HM Revenue & Customs

Deduction of income tax at source: Royalties

Updated Technical Note
27 June 2016

Contents

Introduction

This updated Technical Note supersedes that issued on 16 March 2016. It explains legislative changes the Government has introduced in Finance Bill 2016 to ensure that all royalties arising in the UK will be subject to the deduction of income tax at source unless the UK has explicitly given up its taxing rights under an international agreement. This legislation:

- inserts anti-treaty shopping provisions in the rules in Part 15 of the Income Tax Act 2007 on the requirement to deduct income tax at source from royalties;
- makes a change to the definition of a royalty for the purposes of the rules on the deduction of income tax at source;
- changes the rules that determine whether a royalty comes from a source in the United Kingdom; and
- amends the rules in Part 3 of the Finance Act 2015 to ensure that advantages do not accrue to entities within the diverted profits tax as a result of amendments made to the rules that determine whether a royalty comes from a source in the United Kingdom.

The legislation in Chapter 5 inserting the anti-treaty shopping provision into Part 15 of the Income Tax Act 2007 appeared in the Finance Bill 2016 when it was published and applies to payments made on or after 17 March 2016.

The legislation in Chapter 7 changing the definition of a royalty for the purposes of the rules on the deduction of income tax at source is being introduced at Public Bill Committee Stage and applies to payments made on or after 28 June 2016.

The legislation in Chapter 9 changing the rules that determine whether a royalty comes from a source in the United Kingdom is being introduced at Public Bill Committee Stage and applies to payments made on or after 28 June 2016.

The legislation in Chapter 11 making amendments to the diverted profits tax is being introduced at Public Bill Committee Stage and also applies to payments made on or after 28 June 2016.

Chapter 1: overview

1.1 The Government announced on 16 March 2016 that it intended to introduce legislation in Finance Bill 2016 to reform the rules governing the deduction of income tax at source from payments of royalties.

1.2 This reform:

- denies the benefit of a tax treaty as it applies to royalty payments between connected parties where arrangements have been put in place one of whose main purposes is to secure a benefit that is not in accordance with the object and purpose of the treaty. This part of the measure applies to payments made on or after 17 March 2016;
- widens the class of royalties that require the payer to withhold tax from the royalty payment. The definition will be aligned with the definition of a royalty for the purposes of the OECD model tax treaty. The new definition will, for example, now include royalties for the use of trade names and trademarks that are not annual payments. The effect will be that the definition for UK tax purposes will be aligned with the definition of royalties in the OECD model tax treaty. This part of the measure applies to payments made on or after 28 June 2016; and
- provides a clear rule to determine whether a royalty has a UK source. A royalty that is connected with a trade carried on through a permanent establishment (PE) in the UK, or an "avoided PE" for the purposes of the diverted profits tax, will be treated as having a UK source. This part of the measure applies to payments made on or after 28 June 2016.

Policy Background

1.3 It is a feature of most countries' tax systems that non-residents are taxable on certain types of income that arise in that country. Royalties typically fall within those types of income and, to enforce their taxing right, countries will generally require the payer of the royalty to withhold tax from the payment and account for it to the tax authorities. The UK is no exception to this practice.

1.4 The tax treatment of cross-border payments of royalties is governed by the EU Interest and Royalties Directive (IRD) and tax treaties, also known as double taxation agreements or DTAs, of which the UK has over 120. Many of these DTAs follow the OECD model tax treaty, which stipulates that royalties are taxable only in the country of residence of the beneficial owner of the royalties. A provision of this sort therefore removes the taxing right of the country in which the royalty arises, on a reciprocal basis. The Government thinks that that this is an appropriate treatment, which removes tax obstacles to cross-border investment and provision of services.

1.5 However, countries give up their taxing rights in these circumstances in the expectation that the royalties will be paid for the benefit of a resident of a treaty partner. It is a frustration of the purpose of a tax treaty if a person resident in a third country uses a bilateral tax treaty with the UK to extract tax-free royalties from the UK, especially if no tax is paid on the receipt and no substantive activity is taking place in that third country. It is for this reason that tax treaties contain anti-abuse provisions to prevent so-called “treaty shopping” by these third country residents.

1.6 In a world economy where multinational groups derive large sums from the exploitation of intellectual property (IP), cross-border royalty payments have become increasingly prevalent, and the need to ensure that they are taxed in an appropriate way is more important than ever.

1.7 The Government is concerned that some multinational groups have put in place arrangements under which IP is held by a group company in a jurisdiction where no tax is paid and no substantive activity takes place, and have structured the payments of royalties to that company in a way that takes advantage of the UK’s tax treaties with other countries. This deprives the UK, as the country in which the royalty arises, of the right to tax. Had the royalty been paid direct to that ultimate jurisdiction, the UK would have retained its taxing rights on the basis that there was no treaty in place between the UK and that jurisdiction.

1.8 The OECD has recognised this as a problem and, as part of its recent work to counter base erosion and profit shifting (BEPS), has recommended that countries adopt provisions to counter treaty shopping. These can take the form of a provision in the treaty itself or as a domestic law rule, provided that rule follows the principles embodied in the recommended treaty rule. The government therefore decided to introduce a targeted domestic anti-abuse rule, aimed at royalty payments between related parties that seek to take advantage of the UK’s tax treaties. The rule took effect for royalties paid on or after 17 March 2016.

1.9 As part of this approach to tackling tax avoidance, the government decided to bring the definition of UK royalties on which non-residents are taxable into line with the internationally-accepted definition contained in the OECD model tax treaty. It will do this by applying the familiar withholding requirements to those payments that are classified as royalties for the purposes of the OECD model tax treaty. At present, for example, payments for the right to use trade names and trademarks are subject to a royalty withholding tax only if they are “annual payments”. Under the new approach, all such payments will be subject to withholding tax.

1.10 One effect of conforming the UK’s rules to the internationally-accepted definition of royalties is that the reciprocal balance in the UK’s tax treaties will be better maintained. Where a bilateral treaty preserves the right of the source state to tax a royalty payment, in whole or in part, the UK will now be able to tax the same categories of payments as its treaty partner. And where a treaty is being abused, and its benefits are disapplied by the anti-abuse rule, the UK will be able to tax in full all royalty payments, as it would where no tax treaty was in existence.

1.11 The third part of the Government’s reform, which goes hand in hand with the anti-abuse element, is to change what is meant by royalties “arising” in the UK – that is to say whether they come from a source in the UK. At present, there is no statutory definition of what constitutes a UK source for royalties. Although the source of a payment will not always depend on the residence of the payer, the vast majority of payments made by a person resident in the UK will come from a source in the UK. There are some additional case law tests of source which look at other factors, but, prior to these changes, it was not clear that all royalty payments connected to a PE that a non-resident had in the UK had a UK source.

1.12 The OECD model tax treaty contains no definition of source for royalties because it was thought that one was unnecessary – on the basis that sole taxing rights belong to the state of residence of the beneficial owner. However, a definition is necessary where, for example, an anti-abuse measure is applied and the taxing rights are returned to the state of source.

1.13 In the comparable interest article of the OECD model (which provides for a 10 per cent rate of source state taxation), the source of the interest payment is defined as the country where the payer is resident, except where the payer has a PE in one of the treaty partners, the interest is borne by that PE, and the debt is connected with it. In that case, the source of the interest is the state where the PE is situated.

1.14 The Government has introduced a similar treatment for royalties under domestic law, so that a royalty will have a UK source where the payment is connected to a PE that the payer has in the UK. Royalties paid by a non-resident to another non-resident which are connected to a trade carried on through a UK PE of the payer will now be taxable in the UK and the non-resident payer will be expected to withhold tax and account for it to HMRC. But where there is a tax treaty between the UK and the country of residence of the beneficial owner, that treaty will govern the taxation of the payment. Where that treaty follows the OECD model and the anti-abuse rule does not apply, taxation rights will belong exclusively to that other country.

1.15 Consequential amendments are also being made to ensure parity of treatment between cases where a non-resident company maintains an actual PE in the UK and where a person has contrived to avoid a taxable presence in the UK in circumstances that bring them within the diverted profits tax.

