UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 23, 2018

VIA EMAIL
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Re: USCIB Comments on HM Treasury's position paper on Royalties Withholding Tax

Dear Ms. Rankine and Ms. Arnold,

USCIB[1] is pleased to have the opportunity to comment on HM Treasury's position paper on Royalties Withholding Tax (hereinafter "position paper" or "paper"). USCIB is very concerned with the direction of this paper.

The BEPS project broadly addressed three related concerns of countries with respect to international taxation planning. One concern was aligning value creation with the right to tax. A second concern was the existence of so-called "stateless" income. Stateless income was perceived to be the result of "gaps" in the international tax rules as applied by different countries that permitted income to escape taxation anywhere. A third concern was that "frictions" between systems lead to double or multiple taxation and reduce global trade and investment. So, the overarching goal of the BEPS project was to eliminate the "gaps" without creating "friction" by aligning profits with value creation. To the extent that gaps remain post-BEPS, they should be addressed in accordance with the international consensus to avoid creating friction that will reduce global growth. Unilateral measures such as those proposed in the position paper, will create new frictions that will reduce global trade and investment.

Policy Concerns

Hitting the Target?

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

The position paper describes its intended target as “a narrow range of arrangements that achieve low effective tax rates through holding intellectual property in low or no tax jurisdictions.”[2]

This description of targeted transactions seems relatively innocuous; however, the actual proposal is poorly designed to achieve these goals.

The tests for determining whether a “royalty” will be subject to withholding tax are:

- Does the payment have a UK source? The definition of UK source will be expanded to include payments made for exploitation of IP within the UK regardless of whether the payor has a UK presence.
- Is the payment made between connected parties? If the payment is not between connected parties, then the withholding tax will not apply.
- Is the payment made to a jurisdiction that does not have a double taxation agreement (“DTA”) with the UK? If there is a DTA, does that DTA have a nondiscrimination article (“NDA”)? If there is either no DTA or a DTA without a NDA, then the withholding tax will apply.

The actual tests may hit the target, but only by hitting everything else. First, the proposal as designed does not affect a narrow range of arrangements; any sale of property would potentially be subject to the new “royalty” withholding tax, apparently even if a UK distribution entity or other UK taxable presence is involved in the sale (para. 3.6).

Second, there is no requirement that the actual effective tax rate on the so-called “royalty” be low, which the UK government acknowledges.[3]

Third, even if low effective rates are achieved, the proposal is not limited to countries which are merely holding IP. Rather the paper ignores activity that lead to the development of the IP.[4]

Source vs. Residence Debate

This proposal implicates the debate between so-called “source” and “residence”. The proposal asserts that sales into the UK generate UK source income that ought to be subject to tax in the UK, even though there is no presence or activity in the UK. Imposing a “royalties” withholding tax on an embedded intangible is a novel extension of taxing jurisdiction that would significantly expand “source” basis taxation, runs counter to the current international consensus and would create friction in the international tax system.

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[2] Position paper, para. 2.1, which also provides a diagram of a simple transaction that would be subject to the proposed rule.

[3] Position paper, para. 4.21. Given that the UK taxes some IP income at 5%, it would seem appropriate that in targeting low or no-taxed income, actual taxes paid should be taken into account, in determining whether income is, in fact, low or no-taxed. If the income is, in fact, subject to tax at a higher rate than it would be if earned in the UK can that income be considered low-taxed from a UK perspective?

[4] See, position paper, para. 4.11.

As noted above, the BEPS consensus is intended to align taxation rights with value creation and to prevent stateless income from arising. This alignment between taxation rights and value creation is, of course, not perfect and countries may wish to backstop these rules to prevent stateless income. The recent US tax law is a reminder, however, that there is really no such thing as "stateless" income. The repatriation provisions of the new US law, will impose tax using, controlled foreign corporation rules, on the accumulated post-1986 deferred foreign earnings. These earnings will be subject to tax in the US at either a 15.5% (earnings invested in cash) or 8% (other earnings) rate.[5] On a going forward basis, earnings exceeding a routine return will be subject to an immediate minimum tax in the US. The effective rate on those earnings is likely to exceed, at a minimum, 13.1% and, given the operation of expense allocation provisions, may be even higher.[6] The taxation of this income resolves, in large part, the concern that companies can create stateless income and serves as a backstop to the BEPS rules attempting to align taxation with value creation.[7]

At the very least, the proposed legislation needs to be modified to provide an exemption where the intangible income is taxed currently in a country which has a treaty with the UK containing an NDA, regardless of whether the income flows directly into that treaty country or is picked up by that country's CFC provisions or other rules having the same effect.

