On 29 October 2018, the United Kingdom (UK) Government published draft legislation to apply a UK income tax charge to amounts received by a foreign resident entity in respect of intangible property. The tax will be charged at a rate of 20% on the gross amounts of a foreign resident entity to the extent that the amounts are referable to the sale of goods or the provision of services in the UK.

The measure was first announced in the Autumn Budget 2017 and was originally formulated as an extension to the UK’s withholding tax regime on royalties. This was intended to apply to payments between related parties for the exploitation of intangible property or certain other rights in the UK. A consultation document on the proposed policy design was issued by HM Revenue & Customs (HMRC) and HM Treasury on 1 December 2017.

In the response to the consultation, which has now been published, the Government outlines the thinking behind the redesign of the measure. The policy objective continues to be targeting multinational groups that realize amounts from intangible property held in low-tax offshore jurisdictions and which is exploited directly or indirectly in the UK. But rather than achieving this through an extension of the UK withholding tax regime, the Government now proposes to directly impose UK income tax on foreign resident entities where the entity is resident in a territory that does not have a full treaty with the UK. The Government does not consider that other global reform initiatives (such as US tax reform) fully address the specific tax outcomes at which this measure is targeted.
The draft legislation widens the scope of the originally proposed measure with a broad definition of intangible property, for example including trademarks, know-how, distribution rights and customer lists, and the inclusion of embedded royalties. In some circumstances, amounts from the indirect exploitation of intangible property in the UK market through unrelated parties is also now within scope. However, the draft legislation also introduces a number of exemptions.

The legislation is intended to apply from 6 April 2019, but anti-avoidance provisions will apply from 29 October 2018. Given the limited time before the rules enter into force, groups should be looking at the provisions in detail and considering the impact in order to assess what actions might be needed in advance of the new rules coming into effect.

We are engaging with HM Treasury and HMRC on the rules as it appears that changes will be required to the draft legislation released to give full effect to the policy intentions. It may be possible for the Government to make some changes in advance of the law being enacted. The legislation also contains enabling provisions so that changes can be made by way of regulations.

Summary of the rules

Consistent with the original proposals, the charge to income tax will apply unless the entity is resident in the UK or in a jurisdiction with which the UK has a full tax treaty, meaning a Double Tax Agreement (DTA) which contains a non-discrimination provision.

UK income tax will be charged at a rate of 20% on the gross amounts (whether of a revenue or capital nature) of a foreign resident entity in respect of the enjoyment or exercise of intangible property rights that enables, facilitates or promotes UK sales. This includes UK sales made by the foreign resident entity, related parties and, in some circumstances, UK sales made through unrelated parties. This last scenario may arise, for example, via an arrangement with an unrelated distributor, reseller, manufacturer or franchise arrangements.

As indicated by the examples included in the Government’s response to the consultation, the new measure seems to be intended to only cover UK sales made by unrelated parties where a substantial part of the value of the end product or service sold to UK customers is derived from the use of the foreign resident entity’s intangible property. The examples suggest that when the exploitation of the intangible property relates to a relatively low value and potentially substitutable component of an end product, it may not constitute a UK sale to which the foreign entity’s amounts are referable. This may also be the case when the value derived from the intangible property is largely unrelated to the end product or service sold in the UK.

However, there is no further information on how this would be determined and the draft legislation does not appear to be in line with these examples. Updated legislation to address this could be included in the Finance Bill to be issued on 7 November or by way of later amendment to the Finance Bill.

Where the foreign resident entity receives amounts referable to sales in a number of countries, apportionment by reference to the ratio of UK sales to total sales will be an appropriate measure for determining the proportion of an amount that is liable to UK tax under the measure, to the extent that this is just and reasonable.

The draft legislation therefore requires a detailed understanding of UK and non-UK sales made by related and unrelated parties in connection with the intangible property, as well as good reporting lines to retrieve the relevant information.

Exemptions

There are a number of exemptions from the charge to income tax.

Limited UK sales – where the foreign entity and connected persons’ total value of UK sales does not exceed £10m in the year.

Substantially all activity undertaken in the foreign territory – if at all times, substantially all of the business activity in relation to the intangible property has taken place in the territory of residence of the foreign resident entity and the intangible property has not previously been transferred to the foreign resident entity from a related party, then the foreign resident entity can make a claim for this exemption to apply. This requires consideration of activity done by any person, at any time, for the purpose of creating, developing or maintaining any of the relevant intangible property and rights related to it.

Sufficient local taxation – if the amount of tax paid by the foreign resident entity in respect of UK-derived amounts is at least half of that which would be levied under the UK charge to income tax under this measure. However, it appears that this exemption may compare a local tax on profits with a UK tax on gross income and if not amended would therefore be
hard to satisfy in many circumstances. Also, the exemption does not take into account taxes paid elsewhere in the group, for example if the parent of the recipient is subject to controlled foreign company rules or the recently introduced US Global Intangible Low Taxed Income (GILTI) provisions.

**Anti-avoidance measures**

The draft legislation includes an anti-avoidance rule that targets arrangements that are designed to avoid the income tax charge where the main purpose, or one of the main purposes, of those arrangements is to obtain a tax advantage for the foreign resident entity. In the accompanying Tax Information and Impact Note, the Government considers that this could include arrangements whereby the intangible property is transferred to another group entity in a full treaty jurisdiction. However, this is likely to be fact specific. The anti-avoidance rule is intended to apply to arrangements made on or after 29 October 2018.

**Payment and reporting**

The payment obligation arising from the proposed measure will be a liability of the foreign resident entity directly and will be reported and collected under the existing income tax self-assessment provisions. Non-UK resident entities will be required to complete and submit a SA700 “Tax return for a non-resident company liable to income tax,” and pay the tax due by 31 January following the end of the tax year.

However, the provisions also include a joint and several liability rule allowing for the collection from related parties of income tax due from the foreign resident entity that remains unpaid for six months after the payable date. The definition of related party is a person in the same “control group” as the taxpayer at any time in the tax year to which the payment applies. The draft legislation sets out that two persons are in the same control group if they are consolidated for accounting purposes, one of them has a 51% investment in the other, or a third person has a 51% investment in each of them.

**Who is likely to be affected?**

The rules will impact groups that hold intangible property in jurisdictions that do not have a full tax treaty with the UK, and where the intangible property is used in respect of sales of goods or the provision of services to the UK directly or indirectly by related or unrelated parties.

**What should businesses be doing?**

Groups should be looking at the draft legislation in detail and considering its impact in order to assess what actions might need to be taken in advance of the new rules coming into effect and ensuring compliance with the rules.

Groups may also need to consider the draft proposals together with the new European Union mandatory disclosure regime rules that require the disclosure of certain cross-border arrangements that contain one or more “hallmarks.” The hallmarks include arrangements that involve the transfer of (rights to) hard to value intangibles, and restructuring that results in significant profit shifts following the transfer of functions, risks or assets between associated enterprises. Neither of these hallmarks are subject to the main benefit test which otherwise requires the main benefit or one of the main benefits of the arrangement to be the obtaining of a tax advantage.

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