Outline of the legislation

1.16 The measure first announced on 16 March 2016 comprises the following legislative changes.

1.17 Firstly, a new section 917A of the Income Tax Act 2007 (ITA) introduced a purpose based anti-avoidance rule to counteract arrangements involving the use of a DTA which aim to circumvent the provisions of Part 15 ITA that govern the deduction of income tax at source. This rule only applies to payments of royalties made between connected parties. The legislation in Chapter 5 of this note inserting new section 917A ITA into Part 15 of the Income Tax Act 2007 appeared in the Finance Bill 2016 when it was published.

1.18 Secondly, changes are being made to align the definition in section 906 and 907 ITA of a royalty payment in respect of an intellectual property right with the definition of a royalty for the purposes of the OECD model tax treaty. This change broadens the range of royalties to which the duty in Part 15 of ITA to deduct income tax at source applies. Legislation amending sections 906 and 907 ITA is included in this note at Chapter 7 and is being introduced to the Finance Bill 2016 at Public Bill Committee Stage.

1.19 Finally, changes to the Taxes Acts are being introduced in the Finance Bill 2016 at Public Bill Committee Stage to provide that all royalties connected with a trade that is being carried on through a PE that a non-UK resident person has in the United Kingdom will be considered to be from a source in the United Kingdom. Consequential amendments will also be introduced at Public Bill Committee Stage to amend the diverted profits tax in Part 3 of the Finance Act 2015 (FA15) to ensure that no advantages accrue where royalties are connected with an "avoided PE" as compared to an actual PE.

1.20 The following chapters of this Technical Note explain these provisions in more detail:

- Chapter 2 explains new section 917A ITA.
- Chapter 3 explains the changes being made to sections 906 and 907 ITA.
- Chapter 4 explains the changes being made to the UK source rules when royalties are connected with a PE in the UK, and the consequential changes also being made to the diverted profits tax.

Commencement provisions

1.21 Section 917A ITA applies to payments of royalties made on or after 17 March 2016 under arrangements entered into at any time.

1.22 The changes to the source rules in respect of royalties connected with PEs in the UK, the diverted profits tax and sections 906 and 907 ITA will apply to payments of royalties made on or after 28 June 2016, subject to an anti-forestalling rule (see paragraphs 3.17 to 3.19 below).

Chapter 2: New section 917A of the Income Tax Act 2007

2.1 New rules on tax avoidance arrangements will disapply the UK's obligations under its double taxation agreements (DTAs) where arrangements are in place whose purpose, or one of whose purposes, is to take advantage of a DTA in a way that is not in line with its object and purpose. The legislation can be found in Chapter 5 of this note and appeared in the Finance Bill 2016 when it was published. It has effect for payments made on or after 17 March 2016.

2.2 New section 917A sets out a rule in UK domestic law that will apply to protect DTAs against exploitation in certain circumstances. Subsection (1) sets out the circumstances in which the clause will apply. Paragraph (a) states that the clause applies to royalty payments for IP. Paragraph (b) restricts the rule to cases where the payer and the payee are connected, and paragraph (c) contains the condition that the payment is part of an arrangement to avoid tax.

2.3 Because, as a general matter, the provisions of a DTA "have effect … despite anything in any enactment" (section 6 Taxation (International and Other Provisions) Act 2010 (TIOPA)), it is necessary to provide that this domestic law anti-abuse rule applies to restrict the relief provided under the DTA. Subsection (2) does that by reasserting the duty of a payer under Part 15 of ITA to withhold an amount representing the payee's liability to income tax.

2.4 Where deduction of income tax is required under subsection (2), subsection (3) provides that no amount can be set off by a company against its corporation tax liability under section 967 or 968 of the Corporation Tax Act 2010 (CTA 2010).

2.5 Subsection (4) contains definitions of terms used in the rest of the section. It defines tax avoidance "arrangements" to include any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable. A DTA tax avoidance arrangement is defined in substantively the same way as in the "principal purpose test" developed by the OECD/G20 as part of its "base erosion and profit shifting" (BEPS) project, and in doing so looks to see if the main purpose of an arrangement is the obtaining of a tax advantage by virtue of a benefit under a DTA. An "intellectual property royalty payment" is defined to include royalties where there is an existing duty to withhold tax and also, from the date when the wider definition takes effect, to that wider category of royalties (see Chapter 13 for amendments being made to section 917A at Public Bill Committee stage). The receipt of a royalty payment is defined to include payments made directly or indirectly and includes one off payments and a series of payments.

2.6 Subsection (5) defines what it means for the payer and the payee to be connected, and sets the participation condition as the test.

2.7 Subsection (6) imports the participation condition as it is used in the transfer pricing legislation and applies it for the purpose of this clause.

2.8 As mentioned above, the rule in new section 917A is modelled closely on the OECD anti-abuse rule (principal purpose test or PPT) that was designed as part of the OECD/G20 BEPS project. That rule, which will become a part of the OECD model tax convention, is supported by a commentary. This commentary will help to explain how the rule will operate and how it is to be interpreted. HMRC will follow that commentary when applying new section 917A. However, the OECD rule covers treaty abuse of all types, whereas the domestic rule in new section 917A is a targeted provision confined to royalty payments between connected parties. The section 917A rule will therefore operate in a similar manner to the existing "main purpose" tests contained in the dividend, interest, royalty and other income articles of many of the UK's bilateral tax treaties. It is therefore likely that if those tests do not presently apply to a transaction or arrangement, the section 917A rule will not apply either.

2.9 An example of a case where the section 917A rule (and therefore an existing "main purpose" treaty rule) would apply would be where the payer of a UK royalty paid it as part of a conduit arrangement. Here, the payee could be a resident of a country with which the UK had a DTA that assigned exclusive taxing rights over royalties to the state where the beneficial owner was a resident. But if that person (even though he was the beneficial owner) paid the royalty on, perhaps through a licence/sub-licence agreement, directly or indirectly, to an affiliate in another jurisdiction, and the main purpose of the arrangement was to obtain a tax advantage by virtue of a provision of the DTA, section 917A would apply.

2.10 Another example of circumstances where the rule could apply is where a multinational group assigned IP to an affiliate in a country with which the UK had a treaty providing for residence state only taxation of royalties. Even if that affiliate had a substantive operation and, for example, had a large R&D function of its own, if, on the facts of the case, one of the main purposes of the transfer of the IP was to obtain a tax advantage by virtue of a provision of the DTA, section 917A would apply.

2.11 In both cases, the section 917A rule would not apply where the person could show either that no tax advantage was obtained or that granting the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the DTA. This might be the case in the following example. A multinational group develops and holds IP in Country X whose DTA with the UK provides for the taxation of royalties only in the residence state. The group then decides to consolidate its IP in a regional hub and chooses Country A, whose DTA with the UK also provides for residence state only taxation, in preference to Country B, whose treaty with the UK allows a source state taxing right. Even though one of the reasons for transferring the IP to Country A rather than Country B might have been to obtain the benefits of the DTA between Country A and the UK, section 917A would not be likely to apply to deny those treaty benefits as there was no tax advantage as a result of the transfer of IP from the first country.

2.12 It might also be the case in the following example. A multinational group wants to establish a research and development centre through a subsidiary in Europe. This subsidiary will develop IP in its country of residence through staff engaged for that purpose which it is then expected to licence either to other group companies or third parties. In deciding to establish its subsidiary in State Y, the group considers a number of factors, including the availability of staff with the appropriate skills, infrastructure, reliable legal system, the local tax regime and the comprehensive DTA network of State Y, including its DTA with the UK. In this example, merely reviewing the effect of the DTA between State Y and the UK on future payments of royalties does not enable a conclusion to be drawn about the purposes of the group in establishing the State Y subsidiary. The subsidiary will conduct substantive economic activity in State Y using real assets and controlling the economically significant risks, and will conduct that activity through its own staff located in State Y. As a result, the granting of a treaty benefit in these circumstances would be likely to be in accordance with the object and purpose of the DTA and section 917A would not apply to deny treaty benefits in respect of future royalty payments unless the State Y subsidiary enters into other specific transactions to which section 917A would apply.

2.13 These examples are not exhaustive. As with any purpose-based test the analysis of whether the rule will apply in any particular case will be dependent on the balance of a range of facts and circumstances.

Chapter 3: royalties: amendment to sections 906 and 907 of the Income Tax Act 2007

3.1 The obligation to deduct income tax at source in respect of royalties and other income from IP is set out at Chapter 6 (sections 899-903) and Chapter 7 (sections 906-909) of Part 15 of ITA.

