Key Corporate Tax Haven Indicators

Haven Indicator 16:

Deduction Limitation for Royalties

What is measured?

This indicator measures whether or to what extent a jurisdiction disallows or restricts the deduction of royalties paid to non-resident group affiliates ("intra-group royalty payments") from the corporate income tax base.

A haven score of 100 is given if a jurisdiction applies no limits on the deduction of intra-group royalty payments. The haven score of a jurisdiction is reduced to 75% if the jurisdiction applies a deduction limitation or disallows certain intra-group royalty payments for intangible and intellectual property only if they are not compliant with the OECD nexus rules ("restricted nexus"), as explained further below. The haven score is further reduced to 50 if a jurisdiction applies a deduction limitation or disallows certain intra-group royalty payments irrespective of whether the intellectual property regime complies with the OECD nexus approach ("restricted tight"). A zero haven score is granted if a jurisdiction does not permit any deductions of intra-group royalty payments whatsoever.

Table 16.1. Scoring Matrix Haven Indicator 16

Regulation	**Haven Score** [100 = maximum risk; 0 = minimum risk]
No limits are applied on the deduction No limits are applied on the deduction of intra-group royalty payments.	100
Restricted nexus Deduction limitation/disallowance applies only to certain intra-group royalty payments for intellectual property regimes that are not compliant with OECD nexus approach.	75
Restricted tight Deduction limitation/disallowance applies to certain intra-group royalty payments, irrespective of whether the intellectual property regime complies with the OECD nexus approach.	50

No deduction of intra-group royalty payments is permitted	0

The scoring matrix is shown in Table 16.1, with full details of the assessment logic presented in Table 16.2 below.

The data for this indicator was collected primarily from country analyses and country surveys in the IBFD database.[1] In some instances, we have also consulted additional websites and reports of accountancy firms, academic journals and other local websites.

All underlying data can be accessed freely in the CTHI database.[2] To see the sources we are using for particular jurisdictions, please consult the assessment logic in Table 16.2 and search for the corresponding info ID (520) in the database report of the respective jurisdiction.

Why is this important?

Royalties are defined as payments for the right to a temporary use of intellectual property.[3] Similar to interest payments, royalties are normally considered deductible expenses for the taxpayer and are often abused by companies that engage in profit shifting to reduce their taxable profits. When a company that deducts royalties from its income is based in a high tax jurisdiction and its subsidiary that receives the royalties is in a low (or zero) tax jurisdiction, then the multinational company may end up paying very low or no tax. This is because the deduction of royalties lowers the tax base of the company in the high tax jurisdiction while very low or no tax is levied on the royalties' income in the low tax jurisdiction. Such cross-border royalty payments result in significant base erosion and profit shifting and have become increasingly prevalent given the large sums that multinational companies claim to derive from the exploitation of intellectual property.[4]

The risk that royalty deductions will erode the tax base is of primary concern in cases where a tax treaty limits the taxing rights on royalties in the payer's jurisdiction. The payer's country where royalties are deducted is more exposed to risks of base erosion and profit shifting than the payee's country. In addition, mismatches between the characterisation of a transaction involving royalty payments under the domestic law of two countries may enable taxpayers to structure hybrid transactions to exploit these mismatches.[5]

While the arm's length principle requires that royalties should be tax deductible only up to the arm's length price, in many cases this does not limit the scale of profit shifting. This is because no comparable transactions between unrelated parties exist for royalty payments given that these payments are usually related to intangible property which can be argued to be unique.[6]

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While the OECD does not recommend a specific limitation rule for the deduction of outbound intra-group royalty payments, some countries have already adopted measures to limit the deduction of intra-group royalty payments related to intellectual property regimes. For example, in Germany, a new Act against Harmful Tax Practices with regard to Licensing of Rights of 2 June 2017 has resulted in the introduction of a new provision, Sec. 4j of the Income Tax Act[7]. This aims to anticipate the application of the nexus approach.[8] The restricted nexus approach allows taxpayers to benefit from an intellectual property regime only if they can link the income that stems from the intellectual property to expenditures incurred. Expenditure could by on research and development, for example, by either the taxpayer itself or outsourcing it to a third party, i.e. qualified research and development activities.[9] The provision partially limits the deductibility of royalty payments at the level of the licensee in case the corresponding royalty income is subject to low taxation in a preferential regime that is not in line with the nexus approach.

