

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

AS PART OF THE 2016 BUDGET ANNOUNCED ON MARCH 16, 2016, THE UNITED KINGDOM GOVERNMENT REVEALED CHANGES TO THE WITHHOLDING TAX REGIME WITH RESPECT TO ROYALTIES. MEASURES BEING INTRODUCED INCLUDE: WIDENING THE SCOPE OF ROYALTY PAYMENTS TO WHICH WITHHOLDING TAX APPLIES AND INTRODUCING ANTI-AVOIDANCE LEGISLATION

SUMMARY

Three new measures were introduced in the United Kingdom's 2016 budget, which relate to withholding tax on royalties:

1. UK withholding tax will apply to a wider definition of royalty payments, bringing more royalties within the scope of the rules;
2. UK withholding tax will now apply to royalty payments attributable to UK permanent establishments ("PEs"); and
3. A targeted domestic anti-treaty abuse rule was introduced with immediate effect.

The first two measures will apply to payments made on or after the date that the 2016 Finance Bill receives Royal Assent (expected July 2016) and the anti-treaty abuse measure is effective for payments made on or after March 17, 2016.

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DETAILS

Background

In today's global economy, multinational groups often derive large sums from the exploitation of intellectual property that is often 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, either because the legislation requiring 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.

Current Rules

Under the United Kingdom's existing withholding tax regime, a 20-percent income tax must be deducted from certain UK source royalty payments. "UK source" is not currently defined.

Withholding tax is only required in fairly limited circumstances, for example with respect to payments for patent royalties, copyright owned abroad, certain design rights, and payments of other royalties that are "annual payments" (i.e., payments that are regarded as pure income profit to the recipient). Many royalty payments are, therefore, not currently subject to the UK's withholding tax rules.

Where withholding tax is due, this can often be reduced under the provisions of one of the United Kingdom's many double tax treaties. Under current UK domestic law there is no treaty anti-abuse rule; although many UK treaties include a "main purpose" test, as does the EU Interest and Royalties Directive.

Broadening the definition of royalties subject to withholding tax

The definition of royalties that are subject to UK withholding tax will be broadened. Relevant intellectual property will be defined as:

- a) any patent, trademark, registered design, copyright, design right, performer's right or plant breeder's right;
- b) any similar rights under UK or non-UK law;
- c) any idea, information or technique not protected by rights in (a) or (b) above; and
- d) the public lending right in respect of a book.

There will be no requirement for the payment to be regarded as an annual payment to fall within the definition of relevant intellectual property.

Cinematographic film or video recordings and soundtracks of such continue to be excluded, as do copies of works which have been exported from the UK for distribution outside the UK.

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

The proposed changes will apply to payments made on or after the date that the 2016 Finance Bill receives Royal Assent (expected July 2016), and will include an anti-forestalling rule that will ignore the effect of payments being accelerated and will counteract the effect of any other arrangements put in place March 16, 2016, to avoid the application of the changes.

Definition of UK source - royalties attributable to UK PEs

Withholding tax on royalties applies when a payment is made for relevant intellectual property and the source of that income is the United Kingdom. Source is not currently 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 has in the UK PE.

As well as applying to actual UK PEs, the rule will also apply to notional UK PEs under the Diverted Profit Tax rules.

In both cases, 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 will apply to payments made on or after the date that the 2016 Finance Bill receives Royal Assent, and will also include an anti-forestalling rule.

Disapplication of treaty benefits - purpose based anti-avoidance rule

A new rule comes 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. This will apply to royalties where there is an existing duty to withhold, and, of course, to royalties paid under the wider definition discussed above, once those rules are effective. The payer and payee must be connected for the provision to apply.

The provision is modeled closely on the OECD's anti-abuse rule (principal purpose test) that will become part of the OECD model tax convention. The commentary to the OECD model tax convention, which will help explain how the rules will operate and be interpreted, will be followed by the UK tax authorities ("HMRC") when applying the new UK domestic rule.

Where the relevant double tax treaty with the United Kingdom has a main purpose test with respect to royalties and that provision does not apply to disallow treaty benefits, HMRC have said that it is unlikely that the new domestic rule will apply.

Examples of when the rule would apply include conduit arrangements, and assignment of IP to a treaty country where the main purpose, or one of the main purposes of the assignment is to take advantage of the treaty between that country and the United Kingdom. Each case will, of course, be fact specific..

BDO INSIGHTS

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

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