Chapter 6 of Part 15 of ITA

3.2 Under sections 899 - 902 ITA there is an obligation to deduct income tax at source on annual payments where those payments arise in the UK and attract an underlying income tax charge as defined by section 579 ITTOIA. Under section 903 ITA there is an obligation to deduct income tax at source if the payment is in respect of the use of a patent and it is not an annual payment.

3.3 The rules in Chapter 6 apply to payments to both UK resident and non-UK resident persons.

Chapter 7 of Part 15 of ITA

3.4 The rules in Chapter 7 apply specifically to certain types of royalty payment to persons whose usual place of abode is outside the UK, whether or not the payment is an annual payment.

3.5 The royalties to which Chapter 7 applies are those in respect of ‘intellectual property rights’, which includes copyright, a right in a design and the public lending right in respect of a book, but excludes copyright in a cinematographic film or video recording or the sound track of such except so far as it is separately exploited. In addition, Chapter 7 has an exclusion for copies of works which have been exported from the UK for distribution outside the UK.

3.6 Where a payment falls within both Chapter 6 and Chapter 7, then Chapter 7 has priority by virtue of section 906(8) ITA.

3.7 In effect, therefore, under the rules currently in Part 15 of ITA, income tax is deductible at source from payments to a non-UK resident person in respect of the following IP:

- Copyright (with restrictions);
- A right in design;
- Public lending right in respect of a book;
- Royalties etc. in respect of the use of patents;
- Payments of royalties etc. that are annual payments.

Trademarks and trade names

3.8 The rules currently in Part 15 of ITA apply to payments for the use of certain intangible assets such as trademarks and trade names if the receipt is an annual payment. The meaning of annual payment has been determined by case law and excludes payments that are not ‘pure income profit’ in the hands of the recipient. Accordingly a payment for the use of a trademark that is a receipt of a trade of protecting and exploiting IP will not normally be an annual payment and will not be subject to withholding tax.

3.9 In order to ensure that such payments are taxed in the UK unless the UK has explicitly given up taxing rights over those royalties under a DTA or the EU Interest and Royalties Directive, a clause is being introduced to the Finance Bill 2016 at Public Bill Committee stage amending sections 906 and 907 ITA. This clause can be found at Chapter 7 of this note.

3.10 The clause replaces the definition of a ‘relevant intellectual property right’ in section 907 ITA with a broader definition of ‘intellectual property’. This will follow the definition of rights, payments in respect of which are defined as royalties by the OECD model tax treaty. The withholding rules will therefore be broadly aligned with the taxing rights allocated to the UK under its tax treaties. It follows from this alignment that the UK will consider the commentary to Article 12 of the OECD model tax treaty in determining whether a payment is one to which the deduction of tax applies by virtue of the amended section 906 and 907 ITA.

3.11 The explicit reference to “the public lending right in respect of a book” in section 907 ITA will be retained to ensure that the existing obligation to deduct tax at source in respect of such rights is retained.

3.12 The change will simplify the rules relating to payments of royalties by requiring deduction of tax from all types of payment. Withholding will no longer depend on whether a particular type of royalty is an annual payment.

3.13 The changes made by the clause to section 906 ITA are intended to more clearly state the circumstances in which there is a duty to deduct tax from a payment.

3.14 The rules in Chapter 7 will continue to have priority over those in Chapter 6. In effect, Chapter 6 will now apply only to UK payments and Chapter 7 to payments overseas.

3.15 The exception from the provisions of section 906 for payments in respect of copies of works which have been exported from the UK for distribution outside the UK is retained. Also, the new definition of “intellectual property” in new section 907 excludes from its scope payments in respect of copyright in a cinematographic film or video recording or the sound track of such except so far as it is separately exploited. This retains the effect of the exemptions from the definition of “copyright” currently found at section 907(2)(a) and (b).

3.16 The provisions in Chapter 8 of Part 15 of ITA are unaffected by this change. These rules allow certain royalties to be paid gross or at a reduced rate of withholding tax where the person making the payment reasonably believes that the recipient is entitled to relief under a DTA. As for DTAs that already contain a purpose based anti-avoidance rule, section 917A will be one of the factors that persons making payments of royalties to connected persons will have to consider in determining whether they reasonably believe that the payee is entitled to relief under a DTA.

3.17 The changes to sections 906 and 907 ITA are protected by an anti-forestalling rules contained in subsection (5) of the clause introducing the changes. This rule disregards arrangements which have a main purpose of avoiding the effects of the changes made to sections 906 and 907 by the clause.

3.18 Subsections (6) and (7) of the clause provide that the effect of accelerating payments is ignored in determining when a payment is made for the purposes of the rules on deduction of tax at source.

3.19 For example, company A is paying a royalty in respect of a trademark to company B, which is resident in a country with which the UK does not have tax treaty, under a licence agreement. That payment is not an annual payment. Under that agreement, payments of royalties are required to be made quarterly in arrears on 1 January, 1 April, 1 July and 1 October. On learning that the government plans to introduce rules to expand the categories of royalties to which UK withholding rules apply, the two companies agreed to amend the licence agreement so that payments of royalties are made annually in advance. The first such payment is made on 1 April 2016. The effect of the rules in subsections (6) and (7) of the clause is to regard the payment made on 1 April as having been made on the date it would have been made had the licence agreement not been amended to circumvent the effect of the changes being made to sections 906 and 907. In this case, the payment made on 1 April 2016 is regarded for the purposes of the amended section 906 as having been made on the dates it would have been paid absent the arrangements – in this case four separate payments made on 1 July 2016, 1 October 2016, 1 January 2017 and 1 April 2017. As a result, the payer will be required to account to HMRC for the tax it would have had to deduct from the payments if they had been made on the date they are regarded as having been made under subsection (6) of the clause.

Chapter 4: royalties: changes to source rules in respect of amounts connected with UK permanent establishments

Background

4.1 In common with most other countries, the UK taxes non-residents on certain types of income arising in the UK. Thus, where a non-resident derives royalty income from a source in the UK, such income falls within the charge to income tax as the income arises in the UK. The payer of the royalty may have to deduct income tax at source from the payment and pay it to HMRC.

4.2 The charge to income tax on royalties is contained in Part 5 of ITTOIA. Rules defining the territorial scope of charges under Part 5 are contained in section 577 ITTOIA. Section 577(2) provides that income arising to a non-UK resident is chargeable to UK income tax "only if it is from a source in the United Kingdom"

4.3 The income must have a UK source to fall within the charge to income tax, but the term "source" is not currently defined. The changes announced in Budget 2016 will provide 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 a business in the UK through a PE in the UK; and
- The payments (or part of them) are made in connection with the trade of the non-resident carried on through its PE in the UK.

4.4 In such circumstances, the recipient of the royalty will be within the charge to UK income tax as the income arising will be from a UK source. As a result of the changes outlined to section 906 and 907 ITA in Chapter 3 above, the payment will then be subject to rules governing the deduction of tax at source from royalty payments contained in Part 15 ITA.

4.5 The legislation contained in Chapter 9 implementing the changes outlined above will be introduced to the Finance Bill 2016 at Public Bill Committee Stage and will have effect in relation to payments of royalties made on or after 28 June 2016.

4.6 For the purposes of the new rule, "permanent establishment" takes its meaning from the Corporation Tax Acts definition contained in section 1141 of the Corporation Tax Act 2010 (CTA 2010). Where the non-resident carrying on a trade in the UK is a person other than a company, the definition of permanent establishment in section 1141 CTA 2010 is to be read as if references to a company were references to that person.

Royalty paid in connection with trade carried on through UK PE

4.7 Although the source of a payment will not always depend on the residence of the payer, the vast majority of payments made by a person resident in the UK will clearly have a UK source. Where a non-resident company trades in the UK through a PE, and the activity of the UK PE is connected with the obligation of the non-resident to pay a royalty, that royalty should also be considered to come from a source in the UK.

4.8 Royalties payable under licence agreements between independent parties are typically determined by reference to sales made by the licensee from using IP rather than the profits the licensee made. In most cases therefore it will be appropriate to determine the quantum of the royalty that has a UK source, because it is connected with the activity carried on in the UK through the UK PE, by reference to sales made by the non-resident through the UK PE.

