International taxation of cross-border leasing income
Mehta, A.S.

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CHAPTER 6

TAX TREATY IMPLICATIONS OF LEASE INCOME CHARACTERIZATION

6.1. Introduction

Characterization of leasing income constitutes the starting point for analysing the source country tax implications under an applicable tax treaty, as the applicability of particular distributive rules of the treaty would depend upon the characterization of the income as royalty, interest income or business profits. This chapter examines the characterization issues in the case of finance leases and operating leases.

6.2. Tax treaty definition of "royalties" vis-à-vis lease rentals for ICS equipment

6.2.1. The OECD position

In the OECD 1963 Draft as well as the OECD 1977 Model Convention (MC), the definition of "royalties" included consideration for use of or the right to use industrial, commercial or scientific ("ICS") equipment.

The OECD 1977 MC Commentary distinguished between the royalties for use of the ICS equipment on one hand, and the consideration for the sale of the ICS equipment on the other hand. As per the Commentary, the consideration for the sale of the ICS equipment did not amount to royalties, and accordingly, its tax treatment was governed by other treaty distributive rules. However, as per the Commentary, the consideration for leasing amounted to royalties even where the lessee had an option to acquire the leased equipment. This position was based on the premise that the sole, or at least the principal, purpose of a lease contract is to hire the equipment.

In its 1983 Leasing Report, however, the Committee of Fiscal Affairs deviated from its original thought process. The Committee noted in the Re-

301. Art. 7 (Business profits), Art. 13 (Capital gains), the then Art. 14 (Independent personal services) or Art. 21 (Other income).
302. See OECD Report: The Taxation of Income derived from the Leasing of Industrial, Commercial or Scientific Equipment.
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A report that inclusion of income from the leasing of ICS equipment in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD MC and may even create difficulties in negotiation of bilateral tax treaties. Accordingly, the Committee recommended the deletion of the words “or for the use of, or the right to use, industrial, commercial or scientific equipment,” from the MC definition of “royalties”. Consequently, in the 1992 revision, the consideration for the use of or the right to use ICS equipment was deleted from the definition of “royalties”.

6.2.2. Definition of “royalties” in tax treaties

Though the OECD MC reserves the taxing right in respect of “royalties” in favour of the residence state, many OECD Member countries have expressed reservation against taxation of royalties exclusively by the residence state. Also, though the OECD 1992 MC amended the definition of “royalties” to exclude from their scope the consideration for the use of or the right to use ICS equipment, the majority of tax treaties entered into by the OECD Member countries still include in the definition of royalties “consideration for use of or right to use ICS equipment”. For example, out of a sample of 64 tax treaties examined for the purpose of the present research, in which at least one of the contracting state is member of the OECD, only 16 tax treaties reserve the right to tax royalties in favour of the residence state, and 44 tax treaties include in the definition of “royalties” consideration for use of or right to use ICS equipment. Only 19 treaties exclude from the definition of “royalties” consideration for the use of or the right to use ICS equipment. One tax treaty does not contain a royalties article.

304. For instance, the OECD Leasing Report (paragraph 16) refers to such reservation by 12 OECD Member Countries.
305. See Appendix 3 for the list of tax treaties examined.
306. Both contracting states in the case of many tax treaties.
307. Tax treaty between the Netherlands and Switzerland.
6.3. The characterization issue: effect on treaty distributive rules

6.3.1. Complexity of the issue

One of the most crucial issues to be considered is whether and how the characterization of income from a lease transaction may influence applicability (or non-applicability) of the tax treaty distributive rules, particularly the articles concerning royalties (Art. 12), interest (Art. 11) and business profits (Art. 7).

