EXPLANATORY MEMORANDUM TO

THE INCOME TAX (TRADING AND OTHER INCOME) ACT 2005 (AMENDMENTS TO CHAPTER 2A OF PART 5) REGULATIONS 2019

2019 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument amends the legislation "Offshore Receipts in respect of Intangible Property" which imposes income tax on amounts received by persons resident in low tax jurisdictions for intangible property (such as brands, patents and copyrights) where those amounts are referable to the sale of goods or services in the United Kingdom (UK).

2.2 The instrument introduces legislative changes following consultation. In particular it modifies the definition of UK sales, better targets the legislation (insofar as it is consistent with the UK's international obligations) and makes provisions to relieve double taxation.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 This is the first use of the power provided by paragraphs 10 and 11 of Schedule 3 to the Finance Act 2019 (FA 2019) to amend the provisions of Chapter 2A of Part 5 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005).

3.2 Various parts of this instrument have retrospective effect. The authority to make provisions with retrospective effect is contained in paragraphs 10 and 11 of Schedule 3 to FA 2019. This ensures that, since Chapter 2A came into force on 6 April 2019, the appropriate amendments made by this instrument also have effect from that date. Amendments that are wholly relieving will have effect from 6 April 2019 (save for the consequential amendment made by regulation 15), which is when the existing legislation commenced. The other amendments will have effect prospectively, from the day after the day on which this instrument is made.

3.3 This instrument also inserts into Chapter 2A a new exemption for companies resident in specified territories, which includes a new power for the Commissioners for HMRC to make secondary legislation to specify territories. That power also provides that such regulations may have retrospective effect. The authority to create a power to make secondary legislation is also contained in paragraphs 10 and 11 of Schedule 3 to FA 2019.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.4 The territorial application of this instrument includes Scotland and Northern Ireland.

3.5 The power under which this instrument is made covers the entire United Kingdom and the territorial application of this instrument is not limited either by the Act or by the instrument.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the whole of the United Kingdom.

4.2 The territorial application of this instrument is the whole of the United Kingdom.

5. European Convention on Human Rights

5.1 The Financial Secretary to the Treasury, Jesse Norman MP has made the following statement regarding Human Rights:

"In my view the provisions of the Income Tax (Trading and Other Income) Act 2005 (Amendments to Chapter 2A of Part 5) Regulations 2019 are compatible with the Convention rights."

6. Legislative Context

6.1 These regulations amend Chapter 2A of Part 5 ITTOIA 2005 (Offshore Receipts in respect of Intangible Property) introduced by section 15 of, and Schedule 3 to, FA 2019.

6.2 That legislation seeks to prevent multinational groups from achieving artificially low tax rates on income derived from UK sales by holding intangible property ("IP") in low-tax jurisdictions. The legislation contains a power for the Treasury to make any amendments to Chapter 2A by regulations. These regulations are to ensure that the government better targets the legislation at tax-motivated arrangements and alleviates any unintended outcomes. Such regulations may not be made after 31 December 2019.

6.3 Further regulations for the new exemption from Chapter 2A inserted by these regulations (where a company is resident a specified territory) may be made in the coming months. These can be made under the new power inserted by these regulations which allow the Commissioners for HMRC to specify territories that do not pose a risk to the statutory purpose of the legislation.

7. Policy background

What is being done and why?

7.1 The policy targets multinational groups that generate significant income from intangible property through UK sales, and have made arrangements such that the income is received in offshore jurisdictions where it is taxed at low effective rates. By taxing the proportion of that income which is referable to the sale of goods or services in the UK, this measure reduces the opportunities for large multinationals to gain an unfair competitive advantage by holding their intangible property in low tax offshore jurisdictions, levelling the playing field for businesses operating in UK markets.

7.2 At Budget 2017 an announcement was made to extend the existing rules for withholding income tax on royalties and similar payments. One aim of the measure was to discourage multinational businesses from holding intangible property in low tax jurisdictions separated from where the substantive economic activities that relate to it are carried out, resulting in little or no tax being paid on the income. The measure was subject to consultation from December 2017 to February 2018. Following consultation, some design changes were made to the proposed measure, which is now entitled Offshore Receipts in respect of Intangible Property.

7.3 The legislation included in FA 2019 is widely drawn reflecting the diverse and complex nature of the arrangements that it could apply to and the importance of ensuring that the legislation is robust against tax-motivated behavioural changes by groups of companies. Following further consultation, this instrument amends the existing legislation to ensure that it is appropriately targeted to deliver the policy intention.

7.4 The legislation in FA 2019 generally applies to persons that are located in jurisdictions with whom the UK does not have a full tax treaty. The instrument extends the scope of the income tax charge to persons in low tax jurisdictions which have a full tax treaty with the UK but where the provisions of the agreement mean that they are not covered by the treaty.