4.9 Where the royalty is determined by reference to a factor other than sales, it might, depending on the activity carried on in the UK PE, be appropriate to determine the quantum of the royalty that comes from a source in the UK on a basis other than sales. However, in all cases the obligation to pay a royalty must be connected with the activities carried on in the UK by the UK PE in order for it to be considered that the royalty comes from a source in the UK.

4.10 In all cases, however, there will be no direct link between the separate rules for attributing profits to a UK PE under section 19 CTA 2009 and the rules for determining whether a royalty paid by a non-resident comes from a source in the UK. The test is not for a royalty to be considered to come from a source in the UK only when it is deductible directly or indirectly in computing the profits of a UK PE that are chargeable to corporation tax. Rather, the approach is for a royalty to be considered to have a UK source when the obligation of a non-resident person to make the royalty payment is connected with the activities that the non-resident person carries on in the UK through the UK PE.

4.11 Where the activity carried on in UK relates to the sale of goods, services or other property by the non-resident, the obligation of the non-resident to pay the royalty must arise because of the exploitation of the IP in carrying out those sales activities in the UK through the UK PE. That connection will be clear to see with dependent agent PEs because it is the activity of the non-resident person in concluding contracts for sale that creates the PE in the first instance. Any obligation of the non-resident to pay a royalty is clearly connected to the sales activity carried on through the UK PE.

4.12 There are other circumstances where activities carried on through the UK PE are connected to the sales by the non-resident but do not result in the conclusion of a sales contract between the non-resident and the customer. This could be, for example, because the sales process is automated and the contract is concluded online but it is the activities of personnel in the UK PE that have contributed to that customer entering into the online contract with the non-resident. The obligation of the non-resident to pay the royalty is connected to the trade it carries on in the UK through the UK PE because the activity it carries on through the UK PE that has contributed to the making of a sale by the non-resident that in turn leads to its obligation to pay a royalty.

4.13 Similarly where the activity carried on in the UK through the UK PE is to market goods, services or other products provided by the non-resident or to manage relationships with customers, that activity will be connected with the obligation of the non-resident to pay the royalty where the activity carried on through the UK PE is a part of the process that leads to a sale of goods, services or other property by the non-resident in respect of which the royalty is paid.

Quantification of UK source royalty

4.14 The royalty payable by the non-resident is unlikely to be restricted to sales made through the UK PE and will typically be in respect of a licence to use the IP across a wider geographical area. Subsections (2) and (3) of new section 577A ITTOIA provide that where a royalty payment is made in connection with a trade of a non-resident only carried on in part through a UK PE, only that part connected with the activities of the non-resident carried on in the UK will be considered to come from a source in the UK. In the case of a royalty related to sales made by a non-resident, only the proportion of the royalty payable in respect of sales in which the UK PE has played a part will be considered to come from a source in the UK.

4.15 Subsection (3) of new section 577A ITTOIA provides that the apportionment of a royalty to amounts connected with a trade carried on only in part in the UK through a UK PE should be calculated on a just and reasonable basis, having regard to all the circumstances. In the case of a royalty related to sales made by a non-resident, such a just and reasonable apportionment should be made on the basis of the proportion of the non-UK resident’s total sales in respect of which the royalties arise compared to the proportion of the sales in respect of which the royalties arise that are made through, or that are connected to the trade carried on through, the UK PE. This is illustrated through the following example:

> The non-UK resident has total income of £120m. £30m of this income is in respect of sales made through its PE in the UK, £30m is in respect of sales made through its PE in Germany and £30m is in respect of sales made through its PE in France. The remaining £30m relates to sales made in its country of residence. The non-UK resident makes a royalty payment of £40m. This royalty relates only to the goods sold through its PEs in the UK and France and not those sold through its PE in Germany or in its country of residence. A just and reasonable apportionment allocates £20m of the royalty to a UK source with reference to that part of the sales of the non-resident that create the obligation to pay the royalty. That is:

$$\text{Total royalty payable (£40m)} \times \frac{\text{Sales made through the UK PE that create the obligation to pay the royalty (£30m)}}{\text{Total sales made by the non-UK resident that create the obligation to pay the royalty (£60m)}} = \text{£20m}$$

Anti-avoidance

4.16 Alongside the changes outlined above, new subsection 577(4) provides for an anti-avoidance rule which disregards arrangements put in place before, or on or after, 28 June that have the main, or a main, purpose of avoiding the application of the changes.

4.17 Subsections (5) and (6) of the clause in Chapter 9 ensure that no advantages accrue where a person accelerates payments in order to avoid the application of the new source rule. This provision regards payments made under arrangements with a main purpose of avoiding the new source rule as having been made on the date that they would have been due absent the arrangements. As a result, the withholding tax rules in Part 15 of ITA will apply as if the payment had been made on the date on which it would have been due absent the arrangements.

4.18 Subsections (7), (8) and (9) of the clause in Chapter 9 counter the effect of arrangements which were put in place to take advantage of DTAs between countries other than the UK, or of legislation put in place by another EU Member State which implements the IRD. Following the changes to the source rules outlined above, such arrangements might have the continuing effect of ensuring that royalty payments benefit from the provisions of a UK DTA or the legislation implementing the IRD at section 758 ITTOIA.

4.19 To prevent this result, subsection (7) regards arrangements as being DTA tax avoidance arrangements for the purposes of section 917A ITA where they were put in place before 28 June 2016 and have a main purpose of obtaining a foreign tax advantage by virtue of the provisions of a double taxation agreement between two or more countries outside the UK. If the conditions of subsection (7) of the clause are met, then the benefit of a provision of a DTA between the UK and another country will be denied under the provisions of section 917A ITA.

4.20 In addition, subsection (9) of the clause replicates the effect of section 765 ITTOIA. It applies where any person concerned with the creation or assignment of a right in respect of which a royalty is paid had a main purpose of taking advantage of the law of an EU member state other than the UK which gives effect to the IRD.

4.21 The following example shows how these rules will work in practice:

4.22 A multinational IT group conducts its European business through a hub in State A. A group entity in State A, ACo, has substantial operations and staff supporting sales and customers throughout Europe. It has a subsidiary in the UK, UKCo, which provides sales support services to ACo in relation to UK customers for which it is remunerated by ACo based on a margin on its costs.

4.23 In conducting its business, ACo pays a royalty for the use of trade names, trademarks and patents related to its IT business. All of this IP relates to services sold to end users by ACo. The IP in respect of which the royalties are paid is ultimately owned by a member of the group resident in a country with which the UK does not have a tax treaty, HCo. HCo licences the right to use and exploit its IP to another group company resident in State B, BCo. BCo then sub-licences these rights to ACo to exploit in conducting its business. BCo, the licence from HCo and the sub-licence from BCo to ACo were put in place for the purpose of ensuring that ACo did not have to withhold tax in State A on the payment of the royalty that ultimately ends up in HCo.

4.24 An enquiry into the affairs of UKCo has shown that its staff are concluding contracts for the sale of IT services to customers in the UK on behalf of ACo. ACo therefore has a dependent agent permanent establishment (DAPE) in the UK. Revenue from these sales and the expenses associated with making them are attributed to the UK DAPE in calculating its profits chargeable to UK CT. The enquiry also reveals that UK sales made by the UK DAPE make up 20% of the total sales of services made by ACo.

4.25 Under the IP licence agreement between ACo to BCo, the royalty payable in respect of the relevant period amounted to 1000, with 250 being payable quarterly on 1 January, 1 April, 1 July and 1 October.

4.26 Following the introduction of the new section 577A, royalties will be considered to come from a source in the UK if the payment of a royalty by a non-resident is made connection with the trade that it carries on through a permanent establishment in the UK. As a result, and because of the changes made to sections 906 and 907 ITA, such royalties will be subject to the deduction of UK income tax at source when they are paid.

4.27 In this example, the fact that the UK DAPE is making sales of products on behalf of ACo, and that the IP in respect of which royalties are being paid by ACo all relates to services sold, means that the payments of royalties made by ACo are connected with the trade of ACo carried on through a PE in the UK. The part of the royalty that does arise in connection with the activity carried on in the UK through the PE therefore comes from a source in the UK and will be subject to the deduction of UK income tax at source.

