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FINANCE BILL 2016: WITHHOLDING TAX ON ROYALTIES

In his Budget, the Chancellor announced sweeping changes to the UK's rules on withholding taxes on payments of intellectual property royalties, some of which have immediate effect.

BEFORE THE BUDGET…

Before the Budget, the UK regime for imposing withholding taxes on IP royalties was piecemeal and inconsistent. In summary, certain royalty payments would attract UK withholding tax at 20 per cent. They were payments of royalties in respect of:

- copyrights (other than copyrights in films or video recordings);
- design rights;
- public lending rights in respect of books;
- patents; and
- payments of royalties that were annual payments.

Others did not. In particular, payments of royalties in respect of:

- copyrights in films or video recordings; and
- trademarks and trade names (unless the payments were annual payments).

IN THE BUDGET…

Three measures were announced at the time of the Budget.

- The first is a provision to override relief from UK withholding tax on royalties under double tax treaties. It will prevent UK double tax treaties from being used to reduce or eliminate UK withholding tax on IP royalties paid between connected persons under arrangements where "it is reasonable to conclude that the main purpose or one of the main purposes of the arrangements was to obtain a tax advantage by virtue of any provisions of a double taxation arrangement and obtaining that tax advantage is contrary to the object and purpose of those provisions." This provision, which will be contained in a new section 917A of the Income Tax Act 2007 (ITA 2007), takes effect from 17 March 2016.
- The second is a proposal to extend the class of royalties to which UK withholding taxes will apply in the absence of relief under an applicable double tax treaty or the EU Interest and Royalties Directive. The provision will be based on the more comprehensive definition of "intellectual property" contained in the income tax legislation and will, for the first time, encompass royalty payments in respect of trademarks and trade names which are not annual payments. This provision will be included in the Finance Bill 2016 and will take effect from Royal Assent, which is likely to be in July 2016. It has been produced in draft for consultation, but will not be introduced into the Bill until the Report Stage.
- The third proposal is to extend the concept "UK source" for the purposes of identifying royalties which are subject to UK withholding tax to include royalties connected with a UK permanent establishment (PE). This will be accompanied by a proposal to increase the charge to diverted profits tax on an "avoided PE" where the royalty is connected to the UK activities of the "avoided PE". These proposals have not yet been produced in draft. The aim is to publish a draft for consultation and then introduce the clauses into the Finance Bill at the Report Stage. The provisions will then take effect from Royal Assent.

A FEW COMMENTS…

The new treaty override rule (new section 917A)

- The new treaty override provision (new section 917A ITA 2007) is clearly modelled on the more general anti-abuse rule (the principal purpose test) proposed in the final report on Action 6 of the OECD/G20 BEPS Project. HMRC states in its technical note that it will use the commentary for the principal purpose test in applying the new treaty override provision. It is clear from comments in the technical note that HMRC's intention is to apply the new rule in circumstances well beyond the limits of pure conduit arrangements. Substance alone will not be a defence to the application of the new rule.
- On its terms, new section 917A will not apply to royalties which are exempt from withholding tax under the EU Interest and Royalties Directive. The EU Interest and Royalties Directive allows member states not to apply the Directive in cases of fraud and abuse. The UK's implementation of the Directive contains its own anti-avoidance rule.

Extension of withholding tax on royalties

- The main effect of the extension of the UK's withholding tax regime will be in the context of royalties for trademarks and trade names. In the past, most trademark royalties have been outside the scope of UK withholding taxes on the grounds that they are not annual payments. From Royal Assent, those royalties will be subject to withholding tax (at 20 per cent) unless a treaty or the EU Interest and Royalties Directive provides relief. (The treaty override rule in new section 917A will apply to limit the application of treaties).

New source rules

- The most problematic proposal is likely to be the extension of the concept of "UK source" to include royalties connected with a UK PE. The technical note proceeds on the assumption that most royalty payments made by a UK resident taxpayer will have a UK source. This will not, of course, always be the case. The proposal is to extend that concept of UK source to royalties "connected with" a UK permanent establishment. There is currently no draft of this proposal, but there is a material risk of its being extremely vague.

- It is also likely that difficulties will arise when quantifying the proportion of any royalty payment paid by a non-resident entity (perhaps to another non-resident entity) which is connected with a UK permanent establishment and so subject to withholding tax. The technical note includes some examples, but these are very simplistic. In practice, the provision is likely to be difficult to apply in the context of payments of royalties which may cover transactions in numerous jurisdictions.

- Those difficulties will be compounded by the proposal to increase the amounts of diverted profit tax payable under the "avoided PE" head to include tax on any amount of royalty that would have been treated as "connected with" the avoided PE if it had been an actual PE. The increased tax will be assessed as diverted profit tax and not as income tax deducted from a royalty payment, and so it will not be possible to rely upon a double tax treaty to reduce or eliminate the tax charge.

THINGS TO DO NOW…

- Multi-national groups will need to review their intellectual property licensing structures in the light of these proposals. The scope for material changes to those arrangements may be limited by proposed transitional and anti-forestalling rules which will be included in the final legislation.

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