As regards lease transactions purely in the nature of operating lease, the issue is relatively narrow and fairly simple: whether rentals for such leases amount to royalties under a tax treaty. Rentals for operating leases of movable assets constituting ICS equipment would be governed by the “royalties” article, where the relevant tax treaty includes in the royalty definition the consideration for the use of or the right to use the ICS equipment. In the other cases, the operating lease rentals would, normally, be governed by the “Business profits” article (Art. 7). Also, if the lease rentals are attributable to the lessor’s PE, if any, in the source state, such lease rentals would be governed by the “Business profits” article irrespective of whether the treaty definition of royalties includes the consideration for the use of or the right to use ICS equipment.

Unlike the operating leasing, finance lease transactions give rise to complex characterization issues i.e. whether such income should be regarded as royalty, interest or business income. The conclusion on this issue, in turn, depends on the question as to whether the finance lease transaction should be viewed as a true lease, a transaction involving conditional/credit sale of the leased asset, or a loan transaction. This issue is dealt with at 6.4.

6.3.2. Characterization: from which state’s perspective?

International tax literature reveals divergent approaches as regards the characterization issue (i.e. “qualification problem”).

Primarily, the qualification problem arises in the case of the treaty terms (for instance, “business profit”) that are not defined in the treaty itself. In such cases, “autonomous interpretation” (i.e. both the contracting states interpreting a treaty term consistently in the treaty context) seems the most
preferred approach. However, in the situations that are susceptible to divergent interpretation by the two contracting states, it may be difficult to follow the autonomous approach, and one would find court decisions where the treaty terms were interpreted in accordance with the law of the source country. However, it is more likely that where the autonomous-interpretation approach is not adopted, the contracting states would interpret the treaty terms in accordance with their own laws. Divergent treaty interpretations may lead to double taxation or double non-taxation.

It is important to note that qualification conflicts may also arise in the case of the treaty terms that are defined in the treaty. This aspect seems of crucial relevance in respect of international taxation of cross-border leasing income. For instance, the “royalties” definition in a tax treaty may include the consideration for the use of or the right to use industrial, commercial or scientific equipment. As stated above, the two contracting states may interpret the term “use” from their own perspectives, i.e. in accordance with their respective domestic tax laws. As a result, as discussed at 6.4., in the case of a finance lease involving ICS equipment, the two contracting states may have divergent views on whether the lease rental is for the “use” of the ICS equipment, or whether it is for “acquisition” of the ICS equipment. As application of a particular distributive rule under a tax treaty depends on a particular characterization of the transaction, the characterization issue assumes great significance.

308. See Vogel, K., Klaus Vogel on Double Taxation Conventions, 3rd edition, p. 55. The learned author also cites decisions of courts in Australia, Germany, France and the Netherlands, where an autonomous interpretation approach was adopted.

309. For instance, a 1993 decision by FG Hamburg, 41 EFG 10 in respect of the France-Germany tax treaty.

310. For instance, a 1972 decision by a German Court, BStBl. II 88 in respect of the Austria-Germany tax treaty.

311. See, for instance, Pierre Boulez v. Commissioner of Internal Revenue, (1984) 83 TC 508 (US Tax Court), in which case the term “royalties”, though defined in the treaty, was interpreted differently by Germany and the United States.

312. It is submitted that as regards lease rental payments in respect of ICS equipment, transaction characterization (as lease or conditional sale) by the source state should be relevant for ascertaining the source state’s power to tax lease rentals under an applicable tax treaty.
6.4. Characterization of finance lease income

6.4.1. Finance lease rentals vis-à-vis “royalties” in treaty context

As stated at 6.2.2., though the OECD Model Convention reserves the right for taxing royalties exclusively in favour of the residence countries, many tax treaties entered into by the OECD Member countries (whether between themselves, or with countries that are not members of the OECD) provide for source country taxation by way of withholding tax on royalties. 313 Also, the UN Model Convention (and tax treaties based on that Convention) confers the right on the source countries to tax royalties. The majority of the tax treaties conferring rights on the source country for taxing royalties include, in the definition of “royalties”, consideration for the use of or the right to use ICS equipment. 314 Under such tax treaties, one 315 of the key issues influencing the right of the source country for taxing lease rentals is: can the finance lease rental be regarded as the consideration for the use of or the right to use ICS equipment? Or, alternatively, does the finance lease rental amount to the consideration for acquisition of ICS equipment?

