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# Closing the Net
## The Royalties Withholding Tax Consultation

Following the announcement in the UK Autumn Budget statement by the Chancellor of the Exchequer that the government intends to further extend the provisions on Royalty Withholding Tax, HM Treasury and HM Revenue and Customs published a consultation document on 1 December 2017.

The proposals outlined in the consultation document build further on the changes introduced in the Finance Act 2016, which ensured that all royalties arising in the UK would be subject to deduction of tax at source unless the UK has explicitly given up its taxing rights under an international agreement.

## When Does Non-UK Source Mean UK Source?

What constitutes "UK source" has never been defined by legislation but, very generally speaking, it has normally been found in where the payer is resident (or, where a payment is made by a permanent establishment [PE], where that PE is situated). The essence of the new provisions is to extend the withholding tax regime to situations where there is no UK source (or at least, not one that is so obvious) by radically expanding what "UK source"' means.

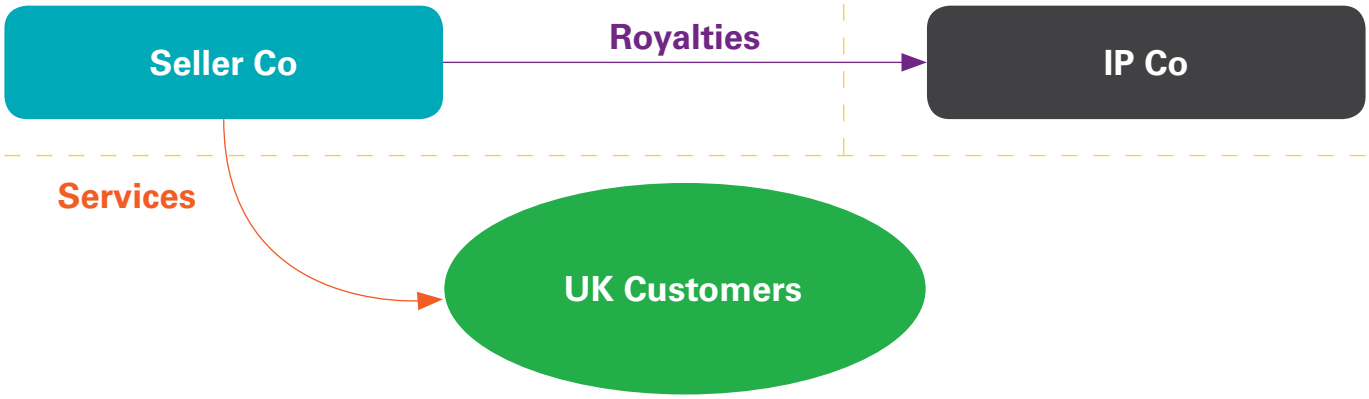
Take, for example, a situation where an online vendor (Seller Co), resident for tax purposes outside of the UK, supplies products to UK customers via the internet. Assume that the vendor does not have a UK PE (or even, indeed, an avoided UK PE under the Diverted Profits Tax [DPT] rules).

In this basic scenario, the UK has no basis on which to impose tax on the profit generated by the sale. The UK recognises that just because a product is sold to UK customers, it does not have a general right to tax the profits a foreign business generates from a product that is designed outside the UK, manufactured and marketed outside the UK, and then sold remotely to a UK customer.

However, the UK (along with most other jurisdictions) is increasingly concerned by arrangements that are designed to ensure cross-border transactions are taxed at very low effective rates and which, therefore, distort competition.

These low effective rates of tax normally manifest themselves where the level of taxable profits, brought into account in the jurisdiction where the Seller Co is resident (i.e. where the sales receipts are received), are reduced (in some case substantially so) by payments made for the use of intellectual property (IP) to an affiliate entity (IP Co), which owns the IP in a third jurisdiction. The value of the sale is effectively passed through to the payments for the use of the IP, with the result that the commercial profit from the arrangements as a whole typically end up being realised in a low (or no) tax jurisdiction (i.e. where IP Co is, conveniently, resident).

A simplified version of a typical structure is illustrated below:



Under such arrangements, the net tax result is that no tax is collected on the profit generated from the sale in the UK (where the consumer is), almost no tax is collected on the profit in Seller Co's jurisdiction of residence and little or no tax is collected in IP Co's jurisdiction.

To further illustrate the effect, consider a music streaming business. The customers are in the UK but the payments for using the streaming service do not attract UK direct tax (because there is no UK resident entity or UK permanent establishment for UK tax to "stick" to). If, however, the payments also do not attract much or any tax where the non-UK sales arm of the streaming business is based, the UK wants (or rather sees an opportunity) to impose a tax charge. From the UK's point of view, money is leaving the UK tax net without being taxed in the UK (or anywhere else).

The consultation document describes the government's current thinking on how to capture, and tax, these hugely valuable, and largely untapped, reserves. It goes on to describe a mechanism for extending the circumstances in which there is a liability to UK income tax and so a duty to deduct tax at source. The proposals seek to establish that the payments to exploit IP in the UK (i.e. by selling to customers in the UK) have a *source* in the UK. This is important because, as already outlined, having a UK source entitles the UK to "fix" a withholding tax obligation to the payments. In the simple example outlined above, the payment by Seller Co to IP Co would, to the extent it related to being able to use the IP to make sales in the UK, have a UK source.