Another approach to limit the deduction of intra-group royalty payments was introduced by South Africa. South Africa allows the deduction of intra-group royalty payments for intellectual property in accordance with the withholding tax rate. As such, one-third of intra-group royalty payments can be deducted when the withholding tax rate is at least 10% while half of the intra-group royalty payments can be deducted when the withholding tax is 15%.[10] This approach follows the same logic of disallowing these payments when they do not comply with the nexus approach.

Several countries have gone further and introduced rules that limit the deductibility of intra-group royalty payments regardless of whether the intellectual property regime complies with the nexus approach. For example, Ecuador limits intra-group royalty payment deductions up to 20% of the taxable base and up to 10% of the asset value in cases where the company is in a pre-operational stage provided there is a taxable income.[11] In Rwanda, a new provision, which came into force in April 2018, limits the deduction of royalties paid by local companies to their related non-resident companies to 2% of their turnover.[12]

The USA has also recently introduced an alternative way to limit intra-group royalty payments regardless of the nexus approach. The US Tax Cuts and Jobs Act of 2017 introduced the base erosion and anti-abuse tax in order to disallow excessive deductible payments (including interest, royalties and management fees), made by certain US firms to related non-US firms.[13] The base erosion and anti-abuse tax is a minimum tax that is imposed at a rate of 10%[14] on the taxpayer’s modified taxable income[15], calculated by adding back most categories of related-party deductible payments.[16] This tax applies to corporations with average annual gross receipts of US$500m for the preceding three-year period; and a base erosion percentage of at least 3% for the tax year, which in practice

means a threshold of base erosion payments as a percentage of total deductions.[17]

While these measures are indeed a significant step in the right direction, they are still open to abuse by multinational companies for tax avoidance purposes. One difficulty in implementing these measures is that tax authorities require significant resources to examine whether there is sufficient evidence for the contribution of the related parties to intellectual property development. The evidence will often be submitted only upon request of tax administrations. As such, due to capacity constraints of tax administrations, it is likely there will be many cases where the deduction of intra-group royalty payments will not be prohibited by the tax administration only because they did not manage to assess the specific tax file.

Lastly, the question of whether the deduction of a specific royalty payment is in line with the nexus approach (or similar approaches), and hence justified, is often not clear. Thus, the decision may be subject to the arguments of the multinational companies' lawyers and accountants or to the discretion of a tax inspector, both of which may lead to an unfair, unlevel playing field. For all the above reasons and the high risk of base erosion and profit shifting as a result of a deduction of royalties paid to non-resident group affiliates, the ideal approach would be to completely disallow the deduction of these payments rather than to limit the deduction.

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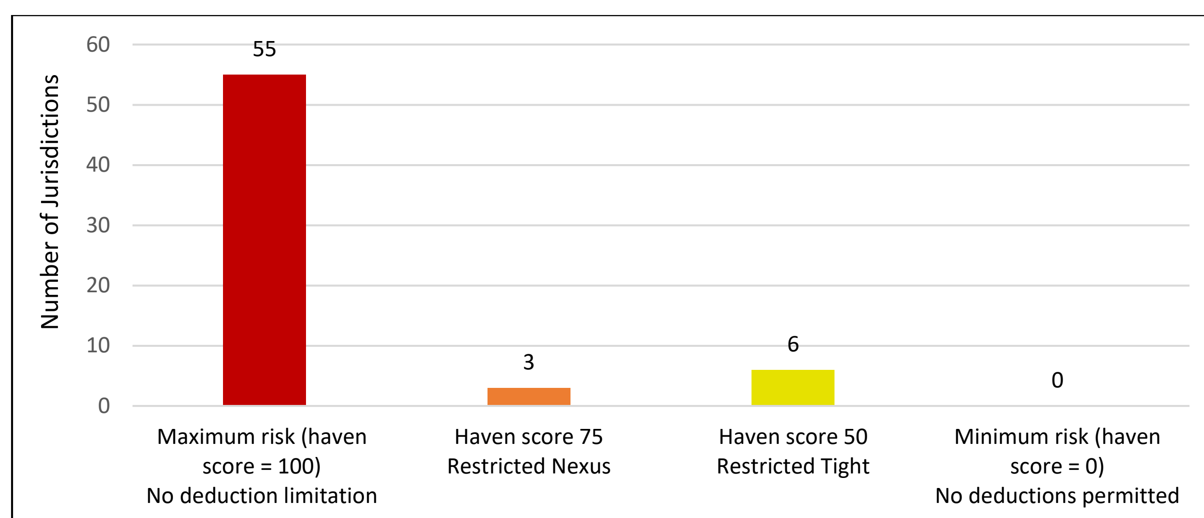
Results Overview