The answers to the above questions vary not only from one jurisdiction to another, but also from one particular lease transaction to another within the same jurisdiction, depending on the relevant terms of the transactions. As discussed in detail in chapter 2, it can be generally stated that in the United States, Germany and the Netherlands, recognition of a transaction as lease depends upon the economic substance of the transaction. On the other hand, in the United Kingdom, a transaction is recognized as lease on the basis of

313. For instance the following tax treaties provide for taxation of royalties by the source countries (by way of withholding tax): United Kingdom–Japan, United States–Japan, Germany–Japan, Germany–Netherlands, Japan–Netherlands, United Kingdom–India, United Kingdom–China, United States–China, Netherlands–India, Netherlands–China, Germany–India, Germany–China, Japan–India and Japan–China.

314. Examples of such tax treaties include: United Kingdom–Japan, Germany–Japan, Netherlands–Japan, United Kingdom–India, Germany–India, Netherlands–India, United Kingdom–China, Germany–China, Netherlands–China, United Kingdom–Malaysia, Germany–Malaysia, Netherlands–Malaysia, United Kingdom–Australia, Germany–Australia, Netherlands–Australia, United Kingdom–Canada, Germany–Canada, Netherlands–Canada, United Kingdom–Korea, Germany–Korea, Netherlands–Korea, United Kingdom–Philippines, Germany–Philippines, Netherlands–Philippines, Netherlands–Israel, Germany–Brazil, Netherlands–Brazil, United Kingdom–Mexico, Germany–Mexico, Netherlands–Mexico, United Kingdom–Singapore, Germany–Vietnam, United Kingdom–Turkey, Germany–Turkey, Netherlands–Turkey and Germany–Venezuela.

315. The interest article being the other important aspect for determining the source country taxing rights in the case of a finance lease, as discussed at 6.4.2.
legal form of the contract. It is submitted that where a transaction is recognized by the source state as lease, lease rentals paid by the lessee to the lessor could be viewed as payments for the use of or the right to use the leased asset. Accordingly, in such cases, if the definition of “royalties” in an applicable tax treaty includes consideration for the use of or the right to use ICS equipment, then lease rentals in respect of the ICS equipment would amount to royalties.

On the other hand, it is also submitted that in the case of a lease contract that is regarded by the source state as conditional sale instead of a lease due to its underlying economic substance, it would be inconsistent to regard the “lease rentals” paid by the lessee to the lessor as payments for the use of or the right to use the asset. Accordingly, in such cases, payments by the lessee to the lessor in respect of lease of ICS equipment must not be regarded as royalties under an applicable tax treaty, even if the definition of royalties in the tax treaty includes consideration for the use of or the right to use ICS equipment.

6.4.2. Finance lease rentals and “interest” in treaty context

6.4.2.1. The characterization issue

The next crucial issue is, if lease rental income from the finance lease is not regarded as “royalties” under an applicable tax treaty, whether the same could be regarded as “interest” income for tax treaty purposes.

316. Since the purpose behind interpretation of the “royalties” definition in a tax treaty would be to ascertain the right of the source state to impose withholding tax, it is submitted that transaction characterization by the source state (rather than the residence state) is determinative. It is also submitted that, as stated at 6.3.2., in the case of lease transactions that are susceptible to divergent characterization by various jurisdictions, an autonomous interpretation of the condition “use or right to use ICS equipment” seems unviable.

317. Since a payment by purchaser of an asset to the seller represents a payment of purchase consideration and not rent.
6.4.2.2. OECD position

As per Art. 11 of the OECD MC, “interest” is defined to mean income from debt-claims\textsuperscript{318} of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.\textsuperscript{319}

As per the OECD MC Commentary, “interest” is generally taken to mean remuneration for money lent.\textsuperscript{320} It is relevant to note that as per the OECD MC Commentary, the definition of interest does not apply to payments under certain kinds of non-traditional financial instruments where there is no underlying debt (for instance, interest rate swaps).\textsuperscript{321} The definition, however, would apply to the extent that a loan exists under the “substance over form” principle.

