The Taxation of Non-Resident Rental Income from Movable Property in the Tax Treaties Concluded by Brazil

In this article, the author considers the implication of the taxation of rental income and royalties that are derived by non-residents in relation to the OECD Model, the UN Model and the tax treaties that Brazil has concluded.

1. Introduction

One of the great misconceptions in the study of international tax law in Brazil, which is reflected in the literature, is that, with regard to administrative decisions, i.e. private rulings and the decisions of the Conselho Administrativo de Recursos Fiscais (Administrative Council of Tax Appeals, CARF) and in judicial decisions, the tax treaties concluded by Brazil are primarily based on the OECD Model. A deeper analysis of the tax treaties that Brazil has concluded, however, indicates a clear preponderance of the tax standards adopted in the UN Model. Although the UN Model has fallen short of the expectations of developing countries, it ensures greater tax powers for developing countries, such as Brazil, that are typically net importers of capital, which are present in the distributive rules that determine which of the contracting states can tax given types of cross-border income.

The purpose of this article is to demonstrate this influence when Brazil’s taxation of non-resident income in respect of rental income and royalties is examined, specifically with regard to rental income relating to movable property, such as industrial, commercial or scientific equipment (see section 3). However, before focusing on Brazilian tax practice, the article compares certain basic similarities and differences between the OECD Model and the UN Model regarding income from rentals (see section 2.).

2. Income from Rental in the OECD Model and the UN Model

Article 6 of both the OECD Model and the UN Model, which deals with the rental of immovable property or real estate income, is essentially the same. Consequently, such rental income can be excluded from further consideration in this article.

Article 12 of both the OECD Model and the UN Model, which covers royalty payments made to non-residents, does, however, exhibit some differences. In this context, it is well known that article 12 of the OECD Model endorses exclusive taxation by the beneficiary’s residence state in respect of royalty payments. On the other hand, the article 12 of the UN Model provides for the possibility of the taxing of “royalties” by the source state.

Although the OECD Model is predominant in international use, Pistone (2012) states that the same does not apply to article 12. In his words:

Bilateral treaties around the world undoubtedly show that the influence of the OECD Model’s royalties clause is more of an exception than it is the rule. Oppositely, the UN royalty clause is the main point of reference for bilateral treaties’ royalty clauses, which are usually accompanied by additional specific arrangements.

Another relevant difference between the OECD Model and the UN Model concerns the taxation of payments relating to equipment rental. There is no specific provision, either in the OECD Model or in the UN Model, dedicated to exclusively taxing rental payments in respect of movable equipment. Given this, tax treaties adopt different approaches to dealing with this issue.

For instance, in the OECD Model (2104), such income now falls within the scope of article 7 (Corporate profits). According to the Commentary on Article 12 of the OECD Model:

Whilst the definition of the term “royalties” in the 1963 Draft Convention and the 1977 Model Convention included payments “for the use of, or the right to use, industrial, commercial or scientific equipment”, the reference to these payments was subsequently deleted from the definition. Given the nature of...
income from the leasing of industrial, commercial or scientific equipment, including the leasing of containers, the Committee on Fiscal Affairs decided to exclude income from such leasing from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits, as defined in Articles 5 and 7.

The UN Model also does not contain any arrangement to specifically address the taxation of income derived from equipment rental. However, in contrast to the OECD Model, the UN Model contains a rule in article 12(3), which includes within the concept of “royalty” income, payments derived from the use of, or the right to use, industrial, commercial or scientific equipment.

In summary:

1. In both the OECD Model and the UN Model, income from rental of immovable property is taxed under the provisions of article 6 (Real estate income).
2. In the OECD Model, income derived from rental of movable property is included within the scope of article 7 (Corporate profits).
3. In the UN Model, income derived from rental of industrial, commercial or scientific equipment is included within the scope of article 12 (Royalties). Rental in respect of other movable property that cannot be classified as industrial, commercial or scientific equipment should be taxed under article 7 of the UN Model.

As the various taxation approaches differ for moveable property depending on whether it is classified as industrial, commercial or scientific equipment, it is worth examining how such equipment is defined (see section 3).

### 3. Taxation of Rental Income Relating to Movable Property

#### 3.1. Industrial, commercial or scientific equipment

Up to OECD Model (1992), the relevant wording did not contain any definition of industrial, commercial or scientific equipment. Similarly, before the Commentary on Article 12 of the OECD Model (1992), no details were provided regarding these concepts either.

The situation does not differ that much when the issue is examined from the perspective of the UN Model. While maintaining that payment for the use of, or the right to use, industrial, commercial or scientific equipment falls within the scope of article 12, the UN Model does not provide any definition in respect of such equipment. Similarly, the Commentary on Article 12 of the UN Model is silent on the matter.

