SLAUGHTER AND MAY

The new income tax charge on offshore receipts in respect of intangibles

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Finance Bill 2019 includes provisions taxing a non-UK resident person that is also not resident in a full treaty jurisdiction on gross income from intangible property held in low-tax jurisdictions to the extent that it is referable to UK sales. The draft legislation will take effect from 6 April 2019, although anti-forestalling provisions and a TAAR will apply from 29 October 2018. It is, in the authors' opinion, debateable whether there is a principled basis for imposing tax on gross income. There are also practical concerns as to how businesses can be expected to trace use of their product or services by third parties; and the TAAR should be clarified to clearly enable restructuring in a way which aligns ownership of the IP with a substantive business in a 'good' treaty jurisdiction.

While the UK's new digital services tax hogged the limelight in the recent Budget, much less attention was paid to the fact that the proposed extension of withholding tax on royalties paid to tax havens (announced at the previous Budget) was converted into a direct income tax charge, recoverable from UK affiliates of the person exploiting the intangible property if not collected directly.

Is this really a withholding tax by another name?

This change to the royalty withholding tax regime was made after consultation but, apart from the mechanics of recovery, the end result is broadly the same as a withholding tax, so there are still some questions of principle and practicability to address.

First, withholding taxes are intrinsically bad when imposed on businesses – because they are taxes on gross income with no relief for costs (such as amortisation, funding costs etc) or other expenses of earning the income. This is likely to mean that there is either double taxation, or one jurisdiction is picking up more than its fair share of the taxes on net income arising from the particular activity. Secondly, in the case of the UK, the rate of income tax is higher than the CT rate that would apply to business profits.

Despite the change here from a tax collected by withholding to a tax collected by assessment, neither of these objections has been dealt with.

So, in two respects, the proposals verge on being punitive – which would make sense if the new tax was designed purely to discourage and change unacceptable tax behaviour (like energy or tobacco taxes that are intended to reduce consumption), and so redemption by changing the particular structure or behaviour was an option. For example, the anti-hybrid imported mismatch rules can deny a deduction for, say, a plain vanilla loan into the UK, because of a hybrid mischief outside the UK and further up the structure; but this deduction can then be restored by restructuring to remove the hybrid mismatch, or if there's a change in foreign law which removes the hybrid mismatch. As discussed below, both of those routes to redemption are, however, rather tougher for the offshore intangibles tax.

Right to tax?

As the reaction to the new digital service tax, also announced in the Budget, illustrates, governments have a choice between:

- taxing something because they can (in other words there is no inherent protection for the recipient through a tax treaty or otherwise); and
- taxing income or gains because, as a matter of principle, they should.

The latter principle is what has allowed the UK to tax income from the exploitation of offshore energy assets, and also income from UK real estate, largely without complaint. In the former case, investors are investing into an area controlled, regulated and protected by the UK; in the latter case, taxing real estate income from assets physically located in your jurisdiction can surely not be questioned as a matter of principle. In both cases, there is a UK footprint and the business is clearly benefiting from UK government activity.

The age-old truth that tax is especially to be commended if paid by someone else can now be supplemented by the statement that governments like to tax people who don't vote, especially if they don't reside in the jurisdictions concerned. Political backlash from any unfair taxation can then be minimised. But taxing inward investors can have consequences in terms of jobs and national competitiveness – so proceeding with caution is always to be recommended.

Better still, being able to defend any new tax on the basis that it is one that 'should' be collected as a matter of principle rather than one that 'can' be collected without meaningful objections gets you on to much safer ground. People generally prefer to pay tax when they can understand why it is being levied.

Digital presence: UK footprint or not?

While the US seems at present to be treating the proposed new digital services tax as a targeted attack on specific US companies dominating a business area in the IT space, there is a principled argument that can be made in support of it.

There are perhaps three alternative ways of doing that.

- First, as the government argues, this could potentially be justified as a temporary proxy for taxing the profits which are properly attributable to user participation in the UK (though other countries continue to challenge whether there is something special about user participation which merits a share of profits – and, if there is, why this should be limited to particular business sectors);
- Second, DST is a market access fee. Any government or local authority setting up a market place for others to use is likely to incur costs in doing that, and a market access fee simply helps to cover those costs. In the digital space, it could be said that the jurisdiction in which a digital presence is established incurs costs as the 'market place' created by the offshore company concerned begins to generate pressures on digital and transport infrastructure in the jurisdiction concerned. This is not the same as the cost that might arise because someone exports goods to the UK – assuming those goods would have been needed and acquired anyway means there is little if any incremental cost; or
- Finally, in the same way as someone can bring a mobile asset into the jurisdiction and earn income by deploying that asset potentially within the scope of UK tax, so (it can be argued) can someone with a powerful IP asset use it to 'hover over' the UK and derive income from the deployment of that asset 'in the UK'.

- Again, deploying the asset in question in your jurisdiction creates costs (so the argument goes) which the jurisdiction concerned needs to recover through tax from someone.

Why pay tax?