4.28 The facts of the example suggest that the most appropriate method of apportionment of the royalty payment made by ACo between that part of the payment that arises in connection with the activity carried on by ACo in the UK through the DAPE, and that which does not, would be sales. Assuming that total sales of ACo were 1250 and 250 of these were made through the UK DAPE, the amount of each individual quarterly royalty payment coming from a source in the UK, and therefore subject to the deduction of income tax at source, would be 250 x 250 / 1250 = 50.

4.29 In the example, the royalty is being paid from ACo to BCo. As such, absent any other considerations, BCo would be entitled to the benefit of the State B/UK DTA which provides for royalties to be taxable only in the state of residence of the beneficial owner. The arrangement under which the royalties were paid was put in place to obtain the benefit of the State A/State B DTA. As such, section 917A ITA2007 would not normally apply to prevent the obligation to deduct income tax from the royalty payment from being switched-off by the State B/UK DTA. However, the rules in subsection (7) of the clause provide that where it is reasonable to conclude that an arrangement was put in place with a main purpose of obtaining a benefit under the State A/State B DTA, those arrangements will be considered for the purposes of section 917A to be “DTA tax avoidance arrangements”. Therefore, in this example section 917A would provide, by virtue of subsection (7) of the clause in Chapter 9, that the obligation to deduct tax from the royalty with a UK source will not be affected by the provisions of the State B/UK DTA.

4.30 Similarly, if a main purpose of any person concerned with the creation of the sub-licence between BCo and ACo was to take advantage of legislation enacted by State A to give effect to the IRD, subsection (9) of the clause will provide that no relief from income tax is available under the provisions of section 758 ITTOIA.

Diverted Profits Tax (DPT)

4.31 Advantages should not accrue to a person who has put in place arrangements to avoid a PE that bring that person within the charge to DPT under section 86 FA15. In particular it would be an inappropriate outcome if a person were not liable to account for withholding tax if it has an avoided PE for the purposes of DPT when it would be so liable if it had an actual UK PE.

4.32 This parity of treatment will be achieved by including within the calculation of the notional profits of an avoided PE an amount equal to the royalties that would have had a UK source had the avoided PE been an actual PE. Apportionment of the royalty would be calculated on the same basis as for an actual PE.

4.33 The legislation in Chapter 11 makes changes to Part 3 of FA15 to achieve this result. In particular, this clause provides that the definition of notional PE profits ("NPEP") in section 88(5) FA15 will include royalty payments in respect of which an obligation to deduct tax would have arisen under section 906 ITA had the avoided PE been a PE in the UK through which the foreign company carried on its trade. This changed definition of NPEP applies to accounting periods ending on or after 28 June 2016. The rule at subsection (8) of the clause ensures that amounts are regarded as being paid in an accounting period ending on or after 28 June 2016 where they are regarded as having been paid in such an accounting period under the provisions dealing with accelerated payments in the clauses amending sections 906 and 907 ITA and introducing section 577A ITTOIA.

4.34 The amendment to section 79 made by subsection (2) of the clause in Chapter 11 ensures that where a royalty payment is included in NPEP by virtue of new section 88(5)(b) FA15, it will be charged to diverted profits tax at a rate of 25%.

4.35 New section 100(2A) FA15 ensures that credit against DPT charged in respect of a royalty payment by virtue of section 88(5)(b) will not be available in respect of foreign tax that is paid by an overseas recipient of a royalty. Had the payment of a royalty been subject to the deduction of income tax at source, then to the extent that such deduction was in accordance with the provisions of a DTA between the UK and the state of residence of the beneficial owner of the royalty, that state would be expected to give relief for the income tax deducted. The UK would not provide the beneficial owner of a royalty with relief from income tax in those circumstances, and therefore no relief should be provided in the equivalent circumstance where a payment of a royalty is included within NPEP (subject to any relief available under subsection 4(C) – see para.4.36 below).

4.36 New sections 100(4B) and (4C) ensure that credit is due against diverted profits tax on profits arising by virtue of new section 88(5)(b) FA15 where relief would have been due had an amount of income tax been deducted from the royalty payment included in taxable diverted profits. Such credit is granted on a just and reasonable basis having regard to all the provisions of the DTA between the UK and the state of residence of the person to whom the royalty payment is made, or the IRD. Section 917A ITA and section 765(2) would be taken into account in determining what amount of credit is just and reasonable.

4.37 The following example shows how the new credit provisions will operate:

ACo, resident in State A, makes a royalty payment of 100 to BCo, company resident in State B, which is included in the taxable diverted profits of ACo by virtue of new section 88(5)(b). Diverted profits tax of 25 is due in respect of the royalty payment.

If there is no treaty between the UK and State B, no credit will be due against ACo's liability to DPT.

If the treaty between the UK and State B provides that the UK cannot tax royalties arising in the UK and beneficially owned by a resident of State B at a rate exceeding 5%, a credit of 20 would be available against ACo's liability to DPT on the assumption that BCo is the beneficial owner of the payment and all other conditions for relief in the treaty are met.

If the treaty between the UK and State B provides that royalties may only be taxed in the state of resident of the beneficial owner of the royalty, a credit of 25 would be available against ACo's liability to diverted profits tax on the assumption that BCo is the beneficial owner of the payment and all other conditions for relief in the treaty are met. However, in this last case, if the arm's length payment of a royalty would have been only 80, the credit would be reduced to 20 having regard to the special relationship provision in the UK/State B treaty.

In all cases, under the provisions of section 100(2A), no relief would be due from ACo's liability to diverted profits tax in respect of any tax that BCo pays in its state of residence on the receipt of the royalty payment.

4.38 New section 100(4A) FA15 prevents DPT being levied twice in respect of the same royalty payment where it is treated under sections 91(4) or (5) FA15 as relevant taxable income of a connected company. This is achieved by providing credit for an amount equal to a company's liability to DPT arising by virtue of new section 88(5)(b) against the DPT liability arising from the treatment of the same amount as relevant taxable income calculated under either sections 91(4)(b) or (5)(b) FA15.

Chapter 5: New section 917A of the Income Tax Act 2007

Deduction of income tax at source: tax avoidance

(1) In Part 15 of ITA 2007 (deduction of income tax at source), after section 917 insert—

"Tax avoidance

917A Tax avoidance arrangements

(1) This section applies if and to the extent that—

(a) a person ("the payer") makes an intellectual property royalty payment,

(b) the payment is received by a person ("the payee") who is connected with the payer, and

(c) the payment is made under DTA tax avoidance arrangements.

(2) Any duty under Chapter 6 or 7 to deduct a sum representing income tax at any rate applies without regard to any double taxation arrangements.

(3) Any income tax deducted by virtue of subsection (2) may not be set off under section 967 or 968 of CTA 2010.

(4) In this section—

"arrangements" (except in the phrase "double taxation arrangements") includes any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable;

"DTA tax avoidance arrangements" means arrangements where, having regard to all the circumstances, it is reasonable to conclude that—

(a) 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

(b) obtaining that tax advantage is contrary to the object and purpose of those provisions;

"intellectual property royalty payment" means—

(a) a payment of a royalty or other sum in respect of the use of a patent,

(b) a payment specified in section 906(1)(a), or

(c) a payment which is a "qualifying annual payment" for the purposes of Chapter 6 by virtue of section 899(3)(a)(ii) (royalties etc from intellectual property);

"receive" means receive—

(a) directly or indirectly;

(b) by one payment or by a series of payments;

"tax advantage" is to be construed in accordance with section 208 of FA 2013.

(5) For the purposes of this section the payer is connected with the payee if the participation condition is met as between them.

(6) Section 148 of TIOPA 2010 (when the participation condition is met) applies for the purposes of subsection (5) as for the purposes of section 147(1)(b) of that Act, but as if references to the actual provision were to the provision made or imposed between the payer and the payee in respect of the arrangements under which the payment is made."

(2) The amendment made by this section has effect in respect of a payment made on or after 17 March 2016 under arrangements entered into at any time (including arrangements entered into before that date).

Chapter 6: explanatory note: new section 917A of the Income Tax Act 2007

Deduction of income tax at source: tax avoidance

Summary

1. This clause amends the rules in Part 15 of the Income Tax Act (ITA) 2007 on the deduction of income tax from payments of royalties by inserting new section 917A. It introduces anti-avoidance rules to prevent the abuse of double taxation arrangements to avoid the duty to deduct income tax from royalty payments made to connected persons.