Under the current consensus, controlled foreign corporation rules to backstop earnings stripping and transfer pricing rules are preferred.[8] One reason for this may be that premium returns should ultimately reflect returns to capital. Investors put money into risky ventures with the hope that premium returns will be earned. While the BEPS consensus rejected premium returns to so-called "cash boxes", that does not imply that "rents" associated with business risk should not accrue to the owners of that business. If countries turn to new approaches without developing a new consensus, then taxpayers may be subject to multiple levels of taxation including countries asserting residence taxation under controlled foreign corporation type rules[9], withholding taxes on the actual royalty payment between related parties – a payment that is a traditional royalty and not the novel embedded royalty proposed by the UK, and the new "source" taxation based on potential withholding taxes on the actual upstream royalty payments between related parties as the result of the existence of an embedded royalty – the new assertion of "source" taxation as exemplified by the UK proposal.

The position paper proposals may even create double taxation of the same income by the UK. To the extent that the withholding applies to a sale in the UK where there was a UK presence

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[5] H.R. 1, 115th Congress, Tax Cut and Jobs Act ("TCJA"), section 14103(a) amending IRC section 965.
[6] TCJA, section 14201(a), adding IRC section 951(A).
[7] The BEPS project may have had its origin in concern over the ability of US companies to use various tax planning techniques to achieve low effective rates of tax. This concern has largely been addressed by the new US rules.
[8] See, Final Report, Action 3.
[9] H.R. 1, 115th Congress, Tax Cut and Jobs Act ("TCJA"). Although the TCJA adopts a territorial system, some provisions of the law will increase residence based taxation, including the provisions on repatriation (IRC section 965), and the provisions on global intangible low-taxed income (IRC section 951A).

and net basis tax was paid, then the “royalty” ought to have reduced the net income in the UK. If a deduction is not allowed against UK net income (which does not appear to be the case), then the UK would impose tax on both the net income in the UK and the embedded “royalty”. Is this consistent with the treatment of an actual royalty paid by a UK business to a foreign related party?

If each country designs proposals to maximize revenue attributable to that country, then the conflicting proposals will create friction that will increase double taxation and harm trade and investment.

The new US tax law makes changes that have been recommended for years including: significantly reducing the corporate rate to be more in line with the global norm; adopting a 100 percent participation deduction for certain foreign income; adopting meaningful restrictions on interest deductibility; and addressing hybrids. One of the key issues in moving to a territorial system is the concern that a territorial system increases the incentives for BEPS behavior; so, the new US law adopts anti-base erosion provisions to limit these incentives that are consistent with the longstanding consensus of using CFC rules to backstop transfer pricing and profit shifting rules.

The new law is generally described as moving to a territorial system because of the adoption of a 100 percent participation exemption. While the participation exemption certainly moves the US towards the international norm of a territorial system, as pointed out above, other changes – the provisions relating to repatriation of post-1986 earnings and those relating to the taxation of global intangible low-taxed income – increase residence based taxation. Indeed, US taxpayers see that the real impact of the new law is to adopt a world-wide system of taxation with a global minimum tax.[10]

The UK position paper would not take these provisions into account, because despite claiming to target low-taxed income, the proposal does not attempt to determine whether the effective rate on the so-called “royalty” income is actually low. If the target of this proposal is, in fact, low-taxed income attributable to holding IP, then the fact that the income is not low-taxed should be relevant to the determination of whether there is a “gap” that justifies some type of anti-abuse rule – if there is no gap then imposing this new tax merely introduces “friction” into the international tax system, which should be avoided.

BEPS consensus

The position paper is also troubling because it ignores the multilateral agreements coming out of the BEPS process. Despite actively participating in the BEPS process and agreeing to the outcomes set forth in the Final Reports, proposed unilateral actions by the UK continue to undermine the concept of multilateral action and the implementation of the BEPS outcomes.

[10] USCIB members are not arguing in support of the GILTI (or the BEAT), just noting that US taxpayers now need to comply with these measures and they will impose significant tax on income that otherwise might be low-taxed.