7.5 The instrument modifies the definition of residence. In particular, it limits the definition, the effect of which is to exclude full treaty territories where persons are liable to tax on their income or capital from sources outside that territory, by reference to the amount remitted to or otherwise received in that territory. This concept is commonly known as remittance-based taxation and the term is used in such double taxation agreements. The aim of this change is to bring as many low tax territories within scope as possible, whilst remaining consistent with the UK's double taxation agreements.

7.6 The instrument modifies the definition of UK sales. In particular, in determining whether a sale is provided in the UK or to UK persons the instrument amends the primary legislation to look through persons who simply sell on unchanged goods and services (for example distributors or resellers). In relation to online advertising services, UK sales are defined by reference to the person to whom the goods or services being advertised are targeted.

7.7 The instrument provides an exception for sales made by third parties where the intangible property (or associated rights) makes an insignificant contribution to these UK sales, for example, the sale of a small component with a patented design from an unrelated party. This provides clarification by removing third party sales where the IP is so diluted it hardly generates any value to the end sale.

7.8 The instrument introduces an exemption for companies resident in specified jurisdictions with which the UK does not have a double taxation agreement who would otherwise be liable to tax under the measure. The Commissioners for HMRC are given a power to add and remove specified jurisdictions by making further secondary legislation. The specified jurisdictions will be those that do not pose a risk to the statutory purpose of the legislation (see paragraph 7.1 above) and are in scope of the income tax charge because they do not currently have an appropriate double tax agreement with the UK.

7.9 The instrument modifies how the legislation applies to partners within partnerships, to ensure that in circumstances where the partnership itself is appropriately taxed on the relevant income in a jurisdiction with which the UK has an appropriate double taxation agreement, the partners will not also be subject to tax under this measure.

7.10 The instrument provides a targeted exemption for tax transparent entities that are situated in a non-low tax jurisdiction and are one hundred per cent owned by residents in that jurisdiction. Without the exemption, these entities will fall into the rules because they do not meet the technical criteria of being tax resident in the non-low tax jurisdiction, even though the relevant IP income will be subject to tax there.

7.11 The instrument makes provision to relieve double taxation by introducing an exemption for instances in which more than one tax charge under this measure applies to the same income in respect of related entities. For example, a royalty might flow through multiple group companies from sub-licences of the same underlying intangible property. If these group companies are based in jurisdictions that the measure applies to, they might all be subject to a charge under the measure. This exemption ensures that where there are multiple charges on group companies from the same income flow, the tax is only charged once.

7.12 The instrument makes a consequential amendment to the Income Tax Act 2007 to provide that where there is a charge under this measure there is not also an obligation to deduct income tax at source on the same income.

7.13 The instrument provides clarification on the meaning of "tax" whether payable or paid, under the laws of territories outside the UK.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 There are no plans to consolidate this legislation in the immediate future.

10. Consultation

10.1 This instrument was published in draft and subject to public consultation from 24 May to 19 July 2019. Meetings were held with and responses received from twelve advisory firms, representative bodies and businesses affected by the rules. The instrument has been updated to reflect the comments received. There are clarifications to the definition of UK sales to make the rules more proportionate and improve their targeting as well as new rules to minimise double taxation; and better targeting of the jurisdictions in scope.

11. Guidance

11.1 Draft guidance on these regulations and the primary legislation which they amend is available online at: https://www.gov.uk/government/consultations/draft-regulations-offshore-receipts-in-respect-of-intangible-property.

12. Impact

12.1 The impact on business, charities or voluntary bodies is confined to large multinational groups. Large multinational groups will be impacted to the extent they

are brought into the scope of UK income tax on the proportion of their income that relates to UK sales, is generated by intangible property and is ultimately realised in a low tax jurisdiction. There is no, or no significant, impact on charities or voluntary bodies.

12.2 The impact on the public sector is in relation to HMRC who will need to administer and police the legislation.

12.3 A Tax Information and Impact Note covering this instrument will be published on the website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 HMRC will monitor the impact of the changes introduced by this instrument on an ongoing basis using information collected from its internal systems.

14.2 The regulation does not include a statutory review clause.

14.3 However statutory review clauses were included in section 92 and section 93 of FA 2019 for the provisions of Chapter 2A as a whole. They required the Chancellor of the Exchequer to review and report on the effectiveness of the measure in relation to tax avoidance and review the impact of the provisions on child poverty, households at different levels on income, people with protected characteristics and different parts and regions of the UK, within 6 months of Royal Assent. The report of these reviews was laid before the House of Commons in March 2019 and can be found here https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785551/tackling_tax_avoidance_evasion_and_other_forms_of_non-compliance_web.pdf.

15. Contact

15.1 Laura Rankine at HMRC, telephone: 03000 585751 or email: laura.rankine@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 Elizabeth Arnold, Deputy Director for the Base Protection Policy Team, Business Assets and International, at HMRC can confirm that this Explanatory Memorandum meets the required standard.

15.3 Jesse Norman MP, Financial Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.