ROYALTY EXTRACTION VIA UK COMPANIES

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UK Conduit Arrangements

The existence of over 100 UK double taxation treaties permitting low or zero foreign withholding tax on royalty income makes a UK resident company a desirable first stop in extracting royalties as a deductible expense from the taxable profits of overseas trading companies in the course of passing these on to an offshore location. Such royalties will normally be payments due to a business based on the number of times another party who has been licensed either reproduces or sells an item, or based on the sales revenue or profits which that other party earns from doing so.

If rights from which a UK resident company is to derive royalty income are being granted to it by an offshore company to which that UK company will make similar royalty payments as part of a proposed royalty extraction structure then for this to be tax effective the UK company must:

- Satisfy any tax treaty conditions necessary to secure reduced or nil foreign withholding tax on the royalty income to be drawn from abroad into that UK company.
- Avoid unacceptable UK withholding tax having to be deducted and paid over to the Inland Revenue in respect of the royalty payments that are to be paid on to the offshore company.
- Ensure that the onward royalty payments from the UK company to offshore are also an allowable outgoing for UK corporation tax.

Despite the UK being perceived as a jurisdiction with sophisticated tax rules which might inhibit exploitation of its treaty network by the use of UK companies in royalty

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extraction arrangements, in fact a close analysis of the relevant UK legislation and case law shows that, for the careful offshore tax planner, worthwhile opportunities may be available with respect to royalties.

Reducing Foreign Withholding Tax

Normally a UK resident company will beneficially own the sub-licensing royalty income it receives from abroad despite having to make onward royalty payments to any offshore company that granted it an exploitation licence over the relevant rights. The "beneficially owned" condition usually imposed in tax treaties for reduced or nil foreign withholding tax on royalties should therefore be satisfied, except in respect of some sub-licensed countries with more sophisticated domestic anti-abuse rules which "look through" conduit arrangements.

If an offshore company that owns the relevant rights grants a licence to exploit these to a UK company primarily for the purpose of that UK company sub-licensing an overseas trading company to extract royalties with reduced foreign withholding tax, hen to avoid foreign withholding tax the UK tax treaty with the territory of the overseas trading company may need to contain a royalties Article that does not have any anti-abuse clause. A commonly found clause is Article 12(5) of the UK/France treaty which has the effect that the original grant of exploitation rights to the UK company must not have been just for the purposes of it obtaining sub-licensing royalties at a reduced rate of French withholding tax.

However, even if royalties anti-abuse rules do exist in the UK tax treaties with certain countries that the UK company is to sub-licence,it can still be possible to avoid or minimise the application of these by first sub-licensing countries with no such rule in their treaty or which will only be paying a small proportion of global royalties to the UK. This may enable the UK company to then show that the terms of an anti-abuse clause such as Article 12(5) of the UK/France tax treaty are not met so that payment gross from the sub-licensed territory could be claimed.

Avoiding UK Withholding Tax

For onward royalty payments by a UK company to an offshore company to escape 23% UK withholding tax they must either be outside the scope of UK withholding tax or be paid under the protection of a suitable royalties Article in a tax treaty. Unfortunately, most UK tax treaties with offshore jurisdictions that have low or nil rates of local tax contain terms such that treaty relief is unlikely to be available. The UK/Malta treaty has an anti-abuse clause similar to that in the UK/France treaty, while Cyprus offshore companies are denied the benefit of the royalties Article of the

UK tax treaty, and so are Madeira companies by the terms of Article 12(2) of the UK/Portugal treaty. The UK treaties with the Channel Islands and Isle of Man only protect "industrial and commercial profits" when the receiving offshore company is paying at least the local standard rate of tax on such profits, and the UK Inland Revenue may in any event dispute that the royalty payments from the UK constitute such profits.