The purpose of much of the guidance in the Final Reports under Actions 8 through 10 was to align income with value creation. To the extent that the income received by various entities in the value chain, including the seller into the UK and any recipient of a royalty is appropriate under the arm's length standard as articulated under Actions 8 through 10, then that income should reflect an appropriate return to value creating activities and should be taxable where value is created, not in the UK. The mere holding of IP in a company that does not engage in development, enhancement, maintenance, protection or exploitation functions ("DEMPE functions") should not generate any return under the BEPS principle. Income properly attributable to DEMPE functions should be subject to tax where those activities take place and should not be subject to a punitive withholding tax intended to target "holding" of IP in a low or no-tax jurisdiction. Further, the changes to tax treaties, including the addition of anti-treaty shopping provisions and new permanent establishment standards, should ensure that the entity making sales into the UK is not able to take advantage of a treaty to protect income of an entity that is subsequently going to be inappropriately shifted out of the first treaty jurisdiction.

The UK has stated that the "significance of the BEPS project should not be underestimated."[11] Governments and businesses are adapting to the new environment and the new rules should be allowed to work. Instead of allowing that process to move forward, the UK government is acting unilaterally to bring more income into the UK, in ways that undercut the multilateral agreement and make further multilateral action more difficult. The position paper's proposal is not supported by any of the BEPS guidance or any historical policy principles – it might be a GAAR if it were actually targeted to address the narrow arrangements it purports to target.

The OECD struggled to come to agreement on principles that limit harmful tax competition,[12] but ultimately agreed on a nexus formulation for certain IP property.[13] Rules restraining harmful tax competition are intended to set limits on the ability of one country to undercut another country's taxing jurisdiction. The reverse side of this is that a tax benefit that is not harmful should be respected by other countries. It was concluded that a so-called "patent box" that meets the agreed standard is not harmful and should be respected. The UK has implemented a qualifying patent box[14] and grandfathered pre-existing arrangements in accordance with the agreed upon BEPS criteria. Presumably the UK government now expects other countries to allow benefits with respect to the patent box and grandfathered arrangements and not impose taxes on the theory that royalties paid to the entity with the qualifying patent box are somehow part of an arrangement that achieves a low tax rate for holding intellectual property in a low-tax jurisdiction. That should be the result since the UK patent box is not considered harmful. Nevertheless, the position paper would not respect this

[11] HM Treasury position paper on Corporate tax and the digital economy, para. 3.3.

[12] It is our understanding that this agreement was largely the result of a compromise between the UK and Germany on the "nexus" principle. It is, therefore, especially disconcerting that the UK proposes to disregard development activity that leads to the creation of the IP in applying the proposals in the position paper.

[13] Action 5 Final Report.

[14] See, OECD's Harmful Tax Practices - 2017 Progress Report on Preferential Regimes, Chapter 2, para. 14.

benefit in the other direction in the absence of a double tax agreement ("DTA") with a non-discrimination article ("NDA"). If the tests proposed by the position paper are satisfied, then whether the income from the IP would be appropriately taxed in that jurisdiction because it does not benefit from a harmful regime (or any special regime at all) is irrelevant.

Inconsistent with Modern Business Practices

The tests proposed by the position paper potentially create perverse results. If a company centrally develops IP in a high tax jurisdiction and licenses that IP to a marketing subsidiary, then the royalty paid to the high-tax developer would potentially[15] be subject to the UK withholding tax. On the other hand, if the IP developer also marketed the product itself, because there would be no payment between connected parties, there would be no withholding tax, even though the income attributable to the IP would be identical and earned in the same jurisdiction. Thus, the proposal penalizes companies that separate IP development from marketing – a common business practice that generally has little or nothing to do with tax planning. Companies routinely separate different aspects of their business into different legal entities for business reasons. Tax considerations should not distort this legitimate business activity.

The royalties position paper also seems to undercut the corporate tax and the digital economy position paper. The digital economy position paper says: "it (the UK) does not believe that the UK should have a general right to tax the profits that a foreign business generates from a product that is designed in another country, manufactured and marketed in that country and then sold remotely to a UK consumer." (para. 2.6) The digital economy position paper then adds: "Instead countries should have the right to tax business profits derived from productive activities, enterprise and human innovation in their jurisdiction, irrespective of where shareholders and customers are located." (para. 2.7)

The royalties position paper would impose a gross basis tax on embedded intangibles even if the innovation took place in the country receiving the royalty. It seems that bifurcating the marketing and the innovation would result in a UK tax on the royalty even though all the profit generating activity took place outside of the UK and even if the activities in the country in which the intangible was developed are substantial within the meaning of the Action 5 Final Report and even if the royalties were not low-taxed. It seems that allowing other countries the right to earn a return without being subject to UK tax only applies if **all** the activities take place in the other jurisdiction -- so that there would be no need for any royalty payments anywhere in the value chain between the development of the IP and the sale into the UK. This does not seem consistent with the professed belief that "countries should have the right to tax business profits derived from productive activities, enterprise and human innovation in their jurisdiction irrespective of where shareholders or customers are located." It is also not consistent with

[15] Depending on whether there is a DTA with a NDA in the country developing the IP.

modern business practices, where different entities in different jurisdictions perform different functions and should be entitled to earn appropriate returns despite that division of functions.