Graph 16.1. Deduction Limitation for Royalties Overview



Results Detail

Table 16.2. Deduction Limitation for Royalties – Haven Indicator Scores

Country Name	Score	ISO		Country Name	Score	ISO
Andorra	100	AD		Kenya	100	KE
Anguilla	100	AI		Latvia	100	LV
Aruba	50	AW		Lebanon	100	LB
Austria	50	AT		Liberia	100	LR
Bahamas	100	BS		Liechtenstein	100	LI
Belgium	100	BE		Lithuania	100	LT
Bermuda	100	BM		Luxembourg	100	LU
Botswana	100	BW		Macao	100	MO
British Virgin Islands	100	VG		Malta	100	MT
Bulgaria	100	BG		Mauritius	100	MU
Cayman Islands	100	KY		Monaco	100	MC
China	100	CN		Montserrat	100	MS
Croatia	100	HR		Netherlands	100	NL
Curacao	100	CW		Panama	100	PA
Cyprus	100	CY		Poland	75	PL
Czech Republic	100	CZ		Portugal (Madeira)	100	PT
Denmark	100	DK		Romania	100	RO
Estonia	100	EE		San Marino	100	SM
Finland	100	FI		Seychelles	50	SC
France	100	FR		Singapore	100	SG
Gambia	100	GM		Slovakia	100	SK
Germany	75	DE		Slovenia	100	SI
Ghana	100	GH		South Africa	75	ZA

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Country Name	Score	ISO		Country Name	Score	ISO
Gibraltar	100	GI		Spain	100	ES
Greece	50	GR		Sweden	100	SE
Guernsey	100	GG		Switzerland	100	CH
Hong Kong	100	HK		Taiwan	100	TW
Hungary	100	HU		Tanzania	50	TZ
Ireland	100	IE		Turks and Caicos Islands	100	TC
Isle of Man	100	IM		United Arab Emirates (Dubai)	100	AE
Italy	100	IT		United Kingdom	100	GB
Jersey	100	JE		USA	50	US

Maximum Risk (Haven Score 100)	Haven Score 76 - 100	Haven Score 51 - 75	Haven Score 26 - 50	Haven Score 1 - 25	Minimum Risk (Haven Score 0)

Table 16.3: Assessment Logic

Info_ID	Text_Info_ID	Answers (Codes applicable for all questions: -2: Unknown; -3: Not Applicable)	Valuation Haven Score
520	Outbound intra-group royalty deduction limitation: Does the jurisdiction restrict or disallow deducting from the corporate income tax base royalties paid to non-resident group affiliates?	0: No deduction limitation for intra-group royalty payments; 1: YES, RESTRICTED NEXUS: Deduction limitation/disallowance applies only with respect to certain intra-group royalty payments to patent boxes that are not complying with OECD NEXUS rules; 2: YES, RESTRICTED TIGHT: Deduction limitation/disallowance applies with respect to certain intra-group royalty payments irrespective of countries complying with OECD NEXUS rules; 3: YES, DISALLOWED: No deductions of any intra-group royalty payments are permitted.	0: 100 1: 75 2: 50 3: 0

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[1] IBFD, *Tax Research Platform: Country Surveys, Country Analyses, Country Key Features*, Accessed 2018-2019, 2018 <https://research.ibfd.org/> [accessed 9 May 2019].

[2] http://www.corporatetaxhavenindex.org/database/menu.xml

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[3] Hugh J Ault and Brian J Arnold, 'Protecting the Tax Base of Developing Countries: An Overview', *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries, New York*, 2015, 44.

[4] HM Revenue & Customs, 'Deduction of Income Tax at Source: Royalties', 2016, 4 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/532314/M1070_revised_TN_final.pdf> [accessed 14 May 2019].

[5] Ault and Arnold, 'Protecting the Tax Base of Developing Countries: An Overview', 44.

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[13] Susan C. Morse, 'International Cooperation and the 2017 Tax Act', *The Yale Law Journal Forum*, 2018 <https://www.yalelawjournal.org/pdf/Morse_ac1hex9k.pdf> [accessed 13 May 2019].

[14] Note that the minimum tax will be increased to 12.5% as of 2026 and was temporarily set to 5% for 2018.

[15] Baker Mckenzie, 'Tax News and Developments- North America Tax Practice Group', *Volume XVIII, Issue 1*, 2018, 17–18 <https://www.bakermckenzie.com/-/media/files/insight/publications/2018/02/nl_na_taxnewsdevelopmentv2_feb2018.pdf?la=en> [accessed 25 November 2018].

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