

UK launches royalty withholding tax consultation

EY Global Tax Alert Library

Access both online and pdf versions of all EY Global Tax Alerts.

Copy into your web browser:

www.ey.com/taxalerts

Executive summary

On 1 December 2017, the United Kingdom (UK) Government launched its consultation on extending the royalty withholding tax regime. The extended regime would apply where the UK does not have a suitable tax treaty with the recipient territory, to cover payments made to related parties in connection with UK sales. It is proposed to apply even where the payer does not have a UK taxable presence. The Government intends to introduce the measures from April 2019 subject to consultation.

This is part of the Government's response to the challenges it sees with the taxation of the digital economy, although it notes that these proposals are intended to have a wider impact than just the digital economy.

The measures aim to address the UK Government's concerns that the existing international tax framework can allow profits derived from selling goods and services to the UK to be transferred to an entity in a low-tax jurisdiction through the mere holding of intangible assets. Although targeted at arrangements where payments are made to low-tax jurisdictions, the proposed approach in fact makes no reference to the tax position of the recipient but instead would apply where the recipient is in a jurisdiction with whom the UK does not have a suitable double tax agreement. This could include some high-tax jurisdictions. Significant reporting obligations could arise under the proposals, even where no UK tax liability exists and where the group has no taxable presence in the UK.

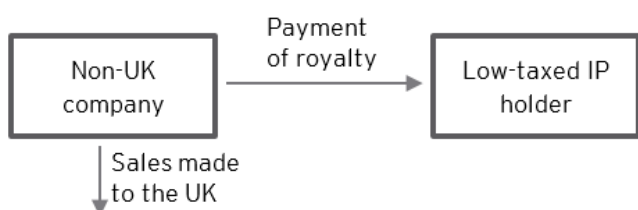
Detailed discussion

Background

Historically, the UK has applied a charge to tax on the payment of certain royalties that have a UK source. In 2016, the rules on royalty withholding tax were amended to extend the scope to cover a wider range of payments made in respect of intangible assets, as well as ensuring that payments made in connection with a UK permanent establishment were treated as having a UK source (and therefore subject to withholding tax unless the UK has explicitly given up its taxing rights under a double tax agreement).

The Government is now proposing to extend the regime further in order to ensure that payments for the exploitation of certain intellectual property (IP) or other rights made to connected parties will be subject to what it considers appropriate taxation.

The particular target is multinational groups that achieve low effective tax rates as a result of holding IP in a low-tax jurisdiction which is exploited in the UK. The consultation gives a simple example of the type of structure that the Government intends to target.



In this scenario, a royalty payment for the right to exploit IP to make sales in the UK is made by a nonresident company to a related company in a low-tax jurisdiction. Under existing rules, such a royalty would not be subject to UK tax unless it was paid in connection with a UK permanent establishment. This is notwithstanding the fact that the payment is made for exploiting rights in the UK. Furthermore, if the payment of the royalty is deductible in the non-UK jurisdiction, the overall tax payable on the UK sales would be reduced, while the royalty income would be subject to little or no tax.

The Government notes that variations on such structures, including where there are sub-licenses through third jurisdictions, are also within the scope of the proposals.

What is being proposed?

The Government proposes that the existing rules should be extended to capture such scenarios by ensuring that payments made for the exploitation of IP or certain other rights (such as distribution rights for goods or services) are deemed to have a UK source, even if the payer does not have a UK taxable presence. The proposals would only apply to payments between related parties.

The extension to certain other rights means that the proposals go wider than the existing royalty withholding tax framework. However, while the proposals extend to cover payments for distribution rights in respect of goods and services, they are not intended to cover payments for the services themselves.

The Government is seeking to define exactly which payments should be covered by the proposals. Rather than providing a defined list of the payment types (which would need updating for evolving business models), the Government's preferred approach is to provide a generic definition with a broad scope such as any payment for rights over, or interests in, the exploitation of intangible property and intangible assets of any description in the UK. This way it hopes to minimize uncertainty over whether a payment is in scope or not.

Recipient

In order to make the proposals consistent with the UK's international agreements, the Government proposes that the measures should only have effect where the UK does not have a relevant double tax agreement with the payment recipient's jurisdiction. Where a relevant treaty does exist, it is intended that there would be no withholding tax arising under these extended measures, regardless as to whether the double tax agreement provides for a full or partial reduction in royalty withholding tax (although it is understood that the current royalty withholding tax rules would continue to apply, subject to the provisions of the agreement).

The Government considers that only applying the extended measures where there is no relevant double tax agreement will also largely focus the proposals on payments to low or no-tax jurisdictions. However, there are some situations where the UK does not have a double tax agreement with a high-tax jurisdiction, Brazil for example. The Government is seeking views on how problematic this might be.