It is also relevant to note that one\textsuperscript{322} of the OECD Member countries has entered a reservation to consider the income derived from financial leasing transactions as interest income.

6.4.2.3. Definition of interest in tax treaties

Out of the 64 tax treaties analysed for the purposes of the research, most (90\%) of the tax treaties define interest as:

(a) income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures (\textit{similar to the OECD definition});\textsuperscript{323} or

\textsuperscript{318} As per the OECD MC 2003 Commentary, the term “debt-claims of every kind” embraces cash deposits and securities in the form of money, as well as government securities, and bonds and debentures.
\textsuperscript{319} Art. 11(3) of the OECD MC.
\textsuperscript{320} See OECD MC 2003 Commentary on Art. 11, paragraph 1 (preliminary remarks).
\textsuperscript{321} See OECD MC 2003, Commentary on Art. 11(3), paragraph 21.1.
\textsuperscript{322} Mexico
\textsuperscript{323} 27 out of the 64 tax treaties define interest in this manner.
(b) in addition to the income stated in (a) above, income that is assimilated to income from money lent by the taxation law of the source state. 324

The characterization issue, i.e. whether the finance lease rental income could be regarded as "interest" income under tax treaties is analysed, in the context of the above-mentioned two versions of the definition of the term "interest", in paragraphs 6.4.2.4. and 6.4.2.5., respectively.

6.4.2.4. Scope of definition of interest (version a): income from debt claims (similar to OECD definition) 325

As a general definition, as stated at 6.4.2.2., the term "interest" is understood to mean remuneration on money lent. This general meaning is also reflected in the treaty definition (version a), as it refers to income from debt-claims of every kind, including income from government securities, bonds and debentures. Thus, the term "interest" presupposes existence of a "loan relationship" between the payer and the recipient of the income. This is further confirmed by reference to "loan" transactions at various places in the OECD Commentary, 326 as well as a categorical statement, that the definition of interest does not apply to payments under non-traditional financial transactions (e.g. interest rate swaps) where there is no underlying debt, unless a loan exists under the "substance over form" principle. 327 Indeed, the existence of the other definition (version b) of "interest" in tax treaties,

324. 33 out of the 64 tax treaties define interest in this manner. It is interesting to note that under the tax treaty between Norway and the United Kingdom, the term "interest" for UK tax purposes includes any item which under the law of the United Kingdom is treated as interest and for Norwegian tax purposes includes any item which under the law of Norway is treated as interest (but excludes any item which is treated as a dividend under the provisions of Art. 10 of the tax treaty).

325. As this version of the definition of the term "interest" is similar to the definition of the term in the OECD MC, the OECD Commentary, besides other aspects, is taken into account for the purposes of the analysis.

326. For instance, the following paragraphs in the OECD 2003 MC Commentary on Art. 11(3) refer to "loan arrangements":

- paragraph 18: "...debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor’s profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest";
- paragraph 19: "...interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company ...";
- paragraph 20: "...Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber ...".

which is wider than this version of the definition, also leads to the conclusion that the term “interest” presupposes existence of a loan relationship. 328

Review of international tax literature gives an impression that, in the tax treaty context, this issue has not yet been examined as such by the international tax scholars or the courts. For the reasons stated below, it is submitted that rental payments under a lease that is regarded as “finance lease” under the domestic tax law of a contracting state does not amount to “interest” under this version of the treaty definition of the term:

- In the case of lease transactions regarded as “finance lease” for the purposes of domestic tax law in many jurisdictions, though the lessor is the legal owner of the leased asset, the lessee is regarded as the economic owner of the asset. As a consequence, the transaction is regarded as a conditional sale, rather than loan, involving transfer of economic ownership from the lessor to the lessee. 329

- Even as regards the economic substance, the lessor in the case of a finance lease enjoys attributes of a vendor in a conditional sale transaction, rather than a lender in a financing transaction. For example, in the case of a financing transaction, unless the transaction is a secured loan, the lender does not have any right on the specific asset of the debtor in case of a default in discharge of debt obligations by the debtor. However, in the case of a finance lease, as in the case of a hire-purchase or a conditional sale transaction, the lessor would be entitled to repossess the leased asset besides pursuing other remedies.