Consequently, in order to start to define this concept more specifically, this article considers the word “equipment”.

In this context, when analysing this question with regard to previous OECD work, Holmes (2002) commented that the word “equipment” refers to the property that is instrumental to some activity, in this specific case, to industrial, commercial or scientific activity. As a result, “industrial equipment” is movable property instrumental in respect of industrial activity, “commercial equipment” is movable property instrumental with regard to commercial activity and “scientific equipment” is movable property instrumental in respect of scientific activity.

This naturally raises a second question, i.e. how are industrial, commercial or scientific activities defined? It appears to be easiest to begin with the last in this list. “Scientific activities” are all those activities relating to research in any branch of knowledge. The concept of “commercial activities” is more complex given the changes resulting from the “intangibleization” of the (digital) economy. Nevertheless, “commercial activities” are those activities relating to the purchase and sale of goods, tangible or intangible. Finally, “industrial activities” are those activities that modify “the nature, operation, finishing, presentation, or purpose of the product, or its enhancement for consumption”.

Based on these definitions, it is possible to establish the premise that the concept of “industrial, commercial, or scientific equipment” does not include all possible situations in which equipment rental is paid to a non-resident. Consider, for example, equipment that is rented for use in the administrative functions of a company, equipment employed in service activities or even equipment rented to be sub-leased to another party.

Given these general guidelines as to what constitutes “industrial, commercial, or scientific equipment”, this article now considers the application of the OECD Model and the UN Model to the tax treaties concluded by Brazil regarding the payments for the rental of this type of equipment. The article also considers the implication of this in respect of the rental of other equipment that does not fall within this category (see sections 3.2 and 3.3).

#### 3.2. The taxation of rental payments in Brazil’s tax treaties

In the tax treaties that Brazil has concluded, payments for rental of immovable properties made to residents of treaty states are taxable in Brazil, as is, typically, provided for in article 6 (Real estate income). This is consistent with both the OECD Model and the UN Model.

With regard to moveable equipment, the tax treaties concluded by Brazil generally follow the UN Model. In fact, out of the 32 tax treaties that Brazil had concluded at the time of writing this article, only the Brazil-Finland...
Income Tax Treaty (1996) does not have a provision that includes income from the use of, or the right to use, industrial, commercial or scientific equipment in the definition of "royalties". However, the tax treatment adopted regarding other types of rental of movable property remains to be resolved.

In this context, it should be noted that Brazil has made a reservation to article 12 of the OECD Model, to the effect that Brazil will continue to:

include in the definition of royalties the income derived from the rental of industrial, commercial, or scientific equipment and containers, as set out in paragraph (2) of the Model Convention on Double Taxation of 1977.

In this respect, it is relevant to note that some of the tax treaties concluded by Brazil establish a threshold rate, which is typically 10% for taxing royalties, whereas, in general, the source taxation of royalties is capped at a maximum of 15%. This is the case in the tax treaties that Brazil has concluded with Israel, Korea (Rep.), Mexico, South Africa, Spain and Turkey. In these cases, the taxation on rental payments should follow the reduced rate provided for in the tax treaties with regard to the payment of royalties. In addition, as the payments in question are qualified as royalties in the tax treaties that Brazil has concluded, these payments fall under the tax sparing rules in the tax treaties that include such rules so that the credit appropriate in the residence state of the lessor may be higher than the amount of tax withheld in Brazil.

### 3.3. Equipment rental and the Brazil-Finland Income Tax Treaty (1996)

The Brazil-Finland Income Tax Treaty (1996) requires separate analysis. In contrast to the other 31 tax treaties that Brazil had concluded at the time of writing this article, article 12 of the Brazil-Finland Income Tax Treaty (1996) does not include the payments for the use of, and the right to use, industrial, commercial or scientific equipment in its definition of royalties.

In the absence of such a rule, it must be concluded that these payments should be subject to article 7 of the Brazil-Finland Income Tax Treaty (1996). Consequently, unless the rental activity is carried out through a permanent establishment (PE) in Brazil, such income is only taxable in Finland.

### 3.4. Effect of a PE on the taxing of equipment rental income

The rationale behind article 7 of both the OECD Model and the UN Model is the same. This is that the result of activities carried on directly by the resident of a contracting state in the territory of other contracting state, i.e. without the intermediation of a PE, is only taxed in the residence state.

It is possible to refer to article 7 of both the OECD Model and UN Model as a rule for "other" income derived from business activities. In other words, there are articles in the OECD Model and the UN Model that deal with the taxation of specific income. And the income from business activities that are not dealt with in any of these articles falls within the rule provided for in the article that relates to "business profits".

