a territorial basis and the problem of expenses is similar to that in territorial systems (see the discussion of territorial taxation in section 1.4.2.1 above).

Second, if a country uses a foreign tax credit to eliminate double taxation, the credit will usually be limited to the amount of that country's tax on the foreign source income. Therefore, for purposes of this limitation on the credit, it is necessary for the country to calculate the amount of the foreign source income, and in particular to determine which expenses incurred by the taxpayer are allocated to the foreign source income. If the proper amount of expenses is not allocated to the foreign source income for this purpose, in effect, the expenses will be deductible against the country's domestic source income. This result is inappropriate and can be viewed as a form of base erosion. However, as discussed in section 1.4.2.1, some countries may not allocate expenses to foreign source income as a means of subsidizing foreign activities of resident companies.

In addition, countries should not permit credit for foreign "royalty payments" for the exploitation of natural resources abroad, since these are not real income taxes and, if creditable, may erode the country's tax base (see section 1.2.10 above for a discussion of these royalties). In general, this point applies to any tax that is not an income tax.

Moreover, depending on the type of limitation used for purposes of the foreign tax credit (overall, per country, or item-by-item), residents of a country may be able to obtain a credit for foreign taxes on income that is higher than the country's tax on such income by averaging those foreign taxes with lower foreign taxes on other income.

If rent and royalty expenses (alone or with other expenses) incurred to earn foreign income are greater than the amount of foreign revenue, the taxpayer will have a net loss. If a foreign loss can be deducted or offset against domestic income, base erosion will result. A similar problem arises under the exemption and credit methods for relief of double taxation. Some countries ring-fence foreign losses so that they are deductible only against foreign income.

Third, even if a country taxes on a worldwide basis, it will not usually tax the income derived by a foreign corporation that is owned or controlled by residents of the country because the foreign corporation is usually considered to be a separate taxable entity and is not resident in the country. Thus, residents of a country may form foreign corporations that they control in order to earn foreign source income. This use of a controlled foreign corporation (CFC) is a relatively simple way for residents of a country to avoid paying tax on their foreign source income. Moreover, such CFCs can sometimes be used to earn income in the country of residence of the controlling shareholder. A similar risk of base erosion may occur with respect to a foreign PE if a country applies the exemption method to income attributable to that PE.

1.4.3 Residents earning foreign source rent or royalty income

1.4.3.1. Introduction

In principle, where a resident of a country derives rent or royalty income from foreign sources, the general issues are similar to those considered in section 1.4.2. This section deals with two specific problems that raise base-erosion concerns. First, expenses incurred to earn foreign source rent and royalties should be allocated to those amounts for the purposes of relief from double taxation. Second, where the asset or right generating the foreign source rent or royalties is located in the residence country, the question arises of how to deal with capital gains derived from the alienation of that asset or right.

1.4.3.2 Territorial taxation of rent and royalty income

As explained above in section 1.4.2.1, if a country applies a territorial system, income from outside the country will generally not be taxed. However, with the exception of immovable property located abroad, countries should probably impose tax on rent or royalties derived from foreign countries unless the asset or right is connected with a foreign PE. If such income is not subject to tax, base erosion results if expenses (for example, personnel, research and development (R&D), amortization of equipment, transportation costs) connected with the production, maintenance or exploitation of the asset or right are deducted from the tax base. Moreover, this result constitutes an incentive for resident taxpayers to earn foreign rent and royalty income.

Example 17

ACo, a resident of Country A, engages in research and development (R&D) activity in Country A for several years and deducts expenses (for example, personnel, amortization of equipment) linked with those R&D activities. The R&D activities result in a patent and, some years later, it is licensed exclusively to a foreign company. The result is the erosion of the tax base of Country A if Country A does not impose tax on the income connected with the patent (for example, Country A might consider royalties to arise or have their source in the country in which the property is used rather than in the country where the owner of the property is resident). ACo will probably prefer to exploit the patent abroad if the expenses are deductible in Country A but foreign source income is not subject to tax.

As shown in the example, expenses may not be incurred in the same year that income is earned. Therefore, if a country decides not to tax foreign rent and royalty income, it may not be easy to match exempt income and expenses incurred to earn that income. In the example, most of the R&D expenses are incurred in years before the foreign income is derived. Therefore, it is very difficult for a country to deny the deduction of expenses connected with exempt foreign income. Presumably, tax returns for years before the income is earned would need to be revised to achieve that outcome.

The difficulties are compounded where an asset or right is used to derive rent and royalty income from domestic and foreign sources at the same time (for example, exploitation of a patent through domestic and foreign licences). As explained above, an allocation system is necessary in these cases and it may not be easy to apply if the expenses and income are not incurred and earned in the same tax years.

An enterprise may not know in advance whether property for which expenses have been incurred will be used within the country, outside the country or both. Rather than denying any expense, the preferable solution is probably to tax foreign rent and royalty income. Some developing countries may intentionally decide to promote R&D activities in their countries by allowing the deduction of those expenses and not taxing any foreign source income from the exploitation of intangible property outside those countries. If so, these cases should be carefully monitored to ensure that the rules are operating in accordance with the country's tax policy and are not being abused. This approach may not be compatible with the minimum standard adopted in the OECD/G20 BEPS Action 5 Final Report (see section 1.4.3.3 below).[21]

If rent and royalty income from foreign sources is not taxed in a country, there is also the risk that taxpayers may attempt to manipulate the source of income in order to avoid or reduce tax. This problem depends on the rules for determining the source of income from rent and royalties. As explained in section 1.2.7, many countries use the place of residence of the payer or the place where the property is used as source rules for taxing non-residents with respect to rent and royalty income. These rules may not be appropriate with respect to residents deriving rent and royalty income from foreign sources, especially if the income is derived indirectly from the residence country through CFCs or PEs abroad.

Example 18

Country A has a place-of-use rule with regard to rent and royalties derived by residents from outside that country. ACo, a resident of Country A, wishes to license a patent and lease equipment to BCo, also a resident of Country A. For that purpose, a foreign corporation is set up to which the licence is granted and the equipment is leased. The foreign corporation, which benefits from a special low-tax regime for rent and royalties in its country of residence, rents the equipment and licenses the patent to BCo. If the tax that the foreign company pays in Country A is less than the tax ACo would have paid had the transaction been structured directly, there will be an incentive to turn domestic income into foreign income through these types of structures.

Similarly, a place-of-use rule may not be satisfactory if the transaction takes place entirely within a country: for instance, if a software licence agreement between two residents requires exploitation outside the residence country, the country may be justified in trying to tax that income. (Otherwise, it may be difficult to allocate the income

[21] OECD, *Action 5: 2015 Final Report: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en.

between domestic and foreign sources.) Therefore, countries should make sure that they have clear rules as to the geographical source of income (foreign and domestic) that cannot be easily manipulated by taxpayers (or that efficient CFC rules, which are unlikely to be present in territorial systems, or anti-avoidance rules apply to these cases).

Rent from immovable property may produce some unique problems. If the property is located abroad, the situs country will usually tax the income from the property, often without permitting the deduction of any expenses. If a country does not impose tax on income earned by its residents from foreign immovable property, the country should deny the deduction of any expenses incurred with respect to the property. A tracing approach can usually be applied to identify expenses linked with immovable property located abroad (for example, condominium contribution, common expenses, local taxes, insurance, repairs). Interest expenses incurred to fund the purchase of the immovable property should also be allocated to the foreign property, especially if the property is used to guarantee the loan.

1.4.3.3 Worldwide taxation of rent and royalty income

Where a resident of a country derives rent and royalty income from outside that country and the country taxes the worldwide income of its residents, the problems are similar to those that arise with respect to income generally. Under a worldwide tax system, regardless of the method for relief of double taxation, expenses to earn foreign rent and royalty income should be allocated to that income. If the income is exempt, the expenses should not be deductible; if the income is taxable, the expenses should reduce the foreign source income for purposes of the limitation on the foreign tax credit (see section 1.4.3.2 above on these issues). Otherwise, if expenses to earn foreign rent and royalty income are not allocated to that income, the country's tax base will be eroded, since the expenses will reduce the tax on other domestic income. Some countries, however, allow this result and, in order to promote R&D activities within their territory, do not allocate all or part of R&D expenses to foreign rent and royalty income (see below with respect to the OECD/G20 BEPS Action 5 Final Report, which affects mainly cases of exemption or low taxation of foreign rent and royalty income).

Foreign rent and royalty income derived by residents of a country (that is not connected with a foreign PE or fixed base) may not be subject to foreign tax or may be subject to reduced withholding taxes (see Articles 7 and 12 of the United Nations and OECD Model Conventions). In addition, rent and royalty payments are likely to be deductible by the payer in its country of residence if the payments are connected with a business carried on in that country. If a country applies the exemption method to this income or taxes it at preferential rates, the income will not be subject to tax at all or will be subject to low tax. The result may be base erosion both for the payer's country of residence and for the recipient's country of residence. It is quite common in some countries to grant special treatment (exemption or low taxation) to income from some types of intellectual property in order to promote R&D activities in the country providing the incentive (so-called "patent or knowledge boxes"). The OECD/G20 BEPS Action 5 Final Report provides specific guidelines on these special regimes,[22] aimed at avoiding harmful tax competition in the country in which the expenses are deductible, as well as avoiding base erosion for the country of residence of the taxpayer earning the income.

The BEPS Action 5 Final Report connects expenditures on R&D within a country with income from intangibles that can benefit from preferential treatment in that country. This so-called modified nexus approach forms part of the BEPS minimum standard for income derived from certain forms of intellectual property that can benefit from preferential treatment (patents and other intellectual property assets that are functionally equivalent to patents[23] and that generate income either exempt from tax or taxed at low rates). Under this approach, qualifying R&D expenditures are directly connected with preferential treatment of income from qualifying intellectual property in the jurisdiction.[24] Preferential treatment should be granted only to "net income", which means that expenses directly connected with income from intellectual property are also included within

[22] Ibid., chapter 4, paragraph 26 ff.

[23] On qualifying intellectual property assets, see ibid., chapter 4, paragraph 34 ff.

[24] See ibid. on the specific details of the "modified nexus approach", paragraph 26 ff.

the preferential regime and should not be deductible against other income;[25] otherwise, base erosion can result.[26] The usual approaches for connecting income with expenditures should be used for these purposes (tracing and apportionment: see section 1.2.8 above) but in the case of patent and knowledge boxes, tracing and apportionment may be very complex for taxpayers and tax administrations.[27] In order to avoid base erosion effects, losses from intellectual property activities included within the special tax regimes should also be separated from losses from other activities taxed at ordinary rates.

Patent and knowledge boxes are complex to administer and apply and may present risks of base erosion for a country if not applied correctly. Credits, deductions or other incentives for R&D not linked to income from intellectual property (rent and royalties) are probably more efficient incentives, and should be considered by developing countries as alternatives to patent and knowledge boxes.[28]

As discussed in section 1.4.2.2 above, a resident of a country may give a licence to a CFC to exploit movable property or rights (for example, equipment, patents) on a worldwide basis. The result is that income that should be subject to tax in the residence country is diverted to the country where the CFC is located. In addition, costs linked with the asset or right may have been deducted in the residence country and may have qualified for specific incentives (for example, special deductions

[25] Ibid., chapter 4, note 10, explains that those costs are: "salaries and wages, direct costs, overhead costs directly associated with R&D facilities, and costs of supplies so long as all these costs arise out of activities undertaken to advance the understanding of scientific relations or technologies, address known scientific or technological obstacles, or otherwise increase knowledge or develop new applications". They do not include interest, building costs, acquisition costs or any costs not directly linked with the intellectual property.

[26] Ibid., chapter 4, paragraph 47: "Overall income [to which special tax treatment applies] should instead be calculated by subtracting IP [intellectual property] expenditures allocable to IP income and incurred in the year from gross IP income earned in the year."

[27] Ibid., chapter 4, paragraph 53 ff., explains the problems and systems for allocating expenses to IP income in patent and knowledge boxes.

[28] See Eric M. Zolt, "Tax incentives: protecting the tax base", in *Protecting the Tax Base of Developing Countries*, chapter IX, pp. 451 – 496.

for R&D expenses). If the foreign CFC sublicenses or rents the asset or right to residents of the residence country, the resulting base erosion is even more serious. These base-erosion effects can also arise if property is exploited through a foreign PE or fixed base, especially if the income attributable to the foreign PE or fixed base is exempt in the residence country. However, the tax base of the residence country is also eroded where it imposes tax on the income attributable to the foreign PE or fixed base but the country where the PE or fixed base is located imposes tax on that income that is equal to or higher than the residence country's tax on that income. In this case, the foreign tax credit allowed by the residence country will eliminate its tax entirely.

1.4.4 Alienation of rights or assets producing rent and royalty income

If a resident of a country transfers property that produces rent or royalties to a related non-resident (a CFC, group company or PE, assuming that the country exempts income attributable to a foreign PE), the country will no longer be able to tax any rent or royalty income generated by that property. Additionally, any capital gain realized at a later stage by the non-resident transferee on the alienation of the property will escape taxation in the residence country. In addition, the price for the property may be set at an artificially low amount to reduce taxation in the residence country. The residence country may also have granted generous incentives for R&D in the hope of promoting the activity and perhaps taxing future income from that activity. The risk of base erosion is exacerbated if capital gains on the disposal of property are not taxed or are taxed at lower rates than ordinary income.

In exemption systems, transfers of income-generating assets (rent and royalties) to foreign PEs have the same effect as transfers to subsidiaries in credit systems: the residence country is no longer able to tax income from the asset after the transfer or any gain from a subsequent sale to third parties. A similar effect may occur in credit systems where the foreign tax levied in the PE country is similar to the tax of the residence country: the credit system will have the effect of attributing the tax to the PE country, and therefore the residence country will not have any right, or will have only a limited residual right to tax the income. Therefore, "transfers" of assets or rights to foreign PEs also present risks of base erosion.

If a country decides to have a patent or knowledge box that complies with the requirements of the OECD/G20 modified nexus approach in BEPS Action 5, capital gains derived from intellectual property assets can also benefit from the special treatment given to income derived from the asset. Any exemption that is broader than the modified nexus approach will not satisfy the minimum standard and may cause further erosion of the country's tax base.

In all the cases presented above (transfer of assets with no or reduced taxation to foreign companies or PEs or for less than their market price), there are risks of base erosion that should be considered and, if possible, corrected (mainly, with sound domestic legislation on taxation of capital gains and transfer pricing rules (see section 1.5 and chapter 4 below).

1.5 Transfer pricing issues with respect to the taxation of rent and royalties

Transfer pricing issues are relevant in all the situations identified in sections 1.3 and 1.4 above (see also section 1.2.4 above with respect to mixed contracts). Cross-border payments of rent and royalties to related persons can be mispriced to reduce a country's tax base, either by reducing income or increasing expenses attributable to the country.

Where a resident of a country pays rent and royalties to a related non-resident without a PE or fixed base in the country, the risks of base erosion are as follows:

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

(b) The amount of the payment may be higher than the price a third party would be willing to pay (excessive payments).

Related parties may be tempted to reduce the rent or royalties paid, or simply not to pay any rent or royalty, in order to avoid the recipient of the payments from being subject to tax. This may often occur when the tax rates in the country of the payer are lower than those in the recipient's country.

With respect to rent or royalties earned by residents, risks of base erosion may arise in the following circumstances:

(a) The rent and royalties may not be paid even where a resident has provided the use of property to a non-resident. Countries should have rules to ensure that payments are deemed to be made to residents where they benefit from the use of property but make no payment or an inadequate payment for that use.

(b) The amount of the payment may be lower than the price a third party would be willing to pay (insufficient payment).

(c) Where the residence country applies a patent or knowledge box regime, income benefiting from that regime may be inflated.

(d) Multinational groups may allocate expenses to the country where taxes are higher without properly allocating those expenses (directly or by apportionment) to the member of the group that should bear them.

The application of transfer pricing rules may solve many of these problems (that is, determination of the proper amount to be deducted, denial of the deduction of certain expenses, and calculation of the amount of capital gains realized by the payer). (Withholding taxes on base-eroding payments of rent or royalties may also help to reduce the effects of base erosion in these situations.) Two situations are especially problematic:

(a) Payments for the use of property that has been developed (or continues to be developed) by the payer and then is transferred to a non-resident related company that leases the property back to the payer. These transactions have serious base-erosion effects, especially with respect to intellectual and industrial property developed in the country of residence of the payer where the gains accrued on the property are not taxable on its transfer to the non-resident. The rent or royalty payments for the use of the property by the resident are deductible against the country's tax base and those payments may not be subject to tax by that country.

(b) Cost-sharing arrangements and contributions to R&D activities of multinational enterprises are often used to reduce the tax base of countries. If the contributions by a resident group company are linked with a right to use a given asset or right, they can be regarded as deductible rent or royalties. However, if the payer acquires an ownership interest in property, any payments for the use of that property should not be deductible and, in addition, the payer should have a right to participate in the income generated by the property.

In both of these situations, the form and amount of payments may be relevant for the purpose of detecting base erosion where intangible property is transferred (as a sale, a licence or pursuant to a cost-sharing arrangement) by a resident to a related or associated non-resident and the costs of development of the intangible property have been deducted in the country of residence of the transferor. Where the value of the intangible property is uncertain at the time of the transaction, the behaviour of arm's length parties can be used as a benchmark for determining the price of the transaction. If arm's length parties provided in their contract for price-correction mechanisms based on ex post facts (for example, sales or turnover of the person acquiring the right) or for the renegotiation of the price in certain circumstances, such mechanisms can be used by tax administrations to adjust the price stipulated in the contract.[29] Similar considerations apply to hard-to-value intangible property. Tax administrations can take ex post outcomes into account as presumptive evidence about the arm's length nature of the price fixed by the parties and the inclusion of price correction mechanisms in contracts between arm's length parties.[30]

Example 19

SCo, a resident of Country S, has developed a patent for a new drug over a five-year period and has deducted 100 in respect of the costs of developing the drug. Before obtaining the authorization to commercialize the

[29] See OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports*, supra note 16, section D.3, paragraphs 6.181–6.185, 107–109.

[30] Ibid., section D.4, paragraphs 6.186–6.195, 109–112.

> drug in several countries, including Country S, the patent is transferred by SCo to a related company resident in Country R for a payment of 80. SCo retains a right to use the patent in Country S in consideration for the payment of a royalty of 10 per year. RCo derives 120 from selling the drug in the first two years after authorization (some months after it purchased the patent).
>
> Three forms of base erosion can be identified on the basis of these facts. First, R&D expenses (100) were deducted by SCo and were not recovered on the sale of the patent to RCo. Second, the patent was probably worth much more than 80 when transferred to RCo in view of the profits earned by RCo in the first two years. Third, the tax base of Country S continues to be eroded by the deductible royalty payments by SCo to RCo (10 per year). Transfer pricing rules should permit the tax authorities of Country S to assess whether the sale price for the patent was equal to its fair market value or the amount that arm's length parties would have agreed to, and whether a price-correction mechanism would have been included in the contract to take into account the future profitability of the new drug. These rules or other anti-abuse rules also permit Country S to disregard the transaction if it does not have a commercial rationale and if RCo does not perform any significant functions or assume any significant risks.

Although related party payments of rent and royalties are common in the context of multinational groups, they can also arise with respect to individuals or companies that have common interests (for example, an individual shareholder who controls a company, two individuals of the same family, an unrelated company that is dependent upon another company for all or most of its business). Countries should have rules similar to transfer pricing rules for these situations (for instance, Article 12 (6) of the United Nations Model Convention or Article 12 (4) of the OECD Model Convention where the concept of a special relationship between the parties is used). The standard transfer pricing methodologies cannot always apply to situations involving individuals.

The definition of associated or related parties and the methods for valuing transactions between them are not specific to rent and royalties; they apply to any type of income derived from related-party transactions. This is why this issue is not explored further in this *Portfolio*.

Chapter 2

Analysis of the treatment of rent and royalty payments under the provisions of tax treaties

2.1 Introduction

In general, tax treaties impose restrictions on the taxes levied by the contracting States under their domestic laws. Therefore, there are two major questions with respect to rent and royalties. First, do tax treaties restrict a country's authority to impose tax on rent and royalties earned by non-residents under its domestic law? Second, do tax treaties require countries to allow the deduction of rent and royalties in circumstances where no deduction would be allowed under domestic law?

The previous chapter examined how countries tax residents and non-residents with respect to rent and royalties in order to acquire a foundation for determining the extent to which their tax bases can be eroded. Since tax treaties restrict a country's ability to tax under its domestic law, the provisions of a country's tax treaties dealing with rent and royalties (payments and deductions) may create risks of base erosion that do not exist under domestic law. In this chapter, the provisions of tax treaties dealing with rent and royalty payments and deductions are analysed in order to acquire a foundation for determining the extent to which a country's tax base can be eroded through such payments and deductions.

First, some basic questions about a country's tax treaty network and the most important provisions of tax treaties dealing with rent and royalties (payments and deductions) are considered. Then the provisions of the United Nations and the Organisation for Economic Cooperation and Development (OECD) Model Conventions[31] dealing

[31] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Develop-*

with such payments and deductions are analysed. These model treaties provide a convenient basis for comparison with a particular country's tax treaties.

2.2 Tax treaty network

Each country's tax treaty network can be analysed by posing a few basic questions. How many tax treaties does the country have? With what countries? For example, does the country have tax treaties with developed and developing countries; with its major trading partners; with countries that are geographically close; with low-tax countries or tax havens?

Are the country's treaties primarily based on the United Nations Model Convention or the OECD Model Convention (or any other regional model)? What, if any, variations from the United Nations or OECD Model Conventions do the treaties usually contain? Do these variations have an impact on the deductibility of rent and royalties or on withholding taxes levied? Does the country have a domestic model tax treaty that it uses as a template for negotiations of tax treaties with other countries?

2.3 The provisions of the United Nations and OECD Model Conventions dealing with payments of rent and royalties and the deduction of rent and royalties

2.3.1 Restrictions on the taxation of non-residents

2.3.1.1 Introduction

Tax treaties have important consequences both for the receipt of rent and royalties by non-residents and the payment of rent and royalties by non-residents. If non-residents derive rent and royalty payments from a country, the provisions of Article 6 (Income from immovable property), 7 (Business profits), 8 (Shipping, inland waterways transport

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ing Countries (New York: United Nations, 2011); and Organisation for Economic Cooperation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

and air transport), 12 (Royalties) or 21 (Other income) of the United Nations or OECD Model Convention may apply. If the non-resident has a permanent establishment (PE) in the country and the rental payments are connected with the activity of that PE, ordinarily they should be taxed by the country in which the PE is located on a net basis under Article 7. In this case, the United Nations and OECD Model Conventions also contain provisions dealing with the deduction of rent and royalties (or any other expenses) incurred in earning income. Section 2.3.1.2 deals with the taxation of non-residents deriving rent and royalties from a country without having a PE or fixed base there, and section 2.3.1.3 deals with the deductibility of rent and royalties in computing the profits attributable to a PE in a country.

2.3.1.2 Non-residents deriving rent and royalties without a permanent establishment or fixed base

2.3.1.2.1 Rent from immovable property—Article 6

Article 6 (1) and (3) of the United Nations and OECD Model Conventions permit a country to tax income from a letting (lease) of immovable property located in that country derived by a resident of the other country (see chapter 1, section 1.2.5.2, above with respect to the meaning of immovable property). Article 6, however, does not provide rules for the calculation of income from immovable property or the applicable tax rate on such income, which means that a country has broad discretion to determine taxable income and tax rates applicable to non-residents. Since both issues are left to domestic legislation, a country may tax gross income or, alternatively, recognize the deduction of expenses, and may apply the same tax rates applicable to residents.

Non-resident owners of immovable property may have substantial expenses connected with the renting of such property (for example, repairs, interest on funds used to buy the property, local taxes on immovable property). For this reason, paragraph 2 of the Commentary to Article 6 (2) of the United Nations Model Convention suggests that "[i]n taxing income from immovable property, the object should be the taxation of profits rather than gross income; the expenses incurred in earning income from immovable [real] property … should be taken into account". If expenses are passed to the tenants (for example, municipal taxes) this should increase the amount of taxable income of the non-resident lessor — many countries have domestic provisions dealing with these situations.

Deduction of expenses by a non-resident should not automatically be considered to be base erosion, since in a purely domestic situation domestic lessors also have the right to deduct expenses and some of those expenses, if paid to residents of a country, will be income for the recipients of the payments. The risks of base erosion in these cases result from the fact that some of those expenses may be paid to related parties with the purpose of reducing the tax base of a country (see chapter 1, section 1.5, above).

The rates applicable to rental income are not limited by tax treaties; they are set by domestic legislation. If developing countries impose tax on rent derived by non-residents, that tax may be inappropriately excessive if non-residents cannot deduct expenses.

Example 20

If Country A applies a tax rate of 30 per cent, a resident corporation that obtains rental income of 100 from immovable property and has expenses of 50 linked with the property will be subject to tax of 15 (100–50 × 30 per cent = 15). However, if a non-resident corporation is subject to a gross withholding tax at a rate of 30 per cent on net rental income from immovable property of 100, the non-resident will be subject to tax of 30. Therefore, the non-resident will be taxed at a similar level as residents only if the rate of withholding tax is 15 per cent. If Country A decides to permit the non-resident to deduct expenses, then it should monitor the amount and actuality of those expenses, especially if payments are made to related parties. However, that concern applies equally to residents and non-residents and does not justify denying the deduction of expenses by non-residents.

Article 6 of the United Nations and OECD Model Conventions does not prevent a country from imposing gross-based withholding taxes on income from immovable property. The rate of the withholding tax, if it is applied on gross income, should take into account the typical expenses incurred by non-residents in connection with income from immovable property. In other words, a gross-based withholding tax should be as much as possible a proxy for a tax on net income.

Based on the facts of the previous example, the withholding tax rate should be lower than the 30 per cent ordinary tax rate applicable to corporations. If the withholding agent applies the 30 per cent rate, the non-resident will have to apply for a refund and prove the actuality of the expenses deducted from gross income. This refund procedure may be too burdensome for some tax administrations, which may prefer to permit the non-resident to elect to have the income from the immovable property taxed on a net basis. In the end, the immovable property located in a country provides security for the collection of the tax due and, therefore, the risk of unpaid tax on rent from immovable property can be mitigated if domestic law allows enforcement action against the property. If a non-resident with immovable property in a country has a PE in that country through which income from the immovable property is earned, it should be taxed on net income in the same manner as resident enterprises (see Article 24 (3) of the United Nations and OECD Model Conventions).

2.3.1.2.2 Rent from movable property derived by enterprises exploiting ships and aircraft in international traffic—Article 8

Under Article 8 of the United Nations and OECD Model Conventions, profits derived from the operation of ships and aircraft in international traffic and boats in inland waterways transport are taxable only in the country in which the enterprise has its place of effective management. Therefore, rental income covered by this Article will not be taxed in the source country.

Article 8 applies to so-called "wet" leases (leases under which the owner/lessor provides not only the aircraft or ship but also all or part of the crew, and maintains operational control of the aircraft or ship) and occasional bare boat charters of planes and ships (leases under which only the use of the aircraft or ship is supplied and the lessee has operational control). Income from other bare boat charters is included within the scope of Article 12 of the United Nations Model Convention.[32] Thus, under Article 8 (alternative A) of the

[32] See paragraph 11 of the Commentary on Article 8 of the United Nations Model Convention, quoting paragraph 5 of the Commentary on Article 8 of the OECD Model Convention.