The measures will only apply to payments between related parties which is to be defined by reference to the "participation condition" contained within the transfer pricing rule (i.e., where one of the parties directly or indirectly participates in the management, control or capital of the other, or the same party directly or indirectly participates in the management, control or capital of each party). The Government's initial view is that avoidance through inserting an unrelated party in a series of payments can be addressed through anti-avoidance provisions.

Calculation of payment

It is intended that the withholding tax will apply to payments for the use or exploitation in the UK of rights over IP or certain other intangible assets. Where a payment covers rights within a wider geographic area, it will be necessary to identify the UK-related amounts. The Government proposes a "just and reasonable" method should be applied, with UK sales generally forming the base (in keeping with typical royalty amount calculations). It is seeking views on common approaches to determine amounts payable in such arrangements.

The Government intends that the extended withholding tax should apply alongside existing legislation on cross-border royalties. As such, it intends that the tax liability should be the highest of the amounts due under the existing rules within the income tax acts, the diverted profits tax rules and the liability introduced under these proposals.

Where there are sub-licensing arrangements (for example, where distribution rights are licensed to a regional hub and are then sub-licensed to an entity selling into the UK), there is a potential for double taxation as payments on each license are potentially related to the UK sales. To avoid such double taxation, the Government proposes to give credit for tax on payments relating to the same IP or rights. It should be noted that credit would only be available against another royalty withholding tax amount if the IP and rights under each agreement is essentially the same, otherwise there might be a liability arising on each payment.

Anti-avoidance

The proposals will include an anti-abuse rule intended to capture arrangements introduced with a main purposes of avoiding a liability under the proposals. It is intended this would apply to payments made after April 2019, even if the arrangements are made before that date. This would include

the introduction of unrelated parties in the series to avoid a charge and the payment to a jurisdiction with whom the UK has a suitable double tax treaty if the payments are made to that jurisdiction as part of arrangements designed to obtain a tax advantage contrary to the object and purpose of the tax treaty. However, the Government does not intend for this anti-abuse rule to impact genuine commercial restructuring.

Collection and reporting

The Government considers that the existing framework for reporting and collecting tax withheld remains an appropriate mechanism and does not propose introducing a separate system. This would require reporting via a return covering a period of up to 3 months, with payments due 14 days after the end of the return period.

In order to facilitate the collection of the tax withheld, the Government proposes joint and several liability with any related party with a UK presence. Where there is no related party with a UK presence, the Government notes that it would seek to enforce collection through existing provisions in the UK's double tax agreements or the European Union's Mutual Assistance in the Recovery of Debt Directive.

While the Government proposes to use existing mechanisms to report amounts of withholding tax to be paid, it is also seeking information on other transactions which would have been within the scope of the provisions apart from the existence of a suitable double tax agreement or where credit has been applied to eliminate a liability in a sub-licensing arrangement. This is to allow the Government to monitor the payments in order to apply an appropriate risk assessment. As such, reporting may be required even where there is no UK liability arising and no UK taxable presence.

UK companies are currently required to report payments of royalties that have been self-assessed as not subject to withholding tax. It is proposed that this is extended so that UK companies would also need to report payments made by non-UK group members. A new reporting obligation would need to be created where there is no existing UK presence.

The Government is seeking views on how it can obtain the relevant information in a proportionate fashion.

Next steps

The proposals outlined in the consultation could create a significant compliance burden for multinational groups, with the potential for double taxation to exist.

They are much broader than originally suggested at Autumn Budget 2017, in that they do not just apply where IP is held in a low or no tax jurisdiction and can apply whenever there is a sale into the UK that exploits IP held in a territory without a suitable double tax agreement with the UK, even where there is no taxable presence in the UK. There is no suggestion in the consultation document of a de minimus level of sales into the UK or value of the UK rights exploited. However, the Government is seeking views on the design of the measure (rather than the policy decision itself) and examples where issues might arise.

The consultation will run until 23 February 2018, with the Government intending to publish a summary of the responses and draft legislation later in 2018. The legislation is intended to enter into force in April 2019.

Given the potentially wide impact for groups, including those not within the "digital economy" and potentially with no taxable presence in the UK, groups should carefully assess the possible impact these proposals may have and consider what action to take, including making representations to the Government.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United Kingdom), London

- ▶ Claire Hooper chooper@uk.ey.com
- ▶ Ian Beer ibeer@uk.ey.com

Ernst & Young LLP, UK Tax Desk, New York

- ▶ James A. Taylor james.taylor1@ey.com

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 EYGM Limited.
All Rights Reserved.

EYG no. 06868-171Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com