- A loan relationship (including debentures, bonds or other securities) essentially involves a flow of money from the lender to the borrower, but it does not involve transfer of economic ownership (in an asset) from the lender to the borrower. The payment of interest by the borrower to the lender represents the compensation for the use of the money lent by the lender. On the other hand, a finance lease does not involve a flow of money from the lessor to the creditor, but involves transfer of

328. The difference between the two versions of the definition is: under version (a), interest means income from debt-claims including debentures, bonds and other securities (i.e. loan relationship) as interpreted autonomously, whereas under version (b), in addition to the said autonomous interpretation, the meaning of the term “interest” also includes income assimilated as money lent under the domestic tax law of the source country. Thus, in either case, interest means income from money lent.
329. For example, in Canada, Germany, Japan, and the United States, a finance lease transaction is considered as a sale-purchase transaction, rather than a loan transaction.
possession and economic ownership of a leased asset from the lessor to the lessee. The payment of lease rentals by the lessee to the lessor represents compensation for the transfer of possession and economic ownership of the leased asset.

- Unlike in a loan transaction, where the interest represents the gross consideration, in a finance lease regarded as conditional sale, the difference between the aggregate lease rentals and the list sale price of the asset represents recovery of the "incremental cost of capital" to the lessor on account of the deferred payment of the sale consideration, although, like in case of any other element of cost, this cost is recovered with a profit margin.

Further, the fact that one of the OECD Member countries entered a reservation to treat income from finance leasing transactions as interest income may indicate that the OECD does not consider the finance lease rental income as interest income.

Accordingly, under this version of the definition of the term "interest", the finance lease rental income should not be regarded as interest.

6.4.2.5. Scope of definition of interest (version b): income assimilated to the income from the money lent

As under this version, the definition of the term "interest" includes the income assimilated to the income from money lent under the domestic tax law of the source state. It is examined whether the rentals from finance lease may amount to interest under the domestic tax laws of the United States, the United Kingdom, Germany and the Netherlands.

6.4.2.5.1. Position in the United States

(a) Commentary to the 1996 US Model Convention

The Commentary to the 1996 US Model Convention states that, for the purposes of tax treaties, the United States would treat as "interest" the interest portion of the periodic payments made under a finance lease or similar contractual arrangement that in substance is a borrowing by the lessee to finance the acquisition of the (leased) property. However, as stated at 2.2.3.2., under the relevant case law in the United States, in most cases
where a “lease transaction” does not amount to lease in substance, it is regarded as a “conditional sale”. As a “conditional sale” is distinct from “borrowing”, and since Sec. 483 of the US Internal Revenue Code (discussed in (b) below) may apply to conditional sales, further examination of this aspect does not seem relevant.

(b) Sec. 483 of the US Internal Revenue Code

Sec. 483 of the US Internal Revenue Code provides that, in the case of sale of property on deferred payment basis (where a part or the whole of the consideration is due more than one year after the date of the sale), the difference between (i) the sale price payable during a period after six months from the date of sale and (ii) the aggregate of the present values of such sale price and the present values of any interest due under the contract, would be treated as interest. For this purpose, the present values are calculated using the applicable federal rate.331

Accordingly, under version (b) of the tax treaty definition of “interest”, in cases where a lease may be recharacterized as a conditional sale transaction in the light of the relevant case law discussed in chapter 2, a part of the lease rentals payable by a US lessee may be regarded as interest for the purposes of an applicable tax treaty containing the version (b) definition of “interest”.