As a result, article 7 of the OECD Model and the UN Model cannot be mistaken for article 21, which deals with "other income". In fact, article 7 of the OECD Model and the UN Model is a rule that relates to the taxation of "other business income", whereas article 21 is a rule that is concerned with the taxation of "other income", which is not derived from business activities.

It should also be noted that the understanding adopted by the Procuradoria Geral da Fazenda Nacional (Office of the Federal Tax General Attorney, PGFN) in Opinion No. 2.363/13, regarding the taxation of payments for the contracting of technical services, corroborates this interpretation. This was also reflected in Ato Declaratório Interpretativo (Interpretative Declaratory Law, ADI) No. 5/14 regarding the same matter.

By way of these two administrative acts, it was acknowledged that the article which deals with the taxation of corporate profits, article 7, applies to all business results earned directly by a non-resident without the intervention of a PE located in Brazil. This position is not only restricted to payments for technical services without transfer of technology, but also applies to any business income that has no specific treatment provided for in any other treaty article.

Similarly, it can be argued that the decisions issued by the Superior Tribunal de Justiça (Superior Court of Justice, STJ) in Case 1.161.467 (2012) (the "COPESUL" case) and in Case 1.272.897 (2015) (the "Iberdrola" case), which also addressed the issue of taxation on the import of services and its inclusion in article 7 of the tax treaties that Brazil has concluded, where a non-resident does not have a PE in Brazil, apply in such circumstances.

Taking these comments into consideration, one question remains to be analysed, i.e. which situations should recognize the existence of a PE of the lessor in Brazil?

As is well known, Brazilian law does not contain a definition of the concept of a "permanent establishment". There

15. It should be noted that, in some cases, the tax rate is reduced to 10% due the application of a most-favoured nation (MFN) clause.
20. BR: STJ, 17 May 2012, Case RE 1.161.467 – RS (the "COPESUL" case), Tax Treaty Case Law IBFD.
are, however, provisions that relate to situations in which the income earned by a non-resident is taxable in Brazil. The only domestic law that contains such an expression is Lei (Law) 12,350/10, which established tax measures relating the operations of the 2013 FIFA Confederations Cup and the 2014 World Cup.

In this way, the concept of a “permanent establishment” is essentially a treaty concept that is to be found in article 5(1) of both the OECD Model and the UN Model and, in the same way, in articles 5 (1) of the tax treaties concluded by Brazil. The starting point of the definition of “permanent establishment” is that it is a “fixed location of business through which an enterprise is wholly or partly carried out”.

In this respect, as Xavier (2015) notes:

Therefore, characteristics of the permanent establishment are the existence of a physical facility, with permanent status, that is at the disposal of the company, which must carry out its activity in this facility or through this facility.

With regard to rental activities, a non-resident has a “permanent establishment” in Brazil only if the non-resident has a fixed facility in the territory of Brazil through which they carry out their business activity, in this case the rental of equipment. Consequently, the fact that the rented equipment is temporarily located in Brazil does not constitute a “permanent establishment”. This interpretation is supported by the Commentaries on Article 5 of the OECD Model and the UN Model. Both indicate that a “permanent establishment”, with regard rental activities, arises when these activities are carried out through a fixed business unit in the other contracting state.

3.5. Rental payments for movable equipment other than industrial, commercial or scientific equipment

Not all equipment that is rented falls within the definition of industrial, commercial or scientific equipment. Consequently, such equipment does not fall within the definition of “royalties” provided for in article 12 of the tax treaties concluded by Brazil.

In such circumstances, the solution is the same as described in section 3.3. In other words, article 7 of the relevant tax treaties applies so that, in the absence of a PE, such income is only taxable in the residence state.

4. Conclusions

Given the foregoing, it is possible to arrive at the following four conclusions:

(1) In the tax treaties that Brazil has concluded, rental payments for the use of, or the right to use, industrial, commercial or scientific equipment are taxed under article 12, which deals with the taxation of royalties. Where this provision applies, the taxation of rental payments follows the rate provided for in the tax treaties in question in respect of the payment of royalties, typically 15%.

(2) With regard to the Brazil-Finland Income Tax Treaty (1996), which has no provision in respect of the rental of movable property, rental payments for such items should be taxed under the provisions of article 7.

(3) The payments made in respect of the rental of movable property other than industrial, commercial or scientific equipment should not be taxed as royalties. Such payments should, instead, be taxed under article 7 of the relevant tax treaty.

(4) In the absence of a PE, income from the equipment rental referred to in (3) should be taxed exclusively by the residence state.