

EXPLANATORY MEMORANDUM TO
THE EXEMPTION FROM INCOME TAX FOR CERTAIN INTEREST AND
ROYALTY PAYMENTS (AMENDMENT TO SECTION 97(1) OF THE FINANCE
ACT 2004 AND SECTION 757(2) OF THE INCOME TAX (TRADING AND OTHER
INCOME) ACT 2005) ORDER 2005

2005 No. 2899

1. This explanatory memorandum has been prepared by the Commissioners of Her Majesty's Revenue & Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Description**

- 2.1 This Order amends the legislation implementing the European Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member States ('the Interest and Royalties Directive') following the adoption of two Council Directives which amend that Directive.

- 2.2 Those amending Directives:

- extend the list of companies to which the Interest and Royalties Directive applies, and
- provide transitional arrangements for the application of that Directive in certain of the accession States which joined the Community on 1 May 2004.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

- 3.1 Article 2 of the Directive applies with retrospective effect in relation to payments made on or after 1 May 2004. The authority for this retrospective effect is section 97(4) of the Finance Act 2004. The effect of article 2 is limited because section 97 of the Finance Act 2004 has been repealed and rewritten by the Income Tax (Trading and Other Income) Act 2005. Paragraph 3 of Schedule 2 to the Income Tax (Trading and Other Income) Act 2005 carries forward the effect of the amendment made under sections 97(3) and (4) of the Finance Act 2004 so that the amendment operates from 1st May 2004 onwards.

4. **Legislative Background**

- 4.1 The Interest and Royalties Directive (2003/49/EC) was adopted by the Council on 3 June 2003. It eliminates double taxation of interest and royalties paid by a company in one Member State to an associated company in another. It applies only to

specified types of companies resident in a Member State. It was the subject of Explanatory Memorandum no. 6615/98 in April 1998. A further Explanatory Memorandum, 5061/04, was produced in January 2004 following a proposal to amend the Directive. This has yet to be agreed by the Council. Explanatory Memorandum 8224/04 of April 2004 was concerned with the application of transitional arrangements for certain of the accession States. The Committees in the House of Commons and House of Lords that scrutinise European issues have cleared all of these documents.

4.2 Chapter 6, Finance Act 2004 implemented the provisions of the Interest and Royalties Directive into UK legislation, now largely incorporated into the Income Tax (Trading and Other Income) Act 2005 at sections 757 to 767.

4.3 Following the enlargement of the Community as from 1 May 2004, the Council approved two Directives that ensured companies from the new accession States were covered by the Interest and Royalties Directive, and also introduced transitional arrangements for the Czech Republic, Latvia, Lithuania, Poland and Slovakia, permitting them to defer full application of the Directive for budgetary reasons.

4.4 This Statutory Instrument is made to ensure that references to the Directive in the implementing legislation are to the Directive as now amended.

4.5 The Instrument is made using the powers contained in s.97(3) & (4) Finance Act 2004, and its successor, s.767 (2) & (3) Income Tax (Trading and Other Income) Act 2005. This is the first use of those powers.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Paymaster General has made the following statement regarding Human Rights:

In my view the provisions of the Exemption From Income Tax For Certain Interest and Royalty Payments (Amendment to Section 97(1) of the Finance Act 2004 and Section 757(2) of the Income Tax (Trading and Other Income) Act 2005) Order 2005 are compatible with the Convention rights.

7. Policy background

Directive 2004/66/EC:

7.1 This is a machinery provision, which ensures that the companies formed under the laws of the accession States are included in the list of entities to which the Interest and Royalties Directive applies. It presents no policy issues to the UK.

Directive 2004/76/EC:

7.2 Where a reciprocal agreement can be reached bilaterally the UK is generally content to give up taxation of interest and royalties which arise here ('source state taxation'). Under the Interest and Royalties Directive Member States have agreed to give up all remaining source state taxation of interest and royalties where the payments are made between associated companies within the EU.

7.3 In agreeing to the Interest and Royalties Directive, the UK and other Member States were prepared to allow transitional rules to Greece, Portugal and Spain for budgetary reasons so that they could gradually decrease their relevant tax rates. The UK is content to extend equivalent transitional rules to the accession States mentioned in paragraph 4.3.

8. Impact

8.1 A Regulatory Impact Assessment prepared for the Interest and Royalties Directive is attached.

8.2 There is no impact on the public sector.

9. Contact

Philip Donlan at HM Revenue and Customs Tel: 020 7147 2633 or e-mail: philip.donlan@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

REGULATORY IMPACT ASSESSMENT

Implementing the Interest and Royalties Directive

Introduction

1. The government will include legislation in the 2004 Finance Bill to implement the Interest and Royalties Directive (Council Directive 2003/49/EC). This Directive was adopted by the Council of the European Union on 3 June 2003. It comes into force from 1 January 2004.