Fortunately, the scope of UK withholding tax rules for royalties paid to a non-resident company is not as broad as might be expected. The royalty payments have to be within one of the following "machinery" provisions for the collection of such UK tax to apply:

- Section 349(1)(a) ICTA 1988, covering any royalties which are UK source income within Schedule D Case III comprising "Annual Payments"; being sums which are pure income received by the payee wholly independently of any obligation to incur related outgoings or expenses (per Lord Justice Bridge in *Lane v Rank Xerox* [1978] 2 All ER at 1132 e-f), and therefore not covering income which a recipient offshore company can only remain entitled to so long as relevant costs continue to be incurred by it, such as under ongoing obligations for the development or marketing of any trademark or other rights which have been licensed in return for the royalties.

- Section 349(1)(b) ICTA 1988, covering UK patent royalties; being the right to reproduce an invention in the UK, and so excluding royalty payments for rights that only permit reproduction abroad.

- Sections 536(1) & 537B ICTA 1988, covering royalties payable for the use of UK copyright & design interests; being the right to reproduce a book, play, etc in the UK but not covering any film, video or sound track nor any non-UK copyright or design rights arising under the laws of an overseas country which govern reproduction/publication abroad.

The Inland Revenue accept that the UK withholding tax provisions covering patent royalties only apply for patents granted under UK patent law such that the UK is the place where the patent rights are exercisable and is therefore the territory of source for the resulting patent royalty income. This conclusion is consistent with *National Bank of Greece v Westminster Bank* (1970) 46 TC 472 at 493 which recognised an implied limitation on UK withholding tax rules that they do not attach to what is foreign source income to a non-resident and so can only catch payments to an offshore company that are income whose source constitutes UK property so as to allow taxation under section 18(1)(a)(iii) ICTA 1988. Furthermore, although not normally relevant to the case of payment of royalties to an offshore company for its foreign patents, it appears that the Inland Revenue also consider UK withholding tax

precluded even if a holder of foreign patent rights, as a person entitled to royalty income therefrom, is acting in the course of a trade exercised within the UK or is a person resident in the UK, and despite no similar exclusion for foreign patents seeming to be implicit in the section 524 ICTA 1988 withholding tax rules for proceed from sales of patent rights.

Similar implicit principles apply to restrict UK withholding tax to UK copyright & design royalties. In addition, the statutory requirement to only apply withholding tax thereon as it applies to Annual Payments, where the legislation expressly confines withholding tax to those which are UK source income, is arguably an express rather than just an implicit authority for this limitation. The Inland Revenue also accept that UK copyright royalties can be taken outside the scope of UK withholding tax if the owner is an author who is non-resident and carrying on his profession abroad; and even though, in contrast, they seem not to regard a non-resident recipient of royalties from foreign patents as coming within UK withholding tax if he receives foreign patent royalties as income from a trade he exercises within the UK so as to be chargeable to UK tax thereon under Case I.

Where one is just considering foreign rights that are owned by an offshore company which does not have any trade exercised within the UK, and such rights are to be licensed abroad to a UK resident company for sub-licensing on to an overseas business, then the only requirements to avoid UK withholding tax should be to ensure that the royalties paid by the UK company to the offshore owner of the rights impose conditions ensuring those onward royalties are not "pure income" Annual Payments, or are "foreign source" Annual Payments made to that offshore company, despite being income received from a UK resident company.

Foreign Source Payments

The factors which case law suggests should all be complied with as far as possible to cause royalty payments from a UK resident company to an offshore company to qualify as income arising from a foreign possession of the recipient, rather than being income derived from UK property or from a trade exercised within the UK to any extent, are as follows:

(a) The royalties are paid for entitlement to use or exploit overseas rights wholly outside the UK for the purpose of business activities only carried out abroad (*International Combustion Ltd v IRC* (1932) 16 TC 532 at 538-9);

(b) The overseas rights producing the income arise under or exist by virtue of foreign law (*CIR v Anderstrom* (1927) 13 TC 482);

(c) The contract between the UK resident company and the offshore recipient of the royalties not only states that it is to be governed by and construed in accordance with the law of an overseas territory and gives the Courts of that territory exclusive jurisdiction, but is also actually entered into abroad (*Chamney v Lewis* (1932) 17 TC 318; *Alloway v Phillips* (1980) 53 TC 372 and *IRC v HK-TVB International Ltd* [1992] STC 723);