United Nations Model Convention, the source country (and the residence country) is restricted to taxing income from wet leases by enterprises to which Article 8 applies (not with regard to bare boat charters in general) and income from occasional or ancillary rentals of ships or aircraft that would otherwise fall within the scope of Article 12 of the United Nations Model Convention.[33] The same treatment applies to the leasing of containers: if the income from the leasing of containers is incidental or supplementary to the international operations of ships and aircraft, it cannot be taxed in the source country (or the residence country) if the effective place of management of the company is located in the other country.[34] However, under Article 8 (alternative B) of the United Nations Model Convention, a country may tax profits from shipping activities that are more than casual, which includes rental payments that fall within the scope of Article 8.

In all cases of rental payments covered by Article 8, there are risks of base erosion, since payments are usually deductible in the country in which the payer is resident but that country cannot impose any withholding tax. The response to this problem is not an easy one, but denying the deduction of those payments by the payer or imposing

[33] The relationship between Articles 8 and 12 of the United Nations Model Convention is subject to different interpretations. See "Article 12 (Royalties): (a) the meaning of "industrial, commercial, and scientific equipment", (b) software payment-related issues", presented at the eleventh session of the United Nations Committee of Experts on International Cooperation in Tax Matters, Geneva, 19-23 October 2015 (E/C.18/2015/CRP.7, paragraphs 45–56), available from http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_CRP7_Royalties_formatted.pdf. It should be stressed that the 2005 changes to paragraph 5 of the Commentary on Article 8 of the OECD Model Convention were not accepted in paragraph 11 of the Commentary on Article 8 of the United Nations Model Convention. The latter refers to "occasional" bare boat charters and the former to bare boat charters that are an ancillary activity for the enterprise to which Article 8 applies. The difference is potentially important for the scope of Articles 8 and 12 of the United Nations Model Convention.

[34] Paragraph 10 of the Commentary on Article 8 of the United Nations Model Convention. Under the Commentary on Article 8 of the OECD Model Convention, profits from the leasing of containers that are directly connected or ancillary to international traffic of ships or aircraft are taxable under Article 8.

high withholding taxes is probably inappropriate. One option is to reduce the scope of Article 8 and clarify that payments for bare boat charters of ships or aircraft are covered in any case by the equivalent to Article 12 of the United Nations Model Convention, so that withholding taxes at source can be applied (see section 2.3.2.2 below on the impact of Article 12 from the perspective of the residence country and the type of income covered by Article 8).

Note that if Article 8 applies, the fact that the taxpayer has a PE in a country to which income otherwise covered by Article 8 is connected is irrelevant, since the country in which the taxpayer has its place of effective management has the exclusive right to tax. Other income (that is, income that is not derived from international traffic) is taxable in accordance with Article 7. However, Article 8 (alternative B) of the United Nations Model Convention permits the source country to tax profits of shipping companies arising in the country that are more than casual.

2.3.1.2.3 Rent from movable property derived by an enterprise not engaged in the exploitation of ships and aircraft in international traffic—Article 12 (3) of the United Nations Model Convention

Article 12 (3) of the United Nations Model Convention includes in the definition of royalties payments for the use or right to use industrial, commercial or scientific equipment (see chapter 1, section 1.2.6.2.4, above on the meaning of these terms). Therefore, the withholding tax under Article 12 of the United Nations Model Convention offsets (totally or partially) the tax saving from the deduction of the payment. Nevertheless, base erosion will result to the extent that the tax saving exceeds the amount of the withholding tax.

In contrast, rent for the use of industrial, commercial or scientific equipment is not included in the definition of royalties under Article 12 of the OECD Model Convention as a result of a revision to Article 12 in 1992. Such rent is now covered by Article 7 of the OECD Model Convention. Under Article 7, income from movable property derived by a resident enterprise of one contracting State from another contracting State is not subject to tax unless the enterprise has a PE and the lease is linked with the PE (see chapter 1, section 1.3.2, above).

Example 21

Country A imposes corporation tax at a rate of 25 per cent, and under its tax treaties agrees to a 10 per cent withholding tax on payments for the use of industrial, commercial and scientific equipment. ACo, resident in Country A, pays 1,000 to BCo, a non-resident company without a PE in Country A, for the use of industrial equipment. Based on these facts, ACo will derive a tax benefit of 250 annually (1,000 × 25 per cent) from the deduction but the withholding tax on BCo will be only 100 (1,000 × 10 per cent).

However, the answer to this base erosion problem related to deductible rental payments for use of equipment is not to impose a withholding tax at a rate equal to the corporation or income tax rate (25 per cent in the example), because the withholding tax is levied on the gross amount of the payment and is supposed to be a proxy for tax on net income. Therefore, even a withholding tax at a low rate on gross rental payments for equipment may be excessive if the taxpayer incurs significant expenses in earning the income (for example, transportation of equipment to the country, repairs, the salary and wages of personnel who supervise transportation and delivery, insurance). Withholding rates should usually take into account a presumptive profit margin in a transaction. Higher withholding rates may also apply but, in this case, some countries allow a presumptive deduction of expenses by applying the withholding tax rate to only a part of the gross payment (for example, 60 per cent). Another option is to impose an interim withholding tax and permit the non-resident to file a return and pay tax on a net basis, in which case if the amount withheld exceeds tax payable, the excess would be refunded.

Non-resident lessors may require resident users of property to bear the costs of any withholding tax on rental payments of equipment by grossing up the amount of the payment. In that case, the tax is effectively borne by residents and increases the cost of renting equipment from non-residents.

Example 22

ACo, a resident of Country A, wishes to lease industrial machinery from BCo, a resident of Country B, at a price of 1,000. BCo has calculated that in order for the transactions to be profitable, it has to obtain a 10 per cent return on its cost in respect of the machinery. If the costs of BCo in renting machinery to ACo are 910 and it charges rent of 1,000, BCo will earn a net return of 90. If a withholding tax of 10 per cent is applied, BCo will obtain only 900, which does not even cover its costs. BCo will be unwilling to lease the equipment to ACo on this basis. Instead, it would require ACo to bear the cost of the Country A withholding tax. This would be accomplished by grossing up (increasing) the amount of the rent paid by ACo so that BCo receives 1,000 after Country A withholding tax (that is, an amount equal to the costs of BCo attributable to the transaction plus the 10 per cent profit):

Grossed-up payment	1,111
Withholding tax (10 per cent)	111
Net amount	1,000

The cost of the leasing of the machinery, therefore, increases for ACo (1,111 instead of 1,000).

As explained throughout this *Portfolio*, the answer to this base-erosion problem is probably to apply a low-rate, broad-based withholding tax on rental payments to non-residents for equipment, not to deny the deduction of expenses. Withholding taxes should be consistent in a country's treaty network. Alternatively, if feasible, the goal of the source country should be to tax net income rather than gross revenue.

2.3.1.2.4 Rental income from movable property derived outside the scope of a business

A non-resident person may rent movable property (for example, a car or yacht) to residents of the other contracting State that is not part of a business carried on by the non-resident. Such rent is not subject to tax in a country unless the country has a provision similar to Article 21 (3) of the United Nations Model Convention in its tax treaties (Article 21 of the OECD Model Convention does not permit taxation of other income in the State of source). These situations are unlikely to occur frequently, since rent derived from leasing industrial, commercial or scientific equipment is covered by Article 12 of the United Nations Model Convention regardless of whether the lessor carries on business; some countries even regard one-off lessors as entrepreneurs. The risks of base erosion in these situations are probably not serious, since non-residents are unlikely to rent movable property frequently to individuals who are not conducting business activities. In any case, Article 21 (3) of the United Nations Model Convention permits a country to tax these unusual types of arrangements without any limit on the tax imposed by the country.

2.3.1.2.5 Royalties (except payments for use of industrial, commercial and scientific equipment)

Article 12 (2) of the United Nations Model Convention permits the source country to impose a withholding tax on royalty payments arising within its territory at a rate to be established through bilateral negotiations. Under Article 12 of the OECD Model Convention, royalties are not taxable in the source country (see chapter 1, section 1.2.6, above on the concept of royalties and the types of payments covered). This provision may exacerbate the risks of base erosion in a country, since payments of royalties, as business expenses, will usually be deductible for payers resident in the country, but no withholding tax will be levied on the recipient of the payment.

If a country levies a withholding tax on royalty payments, the tax will offset, at least partly, the effect of the deduction of the royalties against the source country's tax base. The problems of withholding taxes, grossing up and deduction of expenses by non-residents (see section 2.3.1.2.3 above with respect to rent for movable equipment) are not different from the problems with respect to royalties for the use of intellectual or industrial property. However, there are some issues that deserve special attention with regard to royalties paid to non-residents for the use of technology:

- A country may decide to encourage the importing of certain technology by exempting royalties for the use of such technology from withholding tax or applying a lower rate of tax. It is probably better, however, for a country to grant such exemptions or lower rates in its domestic law rather than in its tax treaties because it provides more flexibility to the country. The country can decide, unilaterally and without breaching the treaty, whether to tax royalties at source or to provide targeted exemptions or reduced tax rates.

- The withholding tax should apply broadly to a wide range of payments as defined in Article 12 (3) of the United Nations Model Convention. For this purpose, a country may include some payments connected with royalties, such as fees for technical assistance (see chapter 1, section 1.2.4, above dealing with mixed contracts, and section 1.2.6.2.3 dealing with patents and know-how).
- Problems and opportunities for base erosion can be reduced if technical services are subject to the same withholding tax as royalties. (Fees for technical services are not usually included within the definition of royalties and, unless otherwise provided, are treated as business profits. However, under new Article 12 A (Fees for technical services), which was added to the United Nations Model Convention in 2017, fees for technical services paid by a resident of one country to a resident of the other country are subject to a gross-based withholding tax irrespective of where the services are rendered.)[35] If withholding taxes applicable to fees for technical services and royalties differ, taxpayers will have opportunities for tax arbitrage. For the same reason, domestic and treaty source rules for both royalties and technical services should be the same. Developing countries should be especially cautious about entering into tax treaties that provide for different rates of withholding tax on royalties and technical services, since tax treaties with low rates or exemptions from withholding tax may encourage treaty shopping by non-residents.

2.3.1.2.6 Source rules for royalties under Article 12 of the United Nations Model Convention

Under Article 12 (5) of the United Nations Model Convention, royalties arise in a contracting State when the payer is a resident of that State.[36] This source rule may not be the same as the domestic source rule for

[35] See United Nations, *United Nations Practical Portfolio: Protecting the Tax Base against Base Erosion: Income from Services*, available from http://www.un.org/esa/ffd/wp-content/uploads/2017/05/PP_Services.pdf.

[36] Under Article 12 of the OECD Model Convention, royalties arising in a country are exempt from tax and therefore no source rule is necessary because the source State has no right to tax any royalty.

royalties if domestic law uses a place-of-use criterion. Therefore, when negotiating treaties, a country may wish to add the place-of-use rule to Article 12 (5) (see chapter 1, section 1.2.7, above and paragraph 19 of the Commentary to Article 12 (5) of the United Nations Model Convention).

If a non-resident payer has a PE or fixed base in a country (whether or not the payer is resident in either of the contracting States), any royalties that are effectively connected with the PE or fixed base and deductible in computing the income attributable to the PE or fixed base are considered to arise in the country in which the PE or fixed base is located.

The application of these rules may result in a payment being sourced in two countries as illustrated in the example 23 A and B.

Example 23 A

ACo, resident in Country A, has a PE in Country B. ACo rents industrial equipment from another company resident in Country A to be used exclusively by the PE in Country B. The payment for the equipment is made from the head office in Country A. Country B has the right to tax the rental payments for the equipment made by ACo. Although the payments are made by a resident of Country A, they are deductible in computing the profits attributable to the PE and are considered to arise in Country B under 12 (5) of the United Nations Model Convention.

Example 23 B

ZCo, resident in Country Z, has a PE in Country A. ZCo pays royalties to BCo, a corporation resident in Country B, for industrial designs that are exclusively used by the PE in Country A. Assuming that Country Z and Country B have a tax treaty with provisions similar to those of the United Nations Model Convention, Country Z is entitled to tax the royalty payments made by ZCo to BCo. Under Article 12 (5) of the United Nations Model Convention, the royalties are deemed to arise in Country Z because the payer is a resident of Country Z and does not have a PE in Country B. Assuming that Country A and Country B have a tax treaty with provisions similar to those of the United Nations Model Convention, the royalties are deemed to arise in Country A, where the PE is located. Consequently, Country A would be entitled to tax the royalties subject to the limits in Article 12. Assuming that Country Z and Country

A have a tax treaty with provisions similar to those of the United Nations Model Convention, that treaty would not apply because, although the royalties arise in a contracting State, they are not paid to a resident of one of the contracting States. Under Article 12 (5) of the United Nations Model Convention, the royalties are deemed to arise in Country A for purposes of the treaty between Country A and Country B. The effect is that both Country A and Country Z are entitled to the royalties. This double taxation can be avoided through the inclusion of special provisions in tax treaties.

2.3.1.3 The deduction of rent and royalties by non-residents under the provisions of tax treaties

2.3.1.3.1 Introduction

In general, the deduction of rent and royalties is governed by domestic law rather than the provisions of tax treaties. Where tax treaties allow the source country to tax a non-resident on a gross basis, which is the case for all income (other than business profits attributable to a PE under Article 7 and income from professional and other independent services taxable under Article 14), the source country is not required to allow any deductions. Despite the provisions of a treaty, a country may allow a non-resident to deduct expenses under its domestic law (see the considerations in section 2.3.1.2.1 above with respect to rent for immovable property). Article 7 of the United Nations Model Convention provides some general rules about deductions and Article 24 (3) precludes a country from discriminating against a resident of the other contracting State carrying on business in the country through a PE (but not through a fixed base).

2.3.1.3.2 Deduction of rent and royalty payments under Articles 7 and 14 of the United Nations Model Convention

Income earned by a resident of one contracting State through a PE or fixed base in the other contracting State is taxable on a net basis under Articles 7 and 14, respectively. Article 7 (3) provides that expenses incurred for the purposes of the business of the PE “shall be allowed as deductions”. It also provides that the deduction of these expenses must be allowed irrespective of where the expenses are incurred (that is, in the country where the PE is located or elsewhere). Thus, any expenses incurred for the purposes of the PE should be deducted from the gross income of the PE if domestic law permits the deduction of the expenses.

Only actual rent or royalty expenses incurred by an enterprise for the purposes of a PE or fixed base are deductible for purposes of computing profits of the PE or fixed base. The application of this general principle may be difficult, since tangible and intangible property are often acquired by an entity for the benefit of the entire entity rather than just one part of the entity. Although the method of allocation of rent and royalty payments to different parts of an enterprise (direct or apportionment) is usually defined in domestic law, the Commentary to Article 7 of the United Nations Model Convention contains some principles that are relevant for this purpose.[37] Basically, it permits allocation of expenses on a factual basis, depending on the facts and circumstances of the case (direct allocation), as well as apportionment of the expenses on the basis of factors such as revenue, sales, assets, number of employees, and so forth.

A direct/factual allocation approach is easy to apply with regard to rental payments for movable and immovable property used exclusively by a part of the enterprise. Rights with respect to intangible assets can also be linked with one part of the enterprise only, as provided in the United Nations Model Convention.[38] However, such

[37] The so-called Authorized OECD Approach (AOA) to the attribution of profits to PEs has not been accepted in the context of Article 7 of the United Nations Model Convention. The United Nations Model Convention follows Article 7 of the 2008 OECD Model Convention and not Article 7 of the 2010/2014 OECD Model Convention.

[38] See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 34 of the Commentary on Article 7 of the OECD Model Convention. This paragraph refers to intangibles created by an enterprise and indicates that those intangibles belong equally to all parts of the enterprise and, therefore, internal notional royalties are not permitted. However, the parts of the enterprise that did not contribute to the creation of the intangible are not entitled to deduct any part of the cost of developing it and will not be attributed any income derived from its exploitation: "[i]t may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise *which will make use of*

an approach may present problems with respect to payments for the use of intangibles and, in some cases, equipment that is used simultaneously by different parts of the enterprise.

In some cases, it may be easy to identify whether a payment benefits only the head office or a PE (that is, where a patent is used only by the PE because the rest of the enterprise is engaged in a completely different activity for which the right to use the patent is irrelevant). In this case, the expense should be allocated in full to the PE. The application of an apportionment approach in this case would have the effect of allocating to the head office some of the expenses incurred for the purposes of the PE.

In other cases, it may be more appropriate to allocate payments for the use of an intangible right or the use of equipment among the various parts of the enterprise (that is, where a patent or equipment is used by both the head office and the PE) that use or benefit from the use of the property.

An intangible right may be used by only one part of the enterprise (for example, the head office) for a certain period of time, and at a later point in time can be used by another part of the enterprise (for example, a PE). This should also be taken into account in terms of the allocation of the expense.[39] If rented movable goods and equipment are used by different parts of the company, the expense should be apportioned (for example, in proportion to the time/hours that the property is used by the various parts of the enterprise).

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them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly" (emphasis added).

[39] Under the Authorized OECD Approach for attributing profits to a PE, notional transactions are also presumed to occur when one part of the enterprise uses an intangible first and, at a later point in time, other parts begin using it. In these cases, depending on the situation, a notional transfer of the right to use the intangible is presumed to occur or a notional licence of the right to use the intangible is presumed to occur. See OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, 2010), paragraph 210, available from https://www.oecd.org/ctp/transfer-pricing/45689524.pdf. These notional transactions are not permitted under Article 7 of the United Nations Model Convention (see the Commentary on Article 7 of the United Nations Model Convention).

Domestic law determines when the direct allocation or apportionment method should be used and what books and records taxpayers must keep to support the allocation. Often, both methods have to be used at the same time for different expenses.

Example 24

ACo has its head office in Country A and a PE in Country B. It installs PVC and aluminium structures in both countries—in Country B through its PE there. ACo has a licence to use a patent with respect to a type of structure (product type 1) in both Country A and Country B, for which it pays a royalty of 100 per year to PCo, a resident of Country P. ACo also has a licence to use another patent with respect to another product (product type 2) only in Country A, for which it pays 50 to PCo. It has also paid rent of 25 to PCo for the use of equipment exclusively in Country A. It makes sense to apportion the royalty paid to company P for the patent with respect to product type 1 (100) between the head office and the PE, since the licence is used by both. This allocation might be based on turnover or sales of the product. However, the application of the indirect apportionment method with regard to the price paid for the licence with respect to product type 2 (50) and the equipment (25) will unjustifiably reduce the profits allocated to the PE in Country B. Royalties for the use of the patent connected with product type 2 and rental payments for equipment should be allocated completely to the activities in Country A. If the equipment is used in both countries, the expenses should be allocated on a factual basis—for instance, by taking into account the number of days of use in Country A and B.

The deduction of notional royalties in respect of patents or other rights is explicitly prohibited by Article 7 (3) of the United Nations Model Convention. The prohibition affects royalties connected with intangible rights that are usually covered by Article 12 of the United Nations Model Convention and rent for immovable property.[40] The deduction of notional expenses could result in base erosion in the country of the PE, which could have its tax base reduced without the possibility of taxing the notional rent or royalties derived by the foreign

[40] The Authorized OECD Approach (AOA) also presumes a "notional rent" in these circumstances; see OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, supra note 39, paragraphs 194 – 199.

parts of the enterprise (head office, other PEs). Therefore, consistent with the approach to the attribution of profits to PEs under Article 7 of the United Nations Model Convention, only the share of the rent and royalties that relates to the use of the property by the PE should be deductible in computing the profits of the PE.

Article 14 of the United Nations Model Convention does not contain any provisions dealing with the computation of income attributable to a fixed base or the deduction of rent, royalties or other expenses. The Commentary to Article 14 of the United Nations Model Convention provides that the principles in Article 7 should apply for purposes of Article 14 and expenses incurred for the purposes of the fixed base "should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment".[41] However, the deductibility of expenses is a matter of domestic law. Article 14 of the OECD Model Convention was deleted in 2000 and as a result, all professional and independent personal services are dealt with under Article 7.

Article 7 of the OECD Model Convention was substantially revised in 2010 and Article 7 (3) dealing with the attribution of expenses to a PE was deleted. The current version of Article 7 of the OECD Model Convention takes the separate-entity principle of Article 7 (2) to its logical conclusion and allows the deduction of notional expenses, including rent and royalties, in determining the profits attributable to a PE (as explained above, the deduction of notional expenses is not allowed under Article 7 (3) of the United Nations Model Convention).

2.3.1.3.3 Non-discrimination—Article 24

Under Article 24 (3) (Non-discrimination) of both the United Nations and OECD Model Conventions, a contracting State is prohibited from taxing a PE of a resident of the other contracting State less favourably than it taxes its own resident enterprises carrying on similar activities. Thus, if resident enterprises are taxable on their profits on a net basis,

[41] See paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraph 3 of the Commentary on Article 14 of the 1997 OECD Model Convention.

non-residents carrying on business through a PE 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. It is important to note in this regard that, although Article 7 (3) deals with the attribution of expenses to PEs and leaves the deductibility of expenses to domestic law, Article 24 (3) covers the deductibility of expenses in computing the profits of a PE.

Where a country in which rent and royalties for equipment and intangible property arise levies a withholding tax on those payments but the non-resident has a PE in the country to which the property is effectively connected, that country is entitled to tax the rent and royalties under Article 7 without the limitations imposed by Article 12. However, as noted above, the tax must be levied on the net profits of the PE unless the country taxes its residents on a gross basis in the same circumstances. Under Article 6, there are no limits on the taxation of income from immovable property derived by a resident of the other contracting State, but if the immovable property is effectively connected with a PE in the country, Article 24 (3) will prevent any discrimination. The imposition of withholding taxes on rent and royalties in these circumstances would appear to be a violation of Article 24 (3) unless withholding tax is also imposed on rent and royalties paid to residents of the country.[42]

Article 24 (3) deals with triangular cases where a PE obtains rent and royalties from a third country. The profits of the PE may be taxed in the country in which the rent and royalties arise, as well as the country in which the PE is located. In these cases, some relief for double taxation should be found. The Commentary indicates that Article 24 (3) should permit relief to be claimed in the country of the PE for the tax withheld at source in third countries.[43] However, the withholding tax in the third State where the rent or royalty payment arises will be levied at the rate specified in the treaty between that country and the country in which

[42] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 62 – 65 of the Commentary on Article 24 of the OECD Model Convention.

[43] With respect to triangular cases, see paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 69 – 72 of the Commentary on Article 24 of the OECD Model Convention.

the enterprise is resident (or, if there is no tax treaty, under domestic law). Therefore, the treaty between the PE country and the source country of the rent or royalty will not apply, which means that the country where the PE is located may wish to limit the relief for double taxation of the PE to the maximum credit that its residents would obtain under the treaty between the country of the PE and the source country. This limit can be regulated in domestic law or treaties.

Example 25

ACo is a resident of Country A and has a PE in Country B. The PE earns rent and royalties from equipment and licensing of patents derived from Country C which are subject to withholding tax by Country C. ACo (on behalf of the PE) cannot invoke the treaty between Country B and Country C, but ACo, as a resident of Country A, qualifies for treaty benefits under the tax treaty between Country A and Country C. Assume that the withholding rate on rent for the use of industrial, commercial and scientific equipment under the tax treaty between Country A and Country C is 15 per cent, but the withholding tax for the same type of income in the treaty between Country C and Country B is 10 per cent. Country B should give relief for double taxation for withholding taxes imposed by Country C. However, some countries take the position that such relief should be limited to the relief that residents of Country B would obtain. Under this approach, since the tax treaty between Country B and Country C permits a 10 per cent withholding tax, the PE in Country B would be limited to a credit for the Country C withholding tax of only 10 per cent (even if the withholding tax at source is 15 per cent).

If the withholding tax rate under the treaty between Country A and Country C is less than the rate in the treaty between Country B and Country A, the credit in Country B would be limited to the withholding tax paid in Country B.

Obviously, the credit should be limited to the tax payable in Country B in both situations.

If a country decides to levy a branch-level tax on rent and royalties,[44] that is, a tax on the amount of any rent or royalties deducted

[44] A branch-level royalty tax is different from a “branch tax”, which is an additional tax levied on the profits of a PE and would be a violation of Article 24 (3).

in computing the profits attributable to a PE, Article 24 (3) does not apply because the tax is levied not on the PE, but on the enterprise to which the rent and royalties are paid.[45]

Article 24 (3) refers only to the taxation of the profits of a PE and not to connected requirements (unlike Article 24 (5), as discussed in section 2.3.2.5 below). Thus, Article 24 (3) does not prevent a country from imposing information-reporting requirements, penalties or other administrative rules connected with the taxation of non-residents carrying on business through a PE that are different from those imposed on residents carrying on similar activities. Therefore, for example, a country could allow a deduction for rent and royalties in computing the profits attributable to a PE only if the payer withholds tax from the payment without imposing a similar requirement on residents claiming deductions for rent and royalties.

2.3.1.4. Rent and royalties from third countries

Article 12 of the United Nations and OECD Model Conventions applies only to royalties that arise in a contracting State and are paid to a resident of the other contracting State. Similarly, Article 6 of both Model Conventions applies only with regard to income from immovable property located in one of the contracting States derived by a resident of the other State, and Article 7 applies only to business profits derived from business conducted in one State by an enterprise resident in the other State. Where rent or royalties arise in a third State, Article 21 (1) (Other income) is triggered and the source country has the right to tax such income if the right or property in respect of which income is paid is effectively connected with a PE or fixed base in the source country. The case of immovable property located in a third State that is connected with a PE in the source country is controversial. It may seem that Article 21 (2) of both the United Nations and OECD Model Conventions attributes the right of taxation to the residence country. However, it can also be interpreted so that the exclusion of immovable

[45] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 61 of the Commentary on Article 24 of the OECD Model Convention. Although that paragraph only refers to "branch level interest tax", the same reasoning can be applied to such a tax applied to rents and royalties.

property in Article 21 (2) refers only to immovable property located in one of the contracting States; therefore, income from immovable property located in a third State could be taxed in the State where the PE is located because the exclusion for immovable property in Article 21 (2) does not cover property in a third State.

2.3.2 Restrictions on the taxation of residents

2.3.2.1 Introduction

The provisions of tax treaties, including both the United Nations and OECD Model Conventions, do not generally limit the ability of the contracting States to tax their own residents.[46] However, there are at least four important exceptions to this general principle that are of importance in connection with rent and royalties. First, Article 8 (Shipping, inland waterways transport and air transport) of both the United Nations and OECD Model Conventions can have an impact on the country of residence, as discussed in section 2.3.2.2 below. Second, Article 23 of both the United Nations and OECD Model Conventions imposes a general obligation on the residence country to provide relief from the double taxation of income earned by its residents in the other contracting State if that State imposes tax in accordance with the treaty. The relief of double taxation under the United Nations and OECD Model Conventions and the treatment of rent and royalties are discussed in section 2.3.2.3 below. Third, Article 24 (4) and (5) provides protection for residents of a country against certain types of discrimination. Fourth, Article 9 allows the contracting States to adjust the

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[46] Se generally, United Nations, *Introduction to Tax Treaties*, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf. On how a treaty affects the residents of a country, see Article 11 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (November 2016), available from http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf; and Article 1 (3) of the OECD Model Convention, as set out in paragraph 63 of OECD, *Action 6: 2015 Final Report: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

prices of transactions entered into between associated enterprises if those prices differ from the prices that would have been agreed to had the parties been dealing with each other at arm's length. The transfer pricing guidelines applicable under Article 9 of the United Nations Model Convention are beyond the scope of this *Portfolio*; however, a brief note on transfer pricing issues is provided in section 2.3.3.