Details of the clause

2. Subsection (1) of the clause inserts new section 917A into Chapter 8 of Part 15 of ITA. Section 917A denies the benefit of double taxation arrangements where payments of royalties are made under tax avoidance arrangements.

3. Subsection (1) of new section 917A provides that the section applies where a person makes a payment of a royalty to a connected person under DTA tax avoidance arrangements. "DTA tax avoidance arrangements" are defined in subsection (4) of new section 917A.

4. Subsection (2) of new section 917A sets out the consequences of meeting these conditions. In such cases the person making the payment must deduct income tax from it regardless of any double taxation arrangements.

5. Subsection (3) of new section 917A prevents any income tax deducted by virtue of this section being set off against a company's tax liability under sections 967 or 968 of the Corporation Tax Act 2010.

6. Subsection (4) of new section 917A defines terms used in the section. In particular, the definition of "intellectual property royalty payment" sets out the payments to which the section applies.

7. Subsection (5) of new section 917A explains that for the purposes of the section, persons are connected if the participation condition is met as between them.

8. Subsection (6) of new section 917A applies section 148 of the Taxation (International and Other Provisions) Act 2010 to determine whether the participation condition is met.

9. Subsection (2) of the clause provides the commencement provisions.

Background note

1. Tax rules in the Income Tax Act 2007 require the deduction of income tax from certain payments of royalties. The person making the payment is required to withhold an amount equivalent to income tax at the basic rate. This is commonly referred to as withholding tax. However, under double taxation treaties between the UK and a number of other territories the person receiving a payment of royalties may be able to reclaim any tax deducted and have future payments made to them gross, that is, without any withholding by the person making the payment.

2. This measure addresses arrangements that seek to avoid the duty to deduct income tax at source from a payment of royalties through the abuse of double taxation treaties, where the payment is made to a person connected with the payer

Chapter 7: legislation amending sections 906 and 907 of the Income Tax Act 2007

Deduction of income tax at source: intellectual property

(1) Part 15 of ITA 2007 (deduction from other payments connected with intellectual property) is amended as specified in subsections (2) and (3).

(2) In section 906 (certain royalties etc where usual place of abode of owner is abroad), for subsections (1) to (3) substitute—

"(1) This section applies to any payment made in a tax year where condition A or condition B is met.

(2) Condition A is that—

(a) the payment is a royalty, or a payment of any other kind, for the use of, or the right to use, intellectual property (see section 907),

(b) the usual place of abode of the owner of the intellectual property is outside the United Kingdom, and

(c) the payment is charged to income tax or corporation tax.

(3) Condition B is that—

(a) the payment is a payment of sums payable periodically in respect of intellectual property,

(b) the person entitled to those sums ("the assignor") assigned the intellectual property to another person,

(c) the usual place of abode of the assignor is outside the United Kingdom, and

(d) the payment is charged to income tax or corporation tax."

(3) For section 907 substitute—

"907 Meaning of "intellectual property"

(1) In section 906 "intellectual property" means—

(a) copyright of literary, artistic or scientific work,

(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.

(2) In this section "copyright of literary, artistic or scientific work" does not include copyright in—

(a) a cinematographic film or video recording, or

(b) the sound-track of a cinematographic film or video recording, except so far as it is separately exploited."

(4) The amendments made by subsections (2) and (3) have effect in respect of payments made on or after 28 June 2016.

(5) In determining whether section 906 of ITA 2007 applies to a payment, no regard is to be had to any arrangements the main purpose of which, or one of the main purposes of which, is to avoid the effect of the amendments made by this section.

(6) Where arrangements are disregarded under subsection (5) in relation to a payment which—

(a) is made before 28 June 2016, and

(b) is due on or after that day,

the payment is to be regarded for the purposes of section 906 of ITA 2007 as made on the date on which it is due.

(7) In determining the date on which a payment is due for the purposes of subsection (6), disregard the arrangements referred to in that subsection.

(8) In this section "arrangements" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable and whether entered into before, or on or after, 28 June 2016)."

Chapter 8: explanatory note: draft legislation amending sections 906 and 907 of the Income Tax Act 2007

Deduction of income tax at source: intellectual property

Summary

1. The clause introduced by this amendment changes the rules in Part 15 of the Income Tax Act 2007 (ITA) on the deduction of income tax from payments of royalties to those whose usual place of abode is abroad. It amends sections 906 and 907 ITA in order to introduce a new definition of "intellectual property". Broadly, this aligns the deduction of tax rules relating to royalties on intellectual property with the OECD Model Tax Convention definition of a royalty.

Details of the clause

2. Subsection (1) of the clause provides that Chapter 7 of Part 15 ITA is amended.

3. Subsection (2) of the clause amends existing subsections 906(1) to (3) so that the circumstances in which there is a duty to deduct tax is more clearly stated. Existing subsection 906(4) is not amended, and as a result the existing exemption from the deduction of tax at source rules for certain works or articles is retained.

4. Subsection (3) of the clause replaces the existing section 907.

5. Subsection (1) of new section 907 replaces the current definition of "relevant intellectual property right" with a new definition of "intellectual property". This is based on the definition of a royalty set out at paragraph 2 of Article 12 of the OECD Model Tax Convention. It also retains the explicit reference to "the public lending right in respect of a book". This ensures that the existing obligation to deduct tax at source in respect of such rights is retained.

6. Subsection (2) of new section 907 ensures that the existing exemptions from the deduction of tax at source rules are retained for certain types of copyright.

7. Subsection (4) of the clause provides for the commencement of the new definition which will have effect in respect of payments made on or after 28 June 2016.

8. Subsections (5) of the clause provides that arrangements should be ignored if they are entered into with a main purpose of avoiding the amended requirement to deduct tax at source introduced under subsections (2) and (3) of the clause.

9. Subsections (6) and (7) of the clause prevent payments being accelerated to circumvent the effect of the changes made to the deduction of tax at source rules by this clause.

10. Subsection (8) of the clause provides the definition of "arrangements" for the purposes of the clause.

Background note

11. Tax rules in the Income Tax Act 2007 require the deduction of income tax from payments of certain royalties to persons whose usual place of abode is abroad if they are in respect of copyright, a right in a design, the public lending right in respect of a book and patent royalties. Other types of royalty or similar income from intellectual property are only subject to the deduction of tax rules if they are also annual payments.

12. However, under double taxation treaties between the UK and a number of other territories the person receiving a payment in respect of royalties and other similar income may be entitled to have payments made to them at the rate specified in the relevant treaty (which is often zero). A company making the payment may do so at the treaty rate if they have the reasonable belief the recipient is entitled to relief under double taxation arrangements.

13. This measure broadens the scope of the UK's domestic withholding rights over royalties in order to ensure that payments abroad are taxed in the UK unless the UK has explicitly given up those taxing rights under an international agreement.

Chapter 9: legislation introducing new section 577A of the Income Tax (Trading and Other Income) Act 2005

Receipts from intellectual property: territorial scope

(1) In section 577 of ITTOIA 2005 (territorial scope of Part 5 charges), at the end insert—

“(5) See also section 577A (territorial scope of Part 5 charges: receipts from intellectual property).”

(2) After that section insert—

“577A Territorial scope of Part 5 charges: receipts from intellectual property

(1) References in section 577 to income which is from a source in the United Kingdom include income arising where—

(a) a royalty or other sum is paid in respect of intellectual property by a person who is non-UK resident, and

(b) the payment is made in connection with a trade carried on by that person through a permanent establishment in the United Kingdom.

(2) Subsection (3) applies where a royalty or other sum is paid in respect of intellectual property by a person who is non-UK resident in connection with a trade carried on by that person only in part through a permanent establishment in the United Kingdom.

(3) The payment referred to in subsection (2) is to be regarded for the purposes of subsection (1)(b) as made in connection with a trade carried on through a permanent establishment in the United Kingdom to such extent as is just and reasonable, having regard to all the circumstances.

(4) In determining for the purposes of section 577 whether income arising is from a source in the United Kingdom, no regard is to be had to arrangements the main purpose of which, or one of the main purposes of which, is to avoid the effect of the rule in subsection (1).