(d) The offshore company is given, by the licensing contract with the UK resident company, some overseas "security" for the royalty payments as they fall due; such as a charge over the foreign bank account into which the UK company receives its own sub-licensing income from abroad (*National Bank of Greece v Westminster Bank* (1970) 46 TC 472 at 493 H-I);

(e) The licensing contract is executed as a deed under seal with an obligation therein specifying an overseas location where each party must keep their original copy (*Lane v Rank Xerox* (1978) 53 TC 185 (CA) per Lord Justice Bridge; although contrast Lord Salmon (HL) therein and also see *Kwok Chi Leung Karl v Comr of Estate Duty* [1988] STC 728);

(f) The royalty obligation is designated in foreign currency and the overseas bank account into which the UK resident company receives its sub-licensing income is the one from which it pays the royalties to a foreign bank account of the offshore company (*Pickles v Foulsham* (1925) 9 TC 261 and *Bray v Colenbrander* (1953) 34 TC 138 at 157-8);

(g) The UK resident company has all of its directors located in an overseas territory that either has no double tax treaty with the UK or only has one which would not cause the UK company to cease to be UK resident under section 249 FA 1994 (e.g. the Channel Islands or Isle of Man) and the business of the UK company is managed, controlled and administered wholly from that non-UK location (*Mitchell v Noble* (1926) 11 TC 372 at 410-2; *Bennett v Marshall* (1937) 22 TC 73 at 93; *IRC v HK-TVB International Ltd* [1992] STC 728).

If it is clear that the offshore company is carrying on a trade wholly abroad in the course of deriving the royalties from the UK company it has licensed, then that overseas trade may be a foreign source of its royalty income. That would not of itself normally prevent the royalties from also having a UK source for withholding tax purposes if they otherwise would; although royalties earned from rights created in the course of a trade or profession, such as by an author writing a book, and which are not derived from purchased rights, have a sole source which is the overseas business itself (*Carson v Cheyney's Executors* (1958) 38 TC 240 at 258-266 and Hansard Vol 791, Col 31, Parliamentary written answer of 10th November 1969; modifying *CIR v*

Longmans Green & Co Ltd (1932) 17 TC 272 and *Rye & Eyre v CIR* (1934/5) 19 TC 164 at 170-3).

The need to be aware that income can have more than one source was highlighted in 'The Source of Income' by the Consulting Editor in *Offshore Taxation Review,* Volume 7, Issue 3 of 1997 at 6.3.5.3 on page 199 citing Lord Atkin in *Rhodesia Metals Ltd v C o T* [1940] 3 All ER 422 (at 426 A-B). For example, interest income may have a foreign source when paid by a UK resident on a debt created by a foreign lender advancing funds in the course of an overseas banking trade such as that in *CIR v Orion Caribbean Ltd* [1997] STC 923 but this will not of itself prevent a UK source also existing with UK withholding tax potentially arising. *Bucks v Bowers* (1969) 46 TC 267 shows that the creation of an interest bearing debt by a foreign bank does not make its overseas business the sole source of the resulting income in the same way as the creation of copyright by a non-resident author does.
Extra Statutory Concession B8, permitting credit for foreign tax withheld on royalties paid from abroad to a UK trader, further acknowledges that a Case I trade may give a UK source to income from abroad, although this should not be regarded as the sole source for section 790(4) ICTA 1988 purposes in the light of *Yates v CGA International Ltd* [1991] STC 157.

UK Corporation Tax Relief for Annual Payments

If royalties to be paid by a UK resident company are Annual Payments, as royalties were held to be in *Delage v Nuggett Polish Co Ltd* (1905) 21 TLR 454 and *Lane v Rank Xerox Ltd* (1979) 53 TC 185, but they comprise "foreign source" income to an offshore company from an overseas possession, then under sections 337(2)(b) and 338(4)(d) ICTA 1988 these outgoings will only be available for relief for UK corporation tax purposes against Case V income of the UK resident company.