2.3.2.2 Profits from shipping, inland waterways transport and air transport—Article 8

Under Article 8 of both the United Nations and OECD Model Conventions, profits derived from the operation of ships and aircraft in international traffic and boats in inland waterways are taxable only in the country in which the enterprise has its place of effective management; thus, neither the country in which the enterprise is resident nor the country in which any of the profits are earned is entitled to tax the profits unless the enterprise has its place of management there. However, under Article 8 (alternative B) of the United Nations Model Convention, a country is entitled to tax profits from international shipping if the operations in the country are more than casual. (With respect to the types of income covered by Article 8, see section 2.3.1.2.2 above).

2.3.2.3 Relief of double taxation — Article 23

Article 23 of the United Nations and OECD Model Conventions requires a contracting State to provide relief from double taxation of its residents where they are subject to foreign tax in accordance with the treaty. Under Article 23 of both Models, the residence country must provide relief from double taxation by exempting the income from tax (Article 23 A) or by granting a credit for the tax paid to the other country against the resident country's tax (Article 23 B). Article 23 A (2) of the United Nations Model Convention allows a country that generally uses the exemption method to apply the credit method to dividends, interest and royalties. Conversely, a country that generally uses the credit method may be required by certain provisions of the treaty to exempt income because that income is taxable exclusively by the source country (for example, Articles 8 (Shipping, inland waterways transport and air transport), 18 (Pensions and social security payments) and 19 (Government service)).

Where the United Nations or OECD Model Convention authorizes the use of the credit method for relieving double taxation (that is, Article 23 A (2) or 23 B (1)), both Conventions provide explicitly that the credit is limited to the amount of the residence country tax that is attributable to the income that may be taxed by the other contracting State in accordance with the treaty.[47] Article 23 A (3) and 23 B (2) also provides that any income that is exempt from tax in the residence country may nevertheless be taken into account for purposes of establishing the tax rate on the taxpayer's other income (so-called exemption with progression).

The limitations on the credit recognize that the credit method is intended to eliminate double taxation but is not intended to require a country to provide any further relief. For example, assume that a resident of Country A earns income from renting immovable property of 100 in Country B that is taxed at a rate of 40 per cent, but Country A taxes that income at a rate of only 30 per cent. Under Article 23 B of the United Nations and OECD Model Conventions, since Country B is entitled to tax the rental income from immovable property located within its territory, Country A is obligated to allow a credit for the tax paid to Country B. However, the credit is limited to the Country A tax attributable to the income taxable by Country B under the treaty, which is 30. If Country A were required to provide a credit for the full amount of tax paid to Country B without any limitation, it would be necessary for it either to provide a refund to the taxpayer of 10 or to allow its tax on the resident's other income to be reduced, both of which would represent a reduction in the tax of Country A, not on the income taxable by Country B, but on other income.

Although Article 23 A and 23 B of both the United Nations and OECD Model Conventions provide for the general principles of exemption and credit, respectively, they do not provide detailed rules for the limitations on the amount of the exemption or credit. The Commentaries to both Model Conventions recognize that the rules for the limitation of the exemption or credit must be provided by domestic law.[48] Some countries that apply the credit method include an explicit

[47] See the second sentence of both Article 23 A (2) and Article 23 B (1).

[48] Se paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 39 – 43 of the Commentary

reference in Article 23 to the provisions of the foreign tax credit under their domestic law. If a country does not use the credit method under its domestic law, but agrees to the application of that method pursuant to a treaty, it should establish rules for the application of the credit method and might consider consulting with the competent authority of the other State for that purpose.[49]

Because the provisions of tax treaties dealing with the relief of double taxation rely on the provisions of domestic law with respect to the detailed application of either the exemption or the foreign tax credit method, they do not present any independent risks of base erosion. Therefore, countries can protect their tax bases from erosion by ensuring that rent and royalty expenses are properly allocated to foreign income for purposes of the exemption of such income or for purposes of the limitation on the foreign tax credit, as discussed above in chapter 1, sections 1.4.2.2 and 1.4.3.3, and in chapter 4, section 4.5, below.

In connection with rent and royalty payments, the application by the residence country of either the credit or exemption method will follow the patterns below:

- *Income from immovable property*: Income from immovable property located in the source country will be taxed in that country according to Article 6 of the United Nations and OECD Model Conventions, and therefore the tax paid in that country will be creditable in the country of residence subject to the limits under the treaty or domestic law. (If the tax paid in the source country is less than the residence country tax on the income, the full amount of tax paid in the source country will reduce the residence country tax.) Some treaties may apply the exemption method for this type of income, which, from the perspective of the residence country, in most cases should not produce a different result compared with the credit method. If income from immovable property is taxed on a gross basis

on Article 23 A of the OECD Model Convention and paragraphs 60 – 64 of the Commentary on Article 23 B of the OECD Model Convention.

[49] See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 60 of the Commentary on Article 23 A of the OECD Model Convention.

without permitting any expense to be deducted, the tax levied at source is likely to be higher than the tax payable in the State of residence. In this case, the credit method and the exemption method will have the same effect. If expenses are deductible in the source country (that is, the income is earned through a PE or, in the case of immovable property, is taxed on a net basis), the tax imposed by that country may be less than the residence country tax, in which case the residence country tax will top up the source country tax.

- *Rental payments that fall within the scope of Article 8*: Rental payments that fall within the scope of Article 8 (Shipping and air transport) of the United Nations and OECD Model Conventions will not usually be taxed by the source State unless Article 8 (alternative B) of the United Nations Model applies (see section 2.3.1.2.2 above on rental payments subject to Article 8). In these cases, the country where the effective place of management of the enterprise is situated has the exclusive right to tax the payments, and it will not have to provide any relief for any source country tax imposed on the income. If a treaty contains Article 8 (alternative B) of the United Nations Model Convention, relief for the tax levied by the source country may be necessary through either the credit or the exemption method.
- *Rent for movable property characterized as royalties (payments for the use of commercial, scientific and industrial equipment in the United Nations Model Convention)*: If the source country imposes withholding tax at source on such payments under Article 12 of the United Nations Model Convention, the residence country must apply the credit method (Article 23 A (2)). However, under Article 12 of the OECD Model Convention, no source country tax is allowed and therefore no relief in the residence country is necessary.
- *Rent for movable property not characterized as royalties*: If rent is derived from property other than industrial, commercial or scientific property, the source country is not entitled to tax such rent unless there is a PE to which the rent is attributable (Article 7 of the United Nations and OECD Model Conventions). Therefore, no relief from double taxation is necessary. Where a resident of one country derives rent through

a PE in the other country, the residence country is required to provide relief from double taxation by exempting the income or allowing a credit for the tax levied by the country in which the PE is located. However, if the taxpayer does not conduct business but obtains rental income from the source country, the income may be taxed in the source country under Article 21 (3) of the United Nations Model Convention even where it is not derived through a PE. The residence country must provide relief under the exemption or credit method. Under Article 21 of the OECD Model Convention, the residence country has the exclusive right to tax other income, and therefore relief for source country tax is not necessary. (See chapter 1, section 1.2.5.3, and chapter 2, section 2.3.1.4, above, for a discussion of Article 21 of the United Nations and OECD Model Conventions.)

2.3.2.4 Non-discrimination—Article 24 (4)

Pursuant to Article 24 (4) of both the United Nations and OECD Model Conventions, a contracting State must allow the deduction of interest, royalties and other disbursements made by an enterprise resident in that State to a resident of the other contracting State under the same conditions as had the amounts been paid to a resident of the first State. This provision is subject to the transfer pricing rules in Article 9 (1) and the rules in Articles 11 (6) and 12 (6) with respect to excessive payments of interest and royalties.

Article 24 (4) prevents a country from imposing conditions on the deduction of rent and royalty payments to a resident of the other contracting State that are different from the conditions imposed on the deduction of such payments to residents of the country. Thus, a country cannot disallow the deduction of rent and royalties paid to residents of the other contracting State where rent and royalties paid to its own residents are deductible.

Article 24 (4) does not prevent a country from imposing withholding tax on rent or royalties paid to residents of the other contracting State. Article 24 (4) prevents discriminatory treatment of rent or royalties paid by residents of a country to residents of its treaty partners, it does not prevent taxation of non-residents on a basis that is different from that applied to residents; nor is there any other provision in Article 24 that would prevent a country from imposing a withholding tax on rent and royalties paid to residents of the other contracting State, even where the country does not impose a similar withholding tax on rent and royalties paid to its own residents. Similarly, Article 24 (4) does not prevent a country from imposing additional or different information-reporting requirements with respect to rent and royalties paid to non-residents as compared to rent and royalties paid to residents.[50]

2.3.2.5 Non-discrimination—Article 24 (5)

Article 24 (5) prohibits a country from discriminating against its own resident enterprises that are owned or controlled, directly or indirectly, by residents of the other contracting State. Pursuant to Article 24 (5), resident enterprises 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. Thus, a country cannot impose information-reporting requirements or penalties on resident enterprises owned or controlled by residents of the other contracting State that are different from those imposed on other resident enterprises, although requirements not based on the ownership or control of residence enterprises by residents of the other contracting State are not prohibited.

Article 24 (5) protects resident enterprises from discrimination; it does not deal with the taxation of non-residents who own or control resident enterprises or who receive payments from such enterprises. Similarly, Article 24 (5) does not prevent different treatment of rent and royalties paid by resident enterprises to residents and non-residents unless the different treatment is based on the ownership or control by a non-resident of a resident enterprise.[51] Therefore, it is doubtful whether Article 24 (5) prevents source countries from applying provisions that restrict the deduction of rent and royalty payments

[50] See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 75 of the Commentary on Article 24 of the OECD Model Convention.

[51] Se paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 79 of the Commentary on Article 24 of the OECD Model Convention.

to companies in the other contracting State where the payments are not taxed or are taxed at lower rates. The same arguments described in section 2.3.2.4 above also apply in this case: there is no discrimination based on the foreign ownership of capital; instead, the different treatment is based on the taxation of the payment in the other contracting State, and therefore this discrimination is not within the scope of Article 24 (5). Finally, Article 24 (5) does not prevent the application of transfer pricing documentation rules or the reversal of the burden of proof applicable to resident enterprises owned or controlled by residents of the other contracting State.[52]

2.3.3 Transfer pricing—Article 9

As explained in more detail in chapter 1, section 1.5, above, domestic transfer pricing legislation can be used to adjust the amounts of payments of rent and royalties between resident and non-resident associated enterprises. Developing countries should have domestic transfer pricing rules that can be applied within the framework of Article 9 of the United Nations Model Convention.

The issues that arise in applying Article 9 to payments of rent and royalties are the same as for other payments, such as interest and fees for services.

Article 12 (6) of the United Nations Model Convention allows the country in which rent or royalties arise to tax those payments without regard to the maximum limit in Article 12 (2) to the extent that the payments are excessive due to a special relationship between the payer and the recipient. The excess part of the payment is taxable in accordance with the domestic law of the source country subject to the application of the other provisions of the treaty. Article 12 (6) does not deal with the deduction of the excessive part of the payments or the recharacterization of that amount. (See chapter 1, section 1.5, above, for a discussion of the meaning of special relationship.)

[52] See paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 80 of the Commentary on Article 24 of the OECD Model Convention.

Chapter 3

Information gathering for tax policy analysis

3.1 Introduction

For purposes of applying tax policy analysis to a country's tax system with respect to payments of rent and royalties to non-residents and the deduction of such payments, the following information would be useful. Ideally, the information should be collected on a country-by-country basis.

3.2 Rent and royalties paid by residents to non-residents—withholding taxes

3.2.1 Total amount of rent and royalties paid to non-residents

It is useful for the tax authorities of a developing country to have an idea of the total amount of rent and royalties paid to non-residents that is potentially subject to withholding tax. The information can be collected from residents that pay rent or royalties to non-residents. It might be difficult to collect the information from resident individuals, although some countries may be able to obtain information supplied for purposes of value added tax (VAT) or goods and services tax (GST). It would be useful for this information to be broken down into categories related to the type of payer (for example, individuals, small and medium-sized companies, large companies) and recipient (financial institutions, related parties). It would be useful to have information about the different types of payments to non-residents discussed in chapter 1, sections 1.2.5 and 1.2.6, above, such as rent from immovable property, rent from movable property and royalties from intangible property, as well as different types of payments within each category, such as payments in respect of patents, trademarks and know-how.

3.2.2 Total amount of rent and royalties subject to withholding taxes

It is useful to know the amount of rent and royalties paid to non-residents that is subject to withholding tax. As discussed above, it would also be useful to have information about the types of property in respect of which rent and royalties are paid, the types of recipients to whom rent and royalties are paid and the types of resident payers.

3.2.3 Total amount of withholding taxes on rent and royalties collected

It is useful to show the amount of tax collected through withholding taxes on rent and royalties paid to non-residents. Such information would be important with respect to proposals to reduce or eliminate the withholding taxes on rent or royalties in full or only for certain categories of royalties or rent. It would be useful to have this information on a country-by-country basis, especially if rent or royalty withholding taxes are reduced or eliminated pursuant to a country's tax treaties.

3.2.4 Rent and royalties exempt from withholding taxes

It would be useful to know the amount of rent and royalties that qualify for any exemptions from withholding tax provided by a country's domestic law or its tax treaties for purposes of evaluating those exemptions. This information would be more useful if collected on the basis of each exemption rather than on an aggregate basis.

3.2.5 Rent and royalties paid to non-residents on a country-by-country basis

Information on rent and royalties paid to non-residents on a country-by-country basis would be useful to determine how much rent and royalties are being paid to residents of tax havens or low-tax countries, where they are unlikely to be subject to any significant tax. It would also be useful to determine how much rent or royalties are being paid to residents of countries with which a country has tax treaties.

3.2.6 Non-resident recipients of rent and royalties

It might be useful to know the amounts of rent and royalties paid by residents of a country to different types of non-residents — for example, corporations, other entities, individuals, and so forth.

3.2.7 Resident payers

It would be useful to know what types of residents — for example, large corporations, small and medium-sized corporations, other business entities, individuals, and so forth — are paying rent and royalties to non-residents, as well as the type and cost of property in respect of which such amounts are payable and the amount of rent and royalties payable.

3.2.8 Non-resident payers

For any countries that extend their withholding taxes on rent and royalties to payments by non-residents that carry on business in the country and deduct such payments in computing their income subject to tax, it would be useful to have information with respect to such payments similar to the information with respect to resident payers.

3.3 Rent and royalties paid to related non-residents

Information on rent and royalties paid to related non-residents is important for purposes of a country's transfer pricing rules as well as withholding taxes. It is important to ensure that residents are not paying more than an arm's length rent or royalty for the use of property leased or licensed from related non-residents. It would be useful to have sufficient information to compare the amounts of rent and royalties paid by resident corporations that are controlled by non-residents with rent and royalties paid by other resident corporations.

In this regard, it should be noted that the Organisation for Economic Cooperation and Development (OECD)/G20 BEPS Action

13 Final Report[53] proposes that multinational enterprises with a total gross revenue of more than €750 million (or equivalent amount) be required to report certain information annually for each jurisdiction in which they are operating (so-called country-by-country reporting). The ultimate parent of a multinational group or a designated member of the group will be required to file the country-by-country report with the tax authorities of the country in which it is resident. Such information will include:

- Revenue earned in the country
- Profits before tax
- Taxes paid and accrued
- Number of employees
- Capital
- Retained earnings
- Tangible assets

In addition, multinationals will be required to identify all entities in the group doing business in the country and the type of business they carry on. However, the information referred to above will be provided on an aggregate basis for each country and not on an entity-by-entity basis. Some developing countries would prefer also to require multinational enterprises to provide information concerning payments to related parties for interest, royalties and services.

The information available to countries pursuant to this proposed country-by-country reporting is an important source of information for the tax authorities to use as a risk assessment tool in combating base erosion. Such information will be available automatically only through the exchange of information provisions in bilateral tax treaties, tax information exchange agreements or the multilateral Convention on Mutual Administrative Assistance in Tax Matters. Developing countries that do not have an extensive network of bilateral tax treaties

[53] Organisation for Economic Cooperation and Development (OECD), *Action 13: 2015 Final Report: Transfer Pricing Documentation and Country-by-Country Reporting* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

may wish to consider ratifying the multilateral Convention on Mutual Administrative Assistance.[54] Country-by-country information is often available on the public websites of some multinationals and may also be a relevant source of information (even if the quality of the information depends on each company).

Apart from country-by-country reporting, which affects only a limited group of large multinational groups, developing countries may require resident companies or non-residents with a PE or fixed base in the country to provide information about payments to related (and even unrelated) parties in their tax returns. Some countries address specific questionnaires to local subsidiaries of multinational groups with respect to transactions (for example, rent and royalties paid) with related parties. This information is important for policy analysis and is relevant as a risk-assessment tool to identify cases that should be audited.

3.4 Deductions of rent and royalties

It would be useful for tax policy analysis to have a wide variety of information about deductions for payments of rent and royalties claimed by both residents of a country and non-residents carrying on business in the country. Such information would include:

- The total amount of deductions for payments of rent and royalties claimed by residents
- The total amount of deductions for payments of rent and royalties claimed by non-residents
- The amount of deductions for payments of rent and royalties claimed by non-resident enterprises carrying on business in a country through a PE or fixed base in the country

[54] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available from http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf. see generally, Diane Ring, "Transparency and disclosure", in *Protecting the Tax Base of Developing Countries* (New York: United Nations: 2015), chapter X, pp. 497–568, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

- The amount of deductions for payments of rent and royalties claimed by various types of resident and non-resident enterprises
- The amount of deductions for payments of rent and royalties claimed by resident enterprises controlled by non-residents with respect to each type of property (immovable, movable and intangible property)

3.5 Gains from the disposition of tangible and intangible property

Countries that impose tax on gains derived by non-residents from the disposal of property require information concerning the identity of the non-resident who owns the property and the nature, cost and proceeds of sale of the property. This information is necessary to calculate the tax on the gain realized on the sale of the property.

Even if a country does not tax all or certain gains derived by non-residents from the disposal of property, information concerning such gains may be useful for tax policy analysis. This information would allow countries to know how much domestic tax is raised from taxing gains of non-residents and how much potential tax is forgone. This information will be more useful if it is collected on the basis of the various types of property: immovable property, tangible movable property, shares of domestic companies and other entities and other intangible property. It is also important to know the identity of the purchaser of the property, whether the purchaser is a resident or non-resident and whether the purchaser and the seller are related.

Where non-residents are not subject to tax on gains from the disposal of property, it will usually be difficult for a country to obtain information about such gains from the non-resident sellers of property. If the purchaser is a resident, the purchaser can be required to provide the information about the property (and withhold tax) and the details of the transaction (other than the non-resident seller's cost of the property since the purchaser will have no knowledge of that cost). Information from the purchaser is especially important where the purchaser and the non-resident seller are related, since the cost of the property to the purchaser may be more or less than the fair market value of the property.

3.6 Value added tax (VAT) and goods and services tax (GST)

VAT and GST are taxes imposed on the consumption of goods, services and intangibles supplied to consumers in a country. In this respect, the OECD/G20 BEPS Action 1 Final Report[55] recommends that countries adopt a destination-based tax whereby goods, services and intangibles provided directly to consumers by non-resident suppliers are subject to tax in the jurisdiction of consumption. For this purpose, countries should have electronic platforms to provide foreign suppliers with the means to electronically register in the country, submit their VAT/GST returns and pay the taxes due for the supplies made in the country. Information collected from these platforms may be useful also for income tax purposes, especially if the payments refer to rent or royalties paid by consumers. The same information systems may also be used for the collection of income taxes.

In general, VAT or GST information is relevant for income tax purposes and vice versa; therefore, it is important for developing countries to match or cross-reference information from these two types of taxes. For instance, information in VAT/GST returns on services/intangibles provided by non-residents may be useful to detect areas of risk with respect to income tax on non-residents.[56]

[55] OECD, *Action 1: 2015 Final Report: Addressing the Tax Challenges of the Digital Economy* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en.

[56] With respect to VAT/GST on cross-border supplies of services and intangibles to consumers or businesses, see generally ibid., Annex D.

Chapter 4

Identification of the risks of the erosion of the tax base of developing countries with respect to rent and royalties and possible responses

4.1 Introduction

As explained in the introduction to chapter 1 (section 1.1), base erosion through cross-border payments of rent and royalties occurs either because the payments are deductible by the payer (and is exacerbated where the payments are not taxable to the non-resident recipient) or the related income is exempt from tax or taxed at a preferential rate. The risks of base erosion through payments of rent and royalties are clearly greatest where the payments are deductible against a country's tax base and are made to related non-residents. Such payments ordinarily reduce the payer's income subject to tax and the amount of tax payable, may be excessive, and are not subject to tax or subject to a reduced rate of tax to the non-resident recipient. These payments are the primary focus of this chapter.

All deductible payments of rent and royalties reduce a country's tax base, and in most countries payments of rent and royalties are generally deductible in computing a taxpayer's profits if they are incurred for the purpose of earning taxable income. Although all deductible payments of rent and royalties erode a country's tax base, not all such deductible payments should be viewed as problematic from the perspective of base erosion, because most of them represent legitimate expenses incurred in earning taxable income and should be deductible. Therefore, the denial of the deduction of all payments of rent and royalties to non-residents is not a reasonable response to base erosion for most developing countries; moreover, countries that have entered into tax treaties that include non-discrimination provisions similar to Article 24 of the United Nations Model Convention[57] would be prevented by those provisions from denying or restricting the deduction of rent and royalties paid to residents of their treaty partners unless the denial or restrictions on the deductions also apply to payments of rent and royalties to their own residents (see chapter 2, section 2.3.2.4).

The risks of base erosion are not as serious where payments of rent and royalties are not deductible against a country's tax base. In such a situation, base erosion may occur to the extent that the non-resident recipients of the payments are not subject to tax on those payments by the country from which the payments are made. If such base erosion is considered to be problematic, it can be dealt with by imposing withholding tax on deductible payments of rent and royalties to non-residents. However, as discussed in chapter 1, section 1.3.3.2, and chapter 2, section 2.3.1.2.5, above, there are good reasons for countries not to impose withholding tax on rent and royalties in certain circumstances. Moreover, it may be difficult to enforce withholding taxes on individuals, especially with respect to payments of rent and royalties that are not deductible. (See the discussion of this issue in chapter 2, section 2.3.)

In the present chapter, the discussion of the risks of base erosion through deductible payments of rent and royalties follows the framework set out in the introduction to chapter 1. In section 4.2, the risks of base erosion from deductible payments of rent and royalties by residents and non-residents to non-residents are discussed and the application of transfer pricing and other similar rules to prevent such base erosion are discussed briefly. In section 4.3, the risks of base erosion through deductible payments of rent and royalties by both residents and non-residents of a country to non-residents, where the non-resident recipient of the payments is not subject to tax or is subject to a reduced rate of tax by that country, and the possible responses, are discussed. In section 4.4, the risks of base erosion from the deduction of rent and royalties by non-residents carrying on business in a country, and the possible responses, are discussed. In section 4.5, the

[57] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

risks of base erosion through deductible payments of rent and royalties by residents of a country where the related income is not subject to tax or is subject to preferential tax by that country, and the possible responses, are discussed. In each section, the risks of base erosion are discussed in general, as well as specifically with respect to each type of property—immovable property, movable property and intangible property. In section 4.6, the special risks of base erosion where deductions are allowed for the costs of research and development (R&D) of intellectual property but the property is transferred to a non-resident, and the possible responses to such base erosion, are discussed. The risks of base erosion where non-residents derive rent and royalties from individual consumers are examined in section 4.7.

The risks of base erosion through deductible payments of rent and royalties can be viewed as a continuum, as shown in table 3 below.

The risks of base erosion through deductible payments of rent and royalties are greatest where the deductions against a country's tax base are excessive, the payments are not subject to that country's withholding tax and the income generated by the property in respect of which the rent or royalties were paid is exempt from that country's tax. Although the risks of base erosion are multiplied where a combination of the relevant base-eroding effects is present, it is convenient to discuss each effect and the possible responses separately with respect to each type of property.

There are three basic responses that developing countries can adopt to deal with cross-border base erosion through payments of rent and royalties:

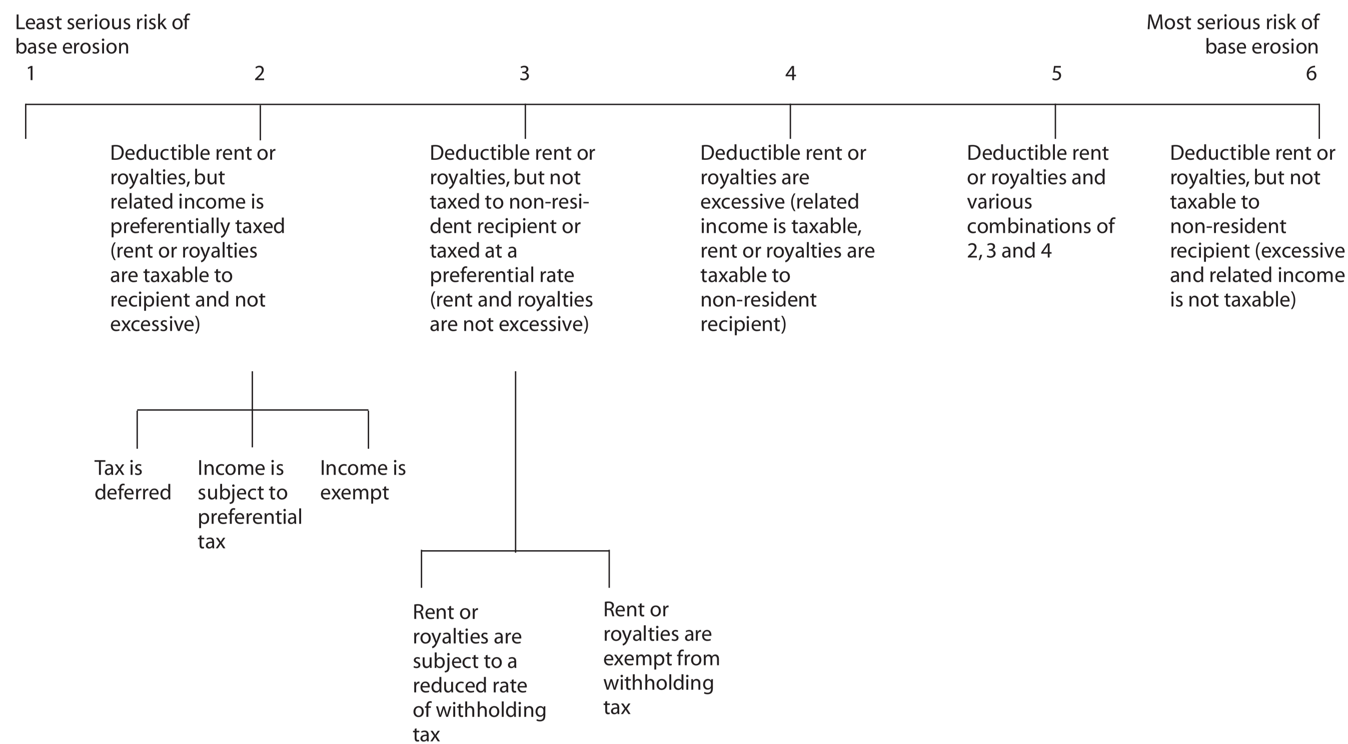
- Restrictions on the deduction of payments of rent and royalties
- The imposition of withholding taxes on payments of rent and royalties, and
- The application of rules, including transfer pricing rules and anti-avoidance rules, to prevent excessive deductible payments of rent and royalties

4.2 Restrictions on the deduction of rent and royalties

1. *Risk*: All deductible payments of rent and royalties for the use of property erode a country's tax base.