(5) In this section—

“arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable);

“intellectual property” has the same meaning as in section 579;

“permanent establishment”—

(a) in relation to a company, is to be read (by virtue of section 1007A of ITA 2007) in accordance with Chapter 2 of Part 24 of CTA 2010, and

(b) in relation to any other person, is to be read in accordance with that Chapter but as if references in that Chapter to a company were references to that person.”

(3) The amendments made by subsections (1) and (2) have effect in relation to royalties or other sums paid in respect of intellectual property on or after 28 June 2016.

(4) It does not matter for the purposes of subsection (4) of section 577A of ITTOIA 2005 (as inserted by this section) whether the arrangements referred to in that subsection are entered into before, or on or after, 28 June 2016.

(5) Where arrangements are disregarded under subsection (4) of section 577A of ITTOIA 2005 (as inserted by this section) in relation to a payment of a royalty or other sum which—

(a) is made before 28 June 2016, but

(b) is due on or after that day, the payment is to be regarded for the purposes of subsection (1) of that section as made on the date on which it is due.

(6) In determining the date on which a payment is due for the purposes of subsection (5), disregard the arrangements referred to in that subsection.

(7) Where—

(a) an intellectual property royalty payment within the meaning of section 917 A of ITA 2007 is made on or after 28 June 2016,

(b) the payment is made under arrangements (within the meaning of that section) entered into before that day,

(c) the arrangements are not DTA tax avoidance arrangements for the purposes of that section,

(d) 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 foreign double taxation arrangement, and

(e) obtaining that tax advantage is contrary to the object and purpose of those provisions,

the arrangements are to be regarded as DTA tax avoidance arrangements for the purposes of section 917A of ITA 2007 in relation to the payment.

(8) In subsection (7)—

“foreign double taxation arrangement” means an arrangement made by two or more territories outside the United Kingdom with a view to affording relief from double taxation in relation to tax chargeable on income (with or without other tax relief);

“tax advantage” is to be construed in accordance with section 208 of FA 2013 but as if references in that section to “tax” were references to tax chargeable on income under the law of a territory outside the United Kingdom.

(9) Where—

(a) a royalty is paid on or after 28 June 2016,

(b) the right in respect of which the royalty is paid was created or assigned before that day,

(c) section 765(2) of ITTOIA 2005 does not apply in relation to the payment, and

(d) it is reasonable to conclude that the main purpose, or one of the main purposes, of any person connected with the creation or assignment of the right was to take advantage, by means of that creation or assignment, of the law of any territory giving effect to Council Directive 2003/49/EC of 3rd June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different member States,

section 758 of ITTOIA 2005 does not apply in relation to the payment."

Chapter 10: explanatory note: legislation introducing new section 577A of the Income Tax (Trading and Other Income) Act 2005

Receipts from intellectual property: territorial scope

Summary

The clause introduced by this amendment amends the rules in Part 5 of the Income Tax (Trading and other Income) Act 2005 (ITTOIA) on the charge to income tax on receipts from intellectual property by inserting new section 577A. It introduces changes to the territorial scope of charges under Part 5 in respect of receipts from intellectual property.

Details of the clause

1. Subsection (1) of the clause inserts a new subsection in section 577 making reference to new section 577A.
2. Subsection (2) of the clause inserts new section 577A into Chapter 1 of Part 5 of ITTOIA. Section 577A includes within the territorial scope of charges under Part 5 income arising where royalties or other sums in respect of intellectual property are paid by a non-resident in connection with a trade carried on by them through a permanent establishment in the UK.
3. Subsection (1) of new section 577A provides that income arising from certain payments of royalties or other sums in respect of intellectual property will be income which is from a source in the UK.
4. Subsections (2) and (3) of new section 577A provide for the apportionment, on a just and reasonable basis, of payments of royalties or other sums that are made in connection with a trade that is only partly carried on through a permanent establishment in the UK.
5. Subsection (4) of new section 577A provides for an anti-avoidance rule which disregards arrangements which circumvent the effect of subsection (1) of new section 577A.
6. Subsection (5) of new section 577A of new section 577A defines terms used in the section. In particular, the definition of "permanent establishment" explains how that expression is to be read in the context of companies and other persons.
7. Subsection (3) of the clause provides the commencement provisions.
8. Subsection (4) of the clause provides that the anti-avoidance rule in subsection (4) of new section 577A applies regardless of when arrangements were entered into.
9. Subsections (5) and (6) of the clause prevent payments being accelerated to circumvent the effect of subsection (1) of new section 577A.
10. Subsection (7) of the clause sets out the circumstances in which arrangements entered into before 28 June 2016 with the main purpose, or a main purpose, of obtaining a benefit under a double taxation arrangements between countries other than the UK are to be regarded as

"DTA tax avoidance arrangements" for the purposes of section 917A ITA.

11. Subsection (8) of the clause defines terms used in subsection (7) of the clause.

12. Subsection (9) of the clause sets out circumstances in which relief under the EU Interest and Royalties Directive can be denied under arrangements entered into before 28 June 2016.

Background note

13. Tax rules in the Income Tax (Trading and Other Income) Act 2005 define the territorial scope of the charge to income tax on royalties and other income from intellectual property. In the case of income arising to a non-UK resident, a charge arises only if the income is from a source in the UK.

14. This measure broadens the scope of payments of royalties and other income from intellectual property that will be considered to come from a source in the UK. This will now include payments made by persons that are non-UK resident person where those payments are connected with a trade carried out by that person through a permanent establishment in the UK. As a result such payments will now be subject to the deduction of income tax at source rules in Part 15 of the Income Tax Act 2007.

Chapter 11: legislation amending Part 3 of the Finance Act 2015

Receipts from intellectual property: diverted profits tax

(1) Part 3 of FA 2015 (diverted profits tax) is amended as follows.

(2) In section 79 (charge to tax), at the end insert—

"(6) But banking surcharge profits and notional banking surcharge profits, to the extent that they are determined by reference to notional PE profits (or what would have been notional PE profits) for an accounting period, do not include any amount which is (or would have been) included in notional PE profits for that period by virtue of section 88(5)(b)."

(3) In section 88 (which relates to the calculation of taxable diverted profits), for subsection (5) substitute—

"(5) "Notional PE profits", in relation to an accounting period, means an amount equal to the sum of—

(a) the amount of profits (if any) which would have been the chargeable profits of the foreign company for that period, attributable (in accordance with sections 20 to 32 of CTA 2009) to the avoided PE, had the avoided PE been a permanent establishment in the United Kingdom through which the foreign company carried on the trade mentioned in section 86(1)(b) , and

(b) an amount equal to the total of royalties or other sums which are paid by the foreign company during that period in connection with that trade in circumstances where the payment avoids the application of section 906 of ITA 2007 (duty to deduct tax).

(5A) For the purposes of subsection (5)(b) a payment of a royalty or other sum avoids the application of section 906 of ITA 2007 if—

(a) that section does not apply in relation to the payment, but

(b) that section would have applied in relation to the payment had the avoided PE been a permanent establishment in the United Kingdom through which the foreign company carried on the trade mentioned in section 86(1)(b)."

(4) In section 100 (credit for UK or foreign tax on same profits), for the heading substitute "Credits for tax on the same profits".

(5) In section 100, after subsection (2) insert—

"(2A) Subsection (2)(b) does not allow a credit against a liability to diverted profits tax if or to the extent that the liability arises by virtue of section 88(5)(b) (payments of royalties etc)."

(6) In section 100, after subsection (4) insert—

"(4A) Subsection (4B) applies where—

(a) a company's notional PE profits for an accounting period include an amount under section 88(5)(b) determined by reference to a royalty or other sum,

(b) the company's liability to diverted profits tax for the accounting period is determined by reference to taxable diverted profits calculated under section 91(4) or (5), and

(c) those taxable diverted profits include an amount of relevant taxable income referred to in 91(4)(b) or (5)(b) determined by reference to the same royalty or other sum.

(4B) A credit equal to the company's liability to diverted profits tax for that accounting period which arises by virtue of section 88(5)(b) in respect of the royalty or other sum, to the extent that it is included in relevant taxable income for the purposes of section 91(4)(b) or (5)(b), is allowed against the company's total liability to diverted profits tax for that period.

(4C) Subsection (4D) applies where—

(a) by reason of the payment of a royalty or other sum a company's liability to diverted profits tax for an accounting period includes liability arising by virtue of section 88(5)(b),

(b) the royalty or other sum is paid to a person who is resident in a country or territory outside the United Kingdom, and

(c) under any relevant provision relief would have been due to that person had the avoided PE been a permanent establishment in the United Kingdom through which the company carried on the trade mentioned in section 86(1)(b).