Purpose and intended effect

2. The Directive provides, in the interests of addressing international double taxation, for the elimination of source state taxation of payments of interest and royalties made between associated companies of different Member States. The income will only be taxable by the state where the recipient is resident.

Risks

3. As far as UK companies are concerned, the international double taxation at which the Directive is addressed is already addressed by double tax relief where the income of a company resident in the UK has already borne tax in the country of source.

Options

4. The UK will give relief under the Directive in the way in which it already gives relief to non-residents from UK source taxation of interest and royalty income under double tax treaties.

Benefits

5. Under the Directive, companies in other Member States will be relieved from tax in the UK of interest and royalty payments they receive from associated companies in the UK. In some cases, the UK has already given up source taxation of interest and royalties. This is the case with payments to Austria, Denmark, Finland, France, Germany, Greece, Ireland, the Netherlands and Sweden. In the case of Belgium, the UK taxes payments of interest at 15 per cent. In the case of Italy, the UK taxes payments of interest at 10 per cent and payments of royalties at 8 per cent. In the case of Luxembourg, the UK taxes payments of royalties at 5 per cent. In the case of Portugal, the UK taxes payments of interest at 10 per cent and payments of royalties at 5 per cent. In the case of Spain, the UK taxes payments of interest at 12 per cent and payments of royalties at 10 per cent.

6. Under the Directive, companies in the UK will be relieved from source state taxation of interest and royalty payments they receive from associated companies in

other Member States. In some cases, other Member States have already given up source taxation of interest and royalties. This is the case with payments from Denmark, Finland, France, Germany, Greece, Ireland, the Netherlands and Sweden. Austria taxes some payments of royalties at 15 per cent. Belgium taxes payments of interest at 15 per cent. Italy taxes payments of interest at 10 per cent and payments of royalties at 8 per cent. Luxembourg taxes payments of royalties at 5 per cent. Portugal taxes payments of interest at 10 per cent and payments of royalties at 5 per cent. Spain taxes payments of interest at 12 per cent and payments of royalties at 10 per cent.

7. The Directive contains transitional rules for some Member States. Greece and Portugal may continue to tax interest and royalties at up to 10 per cent for four years and at up to 5 per cent for a further four years. Spain may continue to tax royalties at up to 10 per cent for six years.

Exchequer effects

8. Implementation of the Directive is expected to have a negligible effect on UK tax receipts in 2003-04, 2004-05 and 2005-06. It is estimated to have a yield of about £5 million a year from 2006-07.

Implementation costs

9. Implementation of the Directive is expected to have a negligible effect on the compliance costs of UK companies paying interest and royalties to associated companies in other Member States. This is because the same rules will apply as already apply for giving relief due under a double tax treaty.

Securing Compliance

10. The UK enforces the liability to UK tax of persons who are not resident in the UK in respect of their UK source interest and royalty income by requiring the payer to deduct tax at source from the payment unless certain conditions have been met. In the case of relief due under a double tax treaty in respect of interest, the payer deducts at source unless the Inland Revenue has issued a notice in response to an appropriate request from the recipient. In the case of relief due under a double tax treaty in respect of royalties, the payer can pay without deducting at source on the basis of a reasonable belief that relief is due. The same rules will apply for giving relief due under the Directive.

11. Relief from UK tax will be restricted under the Directive where there is a special relationship between the payer and the recipient and the amount of the payment exceeds what would have been agreed in the absence of the special relationship. Many of the UK's double tax treaties have similar provisions that apply where there is a special relationship.

12. Relief will also be denied where arrangements exist primarily to take advantage of the Directive. Again, there are equivalent provisions in many of the UK's double tax treaties.

Competition assessment

13. There will be no impact on competition. The rules apply in the same way to all businesses operating in UK markets.

Impact on Small Business

14. The rules will apply in the same way to small businesses as to other businesses. In practice, small businesses rarely have subsidiary companies in other countries and will make or receive few cross-border payments of interest or royalties involving them.

Consultation

15. The draft legislation was made public on 10 December 2003, and four written responses were received. All respondents welcomed the legislation. Some asked that the scope of the legislation implementing of the Directive be widened to include other circumstances outside the terms of the Directive. The Government does not think that it would be appropriate to use this legislation to make such changes.

Monitoring and Evaluation

16. The Inland Revenue will incorporate the monitoring of the new relief with the monitoring of relief given under double taxation treaties.

Contact Point

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REGULATORY IMPACT ASSESSMENT
Implementing the Interest and Royalties Directive
(Council Directive 2003/49/EC)
Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo

Paymaster General

10th March 2004