Table 3

Continuum of base erosion from deductible payments of rent and royalties



Possible response: The obvious, but inappropriate, response to the base erosion from the deduction of rent and royalties would be for a country to disallow any deduction for those amounts. Such action would be inappropriate because, in many situations, rent and royalties represent legitimate expenses incurred to earn income that should be deductible in computing a taxpayer's net income subject to tax. Moreover, where rent or royalties are paid by a resident of a country (or a non-resident carrying on business in the country) to a resident of that country (or to a non-resident carrying on business in that country), the country can and should impose tax on the recipient of the rent or royalties. The tax imposed on the recipient of rent or royalties should offset the reduction in tax from the deduction of the rent or royalties by the payer. Where rent or royalties are paid to a non-resident (other than a non-resident carrying on business in the country), withholding tax imposed on the payments will offset the reduction in tax from the deduction of the payments. Base erosion will occur to the extent that the withholding tax on rent or royalties is less than the reduction in tax from the deduction of the rent or royalties. Any deficiency in this regard does not seem sufficient to justify denying the deduction of rent and royalties paid to non-residents.

Furthermore, unlike the deduction of interest expenses, the deduction of payments of rent and royalties (other than payments to related non-residents, as discussed below) is not generally restricted on the basis that the deduction of such expenses is excessive. Many countries limit the deduction of excessive interest expenses through the application of thin capitalization rules or earnings-stripping rules. There are no equivalent rules with respect to the deduction of rent and royalties.

2. *Risk*: Deductible payments of rent or royalties by residents of a country to related non-residents may exceed the amounts that would have been paid had the parties been dealing at arm's length.

   Possible response: Developing countries can apply their transfer pricing rules to ensure that any payments of rent or royalties by a resident of a country to a related non-resident do not exceed the arm's length amount of such payments. If a developing country's transfer pricing rules apply only to corporations or business entities, the country should ensure that it has similar rules that apply to payments of rent and royalties between related individuals. (See chapter 1, section 1.5, above.)

4.3 Withholding taxes on deductible payments of rent and royalties

4.3.1 Introduction

All deductible payments of rent and royalties erode a country's tax base. Perhaps the most obvious response to such base erosion is to deny or restrict the deductions. However, such a response is undesirable for most countries because, in most situations, the rent and royalties represent legitimate expenses; it would likely have the effect of restricting access of a country's residents to technology and equipment; and it would violate the non-discrimination provision in tax treaties.

Therefore, the next best response to base-eroding payments of rent and royalties may be to impose tax on the non-resident recipients of rent and royalties. Usually, this tax is imposed as a flat-rate tax on the gross amount of the payments by requiring the payers of such amounts to withhold the tax from the payments. A withholding tax on payments of rent and royalties will offset the base-eroding effects of the deduction of rent and royalties. However, where the withholding tax is less than the tax saving from the deductions, base erosion will not be offset completely. (See the detailed discussion of this issue in chapter 1, section 1.3.3.2, and chapter 2, section 2.3.1.2, above.)

Therefore, a country's tax base is eroded by deductible payments of rent and royalties to non-residents in two situations:

- Where certain payments of rent and royalties are exempt from withholding tax under the provisions of a country's domestic law or its tax treaties, and
- Where a country's withholding tax is less than the tax saving from the deduction of the rent or royalties, either because of

the rate of withholding tax under domestic law or because the country's tax treaties require the rate of withholding tax to be reduced.

Although a high rate of withholding tax on rent or royalties may offset the base-eroding effect of the deductions for rent or royalty payments, it may have the unintended consequence of restricting access to foreign-owned technology for the country's residents.[58] For example, non-residents may refuse to license their intellectual property to residents unless those residents gross-up the royalties to reflect the withholding tax. In effect, the withholding tax is borne by a country's residents using foreign-owned technology rather than the non-resident owners of the technology. Therefore, the imposition of withholding taxes on royalty payments involves difficult judgments about balancing the need to prevent base erosion against the need to allow residents access to foreign technology. (See chapter 1, section 1.3.3.2, and chapter 2, section 2.3.1.2.5, above.)

Some countries have decided that the disadvantages of imposing high withholding taxes on royalties outweigh the advantages; as a result, they either exempt certain royalty payments from withholding tax or subject them to relatively low rates of withholding tax under their domestic law. As explained in chapter 1, section 2.3.1.2.5, even countries that maintain high rates of withholding tax on royalties under their domestic law often agree to reduced or zero withholding tax rates on rent and royalties in their tax treaties. For these countries, deductible rent and royalty payments to non-residents may represent an acceptable erosion of their tax base.

Section 4.3.2 describes the risks of base erosion that apply generally with respect to withholding taxes on payments of rent and royalties to non-residents. These risks apply to payments for the use of immovable property, movable property and intellectual property. Sections 4.3.3, 4.3.4 and 4.3.5 describe the special risks of base erosion with respect to payments of rent for the use of immovable property, movable property and intellectual property, respectively. Section 4.6 describes the risk of base erosion where a country allows deductions

[58] The same problem does not apply with respect to payments of rent for the use of immovable property owned by non-residents because residents generally have access to other immovable property owned by residents.

for the costs of R&D of intellectual property and the property is transferred to a non-resident.

4.3.2 General risks of base erosion with respect to withholding taxes on rent and royalties

1. *Risk*: Base erosion occurs where a country does not impose withholding tax on deductible payments of rent and royalties to non-residents, or exempts such payments from withholding tax, or imposes withholding tax on such payments at a reduced rate.

   Most countries tax payments of rent and royalties by their residents to non-residents under their domestic law. Therefore, the risks of base erosion through deductible payments of rent and royalties to non-residents arise only to the extent that a country does not exercise its taxing rights fully with respect to payments of rent and royalties to non-residents.

   Possible response: Developing countries that do not impose withholding tax on rent or royalties paid to non-residents should seriously considering imposing such a tax. Developing countries that impose withholding tax on rent and royalties should review any exemptions from such withholding taxes or any reduced rates of withholding tax for payments of rent or royalties to non-residents under their domestic law to ensure that those exemptions or reduced rates are intentional and justified by tax and economic policies.

   Withholding taxes on rent for the use of movable property and royalties for the use of intellectual property may have the unintended result of increasing the cost for a country's residents to obtain the use of foreign-owned machinery and equipment or technology. Therefore, the imposition of withholding taxes on payments for the use of movable property or intellectual property involves difficult judgments about balancing the need to prevent base erosion against the need to allow residents access to foreign-owned movable property and technology.

2. *Risk*: A country's tax treaties may prevent the country from imposing its 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. Thus, base erosion will result to the extent that the reduction in a country's tax as a result of the deduction of rent and royalties paid to non-residents is not offset by the country's withholding tax on such payments.

   Possible responses: There are several potential responses to this risk of base erosion. First, a developing country could decide not to enter into tax treaties because tax treaties limit domestic taxes. However, this is a drastic response to base erosion through deductible payments of rent and royalties because tax treaties may provide other economic benefits for developing countries. Second, developing countries could refuse to agree to any reduction in their withholding taxes on rent and royalties in their tax treaties. However, such a position is unlikely to be acceptable to other countries and is inconsistent with international practice. Alternatively, 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. Countries should also ensure that any exemptions from withholding tax on interest are clearly justified.

3. *Risk*: If a country imposes withholding taxes on interest paid to non-residents under its domestic law at a rate different from the rate on royalties, or agrees to different rates on interest and royalties in its tax treaties, taxpayers may manipulate transactions to ensure that they receive payments that are subject to the lower rate of withholding tax. Similarly, if a country does not impose withholding tax on payments for services to non-residents or payments for the purchase of goods from non-residents or, even if it does impose such withholding taxes, its tax treaties prevent the application of those taxes, there is a risk that taxpayers may

manipulate transactions to avoid withholding taxes on royalties. As discussed in chapter 1, section 1 (Basic concepts), in certain circumstances, such as finance leasing, technical services closely connected to the licensing of technology and royalties embedded in the cost of goods, rent and royalties can be converted into other payments, and vice versa. Consequently, taxpayers may structure their transactions to minimize tax by converting rent or royalties into other payments that are subject to less tax. See also section 4.3.5 below, dealing with situations in which taxpayers may be able to convert rent or royalties into sales of property resulting in capital gains. (In principle, it is also possible that taxpayers may structure transactions to convert other payments into rent or royalties if rent or royalties are subject to less source country tax).

Possible responses: Developing countries can reduce the risk of base erosion through arbitrage transactions by imposing consistent rates of withholding tax on payments of interest and royalties and payments for services and for goods under their domestic law. Similarly, developing countries should try to ensure that the maximum rates of withholding tax on interest, royalties and technical services are consistent. Any tax treaties that have provisions similar to those of the United Nations Model Convention and the Organisation for Economic Cooperation and Development (OECD) Model Convention[59] will require a country to refund any withholding tax on payments for goods to a resident of the other contracting State. Transfer pricing and anti-avoidance rules that allow the tax authorities to classify transactions based on their substance may help to deal with some of these types of arbitrage.

4. *Risk*: Where non-residents carry on business in a country and deduct payments of rent and royalties against that country's tax base, any such payments made to non-residents may not be subject to withholding tax.

[59] Organisation for Economic Cooperation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Possible response: Developing countries should ensure that deductible payments of rent and royalties made by non-residents to other non-residents are subject to withholding tax. Some countries may tax rent from movable or immovable property or royalties derived by non-residents on a net basis in certain circumstances; for example, where those amounts are derived through a permanent establishment (PE) or fixed base located in a country, they must be taxed on a net basis under Articles 7 (Business profits) or 14 (Independent personal services) of the United Nations Model Convention as a result of Article 12 (4). In such cases, the tax authorities should ensure that the underlying property in respect of which the rent or royalties are paid is effectively connected with the PE or fixed base, that the income is properly calculated and that the tax can be collected effectively (for example, through a system of interim withholding). Note that for this purpose, it is irrelevant whether the payment is made by the non-resident from the PE, fixed base, the head office or another part of the non-resident enterprise as long as the payment is deductible in computing the profits of the PE or fixed base.

5. *Risk*: Where payments of rent or royalties for the use of property are made to a non-resident who claims the benefit of a reduced rate of withholding tax under Article 12 of an applicable tax treaty, there is a risk that the non-resident may not be entitled to the benefit of the treaty.

   Possible response: The tax authorities should verify that the non-resident is entitled to the benefit of Article 12. In particular, the tax authorities should verify that the recipient of the rent is a resident of the other contracting State and the beneficial owner of the rent.

6. *Risk*: Taxpayers may enter into back-to-back arrangements to avoid or reduce withholding tax on royalties, as discussed in chapter 1, section 1.2.11, above.

   Possible response: Developing countries should consider adopting anti-back-to-back rules or the application of their general anti-avoidance rule to back-to-back royalty arrangements. Developing countries should also verify that the recipient of royalties is the beneficial owner of the royalties before granting the reduced rate of withholding tax under the royalty article of their treaties. They should also consider including a general anti-abuse rule similar to the one to be added to the United Nations Model Convention in the 2017 update.

4.3.3 Rent for the use of immovable property

1. *Risk*: The definition of "immovable property" under a country's domestic law may be inappropriately narrow.

   Possible response: Developing countries should review the definition of immovable property in their domestic law to ensure that such definition is appropriate for tax purposes. The issue in this regard is that a country's taxing rights with respect to income from immovable property may be different from its taxing rights with respect to other income. For example, under Article 6 of the United Nations Model Convention, countries are entitled to tax income derived by a resident of the other contracting State from immovable property located in their territory without any limitations on the rate or the method of taxation. For this purpose, "immovable property" is defined in accordance with the domestic law of the country in which the property is located. In contrast, under Article 12 of the United Nations Model Convention, a country's tax on income from movable property is limited to an agreed maximum rate if the non-resident recipient is the beneficial owner of the income.

   As discussed in chapter 1, section 1.2.5.2, above, many issues, including the treatment of income derived from natural resources (mining, timber, and agricultural activities) and property affixed to immovable property, such as pipelines, must be carefully considered in this regard.

2. *Risk*: The definition of "income from immovable property" located in a country may be inappropriately narrow.

   Possible response: Developing countries should carefully consider the provisions of their domestic law to ensure that non-residents cannot avoid withholding tax on rent for the use of immovable property located in a country by receiving compensation for the use of the property in a form other than rent. Issues that should be considered in this regard include the treatment of payments received in lieu of rent, payments dependent upon the use of or production from the property, payments based on the profits of the lessee, and gains from the disposition of the property. (See chapter 1, section 1.2.5.2, above.) For developing countries that tax income from immovable property on a net basis, there is a risk that the expenses incurred in earning the income may be overstated, especially where the expenses are payments made to related non-resident companies.

3. *Risk*: Non-residents may seek to avoid source country tax on income from immovable property through time-sharing and other arrangements, especially with related non-residents, whereby the payments of rent for the use of the property and the source country's withholding tax are reduced.

   Possible response: Developing countries should ensure that they have robust anti-avoidance rules to prevent taxpayers from avoiding withholding taxes on rent for the use of immovable property by structuring arrangements so that payments of the sale price of property or fees for services are substituted for payments of rent.

4.3.4 Rent for the use of movable property

1. *Risk*: If developing countries enter into tax treaties that contain a definition of royalties similar to the definition in Article 12 (3) of the OECD Model Convention, they will be unable to impose withholding tax on payments of rent for the use of movable property. The definition of royalties in Article 12 (3) of the OECD Model Convention excludes payments for the use of industrial, commercial or scientific equipment, with the result that such rent is covered by Article 7 and is taxable by the country in which the property is used only if the non-resident carries on business through

a PE in the country and the rent is attributable to the PE.

Possible response: Developing countries can ensure that any tax treaties they enter into allow them to impose withholding tax on payments of rent for the use of movable property by including a provision similar to Article 12 of the United Nations Model Convention and that they insist on a reasonable rate of withholding tax on rental payments. Under Article 12 (3) of the United Nations Model Convention, rent for the use or the right to use industrial, commercial or scientific equipment is included in the definition of royalties and is subject to withholding tax at an agreed rate on the gross amount of the rental payments.

2. *Risk*: If a country adopts a broad interpretation of Article 8 of the United Nations Model Convention, the country may not be able to impose tax on income from the leasing of ships or aircraft or equipment under Article 12.

   Possible response: Developing countries should consider adopting an interpretation of Article 8 of its tax treaties that follows the Commentary to Article 8 of the United Nations Model Convention rather than the Commentary to Article 8 of the OECD Model Convention (see chapter 2, section 2.3.2.2, above). Developing countries should also consider including Article 8 (alternative B) of the United Nations Model Convention, which allows a contracting State to tax income from international shipping, air transportation and inland waterways transport that is more than casual.

4.3.5 Royalties for the use of intangible property

Risk: The definition of royalties under a country's domestic law for the purposes of withholding tax may be inappropriately narrow (or broad) or may be inconsistent with the definition of royalties in Article 12 (3) of the United Nations Model Convention. Under Article 12 of the United Nations Model Convention, payments for the use or the right to use copyrights, patents, trademarks, designs, models, plans, secret formulas or processes, or for information concerning industrial, commercial or scientific experience, are included in the definition of royalties and are subject to withholding tax at an agreed rate on the gross amount of the rental payments.[60]

Possible response: Developing countries should review the types of payments that are subject to withholding tax and determine whether all payments of rent and royalties for the use of property are subject to the tax. Any exemptions should be reviewed to determine whether they are justified. Also, types of payments subject to domestic withholding tax should be compared with the definition of royalties in Article 12 (3) of the United Nations Model Convention, and any differences should be carefully considered. If the payments subject to domestic withholding tax are not included in the definition of royalties in Article 12 (3) (that is, the definition of payments subject to withholding tax under domestic law is broader than the definition under Article 12 (3) of the United Nations Model Convention), the treaty will prevent the imposition of the domestic withholding tax on such payments (although another article of the treaty may apply).

As discussed in chapter 1, section 1.2, above, there are many issues concerning the characterization of payments as royalties under both domestic and tax treaties. Some of the more important issues include the distinction between payments for industrial, commercial or scientific information—so-called know-how—and payments for services in the form of technical assistance, payments for computer software, the distinction between payments for the transfer of ownership rights with respect to property and the transfer of rights to use the property, the distinction between payments for services and royalties, mixed contracts, which provide for both the right to use property and to receive services, and the scope of payments for copyrights.

[60] Payments for the use of industrial, commercial or scientific equipment are also included in the definition of royalties under Article 12 (3) of the United Nations Model Convention. See section 4.3.4 for a discussion of the risks of base erosion with respect to such payments.

Developing countries should carefully consider the provisions of their domestic law to ensure that non-residents cannot avoid withholding tax on royalties for the use of intellectual property. Countries could also consider the possible application of anti-avoidance rules to prevent taxpayers from avoiding withholding taxes on royalties.

4.4 Deductions for rent and royalties paid by non-residents taxable on a net basis

1. *Risk*: Non-residents subject to net-basis taxation by a country may claim deductions for rent or royalties in computing their income subject to tax by the country. This risk is most likely to apply where non-residents carry on business in a country through a PE or fixed base.

   Possible response: Although countries might consider denying the deduction of rent or royalties paid by non-residents, this may not be an acceptable response for many countries because the payments of rent or royalties represent legitimate expenses incurred for the purpose of earning taxable income. Moreover, to the extent that a country has entered into tax treaties that contain provisions similar to Article 24 (Non-discrimination) 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 PE (although not through a fixed base) unless residents of the country are also not allowed to deduct such payments of rent and royalties.

   A preferable response may be to subject to withholding tax any deductible payments of rent and royalties made by non-residents carrying on business in a country to non-residents. The withholding tax on deductible payments of rent and royalties will offset the reduction in a country's tax base resulting from the deductions for rent and royalties.

2. *Risk*: Non-residents may allocate and deduct disproportionate amounts of rent and royalties in computing net income earned in a country. Only rent and royalties incurred for

the purposes of earning income from the business carried on in the source country should be deductible in computing the income subject to tax by the source country or, if a tax treaty applies, the profits attributable to the PE or fixed base.

Possible response: Developing countries should have 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 a country, and the tax authorities should be vigilant in applying those rules to deductions of rent and royalties claimed by non-residents. For purposes of negotiating the provisions of any tax treaties, developing countries should consider not agreeing to include a provision similar to Article 7 of the OECD Model Convention because that Article requires countries to allow the deduction of notional amounts in computing the profits attributable to a PE. Although notional amounts of rent and royalties may be deductible in computing the profits attributable to a PE in the source country, the source country will be unable to impose any withholding tax on such notional amounts. In determining the profits attributable to a PE under an applicable tax treaty that contains a provision similar to Article 7 of the United Nations Model Convention, the tax authorities of developing countries should allow the deduction only of actual expenses of rent and royalties incurred by a non-resident enterprise to the extent that those expenses are incurred for the purpose of the PE. In addition, in most cases, no mark-up on the expenses incurred for the purpose of the PE should be allowed. Note that for this purpose, it is irrelevant whether the payment is made by the non-resident from the PE, fixed base, head office or other part of the non-resident enterprise as long as the payment is deductible in computing the profits of the PE or fixed base.

4.5 Risks of base erosion with respect to deductible payments of rent or royalties by residents to earn exempt or preferentially taxed income

1. *Risk*: Where residents of a country incur expenses for rent or royalties with respect to property that is used to earn

exempt income, the deduction of the rent or royalties erodes the country's tax base and the related income is not taxable. This type of base erosion may be likely to occur where the relevant property is used to earn foreign source income, which is exempt from tax by the residence country. This risk applies equally to residents earning foreign source income in the form of rent or royalties.

Possible response: As a matter of general principle, expenses incurred to earn income that is exempt from tax should not be deductible. Thus, rent or royalties incurred by residents of a country to earn exempt income, including exempt foreign source income, should not be deductible unless the country has decided to subsidize resident taxpayers to earn such exempt income. Developing countries should consider disallowing or restricting the deduction of rent and royalties incurred to earn exempt income. Similarly, developing countries should consider restrictions on the deduction of rent or royalties incurred to earn preferentially taxed income. See chapter 1, sections 1.4.2 and 1.4.3, above.

2. *Risk*: Where residents of a country incur expenses for rent or royalties with respect to property that is used to earn foreign source income subject to tax by that country, the foreign tax credit allowed against that country's tax for foreign taxes on the foreign source income, rent or royalties may be overstated. If the foreign tax credit is overstated, in effect, domestic tax on domestic source income is reduced inappropriately. This risk applies equally to foreign source income in the form of rent or royalties.

   Possible response: Any expenses, including rent or royalties, incurred by residents to earn foreign source income should be allocated to the foreign source income for purposes of the limitation on the foreign tax credit in order to ensure that the credit is limited to foreign tax on foreign source income. (See chapter 1, sections 1.4.2.2 and 1.4.3, above.)

4.6 Transfers of intellectual property to non-residents

Risk: Where a country provides tax support for the creation of intellectual property through deductions for R&D,

but the property is transferred to a non-resident, the country's tax base is eroded by the deductions allowed for R & D (research and development) costs, and, in addition, no offsetting tax revenues are generated.

Possible responses: Many countries allow generous tax deductions for the costs of R&D of intellectual property for the purpose of stimulating such activity. Although most R&D does not lead directly to the creation of intellectual property that generates a significant income stream, if it does so, countries should benefit from the taxes on the income. However, if the property is transferred to a non-resident, the country that supported the creation of the property may not be able to tax the income generated by the property after the transfer (except perhaps to the extent that the property generates royalties from that country).

To avoid this result, countries might consider adding rules to their domestic tax law to recapture some or all of the previous deductions claimed in respect of the costs of creating the property where the property is transferred to a non-resident. However, such rules are complex and difficult for developing countries to administer. Countries might also consider imposing tax on the gain realized on the transfer of the property to a non-resident. Where the property is transferred to a non-resident dealing at arm's length with the resident transferor, the tax authorities can be reasonably confident that the sale price represents the fair market value of the property. However, if the property is transferred to a related non-resident, the parties may agree to a sale price that is less than the fair market value of the property in order to reduce the gain on the sale. Therefore, countries should have rules in their domestic law (transfer pricing rules or other rules) that deem the proceeds of sale of property, including intellectual property, by a resident to a related non-resident to be the fair market value of the property; special rules may be needed to value transfers of intangibles between related parties (see chapter 1, section 1.5, above). The administration of these types of provisions by the tax authorities involves significant difficulties, especially the valuation of the transferred property.

4.7 Non-residents earning rent or royalties from resident consumers

Risk: Non-resident enterprises may be able to earn substantial amounts in the form of rent or royalties from resident consumers without the need to establish a PE or fixed base in the country. This type of tax avoidance is not limited to non-residents deriving rent and royalties, but may occur with respect to a variety of businesses, including the sale of digital goods and services.

Possible responses: The most obvious response is for developing countries to impose withholding taxes on all payments to non-residents, including payments of rent and royalties. However, the application of such broad withholding taxes is problematic with respect to non-deductible payments to non-residents by individuals, since it is difficult for the tax authorities to enforce withholding obligations on individuals. Moreover, where a country has entered into tax treaties with provisions similar to those of the United Nations Model Convention, those treaties will prevent the country from imposing withholding tax on payments for goods and services. Some countries, such as Australia and the United Kingdom of Great Britain and Northern Ireland, have enacted special rules (the Multinational Anti-Avoidance Law in Australia and the Diverted Profits Tax in the United Kingdom) to impose tax in these circumstances. These special taxes are complex, both in terms of legislation and administration. Tax treaties with provisions similar to those of the United Nations Model Convention will prevent the application of these taxes. (Australia and the United Kingdom have taken steps to ensure that the special rules prevail over the provisions of their tax treaties.) Although developing countries clearly have the right to tax and would like to impose tax on non-residents in these circumstances (subject to the provisions of any tax treaties), the adoption of such a tax requires careful study.

Table 4
Risks of base erosion and possible responses

A	
Risks of base erosion through deductions of rent and royalties and possible responses	
Risk	**Possible responses**
Payments of rent or royalties to related non-residents in excess of arm's length amounts	1. Apply transfer pricing rules
Payments of excessive royalties: countries usually do not have rules for rent and royalties similar to thin capitalization or earnings-stripping rules for interest	1. Consider restrictions on deductions
Provisions of tax treaties (Article 24 (4) or (5)) may prevent the application of restrictions on excessive deductions of rent or royalties	1. Do not enter into tax treaties 2. Do not agree to include Article 24 (4) or (5) 3. Apply any restrictions on deductions of rent or royalties to both residents and non-residents 4. Allow deductions if they conform to the arm's length standard in Article 9 (1) 5. Exclude any restrictions on deductions of rent or royalties from Article 24 (4) and (5) 6. Limit Article 24 (4) and (5) to most-favoured-nation (MFN) treatment 7. Include a saving clause that does not exclude Article 24
Non-residents subject to net-basis tax may claim excessive deductions of rent or royalties	1. Apply restrictions on deductions of rent or royalties to non-residents 2. Apply robust rules for allocating rent or royalty expenses to income earned by non-residents
Non-residents subject to net-basis tax may allocate too much rent or royalty expenses to the country in which the income is earned	1. Apply rules for allocating expenses to computation of income in order to prevent an inappropriate result

	2. 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 the application of rules to disallow excessive deductions of rent or royalties	1. Do not enter into treaties 2. Do not agree to include Article 24 (3) 3. Apply any restrictions on deductions of rent or royalties to residents and non-residents 4. Exclude any restrictions on deductions of rent or royalties from Article 24 (3) 5. Limit Article 24 (3) to most-favoured-nation (MFN) treatment
B	
Risks of base erosion — withholding taxes on rent and royalties and possible responses	
Risk	**Possible responses**
No or reduced withholding tax on rent or royalties paid to non-residents under domestic law	1. Impose high withholding taxes on all payments of rent or royalties to non-residents ▫ This response could have serious disadvantages
No or reduced withholding tax on rent or royalties paid to non-residents under tax treaties	1. Maintain reasonable rates of withholding tax on rent and royalties paid to non-residents 2. Ensure that any exemptions are clearly justified
Withholding tax imposed at different rates on royalties and other amounts such as interest and services	1. Ensure that consistent rates of withholding are imposed under domestic law and tax treaties
No withholding tax on payments of deductible rent or royalties by non-resident	1. Ensure that withholding tax on rent and royalties applies to payments of rent or royalties by non-residents that are deductible in computing their income from business earned in the source country

Non-residents claim the benefit of a reduced rate of withholding under tax treaties	1. 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	1. Adopt specific anti-avoidance rules to prevent back-to-back arrangements 2. Apply a general anti-abuse rule to prevent back-to-back arrangements
C	
Risks of base erosion with respect to rent for the use of immovable property	
Risk	**Possible responses**
Definition of immovable property under domestic law may be too narrow	1. Ensure that the definition of immovable property is at least as broad as the definition in Article 6 of the United Nations Model Convention
Definition of income from immovable property may be too narrow	1. Ensure that all income from immovable property is subject to tax
Non-residents may try to avoid tax on income from immovable property through time-sharing and other arrangements	1. Apply anti-abuse rules to prevent arrangements from avoiding withholding tax on rent from immovable property
D	
Risks of base erosion with respect to rent for the use of movable property	
Risk	**Possible responses**
No withholding tax on rent for the use of movable property under tax treaties	1. Ensure that tax treaties contain a provision similar to Article 12 the United Nations Model Convention that allows withholding tax on rent for the use of equipment

E	
Risks of base erosion with respect to royalties for the use of intangible property	
Risk	**Possible responses**
The definition of royalties under domestic law may be too narrow or inconsistent with the definition under tax treaties	1. Review royalty payments subject to withholding tax under domestic law 2. Ensure that any exemptions from withholding tax are justified 3. Compare withholding tax under domestic law and tax treaties and ensure that tax treaties do not limit domestic withholding tax inappropriately 4. Apply anti-abuse rules to prevent arrangements from avoiding withholding tax on royalties
F	
Risks of base erosion with respect to deductible payments of rent or royalties by residents to earn exempt or preferentially taxed income	
Risk	**Possible responses**
Rent or royalties are deductible but foreign source income is exempt	1. Deny any deduction of such rent or royalties 2. Apply robust rules for allocating rent or royalty expenses to exempt income
Foreign source income is taxable but rent or royalties are not allocated to the income for purposes of the limitation on the foreign tax credit	1. Limit foreign tax credit to domestic tax on the net foreign source income 2. Apply robust rules for allocating rent or royalty expenses to foreign source income
G	
Miscellaneous risks of base erosion with respect to rent and royalties	
Risk	**Possible responses**
Intangible property is transferred by resident to related non-resident and perhaps leased back to resident	1. Ensure that the property is deemed to be transferred for its fair market value and use hindsight to determine fair market value

	2. If the residence country allowed deductions for research and development (R&D) expenses incurred, recapture deductions when the property is transferred to non-resident 3. Apply general anti-abuse rule in appropriate circumstances

Part 3

Designing and drafting domestic legislation and negotiating tax treaties to prevent base erosion with respect to rent and royalties

Chapter 1

Introduction

As discussed previously, the risks of base erosion from deductible payments of rent and royalties arise in four broad situations:

- Deductible payments of rent and royalties paid to non-residents are not subject to foreign tax or are subject to a low rate of foreign tax.
- Deductible payments of rent or royalties are exempt from a country's withholding tax or are subject to reduced withholding tax.
- Payments of rent or royalties by residents of a country or non-residents carrying on business in the country are deductible, but the funds are used to earn income that is deferred, exempt or taxed in a preferential manner. The income may be either foreign source income or domestic source income. The potential base erosion occurs when rent or royalties are deductible but the associated income is not subject to full, current residence country tax.
- The costs of creating or developing intellectual property are deductible but the property is transferred offshore so that any royalties from the exploitation of the property are not subject to tax.