6.4.2.5.2. Position in the United Kingdom

Tax legislation in the United Kingdom does not define “interest”, but the two court decisions in *Euro Hotel (Belgravia) Ltd. and Chevron Petroleum (UK) Ltd. & others v. B.P. Petroleum Development Ltd.* are relevant for the purposes of the present research.332

(i) Euro Hotel (Belgravia) Ltd.333

The relevant facts in this case were as follows. A company had obtained a long lease of land for developing a building on the said land. The company assigned interest in the said lease of land to a bank for consideration, while retaining the obligation to complete the development of the building. Under

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330. In the case of a sale price payable in instalments, the aggregate of such instalments.
331. Determined under Sec. 1274(d) of the IRC.
332. For a discussion on the said two decisions, also see Whiteman, Peter, *Whiteman on Income Tax* (3rd Edition), paragraphs 18-03 and 18-04.
333. (1975) 51 TC 293 (High Court of Justice, Chancery Division).
the agreement between the company and the bank, the bank agreed to make certain payments to the company for financing the development, and to grant lease of the property to the company upon completion of the development. When the said payment by the bank to the company exceeded a specified threshold amount, the company was obliged to pay a quarterly “interest” at a certain rate on the payments made by the bank to the company.

While analysing the facts, the Court noted that the role of the bank was to obtain lease rights in the land (from the owner of the land, through assignment from the company), to provide building finance to the company, and then grant lease of the property to the company at a rack rent.

The High Court opined that for an item of payment to constitute “interest”, two requirements must be met: (i) there must be a “sum of money” by reference to which the payment is to be ascertained, and (ii) the said “sum of money” must be due to the person entitled to receive the “interest payment”.

In the present case, the High Court ruled that the transaction did not involve a “loan”, and though the bank had paid money to the company, that payment was an out-and-out payment (rather than a loan) to enable the company to develop the property and for the bank to obtain the property rights in the development. Accordingly, the Court held that the so-called interest obligation under the agreement between the company and the bank was not interest in the true sense, and the “sum of money” on which the so-called interest was ascertained was merely a unit of calculation.

(ii) Chevron Petroleum (UK) Ltd. v. B.P. Petroleum Development Ltd.334

The relevant facts in this case were as follows. Chevron Petroleum (UK) Ltd. (“Chevron”) held a production licence in respect of an area of the North Sea (Tract A) and B.P. Petroleum Development Ltd. (“BP”) held another production licence in respect of a neighbouring area (Tract B). The parties agreed to share all expenditure in relation to the field and the production of oil from the field in proportions of the total estimated oil attributable to each tract.

The sharing of expenditure was subject to redetermination, at specified intervals of time, to adjust the shares of past expenditure in accordance with

334. (1981) 57 ITC 137 (High Court of Justice, Chancery Division).
the new tract participations. The redetermination process also involved an "interest factor" to be calculated in accordance with a complex formula. In other words, at specified periodic intervals, the share of expenses of the two parties was subject to a re-assessment, and if one party had contributed costs in excess of its share, the same was recoverable from the other party with "interest". Accordingly, upon redetermination, BP made certain payments to Chevron, which included amounts of "interest". While making the payments, BP withheld income tax on the interest amounts, following the provisions of the UK Income and Corporation Taxes Act 1970. Chevron disputed that the amounts calculated in accordance with the "interest factor" were not "interest of money" and hence were not subject to withholding tax under the UK tax law.

Before the High Court, to support its contention, the counsel of Chevron gave an example of purchase of whisky by A for GBP 100, and giving his friend B an option to buy that whisky at any time in next six months at GBP 100 plus "interest" at the rate of 12% per annum. Thus, if B exercised the option after 3 months, then his purchase price would be GBP 103. The counsel for Chevron argued that the said amount of GBP 103 consisted only of the purchase price, and not any interest. The counsel for BP did not contest this example, and the Court did not find fault with the example. Rather, the Court commented that, in the example, the option was a simple option to purchase at a price calculated in a particular way, and the "interest" of GBP 3, as in the Euro Hotel case, was based on a mere unit of calculation and it did not amount to interest in the true sense.