(4D) Such credit as is just and reasonable having regard to the amount of the relief referred to in subsection (4C)(c) is allowed against the company's liability to diverted profits tax.

(4E) In subsection (4C)(c) "relevant provision" means—

(a) the provision of a double taxation arrangement (as defined by section 2(4) of TIOPA 2010), or

(b) section 758 of ITTOIA 2005 (exemption for certain interest and royalty payments)."

(7) The amendments made by this section have effect in relation to accounting periods ending on or after 28 June 2016.

(8) For the purposes of section 88(5)(b) of FA 2015 as inserted by this section, a royalty or other sum which would not otherwise be regarded as paid during an accounting period ending on or after 28 June 2016 is to be regarded as so paid if—

(a) for the purposes of section 906 of ITA 2007 it is regarded as paid on a date during that period by virtue of section (*deduction of income tax at source: intellectual property*)(6) , or

(b) for the purposes of section 577A(1) of ITTOIA 2005 it is regarded as paid on a date during that period by virtue of section (*receipts from intellectual property: territorial scope*)(5) ."

Receipts from intellectual property: diverted profits tax

Summary

1. The clause introduced by this amendment changes the rules in Part 3 of the Finance Act 2015 (FA15) on the diverted profits tax. It revises section 88 FA15 to include within the charge to diverted profits tax an amount equal to payments of royalties and other sums in respect of intellectual property that would have been subject to the deduction of income tax at source had an avoided permanent establishment (PE) been an actual permanent establishment in the UK. Consequential changes are also made to sections 79 and 100 FA15. These changes ensure that no advantages accrue to a person within the charge to diverted profits tax as a result of other changes to the rules in respect of the deduction of income tax from payments of royalties made in Finance Bill 2016 and that the application of the 25% rate continues to disincentivise contrived arrangements.

Details of the clause

2. Subsection (1) of the clause provides that Part 3 of FA15 is amended.

3. Subsection (2) of the clause adds a new subsection (6) to existing section 79 FA15. This new subsection ensures that royalty payments included in taxable diverted profits tax by virtue of the new subsection 88(5)(b) FA15 are charged at a rate of 25% and not treated as banking surcharge profits or notional banking surcharge profits.

4. Subsection (3) of the clause replaces the existing subsection 88(5) FA15 with new subsections 88(5) and (5A) FA15.

5. New subsection (5) of section 88 FA15 provides that "notional PE profits" of an accounting period is now the sum of two amounts.

6. New subsection (5)(a) of section 88 FA15 includes within the definition of "notional PE profits" (NPEP) those amounts that are NPEP under the current subsection 88(5) FA15.

7. New subsections (5)(b) and (5A) of section 88 FA15 include in NPEP of an accounting period an additional amount equal to the sum of certain royalties and other sums in respect of which an obligation to deduct income tax would have arisen under section 906 ITA if an avoided PE had been a permanent establishment in the UK.

8. Subsection (4) of the clause amends the heading of section 100 FA15 as credit under that section can now include amounts for a liability to diverted profits tax arising by virtue of new subsection 88(5)(b).

9. Subsection (5) of the clause inserts new subsection 2A into section 100 FA15. This new subsection ensures that credit is not given for foreign tax paid by the recipient of a royalty that is included within taxable diverted profits by virtue of the provisions of new subsection 88(5)(b).

10. Subsection (6) of the clause inserts new subsections (4A), (4B), (4C), (4D) and (4E) into section 100 FA15.

11. New subsections (4A) and (4B) of section 100 FA15 prevents an amount of profit represented by a single royalty payment being charged to tax twice under different provisions in Part 3 of FA15.

12. New subsections (4C), (4C) and (4D) of section 100 FA15 provide for credit to be given, on a just and reasonable basis, against a company's liability to diverted profits tax arising by virtue of section 88(5)(b) where relief would have been due under either a double taxation arrangement or the EU Interest and Royalties Directive.

13. Subsection (7) of the clause provides the commencement provisions.

14. Subsection (8) of the clause ensures that payments that are accelerated to avoid the application of the changes made to section 88(5) FA15 will be regarded as paid in an accounting period to which the revised section 88(5) applies.

Background note

15. Tax rules in the Income Tax (Trading and Other Income) Act 2005 define the territorial scope of the charge to income tax on royalties and other income from intellectual property. In the case of income arising to a non-UK resident, a charge arises only if the income is from a source in the UK.

16. Other legislation being introduced into the Finance Bill 2016 broadens the scope of payments of royalties and other income from intellectual property that will be considered to come from a source in the UK. This will now include payments made by persons that are non-UK resident person where those payments are connected with a trade carried out by that person through a permanent establishment in the UK. As a result such payments will now be subject to the deduction of income tax at source rules in Part 15 of the Income Tax Act 2007.

17. This measure ensures that no advantages will accrue, as a result of the changes to the source rule, where a non-resident person has an avoided PE within the meaning of Part 3 of FA15 as compared to the situation where a non-resident person has an actual PE in the UK, and that the application of the 25% rate continues to disincentivise contrived arrangements.

Chapter 13: legislation amending Clause 40 to the Finance Bill 2016

Clause **40**, page **80**, leave out lines 33 to 39 and insert——

"“intellectual property royalty payment” means a payment referred to in section 906(2)(a) or (3)(a);”.

Clause **40**, page **81,** line **12**, at end insert—

“(3) In relation to payments made (under any such arrangements) on or after 17 March 2016 and on or before the day on which this Act is passed, section 917A of ITA 2007 as inserted by subsection (1) has effect as if the definition of “intellectual property royalty payment” in that section were as follows—

"“intellectual property royalty payment” means—

(a) a payment of a royalty or other sum in respect of the use of a patent,

(b) a payment specified in section 906(1)(a) (as originally enacted), or

(c) a payment which is a “qualifying annual payment” for the purposes of Chapter 6 by virtue of section 899(3)(a)(ii) (royalties etc from intellectual property);”.

(4) In relation to payments made (under any such arrangements) on or after 28 June 2016 and on or before the day on which this Act is passed, section 917A of ITA 2007 as inserted by subsection (1) has effect as if “intellectual property royalty payment” also included (so far as it would not otherwise do so) any payments referred to in section 906(2)(a) or (3)(a) of ITA 2007 as substituted by section *(deduction of income tax at source: intellectual property)* .”

Amendments to Clause 40: Deduction of income tax at source: tax avoidance

Summary

These amendments to Clause 40 make a change to new section 917A of the Income Tax Act 2007 (ITA) consequential to the introduction of new Clause (*deduction of income tax at source: intellectual property*) to the Finance Bill 2016. These amendments ensure that new section 917A ITA will apply to all payments of royalties or other sums from which income tax will have to be deducted at source following the amendment of sections 906 and 907 ITA.

Details of the amendment

1. The first amendment changes the definition of "intellectual property royalty payment" in subsection (4) of new section 917A ITA to make reference to the new subsections 906(2)(a) and (3)(a) ITA introduced by Clause (*deduction of income tax at source: intellectual property*).
2. The second amendment supplements the commencement provisions in Clause 40 by adding new subsections (3) and (4).
3. New subsection (3) of the clause provides that in relation to payments made on or after 17 March 2017 new section 917A ITA has effect as if the definition of "intellectual property royalty payment" had not been changed by the first amendment above.
4. Subsection (4) of the clause provides that new section 917A ITA has effect in relation to payments made between 28 June 2016 and the date on which the Act is passed as if the definition of "intellectual property royalty payment" also included any amounts referred to in section 906(2)(a) or (3)(a) as submitted by Clause (*deduction of income tax at source: intellectual property*).

Background note

5. Clause (*deduction of income tax at source: intellectual property*) broadens the scope of the UK's domestic withholding rights over royalties in order to ensure that payments abroad are taxed in the UK unless the UK has explicitly given up those taxing rights under an international agreement.
6. These amendments ensure that section 917A ITA as submitted by Clause 40 will apply to all payments of royalties in respect of which there is an obligation to deduct income tax at source under Part 15 of ITA from the date from which Clause (*deduction of income tax at source: intellectual property*) has effect.