In addition, base erosion may occur where resident consumers in a country pay non-deductible royalties or similar amounts to non-resident providers of tangible or intangible property.

As discussed in part 2, chapter 4, these concerns generally require different responses in order to prevent base erosion effectively.

In the case of 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. In the case of withholding taxes on rent and royalties, the goal is to collect tax from non-resident recipients of rent or royalties in order to offset the reduction of tax resulting from the deduction of those amounts where the amounts are deductible, 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. In the case of 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. In the case of intellectual property transferred offshore, the 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.

Chapter 2

The major design elements in drafting domestic legislation to counter base erosion with respect to payments of rent and royalties

2.1 Introduction

The present chapter analyses the major design elements or structural features of domestic legislation for taxing rent and royalties to eliminate the risks of base erosion that were identified in part 2, chapter 4. The chapter covers the following five issues:

(a) Restrictions on the deduction of rent and royalties;

(b) Withholding taxes on rent and royalties;

(c) Non-residents earning rent and royalties taxable on a net basis;

(d) Residents incurring deductible payments of rent and royalties to earn income from foreign sources that is exempt or subject to preferential tax; and

(e) Transfers of intellectual property to non-residents.

As the following four sections indicate, in most countries the rules for taxing residents and non-residents differ; therefore, the distinction between residents and non-residents is important. However, this chapter does not discuss the rules for distinguishing between residents and non-residents — it simply assumes that each country makes such a distinction and that the rules for taxing residents and non-residents with respect to the treatment of rent and royalties differ. Similarly, this chapter assumes that all countries tax certain rent and royalties derived by non-residents on a net basis (that is, allowing the deduction of expenses incurred in earning the income) and other rent and royalties on a gross basis through a withholding tax. The chapter does not examine how countries determine which amounts are subject to net-basis taxation and which amounts are subject to withholding tax (see part 2, chapter 1, section 1.3, for a discussion of how this distinction is made). It analyses the design features of net-basis taxation and withholding taxes in general, rather than as they might apply to particular types of rent and royalties.

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

As described in part 2, chapter 1, section 1.3, several countries have adopted 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 on those payments. The basic idea underlying these rules is that if the non-resident recipient is not subject to tax on the payments, there is a risk that the payments may be excessive or unreasonable, and therefore it is appropriate to disallow the deduction of the payments in order to protect the country's tax base.

It is relatively easy to draft legislation to restrict the deduction of payments of rent and royalties to non-residents if the recipient of those payments is not subject to tax on the payments or is subject to tax at a rate that is less than a specified percentage of the payments. However, the interpretive and administrative problems with any subject-to-tax test present serious difficulties for the tax authorities. In general, such a test requires the tax authorities of a country to determine the tax consequences to a taxpayer under another country's tax system. In turn, this requires access to information about the situation of the particular non-resident and about the foreign tax system, which is necessary to determine whether an amount is subject to tax under that system or whether the foreign tax exceeds a minimum amount.

Because of the interpretive and administrative difficulties with a subject-to-tax test, some countries use a proxy for such a test. For example, some countries deny the deduction of rent and royalties paid to residents of tax havens or low-tax countries. The major challenge with this approach is to define a tax haven or low-tax country. In general terms, the tax policy decision as to which countries are tax havens or low-tax countries involves a comparison between the tax rates in the country against whose tax base the rent or royalties are claimed as deductions and the country in which the recipient is resident. For example, a tax haven or low-tax country could be defined as a country that imposes tax at a rate that is less than a specified percentage (50, 66.66 or 75 per cent) of the source country's tax rate. If such an approach is based on nominal tax rates, it will not provide much assurance that rent or royalties paid to non-residents are actually subject to a reasonable amount of foreign tax. It is preferable that the comparison of domestic and foreign tax rates focus exclusively on effective tax rates on rent and royalties rather than tax rates on income generally so that any special low-tax regimes for royalties, such as patent boxes, can be taken into account.

Because of these difficulties, some countries have a list of countries that are considered to be tax havens or low-tax countries. As a result, any rent or royalties paid to a resident of a listed low-tax country would not be deductible irrespective of the amount of foreign tax actually paid. However, deciding which countries to put on such a list is a difficult task and may involve regard for political issues and international relations as well as tax considerations. In addition, any list of low-tax countries requires periodic monitoring in order to keep the list reasonably up to date. The European Union (EU) is in the process of preparing such a list, which should be ready by September 2017. The list may be used as a model, although effective tax rates is only one factor that will be used to include a country within the list.

Some developing countries might prefer to deal with these situations on a case-by-case basis through the application of specific or general anti-avoidance rules or by applying withholding taxes broadly on payments for rent and royalties to non-residents.

2.3 Withholding taxes on rent and royalties

Where residents of a country pay rent or royalties to non-residents, the country's tax base is eroded if the payments are deductible by the resident payers. This risk of base erosion can be countered in part by imposing a withholding tax on the non-residents receiving the payments. The withholding tax will not completely offset the tax savings from the deduction of the payments of rent or royalties unless it is imposed at a rate that equals or exceeds the country's applicable tax rate.

A withholding tax on rent and royalties must carefully consider the identification of the types of payments that will be subject to tax. The withholding tax should apply not only to rent and royalties, but also to amounts paid in lieu of or in substitution for rent or royalties; otherwise, such payments may be used to avoid the withholding tax on interest.

Since owners of movable property and intellectual property usually incur significant expenses in earning rent and royalties, they may attempt to require lessees and licensees to bear any withholding tax imposed on payments of rent and royalties. Typically, the non-resident owner will require the resident borrower to gross up the amount of the payments of rent or royalties so that the owner receives an amount after tax equal to the rent or royalties that would have been charged had no withholding tax been applied. In this case, the effect of the withholding tax is to increase the cost of renting movable property or equipment or licensing intellectual property for residents. This effect of a withholding tax on rent and royalties can be minimized by exempting certain rent or royalties from withholding tax entirely or by reducing the rate of withholding tax on certain rent or royalties. For example, if a country wants to encourage access by residents to certain types of technology, it might consider exempting royalties for the use of such technology from its withholding tax.

A country's 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, such as dividends and interest. If the rates of withholding tax imposed on various amounts (under domestic law or the country's tax treaties) are identical, the withholding taxes are easier for payers/withholding agents to comply with and for the tax authorities to administer. However, if the rates vary widely, the compliance and administration burdens with respect to the withholding taxes are increased. Similarly, the 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) because withholding agents and tax authorities will be required to determine whether payments qualify for the exemptions. In addition, if the rates of withholding on rent, royalties and other amounts, such as interest and fees for technical services, are consistent, taxpayers will be unable to structure transactions in order to produce payments that are subject to the lowest withholding tax rate.

A country may also impose withholding tax on payments of rent and royalties even where the payments are not deductible by the resident payers. For example, where resident individuals pay rent or royalties to non-residents for the personal use of property, the payments are not usually deductible. Nevertheless, some countries may impose an obligation on resident individuals to withhold tax in these circumstances. Some non-resident enterprises may derive substantial revenue from providing the use of intangible property, especially digital goods and services, to resident individual consumers, and developing countries may see this revenue as a source of significant tax revenues. However, it may be difficult to effectively enforce withholding obligations on individuals, especially with respect to relatively small amounts paid to non-residents.

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. This will usually be the case where a non-resident carries on business in a country or, where a tax treaty applies, where a non-resident carries on business through a PE or fixed base in the country. In these situations, the non-resident's profits are taxable on a net basis and any deductible rent or royalty payments will reduce the country's tax base.

If a withholding agent fails to withhold tax on payments of rent or royalties to a non-resident, countries could consider denying the deduction of those payments, in addition to other penalties.

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

If a country exempts certain income derived by its residents from tax or taxes certain income preferentially, the country's tax base will be eroded unless the deduction of any expenses, including rent and royalties, incurred to earn that income is disallowed or restricted in some manner. The design of legislation to deny or limit the deduction of rent and royalties in these circumstances is relatively simple: the deduction of rent and royalties to earn exempt income should be disallowed. If the income is subject to tax at a preferential rate, the deduction of any rent or royalties to earn such income should be limited proportionately. For example, if only 50 per cent of the income is subject to tax, only

50 per cent of the rent and royalties should be deductible. If the income is deferred, the deduction of any rent or royalties incurred to earn such income should be deferred until the related income is subject to tax.

Similar considerations apply with respect to residents earning rent and royalties from foreign sources (see part 2, chapter 1, section 1.4.3).

2.5 Research and development costs

As discussed in part 2, chapter 4, section 4.6, a country's tax base may be seriously eroded if the country allows generous deductions for the costs of research and development (R&D) of intellectual property but the property is transferred to a non-resident, with the result that the income from the property is not subject to that country's tax. Two major legislative responses may be used to counter this risk of base erosion. First, a country could enact rules that impose tax on the gain on any transfer of intellectual property to a non-resident if the costs of R&D of the property have been deducted against the country's tax base. Second, a country could enact rules to recapture any prior deductions for the costs of R&D of intellectual property if the property is transferred to a non-resident. Although both of these approaches are reasonably straightforward to draft, they present serious problems of tax administration for the tax authorities.

The imposition of tax on gains realized on the transfer of intellectual property transferred by residents to non-residents requires decisions on a few key issues. First, assuming that a country taxes capital gains on a preferential basis, should any gain on the transfer of intellectual property be entitled to that preferential treatment? This issue must be resolved based on the country's general rules for distinguishing between ordinary income and capital gains. Second, the country needs a general statutory provision in order to impose tax on any gain realized on the transfer of intellectual property to non-residents. This general rule may apply broadly to any transfer of property to non-residents or may be more narrowly targeted only at certain transfers of property to non-residents. Where property is transferred to a non-resident that deals at arm's length with the resident transferor, a country can rely on the self-interest of the seller and buyer to ensure that the sale price of the property is equal to its fair market value. However, where the property is transferred to a non-arm's length non-resident, rules are necessary to deem any such transfer to take place at the fair market value of the property at the time of the transfer. In these situations, it may often be difficult for the tax authorities to determine the fair market value of intellectual property accurately because of the lack of information about the value of the property at the time of transfer. To counterbalance this lack of information, countries should consider enacting provisions in domestic law to allow them to take advantage of the benefit of hindsight in valuing the property (see part 2, chapter 1, section 1.5).[1] Third, countries need to consider whether or not relief should be allowed for any loss on a transfer of intellectual property to a non-resident, and if so, whether the use of such a loss should be restricted in some way (for example, the loss could be limited to offsetting gains from the disposition of intellectual property to non-residents).

Statutory provisions to recapture the costs of R&D of intellectual property that is transferred to a non-resident require rules to determine the costs that are recaptured and the transfers of intellectual property covered by the rules. The provisions also require rules to allocate the relevant costs to any transferred property. This allocation may be difficult to make on a factual tracing basis, since R&D expenses may result in the creation of various types of intellectual property, only some of which may be transferred to a non-resident. Alternatively, R&D costs may be apportioned to property on some reasonable basis, such as the cost or value of the transferred property relative to the cost or value of all the taxpayer's intellectual property. Any allocation rules are likely to result in significant compliance and administration costs (see chapter 1, sections 1.4.3.2 and 1.4.3.3). Any recapture rules involve several ancillary legislative design issues: for example, how should the amount recaptured be characterized for tax purposes? This issue may be difficult where the costs of R&D are deductible in different ways.

[1] See also Organisation for Economic Cooperation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, (Paris: OECD, 2010), chapter VI (which permits the use of hindsight in valuing intangible property for transfer pricing purposes), available from http://www.oecd-ilibrary.org/docserver/download/2310091e.pdf?expires=1487955911&id=id&accname=ocid195767&checksum=CB1D33377B58D3E37692723A73B55413.

Should any relief be allowed to alleviate the impact of the inclusion of the recaptured costs in income in the year of the transfer of the property if the costs were deducted over several years? Any rules to recapture costs of R&D must balance the compliance burden on taxpayers and the administrative burden on the tax authorities against the need to protect the tax base.

Chapter 3

Sample legislative provisions with explanatory notes

3.1 Introduction

This section provides some sample legislative provisions dealing with deductible payments of rent and royalties that are designed to reduce the risks of base erosion. The sample provisions presented here deal exclusively with deductions for rent and royalties and withholding taxes on rent and royalties paid to non-residents, and deal only with situations in which the risks of base erosion are considered to be most serious. In addition, this section presents sample provisions only with respect to those provisions that deal exclusively with rent and royalties, rather than to provisions that deal with deductions generally (including rent and royalties).

THE SAMPLE PROVISIONS IN THIS SECTION ARE NOT INTENDED TO BE INCLUDED IN ANY COUNTRY'S DOMESTIC LAW AS IS. THEY ARE PROVIDED FOR GUIDANCE ONLY.

3.2 Sample withholding tax provision with explanatory notes

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;

(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);

(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.

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…

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.*
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.*
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 __.*

Explanatory notes

Paragraph 1 imposes tax on payments of rent, royalties and other similar amounts by residents of Country X to non-residents. The tax is imposed on the gross amount paid without any deductions for expenses incurred by the non-resident recipient in earning the payments. The tax imposed under paragraph 1 is intended to apply broadly to amounts paid or credited to a non-resident as, on account of, or in lieu of, payments for the use of or the right to use immovable property located in Country X, movable property in Country X, and various types of intellectual property in Country X, including know-how and information. Since paragraph 1 applies to any payment listed in the provision, it applies to payments on a periodic or lump-sum basis.

Paragraph 1 does not refer explicitly to "rent" or "royalties" in order to avoid any interpretive issues concerning the characterization of payments. Instead, paragraph 1 applies to all payments, including but not limited to rent and royalties, for the use of or the right to use property or other things. Thus, payments may be covered by paragraph 1 although they are not considered to be payments of rent or royalties or considered to be payments for the use of or the right to use "property" under the domestic law of Country X. Alternatively, a country may choose to limit paragraph 1 to payments of rent and royalties; however, if it does so, it should consider broadening the provision to include "other similar amounts". For example, if a tenant or lessee of immovable property is required by the lease to pay municipal property taxes levied on the property, the payment of such taxes should be subject to withholding tax. If the landlord or lessor pays the property taxes, the rent paid by the tenant or lessee will reflect the property taxes and the gross amount of rent will be subject to withholding tax.

Paragraph 1 applies to the payments listed in subparagraphs 1 (a) to (g). Countries may wish to modify (broaden or restrict) the particular types of payments listed in each paragraph or to add other types of payments to the list. For example, countries may wish to add payments for technical services that are closely related to the use of property. However, if payments for technical services generally are subject to withholding tax under a country's domestic law, it will be unnecessary to include such payments for services in the withholding tax on rent and royalties.

Although paragraph 1 applies to a broad range of payments to non-residents, a country may decide to exclude certain payments for the use of or the right to use property from withholding tax under paragraph 1. Paragraph 9 contains examples of payments that countries often exclude from withholding taxes on rent and royalties. Moreover, paragraph 1 is not intended to apply to payments for the sale of goods or to payments that represent the proceeds of disposition of property. For example, where a non-resident transfers all of the non-resident's ownership interests in intangible property (rather than just limited rights to use the property) to a resident, payments in satisfaction of the purchase price of the property are not subject to withholding tax under paragraph 1; however, any gain on the sale may be subject to tax under other provisions of this Act.

Where a non-resident transfers ownership rights with respect to intangible property that are limited in time or to a particular geographical area, the proceeds of sale are similar to royalties for the use of the property. Countries may deal with such transfers through the application of anti-avoidance rules or by deeming the proceeds of sale of certain limited ownership rights in respect of intangible property to be royalties subject to withholding tax.

Each country must decide the rate of withholding tax to be applied to payments of rent and royalties to non-residents. Setting the rate of tax is a difficult task that involves balancing the need to allow residents to have access to foreign-owned property and technology at competitive prices against the need to protect the domestic tax base. Countries must also be aware that in certain circumstances, any withholding tax imposed on rent or royalties paid to non-residents may be borne by the country's residents and may increase the cost for residents to obtain the use of foreign-owned property or technology. Some countries have maintained relatively high withholding tax rates, which they are prepared to reduce in their tax treaties. This strategy appears to be based on countries having tax treaties with their major trading partners.

More generally, it is important for countries to consider the relationship between any withholding tax imposed under paragraph 1 and the provisions of any tax treaties that it enters into. The withholding tax imposed under paragraph 1 applies to a broader range of payments than the payments covered by the definition of royalties in Article 12 (3) of the United Nations Convention or the Organisation for Economic Cooperation and Development (OECD) Model Convention.[2] As noted above, one consequence of the broader scope of withholding taxes on rent and royalties under domestic law is that the country can agree to reduce or eliminate its domestic withholding tax on such amounts on a reciprocal basis through its tax treaties.

Under Article 12 (2) of the United Nations Model Convention, a contracting State is entitled to impose tax on "royalties" as defined in Article 12 (3) paid by a resident of that State to a resident of the other State; however, if the royalties are paid to a resident of the other contracting State who is the beneficial owner of the interest, the tax is limited to the percentage of the gross amount of the payment agreed to by the States pursuant to bilateral negotiations. Thus, if a country enters into tax treaties with provisions similar to Article 12 of the United Nations Model Convention, the country's withholding tax on payments of interest by its residents to non-residents will be limited to the maximum rate specified in Article 12. If a country enters into a tax treaty with a provision dealing with royalties similar to Article 12 of the OECD Model Convention, that provision will prevent it from imposing any withholding tax on royalties paid to a resident of the other State who is the beneficial owner of the royalties.

Moreover, Article 12 is limited to payments of royalties as defined in Article 12 (3) of the United Nations and OECD Model Conventions. Therefore, to the extent that a country's domestic withholding tax on royalties applies to amounts that are not covered by

[2] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Article 12, any treaties with provisions similar to Article 12 of the United Nations and OECD Model Conventions that the country has entered into will preclude the country from imposing its withholding tax. However, those treaties may contain other provisions that allow the country to impose tax on such amounts. For example, Article 12 does not apply to payments of rent for the use of immovable property; however, Article 6 of both the United Nations and the OECD Model Conventions allows the State in which immovable property is located to tax any income from the property derived by a resident of the other State without any limitations.

If royalties are paid by a resident of one contracting State to a resident of the other contracting State who carries on business through a PE or fixed base in the first State and the royalties are effectively connected to the PE or fixed base, the provisions of Article 7 (Business profits) or 14 (Independent personal services) apply, rather than the provisions of Article 12. Thus, the royalties will be taken into account in computing the profits attributable to the PE or fixed base, which must be taxed on a net basis in accordance with Article 7 or 14.

Problems may be encountered in applying paragraph 1 with respect to payments under so-called "mixed contracts". Under mixed contracts, various types of payments may be required: for example, payments for services, for the use of movable property and for the use of intellectual property. Where the contract does not provide for separate payments for the various elements of the contract, it may be difficult for the tax authorities to determine how much of a contractual payment is made with respect to each element. Nevertheless, under most countries' domestic law, it is necessary to split the amount of any contractual payment into its constituent parts because the tax consequences differ depending on the nature of the payment. This problem can be alleviated to the extent that a country's withholding taxes on services, rent and royalties are imposed at the same rate. Contracts for the supply of goods may sometimes include disguised payments for the use of intangible property. In this case, the purchase price should be disaggregated into its major elements.

Subparagraph 1 (a) imposes withholding tax on payments for the use or the right to use immovable property located in Country X. For this purpose, immovable property is defined broadly in subparagraph 2 (a) to include various types of property or other rights that may or may not be considered to be property under the country's domestic law. Thus, "immovable property" for purposes of Country X withholding tax has the meaning that the term has under the domestic law of Country X plus the items specified in subparagraph 2 (a).

Subparagraph 1 (b) imposes withholding tax on a wide array of payments for the use of various types of property, including industrial, commercial or scientific equipment (as defined in subparagraph 2 (b)), and intellectual property, such as copyright, patents, trademarks, models, designs, secret formulas or processes, and other similar property and rights. It is clear from the wording of subparagraph 1 (b) that it is intended to apply broadly. Countries that are concerned that the provision is too broad may wish to exclude certain payments from withholding tax, as provided by paragraph 9.

Subparagraph 1 (c) imposes withholding tax on payments for the use of or the right to use information concerning industrial, commercial or scientific experience. This provision is intended to capture payments for know-how irrespective of whether such information constitutes property. In the absence of withholding tax on payments for know-how, non-residents may be able to avoid tax by entering into so-called "mixed contracts", which provide for non-residents to provide the use of property, information concerning the use of the property and services related to the use of the property. If payments for know-how and services are not subject to withholding tax, tax authorities will have difficulty in determining the amount of the payment that is attributable to the use of or the right to use property. It is preferable if all elements of a mixed contract—the use of property, know-how and services—are subject to withholding tax at the same rate. Subparagraph 1 (c) is not limited, but could be limited, to payments for the use of information in Country X. However, unlike immovable and movable property, it may be difficult for the tax authorities to determine where information is used.

Also, some countries may wish to add a provision in subparagraphs 1 (b) and (c) with respect to payments for technical assistance related to the use of property and know-how. Such a provision could be worded as follows:

> (__) *Any payment for [technical] assistance that is ancillary or subsidiary to any property described in*

subparagraphs (b) or (c) or that is furnished for the purpose of enabling the use or enjoyment of property described in subparagraphs (b) or (c).

Such a provision is unnecessary if a country imposes withholding tax on payments to non-residents for services.

Subparagraph 1 (d) imposes withholding tax on payments that restrict or prohibit the use of property described in subparagraphs 1 (a) to (c). Such payments made by residents to non-residents are not payments for the use of or the right to use property; they are usually deductible by the resident payers and erode the tax base of the residence country.

Subparagraph 1 (e) imposes withholding tax on any payments that are dependent upon the use of or production from property. This provision is intended to prevent taxpayers from avoiding withholding tax by making payments for the sale or transfer of property dependent upon the use of the property or the production from the property. These types of payments are often disguised rent or royalties since, in substance, they are payments for the use of or the right to use property.

Subparagraph 1 (f) provides for the imposition of withholding tax on payments for the use of or the right to use motion picture films, video tapes and other means of reproduction for the purpose of television broadcasting. Some countries may wish to include payments for internet streaming services in this provision. Subparagraph 1 (f) could be limited to payments for the use of films, tapes, and so forth, in Country X.

Subparagraph 1 (g) provides for the imposition of withholding tax on payments for the use of or the right to use tapes or other means of reproduction for the purpose of radio broadcasting. This provision is similar to subparagraph 1 (f) with respect to payments related to motion picture films and television broadcasting, and could be limited to payments for the use of tapes for radio broadcasts in Country X.

Paragraph 2 provides definitions of the terms "immovable property" and "industrial, commercial and scientific equipment" for purposes of paragraph 1.

Subparagraph 2 (a) provides an inclusive definition of the term "immovable property" for purposes of the withholding tax on payments for the use of immovable property located in a country under subparagraph 1 (a). Because immovable property is defined to include the property specified in subparagraph 1 (b), the term "immovable property" is intended to have the meaning that the term has under the country's general law or its tax law. In addition, immovable property includes property and other rights that may not be immovable property under the country's domestic law but are closely related to the use of immovable property.

Countries should be prepared to modify the definition in paragraph 2 to suit the definition of immovable property under their domestic law. For example, if immovable property under a country's domestic law clearly includes property accessory to immovable property or livestock, references to those items in paragraph 2 can be omitted. Also, it might be necessary for some countries to add certain types of ownership interests in immovable property to the definition, such as time-share arrangements, if those interests are not included in the definition of immovable property under domestic law. The definition of immovable property in paragraph 2 is similar to the definition of that term in Article 6 (2) of the United Nations and OECD Model Conventions, but also includes ownership interests in entities that entitle the owner to the use of immovable property.

Subparagraph 2 (b) can be used to provide an inclusive definition of the expression "industrial, commercial or scientific equipment" for purposes of the withholding tax under subparagraphs 1 (b) and (c). Thus, industrial, commercial or scientific equipment would have the meaning that it has under the country's domestic law but would also include any property specified in subparagraph 2 (b). For some countries that have broad domestic law meanings of industrial, commercial or scientific equipment, it may be unnecessary to define such equipment to include specific types of equipment or property. Other countries may wish to eliminate any uncertainty by specifically including certain types of property such as satellites and computer equipment.

Paragraph 3 imposes an obligation on any resident person that pays an amount described in paragraph 1 to a non-resident person to withhold the amount of the tax from such payments and remit it to the tax authorities on behalf of the non-resident. The amount withheld pursuant to paragraph 2 is considered to be tax paid by the non-resident person and satisfies the non-resident's obligation to pay tax under paragraph 1.

Under paragraph 4, if a resident person fails to withhold as required by paragraph 3, that person is liable for the tax payable by the non-resident person under paragraph 1 to the extent that the amount of that tax is not withheld. Thus, both the non-resident person and the resident payer are liable for the same amount, and the tax authorities may take collection action against either the non-resident person or the resident person, or both. Any amount collected by the tax authorities from one of the parties is considered to satisfy the liability of both parties. The tax authorities shall not collect in total more than the amount of tax payable under paragraph 1. To the extent that a resident person pays an amount under paragraph 3, that person shall have the right to recover that amount from the non-resident person.