If all the factors already mentioned as supportive of "foreign source" status are met in relation to a sub-licensing contract with an overseas business that is paying royalties to a UK company, then the income of the UK company should qualify as Case V revenues whether the business of that UK company is regarded as receiving royalties as part of trading income as in *Noddy Subsidiary Rights Co Ltd v CIR* (1966) 43 TC 458, or as acquiring, holding and exploiting rights by way of deriving investment income from them as in *British Borneo Petroleum Syndicate v Cropper* (1968) 45 TC 201; *Shiner v Lindblom* (1960) 39 TC 367 and *IRC v Sangster* (1919) 12 TC 208.

In *Curtis Brown v Jarvis* (1929) 14 TC 744 and *Lawrence & Others v IRC* (1940) 23 TC 333 royalties were charged under Case VI with recognition of the availability of relief for related outgoings, and the Inland Revenue can normally choose which head

to assess under when income falls into more than one Case of Schedule D (*Liverpool & London & Globe Insurance Co v Bennett* (1913) 6 TC 327). However, as section 18(3) ICTA 1988 makes Case VI a residual head of charge, any income that falls under an earlier one, such as Case V revenue derived from a foreign possession, cannot be brought into charge under Case VI.

Corporation Tax Relief in Other Circumstances

If royalties to be paid by a UK resident company are not Annual Payments and the business of the UK company of deriving Case V royalty income does not constitute a trade, then the royalties it pays should still be an allowable outgoing for UK corporation tax as a necessary cost of procuring plus continuing to maintain and collect the Case V royalty income of the UK company, and to be an essential deduction in arriving at the true figure for the full amount of the profits therefrom (see *Ockendon v Mackley* (1982) 56 TC 2 and IR Manuals at IM 1596 -7 & 1669).

If a UK company is a trader and its royalty outgoings to an offshore licensor are not Annual Payments then it should obtain relief for these as a trading expense. *Paterson Engineering Co v Duff* (1943) 25 TC 43 confirms that section 74(m) ICTA 1988 will not deny relief as a trading expense and as regards section 74(p) ICTA 1988 that the provisions were originally part of the withholding tax rules and so are also subject to the limitation that they do not operate on "foreign source" patent royalties (see further *Lanson Monotype Corporation v Anderson* (1911) 5 TC 675 and *British CIR v Salmson Aero Engines Ltd* (1938) 22 TC at 41-2; in contrast to *James Boyd & Sons v Havelock* (1918) 7 TC 321).

Conclusions on UK Conduit Royalty Arrangements

Royalties extracted from an overseas business that is sub-licensed by a UK resident company may frequently attract tax treaty relief from foreign withholding tax, and, where the sub-licence relates to foreign rights initially licensed from abroad to a UK company by an offshore owner, the onward royalties payable by that UK company should be outside the scope of UK withholding tax. This is providing the arrangements ensure that the onward royalties are not Annual Payments, or that if they are then they constitute "foreign source" income to the offshore company.

Any royalties paid by a UK company under such offshore tax arrangements should be an allowable outgoing for UK corporation tax through being:

- Trading expenses paid out of Case V trading income; or

- Annual Payments paid out of either Case V trading income or Case V investment income; or

- Costs of procuring, maintaining and collecting Case V investment income.

If under such arrangements the owners of the offshore licensing company which has the foreign rights also arrange for genuine independent ownership of the UK conduit company, this should eliminate any need for the profit margin in the UK to be other than a reasonable reward for the chosen owners of that intermediate UK company. In summary, a UK company managed from a suitable offshore jurisdiction can offer the opportunity of effectively accessing the tax treaty network of the UK to reduce foreign withholding tax on royalties. This has been substantially facilitated by the change of UK corporate residence rules in March 1988, given that previously a UK company with its business managed from an offshore centre would normally have been non-UK resident and so denied access to the extensive UK treaty network.