In the absence of any UK resident entity or UK PE (or even UK avoided PE), this is a radical extension of what has traditionally been understood as "UK source". It is a further evolutionary leap beyond the 2016 extraterritorial extension to the royalty withholding tax rules (which still depended on payments being made "in connection with" a UK taxable presence) and represents another erosion of the outer limits of the UK's territorial tax system.

That said, the consultation document does look to make it very clear that the new charge is only to apply where the tax structure has been established to minimise the tax payable by utilising IP holding entities established in countries that do not have a double tax agreement with the UK, which includes a non-discrimination article. That does significantly restrict the focus (if not the impact) of the proposals.

Some of the key design attributes of the government's proposals are examined in more detail below.

## What Payments Are Intended to Be Covered?

The consultation envisages two approaches to define what kinds of payment are to be covered by the new withholding tax. One possibility is a generic approach that would apply to *any* payment for rights over, or interests in, the exploitation of IP. In the UK Treasury's view, adopting this option minimises uncertainty in the long term.

Alternatively, the consultation document suggests defining the specific types of payment that would be included.

The initial governmental view (perhaps unsurprisingly) expressed in the consultation document is to take the more general approach. As well as minimising uncertainty, it would, so the government argues, avoid the need to keep the list of included payments up to date as business practices evolve.

## Which Recipient Entities Are Targeted?

As presented, the proposals are primarily aimed at tackling tax avoidance, and so the measures will only pick up payments from Seller Co to IP Co if those companies are related (and so have been able to structure their affairs in order to minimise the tax cost).

Interestingly, however, the consultation document also asks if there are any circumstances in which the rules should apply to payments between unrelated parties, while at the same time noting that there will be anti-avoidance provisions that will cover off any risk that multinational groups attempt to circumvent the new rule through the artificial insertion of unrelated parties in their structures.

## What Happens if the IP Co Itself Makes Payments to Another IP Co?

The proposals go beyond just the first payment from Seller Co to IP Co. If IP Co 1 makes an onward payment to IP Co 2 (and so on), the new provisions will also impose a withholding tax on that, and subsequent payments.

There will be credit granted for payments along the chain so that, in effect, the highest level of payment between related parties will attract the charge. This is, of course, true until there is a payment to an IP Co in a jurisdiction in which the UK does have a double tax agreement with a non-discrimination article, at which point, the chain will be broken.

## What if the Payments to IP Co Include Payments for the Use of IP Not Linked to UK Customers?

The proposal paper recommends a "just and reasonable" apportionment of payments, most likely based on sales, to split out payments to that "apply" to UK customers. Picking up the theme regarding the breadth of approach being adopted, the UK Treasury recommends that, when defining payments generally, it is proposed to include fixed fees as well.

## What Anti-avoidance Provisions Are Being Proposed?

As well as including anti-avoidance provisions that will be designed to prevent anti-forestalling, the general rule that the provisions are not intended to apply to payments to a jurisdiction that has a double tax agreement with a non-discrimination article will also be unavailable if payments are part of arrangements designed to obtain a tax advantage contrary to the object and purpose of a double tax agreement.

## Closing the Net

These new proposals should be considered in conjunction with the ideas set out in the Corporate tax and the digital economy: position paper (the position paper) published on Budget Day (22 November). Putting the two sets of proposals together, alongside a specific example, shows how HM Treasury is seeking to close the tax net around digital businesses.

Take, for example, a non-UK resident business that offers its UK customers alternatives on how to receive its online services. One option is to receive the businesses services free, but with the proviso that they will be interrupted periodically by advertisements. Alternatively, a premium service can be provided, which will be advert free but will command a regular subscription fee payable by the UK customer.

In the absence of any UK taxable presence, the current UK tax rules would not establish a direct tax charge on either the advertising revenue or the subscription fee. In this respect, it would not matter, at least from a tax point of view, whether the customer chooses the free or the premium subscription payment model.

Assuming that the proposals in the consultation document published on 1 December are introduced, the premium subscription payment model would likely give rise to an extraterritorial royalty withholding tax liability.

In addition, if the proposals in the position paper published on Budget Day are also introduced, the advertising revenue (that replaces the income from the subscription fee) received by non-UK Seller Co under the free service option would also be caught and subject to the *revenue*-based, value-derived tax that HM Treasury is looking at introducing – for more on which, see UK Autumn Budget 2017: Taxing the Digitalised Economy.

Taken together, the two sets of tax proposals seek to catch both versions of the business model. They represent a valiant attempt to bring global digital businesses into the tax net by reshaping, fundamentally, some of the traditional principles that lie at the core of UK tax policy, such as "residence", "profit", "revenue" and "source". The digital economy may not, in the view of the OECD, have necessitated a fundamentally new system for international tax, but there can be little doubt that if the HM Treasury's position paper and consultation document are anything to go by, the elements that form the building blocks of the existing system are facing fundamental change.

For completeness, and whilst appreciating that the following point is worthy of an entire article in its own right, it is worth noting that the VAT rules for electronically supplied services to non-business consumers have the effect of making the place of supply for VAT the place where the customer, rather than the supplier, is located. When you step back and look at direct and indirect taxes together, you see a clear policy trend toward levying tax where the customer is located.

If you would like to discuss this generally, or provide specific input as part of the consultation process, please contact your normal firm contact.

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