A failure to withhold under paragraph 3 should also be subject to interest and penalties. However, such interest and penalties should apply generally to all withholding taxes, not just withholding taxes in respect of rent and royalties.

Paragraph 5 provides an alternative or additional mechanism to enforce the obligation to withhold tax from payments of rent and royalties to non-residents under paragraph 3. Under paragraph 5 a payer that does not withhold from payments subject to withholding tax under paragraph 1 is not allowed to deduct the payment in computing income. Paragraph 5 would not have any effect on the obligation to withhold from payments of rent and royalties that are not deductible by the payer.

Paragraph 6 extends the tax under paragraph 1 and the obligation to withhold under paragraph 2 to non-residents of Country X who make interest and other similar payments to other non-resident persons by deeming such non-resident payers to be residents of Country X. However, non-resident payers are deemed to be residents for this purpose only to the extent that the payments are deductible in computing their income subject to tax under the tax law of Country X. In general, payments by non-residents described in paragraph 1 will be deductible in computing income under the tax law of Country X only if non-residents are carrying on business in Country X through a PE or fixed base. In the absence of paragraph 6, a country would not have any legal basis for imposing an obligation on non-residents to withhold tax from payments to non-residents covered by paragraph 1 because paragraph 1 applies only to payments by residents.

Paragraphs 7 and 8 extend the tax under paragraph 1 to circumstances in which a partnership pays rent or royalties to a non-resident or receives such amounts from a resident. These provisions are necessary only if a partnership is treated as a transparent or flow-through entity for purposes of the country's domestic tax law. If a partnership in which a resident of the country is a partner pays interest or another amount described in paragraph 1 to a non-resident person, the partner resident in that country may not be considered to have paid the partner's pro rata share of the amount paid by the partnership. Thus, if the partnership is not considered to be a resident person, there would be no liability to withhold from the payment by the partnership for either the partnership or the resident partner. By deeming the partnership to be a resident of the country, paragraph 6 has the effect of making the partnership liable to withhold under paragraph 2.

Similarly, if a partnership in which a non-resident person is a partner receives an amount described in paragraph 1 from a person resident in the country, the non-resident partner may not be considered to have received the partner's pro rata share of the amount received by the partnership. Thus, if the partnership is not considered to be a non-resident person for purposes of the country's tax law, there would be no liability to pay tax under paragraph 1 for either the partnership or the non-resident partner. By deeming the partnership to be a non-resident of the country, paragraph 7 has the effect of making the partnership liable for tax under paragraph 1 and the resident payer liable to withhold the tax under paragraph 2.

Chapter 4

Negotiation of tax treaties to prevent base erosion with respect to base-eroding payments of rent and royalties

4.1 Introduction

Tax treaties are bilateral agreements that result from negotiations between the contracting States. They reflect not only the relative negotiating power of the contracting States, but also the prevailing international consensus about the provisions of tax treaties, as shown in the provisions of the United Nations and the Organisation for Economic Cooperation and Development (OECD) Model Conventions.[3] Any attempt by a country to deviate significantly from the provisions of these model treaties is likely to be resisted by other countries. Therefore, although the following discussion makes several suggestions for provisions in tax treaties to limit the risks of base erosion, these provisions may not be acceptable to many countries. If a country decides that it wishes to include some of these provisions in its tax treaties, it must realize that other contracting States may not agree, or may agree only if the country makes concessions with respect to other provisions of the treaty.

The OECD/G20 and the United Nations Committee of Experts on International Cooperation in Tax Matters are currently engaged in a project to limit base erosion and profit shifting (BEPS). This project

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); Organisation for Economic Cooperation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

is likely to result in several changes to the United Nations and OECD Model Conventions. Therefore, a country may find that other countries are more willing to agree to anti-base erosion provisions if these provisions have been included in one or both of the model treaties or if a multilateral agreement to amend existing treaties is successfully concluded, as proposed in BEPS Action 15 (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties). The multilateral instrument (the Multilateral Convention To Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) was released by the OECD on 24 November 2016.[4]

Tax treaties have the effect of limiting the taxes imposed under the domestic laws of the contracting States. When a country is negotiating a tax treaty, it should be aware that the treaty may prevent it from applying the provisions of its domestic law to prevent base erosion if those provisions conflict with the provisions of the tax treaty. Therefore, in general, if a country decides to enter into tax treaties, it should carefully consider including a specific provision in its tax treaties to allow it to apply the provisions of its domestic law designed to prevent base erosion, as suggested in part 2, chapter 4, section 4.3.2.

The following discussion examines provisions that might be included in a country's tax treaties to prevent base erosion. The discussion is organized on the basis of the provisions of the United Nations Model Convention dealing with rent and royalties — both the taxation of income in the form of rent and royalties and the deduction of rent and royalties — as they affect residents of a country and residents of the other contracting State. (These provisions of the United Nations Model Convention are discussed in part 2, chapter 1, section 1.2, and in chapter 2.) It assumes that a country's tax treaties are based on the United Nations Model Convention and that the relevant income is taxable under a country's domestic law.

At a broad conceptual level, a country can protect its tax base from base-eroding payments of rent and royalties in two basic ways: imposing tax on the recipient of rent or royalties and denying or

[4] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (November 2016), available from http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.

limiting the deduction of rent or royalties by the payer. As discussed in part 2, chapter 2, if a country's domestic tax law does not impose tax on the recipient of rent or royalties and/or deny or limit the deduction of rent or royalties by the payer, the country's tax treaties will not provide any protection from the erosion of its tax base. Tax treaties limit a country's domestic tax; therefore, if the country does not impose tax on base-eroding payments of rent and royalties under its domestic law, the provisions of its tax treaties will not allow it to impose tax on those payments. Similarly, if a country's domestic law allows a deduction for base-eroding payments of rent and royalties, the provisions of its tax treaties will not provide authority for it to deny or limit such deductions.

However, if a country does impose tax on the recipient of payments of rent or royalties and/or deny or limit the deduction of such payments by the payer under its domestic law, the country's tax treaties may prevent it from imposing tax on those payments or denying or limiting the deduction of those payments. Therefore, if a country wants to protect its domestic tax base from base-eroding payments of rent and royalties, it must be careful when negotiating any tax treaties to ensure that the provisions of those treaties do not limit its ability to tax payments of rent and royalties or deny deductions for such payments.

4.2 The effect of tax treaties on non-residents

4.2.1 Introduction

As discussed above in the introduction to this chapter, a country can protect its domestic tax base from base-eroding payments of rent and royalties by taxing such payments to the recipient or by denying or limiting the deduction of such payments by the payer. In the case of non-residents, a country can restrict the deduction of rent and royalties by non-residents in certain circumstances and can impose tax on payments of rent and royalties received by non-residents in certain circumstances. Therefore, with respect to the negotiation of tax treaties, countries that want to combat base erosion by non-residents through payments of rent and royalties should ensure that the provisions of any tax treaties they enter into allow them to restrict the deduction of payments of rent and royalties by non-residents in certain circumstances and allow them to impose tax on such payments received by non-residents in certain circumstances.

4.2.2 Deduction of rent and royalties by non-residents

If a resident of one contracting State carries on business in the other contracting State through a permanent establishment (PE) located in that other State or performs professional or other independent services in that other State through a fixed base in that other State, the other State is entitled to tax the profits attributable to the PE or fixed base under Article 7 (Business profits) or Article 14 (Independent personal services) of the United Nations Model Convention, as the case may be. Under Article 7 (3),[5] the other State must tax the profits attributable to the PE on a net basis (that is, it must allow deductions for the expenses, including rent and royalties, incurred by the non-resident that are properly allocated to the PE or fixed base). However, Article 7 (3) does not mean that all rent and royalties incurred for the purposes of a PE or fixed base must be deductible. (This aspect of Article 7 is widely misunderstood.) The deductibility of expenses is a matter of each country's domestic law. Therefore, if a country restricts the deduction of rent or royalties incurred by non-residents to earn income through a PE or fixed base in the country, Article 7 (3) will not prevent the application of those restrictions.

However, the non-discrimination protection in Article 24 (3) becomes relevant at this point. Under Article 24 (3), a country is prohibited from taxing the profits attributable to a PE (but not a fixed base) of a resident of the other contracting State less favourably than it taxes its own residents carrying on similar activities. If a country's tax treaties contain provisions similar to Article 24 (3) of the United Nations Model Convention, the country will be unable to apply any

[5] Although Article 14 of the United Nations Model Convention does not contain explicit wording requiring the deduction of expenses incurred for the purpose of a fixed base, paragraph 10 of the Commentary on Article 14, quoting paragraph 3 of the Commentary on former Article 14 of the OECD Model Convention, indicates that the same principles for the computation of the profits attributable to a PE under Article 7 of the OECD Model Convention, including the deduction of expenses, should apply for purposes of Article 14.

restrictions in its domestic law on the deduction of rent or royalties by non-residents carrying on business through a PE in the country unless those restrictions also apply to its own residents. Therefore, to the extent that a country's tax treaties contain a provision similar to Article 24 (3), that country must allow the deduction of any rent or royalty expenses incurred by a resident of a treaty country with respect to property that is used for the purposes of a PE in the country even if those amounts are not deductible under domestic law. These deductions will erode the country's tax base. However, Article 24 (3) does not affect any restrictions in a country's law on the deduction of rent or royalties by non-residents carrying on business through a fixed base in the country.

If a country wants to apply any restrictions in its domestic law on the deduction of rent or royalties by non-residents carrying on business in the country through a PE, it might consider:

(a) Not agreeing to include Article 24 (3) in its treaties;

(b) Including a most-favoured-nation (MFN) version of Article 24 (3), under which it would agree to treat residents of the other contracting State carrying on business in the country through a PE no less favourably than the residents of any other foreign country carrying on business in the country through a PE. This MFN version of Article 24 (3) could be worded as follows:

(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….

(c) Including a specific exception in Article 24 (3) for any restrictions on the deduction of rent and royalties by non-residents under the country's domestic law. Such an exception could be worded as follows:

(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.*
>
> Under this type of provision, a country would be able to apply its restrictions on the deduction of payments of rent or royalties by non-residents carrying on business in the country through a PE, but would not be able to tax such non-residents less favourably in any other respect.

Although base-eroding payments of rent or royalties are legitimate business expenses, the deduction of such expenses in computing the profits of a PE or fixed base raises several concerns. First, a country's tax administration must ensure that non-residents do not claim excessive deductions of rent or royalties in computing the profits attributable to a PE or fixed base. Second, the country should not agree to a version of Article 7 (such as Article 7 of the OECD Model Convention) or Article 14 that would allow a non-resident to deduct notional amounts of rent or royalties in respect of property used by the PE or fixed base. If the country enters into a treaty that allows non-residents to deduct notional amounts of rent or royalties, it will not be able to impose withholding tax on such notional amounts; as a result, its tax base will be eroded by the deduction of the notional rent or royalties, but it will be unable to tax those notional payments. Third, the country should impose withholding tax on payments of rent or royalties by non-residents to the extent that those payments are deductible in computing the profits attributable to a PE or fixed base in the country and are paid to non-residents. In most cases, such a withholding tax will be enforceable because of the presence of a PE or fixed base in the country. Article 12 (5) of the United Nations Model Convention deems royalty payments to arise in the country in which a PE or fixed base is located. Therefore, a country should ensure that it includes a provision similar to Article 12 (5) in its tax treaties.

Where a resident of one contracting State derives rent from immovable property located in the other contracting State or royalties from a resident of the other contracting State, but not through a PE located in the other contracting State, under Article 6 (in the case of income from immovable property) or Article 12 (in the case of royalties), the other contracting State is entitled to tax those amounts on a gross basis without allowing any deductions for expenses incurred in earning those amounts. In these situations, Article 24 (3) does not apply.

4.2.3 Withholding tax on rent for immovable property

Under Article 6 of both the United Nations and OECD Model Conventions, any income from immovable property located in a contracting State is taxable by that State without any limitation on the rate or method of taxation. Therefore, a country is entitled under Article 6 to impose a withholding tax on the gross amount of any payments made by residents of that country to residents of the other contracting State for the use of immovable property located in the first country. Developing countries can prevent the erosion of their tax base through deductible payments for the use of immovable property located in their countries by ensuring that they insist on the inclusion in their tax treaties of a provision similar to Article 6 of the United Nations or OECD Model Conventions. Such a provision will allow developing countries to tax income from immovable property under their domestic law without any limitation imposed by the treaty. Therefore, developing countries simply need to ensure that they have a reasonably broad definition of immovable property under domestic law and that they impose tax on all income from immovable property under their domestic tax law.

Developing countries should recognize that non-resident owners of immovable property located in their country may incur significant expenses in earning their income, and therefore a high rate of withholding tax imposed on gross rental payments may be excessive. This problem can be dealt with by allowing non-residents deriving rent from immovable property to elect to pay tax on their net income. Such an election can be provided in domestic law to all non-residents, or only in a country's tax treaties.

4.2.4 Withholding tax on royalties

As discussed in part 2, chapter 2, sections 2.3.1.2.3 and 2.3.1.2.5, under Article 12 of the United Nations Model Convention, a contracting State is entitled to impose a final withholding tax at an agreed rate on royalties paid by residents of that State to residents of the other contracting State. Countries will usually be expected to agree to a provision similar to Article 12. If they do so, Article 12 will limit any withholding tax on payments of royalties under their domestic law to the payments identified in Article 12 and the rate specified in Article 12 (2). Therefore, countries should consider carefully the extent to which a provision similar to Article 12 of the United Nations Model Convention will require them to give up their withholding tax on payments of rent, royalties and other similar amounts under domestic law.

Three issues are most important in this regard: the definition of royalties, the treatment of payments for the use of equipment, and the rate of withholding tax.

First, the definition of royalties will determine the scope of the payments that are subject to withholding tax. If a payment is not a royalty within the definition of the royalty article of the treaty, obviously that article will not apply to the payment; however, it may be subject to another provision of the treaty, and as a matter of last resort, may be covered by Article 21 (Other income). Article 12 (3) of the United Nations Model Convention defines royalties broadly, to mean payments of any kind for the use of or the right to use any copyright, patent, trademark, design or model, plan, secret formula or process, industrial, commercial or scientific equipment or information concerning industrial, commercial or scientific experience. The definition does not refer to or depend upon the definition of royalties under a country's domestic law. Therefore, countries should review their withholding taxes on royalty payments to determine whether those withholding taxes apply to payments that are not covered by the definition in Article 12 (3) of the United Nations Model Convention. If a country's withholding tax applies to payments that are not covered by the definition in the United Nations Model Convention, it may consider trying to get the other country to agree to expand the definition of royalties in Article 12 (3) to cover those payments.

Second, the definition of royalties in Article 12 (3) of the United Nations Model Convention includes payments for the use or the right to use industrial, commercial or scientific equipment. However, under the OECD Model Convention such payments are treated as business profits, which are taxable under Article 7 only if the taxpayer has a PE in the source country and the payments are attributable to the PE. Therefore, countries that wish to impose withholding tax on rent for the use of movable equipment should insist on the inclusion of rent for the use of equipment in the definition of royalties in their tax treaties. However, such countries should recognize that the owners of equipment may incur significant expenses in earning rental income and a withholding tax on the gross amount of the rent may be excessive with respect to the net income derived by the owners. This problem can be dealt with by agreeing to a relatively low rate of withholding tax on equipment rentals, by agreeing to tax such amounts on a net basis under Article 7 or by providing taxpayers with an election to pay tax on such amounts on a net basis.

If payments by a resident of one contracting State to a resident of the other contracting State are not within the treaty definition of royalties and are not dealt with in any of the other distributive provisions of the treaty (Article 6 to Article 20), Article 21 will apply to the payments as other income. According to Article 21 (1) of the United Nations Model Convention, other income may be taxed by the country in which the taxpayer who receives the income is resident, wherever the income arises; however, under Article 21 (3), such income may also be taxed in the country in which it arises. Unlike Article 12 (2), Article 21 (3) does not place any limit on the tax imposed by the source country on other income. Therefore, to the extent that a country imposes withholding tax on payments that are not within the definition of royalties in Article 12 and are not covered by any of the other provisions of the treaty, Article 21 may allow that country to tax any such payments that arise in the country in accordance with its domestic law without any limitation imposed by the treaty. Countries should consider carefully whether a discrepancy between their withholding tax on royalties and their withholding tax on other similar payments is desirable. If they decide that such a discrepancy is undesirable, as mentioned above, they could attempt to get their treaty partners to agree to include such payments in the definition of royalties covered by Article 12. Alternatively, they might agree to limit the domestic rate of tax imposed on other income under Article 21 (3) to the same maximum rate on royalty payments agreed to for purposes of Article 12 (2).

Third, the contracting States must agree on the maximum rate of withholding tax on royalties. In general, a particular country will be expected to agree to a rate of withholding tax on royalties that is less than the rate imposed under its domestic law. Determining the maximum rate of withholding tax on royalties that is acceptable to any particular country is a difficult decision that requires a delicate balancing of many considerations, including:

- The maximum rate of withholding tax on royalties agreed to in the country's other treaties
- The relative cross-border flows of royalty payments between the country and the other contracting State
- The extent to which owners of intellectual property in the other contracting State can require users resident in the country to pay the withholding tax through grossed-up payments
- The maximum rate of withholding tax on other payments that are substitutes for royalties, and
- The impact of the withholding tax on foreign investment in the country

4.3 The effect of tax treaties on residents

4.3.1 Elimination of double taxation

As discussed in part 2, chapter 2, section 2.3.2.3, under Article 23 of the United Nations Model Convention, a contracting State is required to provide relief from the double taxation of income derived by its residents by exempting the relevant income from tax or allowing a credit for the foreign tax paid on the relevant income. This obligation to relieve double taxation applies to any income derived by a resident of a contracting State that is taxable in the other contracting State in accordance with the provisions of the treaty.

A country will be expected to agree to provide relief from double taxation in accordance with Article 23 A or 23 B of the United Nations Model Convention in negotiating a tax treaty with another country. In general, a country can agree to include Article 23 A or 23 B in its tax treaties without any concern about creating opportunities for base erosion. Neither Article 23 A nor Article 23 B requires a contracting State to give up domestic tax on its residents. Under Article 23 A, a contracting State is required to exempt only income which is taxable in accordance with the treaty by the other contracting State. Under Article 23 B, a contracting State is required to allow a credit for the taxes paid to the other contracting State only to the extent that the income on which the foreign tax is imposed is taxable by the other contracting State in accordance with the treaty.

If a country agrees to include Article 23 A, the exemption method, in its tax treaties, it will be required to exempt any income derived by its residents, other than dividends, interest and royalties, that is taxable by the other contracting State under the terms of the treaty. Therefore, the country would be required to exempt any income from immovable property located in the other contracting State and any royalties that are attributable to a PE or a fixed base in the other contracting State if the underlying property is effectively connected to the PE or fixed base.[6]

In contrast, a particular country would not be required to exempt the following income, but would be required to provide a credit for the taxes imposed by the other contracting State on such income:

(a) Any royalties paid by a resident of the other contracting State to a resident of the particular country; in this case, the credit is limited to the lesser of the tax paid to the other contracting State on the interest in accordance with Article 12 (2) and is also limited to the particular country's tax on the royalties;

(b) Any royalties derived by a resident of the particular country, other than royalties described in (a), arising in the other contracting State that are taxed in that State in accordance with Article 21 (3) (Other income). In this case, the treaty does not impose any limit on the tax imposed by the other contracting State. However, the particular country is required to allow a credit for the other State's tax only to the extent of the particular country's tax on the royalties.

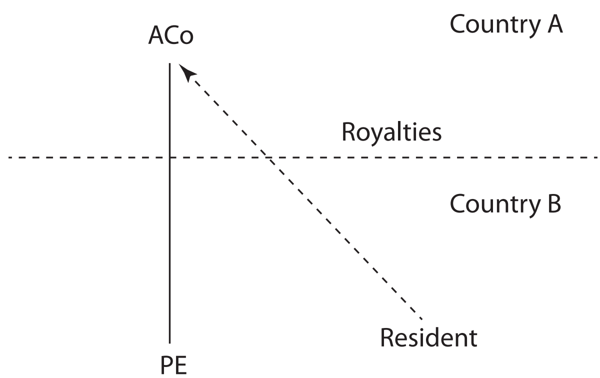
A country is not obligated to exempt rent or royalties or give a credit for any foreign tax on rent or royalties that are derived by a resident but do not arise in the other contracting State. For example, if a resident of Country A receives royalties from a resident of Country B but the royalties are borne by (that is, deductible in computing the profits of) a PE or fixed base that the resident of Country B has in Country A, or in a third country, the royalties are not taxable by Country B in accordance

[6] Article 12 (4) of the United Nations Model Convention.

with Article 12 because they do not arise in Country B (see Article 12 (5)). Nor are the royalties taxable by Country B under any other provision of the United Nations Model Convention. Therefore, Country A would not be required by Article 23 to exempt the royalties from tax or give a credit for any tax imposed by Country B on the royalties.

Example 1

ACo, a resident of Country A, carries on business through a PE in Country B. ACo receives royalties from a resident of Country B for the use of intellectual property owned by ACo. The intellectual property is effectively connected with the PE of ACo in Country B and the royalties are included in the profits attributable to the PE. Assuming that Country A and Country B have entered into a tax treaty with provisions identical to the provisions of the United Nations Model Convention, including Article 23 A, Country A would be required to exempt from tax the royalties received by ACo because those royalties are taxable by Country B in accordance with Article 12 (4) and Article 7 of the treaty.



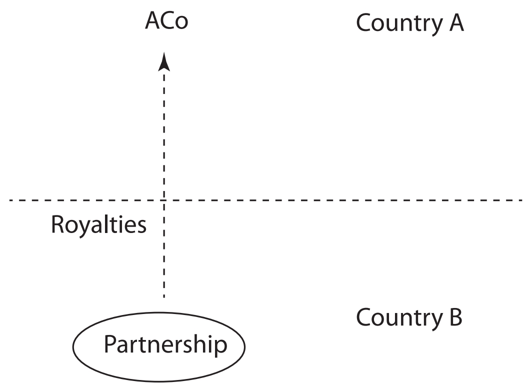
- Royalties are paid by the resident of Country B to ACo
- Debt is effectively connected with the PE
- Royalties are included in computing profits of the PE

If the intellectual property is not effectively connected to the PE of ACo in Country B, the treaty would not require Country A to exempt the royalties from tax. Instead, if Country A imposes tax on the royalties, it would be required to allow a credit for any tax paid by

ACo to Country B on the royalties in accordance with Article 12 (2) of the treaty.

Example 2

ACo, a resident of Country A, receives royalties from a partnership organized under the laws of Country B. The partnership is not subject to tax under the laws of Country B and therefore it is not a resident of Country B for purposes of the treaty between Country A and Country B. As a result, Article 12 of the treaty does not apply to the royalties because they are not paid by a resident of Country B. Under Article 21 (3) of the treaty, Country B is entitled to tax the royalties paid to ACo if they arise in Country B. Assuming, therefore, that the royalties arise in Country B and that Country B imposes withholding tax on the royalties, Country A would be required to exempt the royalties from the Country A tax on ACo.



- The partnership pays interest to ACo
- The partnership is not a resident of Country B
- Article 12 does not apply

Article 23 of the United Nations Model Convention does not provide detailed rules for the operation of either the exemption method under Article 23 A or the foreign tax credit method under Article 23 B; as a result, these rules must be supplied by domestic law. Developing countries should ensure that the rules for exemption or foreign tax credit under their domestic law are adequate to protect their domestic tax base. In particular, each country should ensure that any rent or royalty expenses that are properly attributable to the foreign source income are allocated to that income for purposes of the exemption of such income or for purposes of the limitation on the foreign tax credit, as explained in part 2, chapter 1, section 1.4.3.

4.3.2 Non-discrimination—Article 24 (4) and (5)

As explained in part 2, chapter 2, section 2.3.2.4, Article 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. Therefore, Article 24 (4) prevents a country from applying any rules in its domestic law that restrict the deduction of rent or royalties paid to residents of the other contracting State unless those rules also apply to the country's own residents.

Similarly, as explained in part 2, chapter 2, section 2.3.1.5, Article 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. Therefore, Article 24 (5) prevents a country from applying any rules in its domestic law that restrict the deduction of rent or royalties paid by its resident enterprises to residents of the other contracting State that own or control those resident enterprises, unless those rules also apply to such amounts paid by resident enterprises that are not owned or controlled by residents of the other contracting State.

Articles 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, Articles 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 Article 12 (6). These exceptions are expressly included in the words of Article 24 (4) and, according to the Commentary to Article 24 (5), are implicit in Article 24 (5).[7] There is no provision equivalent to Article 12 (6)

[7] See paragraph 4 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 79 of the Commentary on Article 24 of the OECD Model Convention.

with respect to income from immovable property located in a country. Therefore, although Article 24 (4) would not prevent the application of a country's transfer pricing rules to adjust the amount of rent or other amount with respect to income from immovable property located in the country, it would apply to prevent a country from adjusting excessive payments for the use of immovable property resulting from a special relationship between the payer and the owner of the property.

Part 4
Tax Administration Manual

Chapter 1
Introduction

Part 4 of the *Portfolio* deals with issues of tax administration with respect to the taxation of income in the form of rent and royalties and the deductibility of payments of rent and royalties; it focuses on the prevention of base erosion and profit shifting. Chapter 2 deals with disclosure and information-reporting requirements. Chapter 3 deals with audit and verification activities by tax officials to detect and counter base erosion and profit shifting with respect to deductible payments of rent and royalties. Chapter 4 examines the issues involved in the administration of the provisions of a country's tax treaties with respect to the taxation of rent and royalties and the deduction of rent and royalties.

As with the other parts of this *Portfolio*, this part concentrates on the risks of base erosion and profit shifting with respect to deductible payments of rent and royalties. Each country must decide for itself whether and to what extent it is concerned about the risks of base erosion and profit shifting, and if so, the appropriate action to take to combat those risks. Countries must consider a wide variety of factors in addition to the risks of base erosion in establishing their tax policy for the taxation of rent and royalties derived by non-residents and the deductibility of rent and royalties by both residents and non-residents. Therefore, the material in this *Portfolio* should not be regarded as providing recommendations that developing countries should adopt to prevent base erosion. Instead, the *Portfolio* is intended to provide guidance for developing countries to consider in assessing the risks of base erosion with respect to payments of rent and royalties and in deciding whether to adopt measures to prevent such base erosion and, if they decide to adopt such measures, guidance concerning the application of those measures.

The tax administration issues involved in combating base erosion with respect to deductible payments of rent and royalties depends on each country's situation: its domestic tax legislation, its tax treaties and the organization of its tax administration. The guidance provided in part 4 is general and must be adapted and modified according to the needs of any particular country.

Tax is imposed pursuant to a country's domestic law. Tax treaties generally limit the tax imposed under domestic law. Therefore, if a country does not impose tax on rent and royalties derived by non-residents under its domestic law, the provisions of its tax treaties are irrelevant. If a country imposes tax on non-residents under its domestic law, then that country must ensure that the tax is correctly determined and collected and that any limitations on domestic tax available under a tax treaty are properly applied. Similarly, to the extent that a country allows the deduction of rent or royalties under its domestic law, the provisions of its tax treaties are irrelevant. However, if a country disallows the deduction of rent or royalties under its domestic law, the provisions of the country's tax treaties must be considered to determine whether they require the country to allow the deduction of that rent or those royalties.

