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AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

UNITED KINGDOM ANNOUNCES START DATE FOR EXPANDED RULES ON ROYALTY WITHHOLDING TAX

SUMMARY

As part of the 2016 Budget, which was announced on March 16, 2016, the United Kingdom ("UK") government revealed changes to the withholding tax regime with respect to royalties. Three new measures were introduced:

1. The UK withholding tax will apply to a wider definition of royalty payments, bringing more royalties within the scope of the rules;
2. A clear rule will be put in place to determine whether a royalty is UK source; specifically, to treat a royalty connected with a UK permanent establishment ("PE"), or "avoided PE" for Diverted Profits Tax ("DPT") purposes as UK source; and
3. A targeted domestic anti-treaty abuse rule.

It was originally announced that the first two measures would apply to payments made on or after the date that the 2016 Finance Bill received Royal Assent. This was expected in July 2016, but has been pushed back to November 2016. HM Revenue & Customs ("HMRC") announced that these two measures will take effect for royalty payments on or after June 28, 2016.

The anti-treaty abuse measure is effective for payments made on or after March 17, 2016.

BACKGROUND

Under the previous UK tax regime, multinational groups had the ability to derive large sums from the exploitation of intellectual property that is held in low tax, low substance locations. The UK government is concerned that groups are able to structure tax deductible royalty payments from the United Kingdom in such a way that the United Kingdom loses its right to tax those royalties,

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either because the legislation that requires withholding tax is not broad enough to capture such payments, and/or the payments are structured in such a way as to take advantage of one of the UK's double tax treaties.

DETAILS

Definition of Royalties Subject to Withholding Tax

The definition of royalties that are subject to the UK withholding tax at 20 percent has been broadened under the 2016 Budget. Relevant intellectual property is now defined as:

a) Copyright of literary, artistic or scientific work (excluding certain cinematographic or video recordings);

b) Any patent, trade mark, design, model, plan or secret formula or process;

c) Any information concerning industrial, commercial or scientific experience; or

d) Public lending right in respect of a book.

The impact of this change will mean that many royalty payments that were not subject to UK withholding tax previously, e.g. royalties on trademarks or brands that were not "annual payments," will now be within the scope of the UK withholding tax rules.

Definition of UK Source - Royalties Attributable to UK PEs

Withholding tax on royalties applies to payments in respect of relevant intellectual property that have a UK source. "Source" was not defined under UK tax legislation. As a result, it was often unclear whether withholding tax should apply to royalty payments attributable to UK PEs of foreign companies.

A new rule provides that the payment of a royalty by a non-UK resident will always have a UK source when the payer is a non-UK resident carrying on business in the UK through a PE in the UK, and the obligation to make the payments arises in connection with the business carried on through that UK PE. It is not necessary that the royalty payment be deductible in the UK PE under the UK's profit attribution rules for a withholding tax obligation to arise. Rather, the test is whether the obligation of the non-resident to make royalty payments arises or is connected with the activities that the non-resident performs in the UK PE.

Where the UK has a double tax treaty with the country of residence of the beneficial owner of the royalty, that treaty will govern the taxation of the payment, subject to the anti-avoidance rule discussed below.

The proposed changes to the definition of royalties and UK source will apply to payments made on or after the June 28, 2016, subject to an anti-forestalling rule.

As well as its application to UK PEs, the rule will also apply to notional ("avoided") UK PEs under the Diverted Profit Tax rules ("DPT"). In that case, royalties payable by the non-UK company with the avoided UK PE will be included in the diverted profits calculation and subject to DPT at 25 percent. To the extent that a double tax treaty would reduce UK withholding tax, then a credit will be allowed against that DPT in the appropriate amount.

This change also applies for accounting periods ending on or after June 28, 2016, again subject to an anti-forestalling rule.

Disapplication of Treaty Benefits - Purpose Based Anti-Avoidance Rule

A new rule came into effect for royalty payments made on or after March 17, 2016, where there are arrangements in place of which the purpose, or one of the main purposes, is to obtain a tax advantage by virtue of a double tax treaty in a way that is not in line with the object and purpose of the treaty. The payer and payee must be connected for the provision to apply.

BDO INSIGHTS

- Groups should be reviewing their royalty arrangements urgently in light of the new UK rules to determine whether UK withholding tax or DPT obligations will arise on future royalty payments.