The proposal especially is damaging because it undermines agreed upon international norms, which the business community relies upon to do business around the globe. Further, limiting the application of the withholding tax to non-DTA countries or DTA countries that do not have an NDA implies that the UK recognizes that the proposal set forth by the position paper is discriminatory as that concept is understood in tax treaties.

Administrative Concerns

In addition to the objections based on policy, USCIB has objections based on the administrative difficulties the proposal set forth in the position paper will create.

Complexity

The position paper uses a very simple example to illustrate the arrangements that are in scope.[16] The position paper is clear, however, that there "may be variations on such structures"[17] and that the withholding tax would apply, even where the parties to the license do not include the party to the sale in the UK and even if there are intervening entities that would not be subject to the tax because, for example, they are entities that resident of a tax treaty jurisdiction with an NDA. Further, it is not clear how an entity that is remote from the sales transaction would know whether the sale into the UK is a remote sale or whether the sale is made by a UK entity or a permanent establishment, in which case the withholding tax could be collected from the in-country entity or PE.

Cascading Withholding Taxes

The position paper also attempts to eliminate cascading withholding taxes.[18] The position paper limits this benefit to cases in which the IP and rights under each agreement are essentially identical.[19] This is overbroad. Given that the approach to avoiding cascading payments is to give a credit for taxes paid against the same IP and rights, it seems that even if the rights were not identical, for example one set of rights were broader than the other set of rights, the credit could still be granted taxes paid on the narrower set of rights against the broader set of rights.

Anti-abuse Provisions

The position paper provides that an anti-abuse rule "will apply to arrangements that have as the main purpose, or one of the main purposes, the avoidance of liability under this measure. This will apply to payments made after the operative date of the measure, even if made under

[16] Position paper, para. (2.1).
[17] Position paper, para. (2.7).
[18] Position paper, para. (4.12).
[19] Position paper, para. (4.14).

arrangements entered into before that date."[20] USCIB objects to two aspects of this anti-abuse rule. First, any test that applies to "one of the main purposes" is extremely subjective and difficult to apply in practice, the test should, therefore, be limited to the "main purpose". The position paper provides no guidance on what might be considered in making this determination. Second, the anti-abuse rule is proposed to apply retrospectively. USCIB generally does not support retrospective application of rules. In this case, it would seem impossible to apply the rule retrospectively since it would require finding that the taxpayer had as one of its main purposes avoiding a rule that did not yet exist at the time the transaction occurred.

As noted above, the BEPS changes pertaining to treaty shopping will limit the ability of taxpayers to make use of a tax treaty inappropriately. To the extent that this anti-abuse rule relates to arrangements designed to obtain a tax advantage contrary to the object and purpose of the DTA, how does this differ from the new anti-treaty shopping language? If it does not differ, is it necessary? If a treaty partner (for example, the US) has rejected "main purpose or one of the main purposes" language because of the subjectivity of that standard, is it appropriate for the UK to apply that test unilaterally to income that would otherwise be protected under a DTA with a NDA?

Reporting and Payment

As noted above, the payor of the royalty may be remote from the person making a sale into the UK. Therefore, the payor of the royalty may have no knowledge of the sale into the UK that would create the reporting or withholding obligation on its payment to person resident in a third country. Any time a company is paying royalties to a related party, the DTA (if any) between the UK and the country of the party receiving the royalty at country would need to be examined to determine whether there is a NDA. If there is no DTA or a DTA without an NDA, then withholding would apply and the payor of the royalty would need to determine if there are sales into the UK. If there are, have taxes already been withheld? If not, does the royalty cover non-UK intangibles? If so, does the payor of the royalty have the relevant information to determine the portion of the royalty that is attributable to UK sales? If not, how will it obtain that information? Given the possible remoteness of these transactions, this information may be very difficult to obtain.

With respect to payment, the UK proposes to impose joint and several liability on associated companies using TIOPA definitions. These definitions would sweep in joint ventures and other non-wholly owned companies, without regard to whether the sales generating the royalty had any relation to a potentially entirely separate business.

[20] Position paper, para. (4.23).

At a minimum joint and several liability should prioritize collection of tax from related parties that are wholly-owned by the same person or persons that have failed to pay the tax on the payment of the royalty.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)