As noted several times in this *Portfolio*, the risks of base erosion are greater with respect to non-residents receiving rent or royalties than they are with respect to residents earning such income. Payments of rent or royalties by residents or non-residents carrying on business in a country are usually deductible against that country's tax base. If such payments of rent or royalties are received by residents of the same country (that is, the country that bears the deduction of the payments), those residents will usually be subject to tax by that country. However, if the payments of rent or royalties are received by non-residents, the payments are more likely not to be taxable, or to be taxable at a reduced rate by the country that bears the deduction of those payments. Accordingly, part 4 focuses more on tax administration issues with respect to non-residents.

In general, non-residents are subject to tax on rent and royalties in two fundamental ways, depending on the circumstances. First, in some situations (usually where they carry on business and derive profits in the form of rent or royalties), they may be taxable on their net income in the same manner as residents. In this case, they are usually required to file tax returns showing their income subject to tax and the tax payable. Any rent or royalties derived by these non-residents may be subject to withholding tax, but such withholding is provisional and represents payments on account of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. The tax finally assessed may be more than the amount of tax withheld, in which case the non-resident is liable to pay the balance, or it may be less than the tax withheld, in which case the non-resident is entitled to a refund of the excess. Second, in other situations non-residents may be subject to final withholding taxes on the gross rental or royalty payments they receive from residents. In this case, the tax withheld is the final tax; the non-resident is not required or allowed to file a tax return and pay tax on a net basis.

The tax administration issues differ significantly depending on whether non-residents are subject to interim or final withholding tax or are taxable only by assessment. Where non-residents are taxable by assessment, compliant taxpayers will file tax returns that provide the tax authorities of the country with a starting point to verify the amount of income and tax payable. However, if non-residents are not compliant, either intentionally or inadvertently (because they do not consider that they are subject to tax by the country), then the tax authorities of the country face the difficult task of identifying non-residents that it considers to be subject to tax as a preliminary step to ensuring that such non-residents comply with their tax obligations under domestic law. These difficulties can be minimized if payments of rent and royalties to 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 the amount of the tax are effectively shifted to the withholding agents.

Chapter 2

Disclosure and information-reporting requirements

2.1 Introduction

The tax authorities of a country require various types of information in order to apply the provisions of domestic law and tax treaties to ensure that any income in the form of rent or royalties derived by residents and non-residents is taxed properly, and that any expenses in the form of rent or royalties are properly deducted so that the country's tax base is not eroded. With respect to residents of a country, the information that the tax authorities need depends on whether the residents are exempt from tax in that country on foreign income or are taxable with a credit for the foreign taxes on the foreign income (as discussed in part 2, chapter 1, section 1.4), and also on whether that country disallows or limits the deduction of rent or royalties (as discussed in part 2, chapter 4, section 4.2). As noted in part 2, chapter 1, section 1.3, the necessary information with respect to non-residents depends on whether they are taxable on a net basis or subject to interim or final withholding taxes.

Developing countries should carefully balance their need for information against the compliance burden imposed on taxpayers and third parties required to provide the information. Therefore, in general, the tax authorities should not require the reporting of information unless they have the administrative capacity to use the information. In addition, care should be taken to avoid requesting the same information from multiple persons.

2.2 Disclosure and information-reporting requirements for residents incurring rent or royalty expenses to earn income from foreign sources

In general, the information necessary for purposes of properly taxing residents of a country on their income from sources outside the country, and in particular, any rent or royalty expenses incurred to earn such income, is available from the resident taxpayers themselves. Although information about a resident's foreign source income may be available from the tax authorities of another country with which the residence country has a tax treaty that provides for exchange of information, the foreign tax authorities are unlikely to have access to better information than the residence country's tax authorities concerning any rent or royalty expenses incurred by its own residents. However, they will have information about the amount of any rent or royalties claimed as a deduction in computing the profits attributable to a PE or fixed base in their country, and this information may be useful for the residence country in determining the appropriate relief from international double taxation—that is, the amount of foreign source income exempt from tax or the amount of foreign tax to be allowed as a credit against the residence country's tax on the foreign source income.

If residents of a country are taxable on their worldwide income, they can be required by that country to provide information in their tax returns or supporting schedules with respect to the amount of such income, the country or countries in which the income is earned and the amount of foreign tax on the income. This information is necessary to determine a resident's worldwide income subject to tax, as well as the possible entitlement of the resident to a foreign tax credit for foreign taxes on the foreign income. Perhaps the best evidence of the amount of income earned in another country and the amount of tax paid to that country is the taxpayer's foreign tax return.

Even if a developing country does not tax foreign source income (that is, it taxes on a territorial basis) or exempts certain foreign source income, such as active business income earned in foreign countries, the country may require its residents to provide information about the exempt foreign source income. This information can be used to verify that the resident is not claiming an exemption for foreign income in excess of the amount of such income, as well as to ensure that any expenses incurred in earning that income, including rent and royalties, are not deductible against the resident's domestic source income. In addition, for countries that exempt a resident's foreign source income but take that income into account in determining the rate of tax (exemption with progression), such information is important in order to verify that the tax rate applied is correct.

Where residents pay rent or royalties to non-residents with whom they do not deal at arm's length, the tax authorities need information about those transactions in order to apply transfer pricing rules. Thus, residents can be required to provide information to the tax authorities about payments of rent and royalties to related or non-arm's length non-residents. Such information can be provided either in a resident's tax return or in separate information returns and transfer pricing documentation (master and local files). The information should include at least the name and address of the recipient of the payment, the country of residence of the recipient, the amount of the payment, and the nature of the property in respect of which any rent or royalties are paid.

If a country has tax treaties with other countries, it can request its treaty partners to provide any relevant information pursuant to the exchange of information provisions in those treaties.[1]

2.3 Disclosure and information-reporting requirements with respect to restrictions on the deduction of rent or royalties

2.3.1 Introduction

If a country has enacted rules to prevent or limit deductions for certain payments of rent or royalties, the tax authorities require information in order to apply such rules effectively. The precise information required depends on the details of the domestic legislation. This information can be obtained from the taxpayers to which the rules apply, and for this purpose, all taxpayers should be required to maintain the books and records necessary to support the application of the rules. Useful information may also be obtained from public sources, such as public financial information. If, for example, the rules deny the deduction of rent or royalties paid to a non-resident unless the rent or royalties

[1] See Diane Ring, "Transparency and disclosure", in *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), chapter X, pp. 497-568, available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

are subject to tax or subject to a minimum tax rate by the country in which the non-resident is resident, the tax authorities may find it difficult to get the non-resident to provide accurate evidence concerning the amount of tax paid on the rent or royalties. In this situation, it would be useful for the tax authorities to obtain the necessary information from the foreign tax authorities; however, this is possible only if the country has a tax treaty with an exchange of information article with the other country or has signed the Organisation for Economic Cooperation and Development (OECD)/Council of Europe multilateral Convention on Mutual Administrative Assistance.[2]

2.3.2 Non-residents subject to restrictions on the deduction of rent and royalties

If a country's restrictions on the deduction of rent or royalties apply to non-residents, the tax authorities should be able to identify without much difficulty the non-residents covered by the rules. In effect, the rules should apply to any non-resident that is entitled to pay tax on a net basis and that claims deductions for rent or royalties paid to a non-resident. The tax authorities require information about the rent and royalties paid by these non-residents that is related to their business activities carried on in the country. This information should be available from the non-resident's tax return and the books and records it is required to maintain. However, it may be difficult for the tax authorities to verify that the rent or royalties reported by a non-resident as related to its business activities in the country are accurate.

2.4 Disclosure and information-reporting requirements for non-residents

2.4.1 Introduction

In general, the information necessary to tax non-residents on their income from immovable property and rent or royalties properly and

[2] Organisation for Economic Cooperation and Development (OECD)-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available from http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

to ensure that any rent and royalty expenses are properly deductible is available from five main sources:

- The non-resident
- A local agent or representative of the non-resident
- Persons, usually residents, making payments of rent or royalties to non-residents
- The tax authorities of other countries with which a country has a tax treaty providing for exchange of information
- Public information

Pursuant to the OECD/G20 BEPS Action 13 Final Report, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*,[3] multinational enterprises with a total gross revenue on a consolidated group basis of more than €750 million (or equivalent amount) will be required to report certain information annually for each jurisdiction in which the group operates (so-called country-by-country reporting). The ultimate parent of a multinational group, or a designated member of the group, will be required to file the country-by-country report with the tax authorities of the country in which it is resident. Such information will include:

- Revenue earned in the country
- Profits before tax
- Taxes paid and accrued
- Number of employees
- Capital
- Retained earnings
- Tangible assets

In addition, multinationals will be required to identify all entities in the group doing business in the country and the type of business they carry on. However, the information referred to above

[3] OECD, *Action 13: 2015 Final Report: Transfer Pricing Documentation and Country-by-Country Reporting* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report_9789264241480-en.

will be provided on an aggregate basis for each country and not on an entity-by-entity basis. Moreover, multinational enterprises are not required to provide information concerning payments to related parties for interest, royalties and services.

The country-by-country reports will be available automatically for the tax authorities of developing countries through the exchange of information provisions in bilateral tax treaties, tax information exchange agreements, or the multilateral Convention on Mutual Administrative Assistance in Tax Matters. Therefore, developing countries that do not have an extensive network of bilateral tax treaties should consider ratifying the multilateral Convention on Mutual Administrative Assistance. Country-by-country information may also be available on the public websites of some multinational companies and may also be a relevant source of information (even if the quality of the information depends on each company).

Although the information provided in the country-by-country reports will not contain information on intergroup payments of rent and royalties on an entity-by-entity basis, it should be useful in order to give a high-level picture of the multinational group that the tax authorities of developing countries can use to assess the risks of base erosion and select entities for audit.

Apart from country-by-country reporting, which affects only a limited group of large multinational groups, developing countries should require resident companies or non-residents with a PE or fixed base in the country to provide information about payments to related (and even unrelated) parties in their tax returns. This information is important for policy analysis and is relevant as a risk-assessment tool to identify cases that should be audited. The following parts of this section are organized on the basis of the type of information that a country needs in order to tax non-residents on their income from immovable property and royalties properly and to ensure that the deduction of their rent and royalty expenses is appropriate. The sources for the information are discussed in each section.

It is assumed for the purposes of the following discussion that the tax authorities of a country have the authority under domestic law to obtain the necessary information from the taxpayer, the person making payments to a non-resident or other persons.

2.4.2 Identification of non-residents

In order to impose tax on non-residents deriving income from immovable property located in a country, rent or royalties from a country, it is necessary, at a minimum, for the tax authorities of the country to know the names and addresses of those non-residents. For non-residents carrying on business in a country, this information may be provided pursuant to business registration requirements, in applications for taxpayer identification numbers or in tax returns. In other situations, if payments of rent or royalties to non-residents are subject to withholding tax, the withholding agent can be required to obtain and supply this information in order to comply with its withholding obligations.

Some countries require non-residents engaged in business activities in the country to register with the tax authorities or some other government agency. Sometimes non-residents may also be required to obtain taxpayer identification numbers or appoint a local agent or representative.[4] However, where non-residents are present in a country for only a short period of time, it may be difficult or impossible to identify them and to impose tax effectively on any rent or royalty income they derive from the country. In such situations, the only effective way to identify non-residents deriving rent or royalty income from a country may be to require the payers of rent or royalties to non-residents to provide information concerning the identity of the non-resident recipients as part of an obligation to withhold tax from the payments. The administrative aspects of withholding taxes on payments of rent and royalties to non-residents are dealt with in chapter 4, section 4.7.2, below.

Some countries may link the obligation on residents or non-residents with a PE or fixed base in the country to withhold tax from payments of rent and royalties to non-residents to taxation of such non-residents on a net basis. If a non-resident carries on business in a country and is subject to tax in the country on a net basis — because, for example, the non-resident carries on business through a PE or fixed base in the country — any rent or royalty income earned

[4] See Colin Campbell, "Taxation of non-residents", in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), chapter IV, pp. 173 – 191, available from http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

by the non-resident as part of that business will usually be subject to tax by that country. Therefore, it may be considered unnecessary in these circumstances to require residents or certain non-residents paying rent or royalties to such non-residents to withhold tax from those payments. However, it may be difficult for payers to determine whether a non-resident recipient of rent or royalties is subject to taxation on a net or gross basis.

2.4.3 Amount of income derived by non-residents

Where non-residents are taxable by a country on their net income, they will usually be required under that country's domestic law to provide the information necessary to compute their net income subject to tax. This information, which is usually provided in a tax return or other supporting schedules, provides a starting point for the tax authorities to determine whether the amount of income is correctly reported. In particular, these non-residents should be required to keep financial books and records that are necessary to support the computation of their net income for tax purposes, including any rent or royalties earned and any deductible rent and royalty expenses. The general requirement to keep books and records for non-residents who are subject to tax in a country on a net basis should be the same as that for residents.

Other information may also be useful. For example, it would be useful to have information from persons resident in a country or non-residents with a PE or fixed base in the country who make payments of rent or royalties to non-residents taxable by the country on a net basis. If such payments are subject to interim or final withholding taxes, the withholding agent could be required to supply information concerning the name and address of the non-resident recipient, the amount of the payment, the nature of the property in respect of which the rent or royalties are paid and whether the payer is related to the non-resident. However, even if the payments are not subject to withholding, a country might require the payers to provide such information. As discussed in section 2.4.5 below, for this purpose a country may wish to consider providing prescribed forms that withholding agents can use to provide this information.

If a country (the source country) has a tax treaty with the country in which the taxpayer earning the rent or royalties is resident, the source country can request the other country to provide information about the taxpayer. This source of information is unlikely to prove fruitful unless the tax authorities know at least the name of the taxpayer in order to make a request for information.

2.4.4 Information concerning related-party payments of rent and royalties

Where a non-resident receives rent or royalties from a resident of a country who is related to or does not deal at arm's length with the non-resident, the possibility arises that the amount of the payment by the resident may not be equal to the amount that would have been paid if the parties were not related or were dealing with one another at arm's length (see part 2, chapter 1, section 1.5). The rent or royalty for the use of the property may be more or less than an arm's-length rental or royalty rate. Some countries may be concerned where the amount of rent or royalties paid by their residents is more or less than the arm's length amount of rent or royalties for the use of the property. If the rent or royalties paid are greater than the arm's length amount, the resident payer may be claiming an excessive amount as deductible expenses against a country's tax base. If the amount paid is less than the arm's length amount of rent or royalties, the amount of any withholding tax imposed on the payment will be less than it should be.

Most countries have transfer pricing rules that require the prices charged for goods and services, including rent and royalties, in transactions between a resident and a related non-resident to be adjusted if the prices are not equal to the prices that parties dealing at arm's length would charge. Also, any tax treaties that a country has entered into will likely contain provisions similar to Article 9 of the United Nations and OECD Model Conventions,[5] which allow the country to adjust the prices of goods and services in transactions between associated enterprises in accordance with the arm's length standard.

[5] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

A country may wish to consider requiring business enterprises resident in the country and non-resident enterprises with a PE or fixed base in the country that make payments of rent or royalties to related non-residents to provide information to the tax authorities about those payments. Taxpayers may already be required to provide such information pursuant to the country's transfer pricing rules. If so, the tax authorities need to ensure that the information is also available to officials who deal with withholding taxes. The requirement to provide this information might be limited to deductible payments of rent and royalties. This information-reporting requirement could also be extended to individuals paying rent or royalties to non-residents; however, the compliance burden on individuals might be considered to be inappropriate and the requirement might be difficult to enforce.

The type of information that might be required includes:

- The name and address of the non-resident recipient
- The legal relationship between the payer and the non-resident recipient
- The amount of the payment
- The nature of the property in respect of which the rent or royalties are paid, and
- Whether the non-resident has a fixed place of business in the country

Transfer pricing rules typically apply only to related or associated enterprises such as corporations and other legal entities. However, similar issues can arise with respect to rent or royalties paid by individuals resident in a country to related non-resident individuals (or other non-corporate entities). If the amount of rent or royalties paid is more or less than the arm's length amount, a country's tax base may be eroded. Therefore, the tax authorities may also require resident persons, other than entities subject to the transfer pricing rules, to provide information about payments of interest to related non-residents. As with transfer pricing documentation, this information reporting might be limited to deductible payments of rent and royalties.

This information may also be important for purposes of applying Article 12 (6) of the United Nations Model Convention dealing with royalty payments that are excessive because of a special relationship between the payer and the recipient of royalties. Under Article 12 (6), the excessive portion of the royalty payments does not qualify for the reduced rate provided in Article 12 (2), but is taxable in accordance with the domestic laws of the contracting States with due regard to the other provisions of the treaty. Article 12 (6) applies if the amount of the royalties paid is excessive. (See part 2, chapter 1, section 1.5, and chapter 2, section 2.3.3, for a discussion of Article 12 (6).)

2.4.5 Information forms

It would be useful for countries to prescribe forms for taxpayers and withholding agents to use to provide information required by their tax authorities with respect to payments of rent and royalties to non-residents. Such forms would help to ensure that the proper information is provided and that the information is uniform and consistent. Penalties could be imposed for failure to provide the forms, failure to provide them on a timely basis and failure to provide all the required information. It should be possible for the forms to be filed electronically.

A sample information form is shown below.

Payments of rent or royalties to non-residents	**Year:____**
Name and address of non-resident recipient	
Taxpayer identification number of non-resident recipient	
Name and address of payer	
Taxpayer identification number of payer	
Amount paid	
Nature of the property	
Location of the property (movable and immovable property only)	
Tax deducted	
Relationship of payer with the non-resident recipient	

Persons subject to withholding obligations should be required to file this type of form for each payment of rent or royalty to a non-resident that is subject to withholding tax under domestic law. It may be possible for information about some types of payments (for example, rent from immovable property) to be filed on a monthly, quarterly or yearly basis. The payer could also be required to provide a copy of the form to the non-resident recipient. In addition, it would be useful for payers to be required to file annual forms showing the total payments of rent and royalties made to non-residents during the year, the amount of tax deducted, the amount of tax remitted to the tax authorities and the total number of forms filed for payments of rent and royalties to non-residents during the year. This information would be useful for audit and verification purposes.

Chapter 3

Auditing and verifying rent and royalty income and deductions of rent and royalties

3.1 Introduction

The present chapter deals with the audit and verification activities of a country's tax authorities to ensure that the provisions of domestic law with respect to deductible rent and royalty expenses and withholding taxes on rent and royalties have been complied with. The audit and verification activities undertaken by the tax authorities are dependent upon the provisions of the country's domestic law. For purposes of this discussion, it is assumed that a country taxes all payments of rent and royalties to non-residents by residents of the country or by non-residents carrying on business in the country. Even if a country chooses not to impose tax on certain rent or royalty income derived by non-residents, it is necessary for the tax authorities to verify that any exemptions are properly claimed.

This chapter is not intended to provide basic guidance as to standard auditing techniques. The same auditing techniques that are used with respect to other types of deductible payments that erode a country's tax base are equally applicable to payments of rent and royalties. Although this chapter focuses on base-eroding payments of rent and royalties, such payments are merely one aspect of non-compliance. The tax authorities should perform an assessment of the risks of non-compliance by residents and non-residents generally, and with respect to deductible payments of rent and royalties specifically, based on the guidance provided in part 2, chapter 4, of this *Portfolio*. They should target their audit resources on the areas where there are the greatest risks of non-compliance and where the taxes generated by enforcement efforts are likely to be greatest.

As noted above, the audit and verification activities of the tax authorities are dependent upon the provisions of domestic law with respect to deductible rent and royalty expenses. In particular, it is worth noting that if rent or royalties paid to non-residents are treated differently under a country's domestic law depending on various factors, such as the nature of the property in respect of which the payment is made, whether any rent or royalty is paid to a related party, and whether the rent or royalty is deductible by the payer, the compliance burden imposed on withholding agents and the administrative burden imposed on the tax authorities will be significantly greater than if all rent and royalty payments to non-residents are treated similarly. For example, if all deductible rent and royalty payments to non-residents are subject to withholding, whether provisional or final, at the same rate, withholding agents will not be required to distinguish between various types of rent and royalty payments. Auditing activities by the tax authorities will be similarly simplified. Similarly, if payments such as interest and fees for technical services that can be substituted for rent or royalties in certain circumstances are subject to withholding at the same rate as rent and royalties, withholding agents will not be required to distinguish between royalties and other types of payments.

3.2 Auditing the taxation of residents with respect to the deduction of rent and royalties

3.2.1 Introduction

If a country has enacted any restrictions on the deduction by residents of rent or royalties to earn foreign source income or rent or royalties paid to non-residents, the auditing and verification of those deductions is similar to the auditing and verification of any deductions claimed by resident taxpayers generally. The auditing requirements with respect to these rules depend on the precise details of the rules.

3.2.2 Checklist

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)
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
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)

3.3 Auditing the taxation of rent or royalty income earned by non-residents on a net basis

Usually, non-residents carrying on business in a country, often through a PE or fixed base, are subject to tax on their income from the business, including any rent or royalties, on a net basis. If this is the case, the audit and verification activities of that country's tax authorities can focus on the books and records of the PE or fixed base. As noted in section 2.3 above, any non-residents carrying on business in a country, including but not limited to carrying on business through a PE or fixed base, should be required under that country's domestic law to keep the necessary books and records to support the computation of their income in accordance with domestic rules. The books and records should be similar to the books and records that resident taxpayers engaged in business must keep.

The tax authorities can check the non-resident's books and records to determine whether they have been maintained properly and to verify amounts against original documents such as invoices and banking records.

Where non-residents are subject to provisional withholding on payments of rent or royalties received from residents of a country or from non-residents with a PE or fixed base in the country, the tax authorities can use the information provided by the withholding agents to verify that any payments made to non-residents have been included in their income. This assumes that the withholding agents are required to provide useful information, as outlined in section 3.5 below, and that the tax authorities have the necessary resources to use the information effectively.

3.4 Provisional or final withholding taxes

If certain persons—usually residents and non-residents carrying on business through a PE or fixed base in a country—are required to withhold tax from payments of rent or royalties to non-residents, the tax authorities need to audit the withholding agents to ensure that they have withheld the proper amounts. Where non-residents are subject to provisional withholding and are entitled to file tax returns and pay tax on a net basis, the tax authorities will have access to both the information provided by the non-residents in their tax returns and the information provided by the withholding agents. These two sources of information can be cross-checked to determine whether the non-residents have reported the correct amount of rent and royalty income and tax payable and the withholding agents have withheld the correct amounts.

Where non-residents are subject only to a final withholding tax on payments of rent and royalties, the only issue for the tax authorities to verify is whether the withholding agents have withheld the proper amount from any payments of rent and royalties to non-residents; the only source of information for this purpose is information provided by or in the hands of the withholding agents. As discussed in chapter 2 above, withholding agents should be required to provide certain information with respect to the amounts withheld and remitted to the tax authorities. This information can be checked against the withholding agent's books and records and its banking records. For example, if a resident payer claims a deduction for rent or royalties paid to a non-resident, the payer's books and records and the information provided in its tax returns or information reporting forms can be cross-checked against the information provided with respect to the amounts withheld.

If withholding agents are subject to serious penalties for failure to withhold properly, they will be more likely to comply in order to avoid the penalties. Such penalties may reduce the need for the tax authorities to audit withholding agents with respect to payments of rent and royalties to non-residents. For example, if persons paying rent or royalties to non-residents fail to withhold, they may be made liable for the tax payable by the non-resident and/or might not be allowed to claim a deduction for the rent or royalties paid.

Countries must carefully consider the compliance burden imposed on payers to withhold tax from payments of rent or royalties to non-residents and provide information about such payments. Where the payers are individuals resident in a country and do not claim any deduction for the rent or royalties paid, it may be difficult to enforce withholding obligations on such individuals

If a country provides waivers from the obligation to withhold tax from payments of rent or royalties in certain circumstances, it will be necessary for the tax authorities to review and audit the waiver programme to ensure that it operates properly.

In some cases, domestic law may provide exceptions from withholding tax on certain payments of rent or royalties. For instance, some treaties provide that copyright royalties paid for literary and artistic works are exempt from withholding tax or are subject to a reduced rate of withholding tax. In such cases, the taxpayer should be required to provide adequate proof that the payment is exempt from withholding tax.

3.5 Checklist

1. If non-residents are subject to tax on rent or royalties on a net basis:
   - ➤ 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

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

Chapter 4

Administration of tax treaty provisions to counter base-eroding payments of rent and royalties

4.1 Introduction

If a country does not tax non-residents on certain payments of rent or royalties under its domestic law or allows the deduction of rent or royalty expenses under its domestic law, then the provisions of its tax treaties are irrelevant. This result is due to the fundamental proposition that, for most countries, tax treaties do not have the effect of imposing tax; they limit the tax imposed under a country's domestic law. Therefore, if a country's tax base is being eroded with respect to payments of rent or royalties because the country does not impose tax on such payments or limit the deduction of such payments under its domestic law, the country may wish to consider whether its domestic law is appropriate in this regard or whether the law should be amended to impose tax on rent and royalties paid to non-residents or to restrict the deduction of rent and royalties in certain circumstances. Part 3 of this *Practical Portfolio* provides a discussion of the provisions of domestic law that might be adopted to prevent base erosion and profit shifting with respect to payments of rent and royalties.

However, even if a country imposes tax on rent and royalties derived by non-residents under its domestic law or restricts the deduction of rent and royalties under its domestic law, it may be required to give up that tax or allow those deductions pursuant to the provisions of the tax treaties that it enters into. Part 3 of this *Portfolio* also provides guidance for developing countries to minimize the risks of base erosion with respect to the provisions of its tax treaties dealing with rent and royalties. Like the provisions of domestic law, the provisions of a country's tax treaties are not self-executing. The tax authorities must ensure that any treaty provisions are applied properly so that the benefits of a treaty are given only in situations where the taxpayer is entitled to those benefits. This chapter deals with the administration and application of the provisions of tax treaties by developing countries to minimize base erosion, and also provides guidance for tax officials of developing countries in applying the provisions of their tax treaties dealing with rent and royalties.

This chapter focuses primarily on the risks of base erosion with respect to the provisions of tax treaties dealing with rent and royalties. As emphasized throughout this *Portfolio*, base erosion with respect to payments of rent and royalties occurs in two ways: payments of rent or royalties received by non-residents may not be subject to tax by a country (or may be subject to tax at reduced rates) or payments of rent or royalties may be deductible by residents of the country or non-residents carrying on business in the country. Therefore, this chapter deals with the application of tax treaty provisions that affect both the taxation of non-residents receiving payments of rent or royalties from a country and the deduction of rent or royalty expenses by residents of the country and non-residents carrying on business in the country through a PE or fixed base. However, it does not deal with the provisions of tax treaties requiring the elimination of double taxation or the administration and application of tax treaties generally. For information and guidance concerning the administration of tax treaties generally, including the organizational structure of the tax administration and the relationship between tax treaties and a country's domestic law and between its tax treaties and its trade and investment treaties, see *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.[6] As the *Handbook* explains, tax treaties do not contain many rules dealing with the application of their provisions. Thus, the rules for the application of the provisions of a tax treaty must be found in a country's domestic law; yet few countries have such provisions. As a result, the *Handbook* suggests that developing countries may wish to consider adopting uniform legislative or administrative rules for the application of the provisions of their tax

[6] *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Handbook_DTT_Admin.pdf.

treaties. Most important, these rules should deal with the procedural requirements for non-residents to qualify for claiming the benefits of a tax treaty.