If you step back and ask why people pay taxes at all, the answer is that individuals or resident corporations pay by virtue of membership of a society where everyone has agreed that certain services will be provided and the costs will be shared. Offshore companies that have a permanent establishment pay proportionally, according to their profits generated in the UK, for the same reason – if part of their activity is on the ground here then they should make a contribution to the services and facilities they benefit from.

With someone who has a digital presence in the UK which nevertheless results in costs having to be incurred in the UK, we need to find a way of fairly allocating those costs among the contributors, pending a changed global profit allocation method that recognises the challenges of the digital age. As the DST consultation goes on, arguments are likely to rage as to whether one or more of the above justifications for DST holds water.

In the shorter term, attention is also bound to be focused on the new intangible income tax charge to see whether it can be justified in the same or another way.

The market access fee argument does not seem to apply, nor the ‘user participation’ argument, but the argument based on deployment of IP in your jurisdiction could certainly be used. The real question, however, is whether or not that deployment imposes additional costs on the UK, simply because sales are made in the UK.

Detailed implementation issues

When we then turn to more detailed issues over the application of the tax, it’s worth starting with the basic ingredients of this charge:

(a) it does not apply to people within the charge to corporation tax (ie with a UK PE in this context);

(b) it only applies to amounts received in a low tax jurisdiction (which basically means a jurisdiction with whom the UK does not have a full tax treaty containing non-discrimination provisions);

(c) it is charged on all receipts (income and gains) in respect of intellectual property to the extent that those amounts are attributable to the sale of goods or services in the UK;

(d) it will apply to all such income from those related and unrelated parties with effect from 6 April 2019; and

(e) while the most obvious application of the new tax will be to royalties, it also extends to income that is earned when goods or services are sold in the UK and the value derived depends to some extent from utilisation of the intangible property. (Indeed, as the guidance makes clear, this can occur even if the goods or services pass through several unconnected parties before there is a sale into the UK. The guidance says that the charge will not apply if the intangible does not represent a ‘substantial’ part of the value attributable to the UK sale; however, this exclusion is not included in the legislation, and applying this test will, we are told, depend on the specific facts and circumstances. Tracing non-UK sales through third parties to determine if they generate substantial value from a UK sale looks rather challenging.)

Beyond the treaty defence, there are some exemptions, though all will be rather difficult to apply:

- There is a £10m de minimis UK sales threshold. However, to determine if this applies, you need to trace through the full supply chain to identify the value of any eventual sales into

the UK, which makes this unappealing for any businesses with substantial global sales.

- A second exemption looks at whether or not all or substantially all of the trading activities generating the income have always been undertaken in the low tax jurisdiction *and* the intellectual property was not acquired from related parties. In practice, we expect this to be quite unusual.

- Another exemption applies if the tax paid on the relevant amounts by the entity in the host jurisdiction is more than half the IT charge. This seems unlikely to be of much use, especially since the IT charge is on gross income whereas the local charge will most likely be on the net profits.

Notably, there is no exemption if the income is subject to a CFC or GILTI charge at the parent company level. This is justifiable as a matter of tax principle, in the same way that withholding tax charges on payments to low-tax jurisdictions are not switched off if the recipient's parent suffers a CFC charge on the income. However, it can be contrasted with the position for the hybrid imported mismatch rules: US business might argue that US tax reform has already dealt with the base-erosion risks of the old US deferral regime, and that the effect of the offshore intangibles tax is to shift the tax base from the US (through GILTI charges) to the UK, even though the 'DEMPE' functions generating the IP are typically based in the US.

Finally, there is a broad TAAR which enables HMRC to counteract any arrangements which have a main purpose of seeking to reduce the offshore intangibles tax charge. Where this involves claiming treaty benefits, the TAAR overrides the treaty if obtaining those benefits is 'contrary to the object and purpose of the provisions'. (One odd and, we believe, unintended, result of this is that, if a company reacts to the offshore intangibles tax by moving the relevant IP to the UK, it will be in a worse position than if it moves the relevant IP to a treaty partner, as it will not be able to rely on the 'object and purpose' defence.) In practice, many of the businesses which are affected by the offshore intangibles tax charge will be US companies holding their IP under a 'double Irish' structure, which will in any case need to be restructured from 2020 thanks to changes in Irish tax law. It would be helpful if the government indicated what sort of restructuring to close down 'double Irish' structures might fall on the right (and the wrong) side of the TAAR.

So what is to be done?

This is *not* a consultation - unlike the DST proposal - but there nevertheless seems to be much still to be done before the tax comes into force in April 2019.

To our minds, the three main questions that should be raised are:

- is there a *principled* basis for imposing tax on gross income - or should affected parties be allowed to elect into a net profits charge to CT (essentially a deemed PE) if a basis for agreeing what *profits* arise from the exploitation of IP in the UK can be established?;

- in practice, how will businesses be expected to trace use of their product or services by third parties, to determine if that has been used as a substantial part of an eventual UK sale by a third party; and

- should the TAAR be clarified, so that it clearly allows people to restructure in a way which aligns ownership of the IP with a substantive business in a 'good' treaty jurisdiction (or, indeed, allows them to transfer the IP to the UK)?

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