However, based on facts in the case, the Court found that the present case satisfied the two requirements set out in the Euro Hotel case, i.e. (i) the amounts calculated in accordance with the interest factor were based on "a sum of money", and (ii) such "sum of money" was payable by BP to Chevron. Accordingly, the Court held that the amounts calculated in accordance with the "interest factor" were, indeed, interest in the true sense.

(iii) Finance lease rental vis-à-vis "interest"

In the light of the decisions in Euro Hotel and Chevron cases, it appears that the rentals from a lease amounting to "finance lease" should not be regarded as interest under the UK tax law. This view is based on the following rationale:

- Except in the case of a lease providing a purchase option to the lessee, as the United Kingdom follows the legal form rather than the economic
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substance, the lessor is treated as owner of the leased asset for tax purposes. Accordingly, in such cases, the transaction cannot be viewed as a “loan arrangement” and hence the lease rental income receivable by the lessor must not be regarded as income from “money lent”.

- Even in a case of a lease conferring a purchase option to the lessee, which is regarded as a hire-purchase transaction, the total consideration payable by the lessee (or the hire-purchaser) to the lessor (or the vendor), as a whole, should constitute one single purchase/sale price with the base (cash) price as merely a unit of calculation. For example, a company requiring an equipment may have options to either buy it outright at a price of GBP 100,000, or to lease it for 60 months for a monthly lease rental of GBP 2,000 with an option to purchase the said equipment at the end of the 60-month lease period for GBP 10,000. If the company opts for the second alternative and exercises the purchase option at the end of the lease period, it would end up paying GBP 130,000 over a period of 60 months instead of GBP 100,000 outright. Under the second alternative, the lessor takes into account the outright price of GBP 100,000 as a unit of calculation\(^{335}\) to determine the amounts of instalment payments, but it would not be tenable to infer that the lessor has provided a loan of GBP 100,000 to the lessee. Even if the lessee is deemed as upfront acquiring (rather than leasing) the equipment from the lessor, for want of existence of a loan relationship between the lessor and the lessee, the entire amount of instalment payments must be regarded as payment of “sale price” rather than “interest”.

6.4.2.5.3. Position in Germany and the Netherlands

In Germany, except for interest from convertible bonds, profit-sharing bonds and participating loans, interest payments are not subject to withholding tax.\(^ {336}\) Similarly, in the Netherlands, except in the case of certain contingent interest loans, interest payments are not subject to withholding tax.\(^ {337}\) Accordingly, in the case where a finance lease is regarded as a “conditional sale transaction” for tax purposes, it would be inconsequential whether a portion of rentals (i.e. the conditional sale price) is treated as in-

\(^{335}\) Similar to GBP 3 in the example in the Chevron case.
Characterization of operating lease income

Even if a portion of the rentals is treated as interest, in a cross-border in-bound lease, due to non-taxability of the interest income under the domestic tax law itself, such portion of the lessor’s income would be taxable in Germany or the Netherlands (as the source state) only if the income is attributable to the lessor’s permanent establishment, if any, in the source state. Conversely, where the lessee is regarded as the economic owner of the leased asset, if a portion of the lease rental is not deemed as interest, even then, the lessor’s income is taxable only if and to the extent attributable to the lessor’s permanent establishment in Germany or the Netherlands.

6.5. Characterization of operating lease income

In the case of an operating lease, the payment by the lessee to the lessor would be clearly in respect of the use or the right to use the leased asset. Accordingly, in cases of lease of assets that can be regarded as industrial, commercial or scientific equipment, rentals in respect of “operating leases” would amount to royalties if the definition of “royalties” in the applicable tax treaty includes consideration for the use of or the right to use industrial, commercial or scientific equipment. In other cases, it would be characterized as “business income”.

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