4.2 Identification of non-residents deriving income in the form of rent or royalties

As discussed in section 2.4.2 above, the first step for a country that imposes tax on any income of non-residents, including rent or royalties, is to identify those non-residents. This step is crucial for the imposition of domestic tax as well as the application of the provisions of an applicable tax treaty. If a country cannot identify non-residents deriving income from the country, the issue of whether such non-residents are entitled to treaty benefits is irrelevant. Therefore, countries should have strategies in place to identify non-residents doing business in the country or deriving rent or royalties that are subject to tax under their domestic law, as discussed in chapter 2 above.

For the purposes of this chapter dealing with the application of tax treaties, it is assumed that countries have identified non-residents receiving payments of rent and royalties that are subject to tax and non-residents claiming deductions of rent and royalties under their domestic tax law. Therefore, the basic issues in this chapter are:

(a) Is a non-resident entitled to a reduction or exemption from a source country's tax on rent or royalties under a tax treaty and, if so, how are the provisions of the treaty applied by the tax authorities of the source country?

(b) Are non-residents carrying on business in a source country through a PE or fixed base entitled, under the provisions of a tax treaty, to deduct any rent or royalty expenses incurred in earning income attributable to the PE or fixed base, and, if so, how are the provisions of the treaty applied by the tax authorities of the source country for this purpose?

(c) 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, and, if so, how are the provisions of the treaty applied by the tax authorities of the residence country for this purpose?

4.3 Determining the country of residence of the non-resident recipient of rent or royalties in order to establish the relevant treaty

4.3.1 Residence for purposes of tax treaties

Assuming that a country has identified a non-resident receiving income in the form of rent or royalties that is taxable under the country's domestic tax law, the first step in applying the provisions of a tax treaty is to determine whether the country has a treaty with the country in which the recipient of the rent or royalties is resident. Only residents of a contracting State are entitled to the benefits of that State's tax treaties. Therefore, to determine whether a particular non-resident is entitled to the benefits of a country's tax treaties, it must be determined whether the non-resident is a resident of a country with which the country has a tax treaty. As set out in Article 4 of the United Nations Model Convention,[7] the test of residence usually depends on whether the non-resident is liable to tax under the laws of the other country on the basis of residence, domicile, place of management, place of incorporation or any other similar criterion, which might include nationality or substantial periods of presence.

The important point about the determination of the residence of a taxpayer for tax treaty purposes is that the question must be determined under the law of the treaty partner, not under the source country's law. Article 4 states that a person is a resident of a country if the person is liable to tax "under the laws of that State". A source country's tax authorities may not be knowledgeable about the laws of its treaty partners with respect to the residence of taxpayers. Therefore, where a taxpayer claims the benefits of a tax treaty, it is customary for the tax authorities to verify that the taxpayer is a resident of the other country by requesting the taxpayer to provide a certificate from the tax authorities of the other country that the taxpayer is a resident of that other country.

The use of residence certificates is widespread. Where there is substantial cross-border activity between the two contracting States, it

[7] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

may be beneficial to formalize the use of residence certificates (as well as other matters, as discussed below) through an agreement between the competent authorities of the treaty partners, as provided by Article 25 (Mutual agreement procedure) of the United Nations Model Convention. The efficiency of the use of residence certificates can be improved if special forms for that purpose are created in the relevant languages of the two countries. In this way, the taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

A country may require the tax authorities of the other country to certify other things besides residence. For example, a country may require the foreign tax authorities to certify that the taxpayer is the beneficial owner of royalties in order to obtain the benefit of the reduced rate of source country tax under Article 12 (2) of the United Nations Model Convention. This assumes that, like residence, beneficial ownership is determined under the law of the treaty partner rather than under the source country's law.

There are potential problems with the requirement of residence and other certifications from the tax authorities of the other countries. Although the requirement of a certificate of residence imposes an additional compliance burden on the taxpayer and administrative burden on the tax authorities, this additional burden does not seem overly onerous if it is simply an annual requirement. If, however, a separate certificate is required for each payment of rent or royalties, the burden could be significant. Another problem is the potential delay in obtaining the benefits of the treaty caused by the necessity to obtain residence or other certifications from the foreign tax authorities. The delay is dependent upon how frequently such certificates are required and how much information about the tax affairs of the taxpayer must be certified by the foreign tax authorities.

Unfortunately, some countries do not apply rigorous standards in granting residence certificates to taxpayers, since it is another country's tax that will be reduced. Therefore, countries should be cautious about accepting residence certificates without any verification.

Some countries allow withholding agents to reduce the amount withheld pursuant to a treaty based on the address of the recipient.

In effect, where the non-resident's address reflects a location in the treaty partner country, treaty benefits in the form of lower withholding tax are granted. Relying on addresses in this way makes the delivery of treaty benefits much more efficient, but it is also susceptible to abuse. Therefore, countries may consider not allowing a withholding agent to rely on a recipient's address if the agent has reason to suspect that the recipient is not a resident of the other contracting State. In this case, the taxpayer or the withholding agent could be required to obtain a residence certificate in order to obtain the benefit of the lower treaty rate of withholding. Otherwise, withholding agents are likely to withhold the higher amount required by domestic law, in which case non-resident recipients of royalties will be required to apply for refunds.

In order for a taxpayer to qualify as a resident of a country for tax treaty purposes, the taxpayer must be a "person" for purposes of the treaty. Tax treaties based on the United Nations Model Convention provide a broad definition of "person", which includes individuals and legal entities. The definition of a person is discussed below in connection with the qualification for treaty benefits.

In addition to the requirement that a person must be a resident of one of the contracting States to obtain the benefits of a tax treaty, some treaties contain anti-treaty shopping provisions (also known as "limitation-on-benefits" provisions) to further restrict the granting of treaty benefits to appy to "real" residents of a country.[8] For example, a resident of one country may wish to make an investment in another country. If there is no treaty between those two countries, the investor may establish a shell company in a country that does have a treaty with the country in which the investment will be made. However, that company may have little or no substance (that is, no employees, no business in the country in which it is established and no assets other than the investment in the other country). The anti-treaty shopping rule in the Commentary to Article 1 of the United Nations Model Convention would prevent such a company from obtaining the benefits of the treaty in these circumstances. (See part 2, chapter 1, section 1.2.11, for a discussion of the use of back-to-back arrangements to obtain treaty benefits improperly.)

[8] See paragraph 20 of the Commentary on Article 1 of the United Nations Model Convention for a discussion of this type of provision.

4.3.2 Dual residence

Situations in which a taxpayer is considered to be resident in both contracting States for purposes of a tax treaty are frequently encountered because countries' domestic residence rules tend to be overly broad. In these dual-resident cases, the United Nations Model Convention and the Organisation for Economic Cooperation and Development (OECD) Model Convention[9] provide tie-breaker rules to allocate residence exclusively to one contracting State for purposes of the treaty. Under Article 4 (2) of both Models, a hierarchy of four tie-breaker rules is provided for individuals, whereas under Article 4 (3) the tie-breaker rule for other persons (legal entities) is the person's place of effective management. The Commentary to both Models allows countries to substitute an alternative version of Article 4 (3) under which the dual residence of entities other than individuals is resolved by the competent authorities on a case-by-case basis pursuant to the mutual agreement procedure, instead of by reference to the entity's place of effective management.[10] Note that pursuant to the OECD/G20 Report on BEPS Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,*[11] Article 4 (3) of both the United Nations and the OECD Model Conventions will be amended to allow the competent authorities to resolve dual-residence cases involving legal entities on a case-by-case basis. The new rule will be included in the 2017 update of the United Nations Model Convention.

The application of the tie-breaker rules has important implications for the contracting States to a tax treaty because it determines which country must give up its taxing rights. Consequently, the application of the tie-breaker rules should be carefully considered. For

[9] Organisation for Economic Cooperation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[10] See paragraph 10 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 24.1 of the Commentary on Article 4 of the OECD Model Convention.

[11] OECD, *Action 6: 2015 Final Report: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Paris: OECD, 2015), available from http://www.oecd-ilibrary.org/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en.

individuals, the tie-breaker rules are intensely factual and should be applied on a balanced basis to give residence to the country with which the individual is more closely connected. However, dual-resident entities are usually used for tax avoidance purposes. Therefore, when the tax authorities of a country encounter dual-resident entities, they should consider whether the entities have been used for tax avoidance purposes, and if so, whether such tax avoidance can be countered by anti-abuse rules in the country's domestic law or in its tax treaties.

Example 1

ACo is considered to be a resident of Country A because its place of management is located in Country A. ACo is also considered to be a resident of Country B because it is incorporated under the laws of Country B. Assume that ACo carries on business in Country B and also in Country A and pays royalties of 100 to another company resident in Country A. Assume that Country B imposes a withholding tax of 10 per cent on payments of royalties to non-residents. If Country B and Country A have entered into a tax treaty with provisions identical to those of the United Nations Model Convention, under Article 4 (3) ACo would be considered to be resident where its place of effective management is located. Although place of effective management is not precisely the same as place of management, assume that the place of effective management of ACo is considered to be in Country A. As a result, ACo would be considered to be resident in Country A for purposes of the treaty between Country B and Country A. Therefore, Country B would be required to provide the benefits of the treaty to ACo. This would likely mean that Country B could not tax ACo on the income it derives from carrying on business in Country B unless ACo has a PE or fixed base in Country B and the business is carried on through that PE or fixed base. However, the provisions of the treaty would not eliminate the obligation on ACo, under the domestic law of Country B, to withhold tax from the royalties of 100 paid to the company resident in Country A. ACo is a resident under the domestic law of Country B for purposes of Country B withholding tax; the tie-breaker rule in the treaty makes ACo a resident of Country A only for purposes of the treaty, not for all purposes. Note, however, that many countries have provisions in their domestic law that allow withholding agents to withhold only the amount required under an applicable tax treaty if the payments are made to a resident of that treaty country.

4.4 Determining the applicable provision of the treaty

Once the tax authorities of a country have determined that a non-resident taxpayer is a resident of a country with which the country has a tax treaty, they must decide which provision of that treaty applies to the payments of rent and royalties received by the non-resident. The treaty provisions that are primarily relevant are Articles 6 (Income from immovable property), 7 (Business profits), 12 (Royalties) and 14 (Independent personal services) of the United Nations Model Convention. As explained in part 2, chapter 2, if both Articles 6 and 7 apply to income from immovable property, Article 6 has priority pursuant to Article 6 (4); and, if both Articles 7 and 12 apply, Article 12 takes priority pursuant to Article 7 (6). However, if a non-resident carries on business in a country through a PE in that country and the property in respect of which royalties are payable is effectively connected with the PE, Article 12 (4) provides explicitly that the provisions of Article 7 apply. Therefore, Article 7 will apply to royalties derived from a country if:

(a) The non-resident carries on business in the country through a PE in the country;

(b) The underlying property is effectively connected with the PE; and

(c) The royalties are attributable to the PE.

If Article 7 applies, the source country is entitled to tax the net profits attributable to the PE, including any royalties, at the applicable rate under its domestic law (that is, the treaty does not limit the rate of tax imposed by the country).

A similar analysis applies with respect to Article 14, although there is no specific conflict rule in Article 14 similar to Article 7 (6). If a non-resident provides professional or other independent services in a country through a fixed base in that country and the property in respect of which royalties are payable is effectively connected with the fixed base, Article 12 (4) provides explicitly that the provisions of Article 14 apply. Therefore, Article 14 will apply to royalties derived from a country if:

(a) The non-resident performs professional or other independent services in the country through a fixed base in the country;

(b) The property is effectively connected with the fixed base; and

(c) The royalties are attributable to the fixed base.

If Article 14 applies, the source country is entitled to tax the net profits attributable to the fixed base, including any royalties, at the applicable rate under its domestic law (that is, the treaty does not limit the rate of tax imposed by that country).

Otherwise, any royalties derived from a country by a resident of the other contracting State are subject to Article 12, under which the source country is entitled to impose tax on the gross amount of royalties paid at the rate specified in Article 12 (2). It is important to recall that the term "royalties" for the purposes of Article 12 includes rent for the use of industrial, commercial and scientific equipment.

Where an enterprise derives rent from the use of ships or aircraft in international traffic or from the operation of boats in inland waterways transport, Article 8 (alternative A) of the United Nations Model Convention provides for exclusive taxation of the profits from such activities by the country in which the place of effective management of the enterprise is located. Under Article 8 (alternative B), if an enterprise resident in one contracting State derives profits from the operation of ships in international traffic in the other contracting State that are more than casual, the other contracting State is entitled to tax those profits.

If income that is not covered by Articles 6 to 20 of the United Nations Model Convention arises in a contracting State, that State is entitled to tax that income under Article 21 of the Convention (Other income).

4.5 Qualification for treaty benefits

Once the tax authorities have determined whether Article 6, 7, 8, 12 or 14 applies to any rent or royalty income derived by a non-resident taxpayer, they must determine whether the non-resident satisfies all the conditions for entitlement to the benefits of the particular article. The requirements of Articles 6, 7, 8, 12 and 14 of the United Nations Model Convention dealing with rent from immovable property and royalties are discussed in detail in part 2, chapter 2. In this section, the issue is how the tax authorities verify or ensure that the requirements for entitlement to treaty benefits are met.

Under Article 6, the country in which immovable property is situated is entitled to tax the income from that property without any limitations. Therefore, if Article 6 applies, the taxpayer is not entitled to any treaty benefits. The application of Article 6 is dependent upon three issues: whether the property producing the income is immovable property under a country's domestic law or the definition in Article 6 of the treaty, whether the immovable property is situated in the country and whether the income is derived from the immovable property.

A comprehensive list of the requirements for entitlement to treaty benefits under Articles 7 and 14 includes the following:

- The non-resident must be a person
- The non-resident must be a resident of the other country for purposes of the treaty
- The non-resident must have a PE or fixed base in the source country or be present in that country for a minimum period of time
- The income must be attributable to the PE or fixed base (or derived from activities performed in the source country in the case of a non-resident who stays in that country for more than 183 days)
- Any anti-treaty shopping or limitation-on-benefits provision must not apply (see section 4.3.1 above for a brief discussion of such provisions)

The requirements for entitlement to treaty benefits under Article 8 includes the following:

- There must be an enterprise
- The enterprise is not taxable in a contracting State on profits from the operation of ships or aircraft in international traffic or from the operation of boats in inland waterways transport unless the enterprise has its place of effective management in that State or, if Article 8 (alternative B) applies, the shipping activities in that State are more than casual

A comprehensive list of the requirements for entitlement to treaty benefits under Article 12 includes the following:

- The non-resident must be a person

- The non-resident must be a resident of the other country for purposes of the treaty
- The non-resident must be the beneficial owner of the royalties
- The royalties must be paid by a resident of the source country or be borne by a PE or fixed base in that country
- Any anti-treaty shopping or limitation-on-benefits provision must not apply (see section 4.3.1 above for a brief discussion of such provisions)

A comprehensive list of the requirements for entitlement to treaty benefits under Article 21 includes the following:

- The non-resident must be a person
- The non-resident must be a resident of the other contracting State for purposes of the treaty
- The income must not be dealt with in Articles 6 to 20 of the treaty
- The income must not arise in the State

As mentioned above, often a non-resident's residence in the other country is verified through a certificate of residence obtained from the tax authorities of the other country. Similarly, the treaty partner might be requested to certify that the non-resident is the beneficial owner of the income. (Note that this assumes that the meaning of beneficial owner is determined under the law of the recipient's country of residence. It is unclear under the provisions of the United Nations and OECD Model Conventions and their Commentaries which country's law should be applied for the purpose of determining who is the beneficial owner of the relevant payment or whether the term has a treaty meaning independent from the meaning under the domestic law of the two countries.) All the other requirements for entitlement to treaty benefits must be determined by each country's tax authorities on the basis of its own information and expertise.

Where Article 7 or 14 of the treaty requires a country to tax a non-resident's royalty income on a net basis, the country must determine, first, whether the non-resident has a PE or fixed base in the country and, second, the income attributable to the PE or fixed base. The domestic laws of most countries require any non-resident carrying on business in the country through a PE or fixed base to register and file a tax return. These tax returns and the supporting financial information should provide the tax authorities with the necessary information to determine the amount of income and tax payable under domestic law and the relevant treaty. If a non-resident does not file a tax return or does not file it on a timely basis, interest on unpaid tax and penalties should be imposed. However, in most situations where non-residents are claiming treaty benefits, they are likely to attempt to comply with the source country's laws.

Therefore, the primary challenges with respect to the application of Article 7 or 14 consist of verifying:

(a) The taxpayer's claim that it has a PE or fixed base in the source country or that it has spent the requisite amount of time in the source country so that any royalties are taxable on a net basis; and

(b) The amount of income, including royalties, attributable to the PE or fixed base.

For this purpose, the tax authorities will likely start with the information provided by the taxpayer and then use standard audit techniques to verify that information.

The primary challenges of applying Article 12 consist of verifying that the recipient of royalties is a resident of the other contracting State and the beneficial owner of the royalties. For this purpose, the tax authorities will likely rely on information supplied by withholding agents and information from the tax authorities of the other State.

If a country has imposed withholding tax on royalties paid to non-residents that are taxable on a net basis under the terms of the treaty, the country must allow the non-residents to apply for a refund of any tax withheld in excess of the tax payable in accordance with the provisions of the treaty. Issues with respect to withholding taxes are discussed in section 4.7.2 below.

4.6 Computation of income

Although the amount subject to tax by a source country in accordance with the provisions of an applicable tax treaty may be limited, the rules for the computation of the income are the rules for that purpose under that country's domestic law. For example, each country's tax rules determine what amounts are included in income, what amounts are deductible in computing income and the timing of those inclusions and deductions. Where rent or royalties derived by a non-resident are subject to tax on a net basis under Article 7 or 14 of a treaty based on the United Nations Model Convention, the treaty provides some basic rules for computing the amount of income that is attributable to a PE or fixed base. The rules in Article 7 of the United Nations Model Convention with respect to rent and royalty expenses may be summarized as follows:

- The deduction of expenses is a matter of the domestic law of the country in which the PE is located; however, the deduction of expenses incurred on behalf of the PE cannot be denied on the basis that the expenses are incurred outside that country
- No deductions are allowed for notional rent or royalties paid by a PE to its head office or other parts of the enterprise
- Notional rent or royalties charged by a PE to its head office or other parts of the enterprise must not be taken into account
- If it has been customary to determine the profits of a PE on the basis of apportionment, such an apportionment is acceptable if the result is in accordance with the principles of Article 7
- The profits of a PE must be determined consistently from year to year unless there is a good reason to make a change

Although Article 14 of the United Nations Model Convention does not explicitly provide rules similar to those in Article 7 for the computation of the profits attributable to a fixed base, it is generally considered that similar rules apply.

In addition, where rent or royalties are derived from transactions between an enterprise that is resident in one country and a related or associated enterprise resident in the other country, the transfer pricing provisions of the treaty (Article 9) will apply. Similarly, under Article 12 (6) of the United Nations Model Convention, rent or royalty payments that are excessive because of a special relationship between the parties will not be subject to the provisions of Article 12 to the extent that they are excessive. Therefore, the tax authorities must determine whether payments of rent or royalties between related parties are in accordance with the arm's length standard in Article 9 of the treaty and whether such payments between parties with a special relationship are excessive, and, to the extent they are non-arm's length or excessive, how they should be treated. There is no provision in the United Nations Model Convention dealing with excessive rent for the use of immovable property similar to Article 12 (6) with respect to rent and royalties.

Where payments of rent or royalties received by a non-resident are taxable under a country's domestic law and the treaty on a gross basis, the amount subject to withholding tax is the amount under that country's domestic law as limited by the treaty. For example, if a treaty allows a country to tax rent or royalties paid to a resident of the other country at a maximum of 15 per cent of the gross amount paid, but the country imposes a withholding tax on interest of 30 per cent under its domestic law, the treaty requires the country to refund any withholding tax levied in respect of payments to the resident of the treaty partner in excess of 15 per cent.

4.7 Collection of tax

4.7.1 Tax imposed on a net basis

If a treaty requires a country to tax certain income in the form of rent or royalties on a net basis under Article 7 or 14, it does not mean that the country cannot collect the tax through withholding tax. Instead, it means that, to the extent that the withholding tax exceeds the tax on the net income subject to tax by that country in accordance with the treaty, the country must refund the excess to the non-resident. Similarly, if the withholding tax is less than the country's tax on the non-resident's net income, the non-resident would be required to pay the difference. Alternatively, a country can collect tax from non-residents earning rent or royalties in the same way that it collects tax from residents. Therefore, for example, some countries may require residents and non-residents carrying on business in the country to pay instalments of tax on a periodic basis and then pay any balance owing or claim a refund when the tax return for the year is due. The instalments of tax should probably be set at an amount that approximates the amount of tax payable for the year and could be based on the tax payable for the previous year.

However, these techniques may not be effective with respect to non-residents that do not have significant assets in a country or are not physically present in a country. As discussed in section 4.7.3 below, Article 27 (Assistance in the collection of taxes) of the United Nations Model Convention provides a mechanism whereby a country can request its treaty partner to collect any tax owing to the country by a resident of the treaty partner as if the tax were tax owing to the treaty partner.

4.7.2 Withholding tax

Under Article 12 of the United Nations Model Convention, a country is entitled to impose tax on the gross amount of royalties paid by a resident of a country or a non-resident with a PE or fixed base in the country to a resident of the other contracting State. If the recipient is the beneficial owner of the royalties, the rate of tax levied by the country cannot exceed the rate specified in Article 12 (2) of the treaty. Most countries tax royalties received by non-residents by imposing an obligation on the payer of the royalties to withhold tax on behalf of the non-resident. The provisions of tax treaties do not specify how countries should impose or administer withholding taxes on royalties.

Although withholding taxes are imposed on non-residents deriving rent and royalties, the taxes are collected by requiring the payers to withhold an amount from the rent or royalty payments and remit that amount to the tax authorities as tax on behalf of the non-residents. The obligation to withhold is usually imposed on residents of a country and non-residents carrying on business in a country through a PE or fixed base. As discussed in part 2, chapter 2, section 2.3.1.2.5, many countries provide at least some exemptions from the obligation to withhold from payments of rent and royalties to non-residents. Residents of a country and non-residents with fixed places of business in a country have substantial connections to the country, and that country can take enforcement action against them if they fail to withhold. Various penalties can be imposed on withholding agents to ensure that they withhold properly. These penalties include interest and financial penalties, liability (together with the non-resident) for any tax that should have been withheld, and the denial of any deduction for the payments of rent or royalties to a non-resident if tax is not withheld.

Where the treaty specifies a maximum rate of tax, it does not prevent a country from requiring payers to withhold at a higher rate; however, if it does so, the country would be required to refund any tax withheld in excess of the maximum rate provided in the treaty.

Since tax treaties do not deal with how a country imposes tax, the method of taxation is a matter of domestic law. Therefore, countries have flexibility in determining how to apply their withholding taxes. First, withholding can be imposed on an interim or provisional basis or as a final tax. If withholding is imposed on an interim basis, the taxpayer is entitled or obligated to file a tax return and determine the amount of income — usually on a net basis — and tax owing. This type of withholding imposes a considerable compliance burden on taxpayers and an administrative burden on the tax administration. Taxpayers must file returns and the tax administration must establish a unit to process those returns and make refunds of any excessive tax withheld. In contrast, under a final withholding tax, the amount withheld is the tax payable; no tax returns are filed and no refunds of tax are made.

Second, countries have flexibility to establish the rate of withholding on royalties in their domestic law at a rate that is more than, less than or equal to the rate specified in the treaty. If the domestic rate is less than or equal to the treaty rate, a country will meet its treaty obligations simply by applying its domestic law. For example, as discussed in part 2, chapter 1, section 1.3.3.2, and chapter 2, section 2.3.1.2.5, the rate of withholding on royalties paid to arm's length non-residents under domestic law may be less than the treaty rate in order to provide residents with unrestricted access to foreign-owned technology. If the domestic withholding rate imposed by a particular country is greater than the treaty rate, the country must provide a procedure for non-residents to claim a refund for the excess tax withheld in order to meet its treaty obligations. If withholding agents are liable for the tax payable by the non-resident recipients of rent or royalties in the event that the agents fail to withhold properly, the agents will likely be unwilling to accept the risk of withholding less than the full amount required by domestic law. As a result, countries may consider allowing withholding agents to withhold at the treaty rate under certain conditions (for example, by obtaining certificates of residence and beneficial ownership from the treaty country or filing a form with certain information).

Some countries have adopted procedures that allow non-residents or their withholding agents to apply to the tax authorities for waivers from the obligation to withhold. Such procedures require a significant commitment of resources. However, if the conditions imposed for reduced withholding are too onerous, the withholding agent is likely to withhold at the domestic rate, thus forcing non-residents to apply for a refund. As a result, some countries have provisions in their domestic law that allow withholding agents to withhold at the rate specified in the treaty.

In summary, the application of reduced rates of withholding taxes provided by tax treaties requires a difficult balancing between the need to deliver treaty benefits in an efficient manner and the need to ensure that those benefits are not given in situations where they are unjustified. It may also be noted that the problems become more serious as the number of a country's tax treaties grows, especially if there are many exemptions from withholding tax on royalties and the limits on the rate of withholding tax in the treaties vary.

4.7.3 Assistance in collection

If a country has provisions in its tax treaties similar to Article 27 of the United Nations and OECD Model Conventions, the country may request its treaty partner to collect tax owing to it by a resident of that treaty partner. Article 27 requires the requested country to collect the taxes owing as if they were taxes owed to that country. However, Article 27 is a relatively recent addition to the United Nations and OECD Model Conventions and some countries may not have that Article in any of their tax treaties.

The OECD/Council of Europe multilateral Convention on Mutual Administrative Assistance[12] also permits signatories to obtain assistance in the collection of taxes from other signatories to the Convention, although some countries enter reservations to this part of the Convention.

[12] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available from http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

In the absence of a provision similar to Article 27 of the United Nations and OECD Model Conventions or the application of the OECD/Council of Europe multilateral Convention, a country is usually unable to enforce a judgment that it obtains from its own courts for the recovery of unpaid tax owing by a resident of another country in the courts of that country.

4.8 Checklist

1. Determine whether a non-resident who receives rent or royalties is a resident of a country with which the source country has a tax treaty
   - Residence certificates will often be useful for this purpose
2. Determine whether Article 6 of the treaty is applicable to the income
   - Depends upon whether the income is derived from immovable property situated in the country
3. Determine whether Article 7, 12 or 14 of the treaty is applicable to the rent or royalties derived by the non-resident
   - Depends upon whether the rent or royalties are derived as part of a business, as part of a business of providing professional or other independent services, or otherwise
4. Determine whether the non-resident qualifies for the benefits of the particular article
   - Article 7:
     - Is the non-resident a person?
     - Is the non-resident a resident of the other country?
     - Does the non-resident have a PE in the source country?
     - Are the activities performed at the PE merely preparatory and auxiliary activities?
     - Are the royalties derived by the non-resident attributable to the PE in the source country?
   - Article 14:
     - Is the non-resident a resident of the other country?
     - Does the non-resident have a fixed base in the country that is regularly available to the non-resident?

  - Does the non-resident perform professional services or other personal services of an independent character through the fixed base?
  - Are the royalties derived by the non-resident attributable to the fixed base in the source country?
- Article 12:
  - Is the non-resident a person?
  - Is the non-resident a resident of the other country?
  - Are the royalties paid by a resident of the source country or a non-resident with a PE or fixed base in the source country?
  - Is the non-resident the beneficial owner of the royalties? It is 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 deductible in computing the profits or income attributable to the PE or fixed base?
  - Are the royalties paid excessive because of a special relationship between the payer and the payee?