UK withholding tax on interest paid to non-UK residents

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CATEGORY:
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1. Background

Under UK domestic tax law historically it has been the policy of the legislation relating to income tax to collect such tax in respect of recurring payments, by deduction. This is normally achieved by requiring the person making the payment (whether a corporate or an individual) to make a deduction at source on account of income tax, usually at the basic rate. The current basic rate of income tax in the UK is 20%. Whilst there are various circumstances to which deduction of income tax at source is relevant, the specific purpose of this article is to describe the position that applies when UK source interest is paid to a non-UK resident and the various circumstances and strategies that can apply or be utilised which will result in a deduction not being required.

The UK is generally thought to be a suitable jurisdiction in which to locate the holding or sub-holding company of an international group or sub-group in view of its reasonably generous and wide-ranging participation exemption in respect of inbound dividends, and its substantial shareholding exemption in respect of capital gains arising on share disposals. Additionally, the UK is one of the few jurisdictions in Europe which do not apply withholding taxes to dividends paid to non-residents whether such non-residents are corporates or individuals and whether or not the dividend recipients are resident in an onshore or offshore jurisdiction. However, one significant disadvantage that the UK has when considering where to locate a holding company or a group finance company is the 20% interest withholding tax imposed by UK domestic law. By contrast, Luxembourg and the Netherlands have no interest withholding taxes and for this reason are strong competitors to the UK when an international group is considering where to locate its group finance company. (Luxembourg and the Netherlands are also, to some extent, competitors to the UK in the group holding company area, although the fact that both impose a 15% withholding tax on outbound dividends compared to the UK's complete lack of dividend withholding probably negates any advantage in the area.)

Various other European jurisdictions also do not generally impose withholding taxes on outbound interest under their domestic law, although in the case of several of these jurisdictions there may be other tax or non-tax reasons why a particular jurisdiction is not generally a suitable location in which to establish a group holding company or finance company. At the present time, these jurisdictions are Cyprus, Norway, Sweden, Denmark, Austria and Hungary.

2. UK obligation to deduct income tax on payment of interest to non-residents

Under Section 874 (1) (d) and Section 874 (2) of the Income Tax Act (' ITA') 2007 where 'a payment of yearly interest' that arises in the UK is made by any person to another person 'whose usual place of abode' is outside the UK, then the person by, or through whom, the payment is made must, on making the payment, deduct from it a sum equal to the basic rate of income tax in force for the year in which it is made (currently 20% as noted above).

These provisions raise a number of interesting questions that must be examined in order to understand when a deduction is actually required – namely the meaning of 'payment', the meaning of 'yearly interest', the meaning of 'arises in the UK' (UK source) and the meaning of 'usual place of abode'. These are each looked at briefly below:

2.1 Payment

The obligation to deduct income tax only arises either where interest is paid or is treated as paid. It follows that there is no general obligation to deduct tax in respect of interest that has accrued but which has not actually been paid.

At its simplest, a payment of interest is treated as paid where one person makes an unconditional transfer of cash to another person in order to extinguish an obligation to pay interest. The crediting of interest to the bank account of a depositor will also constitute payment of interest. Payment can also be made by way of book entry but it is important that this does more than simply record the fact that interest has accrued and is due and payable. For example, where interest is simply capitalised by adding an amount referable to interest fallen due to the amount of principal due to a lender then this will not amount to payment. However, where a book entry records the set off of an obligation to pay interest against an obligation owed by a lender to pay an amount to a borrower, then this will probably constitute payment.

2.2 Yearly interest

The meaning of the term 'yearly interest' has developed through case law over a long period of time. However, it is now clear that interest will be treated as yearly interest where the parties had the intention that the relevant loan was to subsist for a period of more than one year (for example, a loan for a fixed term of five years). Yearly interest will also arise where the loan was capable of being outstanding for more than one year (for example, a 'demand' loan without a fixed repayment date but which would become repayable upon the issue of a notice by the lender to the borrower). By contrast, the interest payable under a loan which had a fixed term of less than one year (for example, a loan for a strictly nonextendable period of six months) would not amount to yearly interest.

2.3 UK source

There has been considerable debate but very limited case law regarding the issue of whether or not interest has a UK source. The term is not defined by the UK legislation so, in practice, considerable reliance is placed on HMRC's published guidance that states that whether or not interest has a UK source depends on all the facts and on exactly how the relevant transaction is carried out. Relevant factors are derived from the 1970 leading case on source of interest namely Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA (46 TC 4572). These factors are as follows:

- the residence of the debtor and the location of its assets;
- the place of contractual performance and the manner of payment;
- the competent jurisdiction for legal action and the proper law of contract; and
- the residence of any guarantor and the location of any security for the debt.

HMRC have stated that they consider the first factor relating to the debtor's residence and the location of its assets as the most significant. This is on the basis that these factors will influence where a creditor will sue for payment of any unpaid interest and the repayment of its loan.

There have been two recent UK tax cases heard by the First Tier Tribunal on the meaning of source of interest, namely *Perrin v HMRC* and *Ardmore Construction Ltd v HMRC*. In both cases, UK resident borrowers with assets in the UK tried to show that, despite this, the interest paid to non-UK lenders was not UK source. They tried to ensure that all the other factors were consistent with the interest being foreign source. The loans were unsecured with no guarantor so that the fourth factor was not relevant. The loans were documented with foreign choice of law and jurisdiction clauses so that the third factor pointed to non-UK source. Additionally, both borrowers tried to create arrangements for performance and payment method outside the UK (factor 2). The Tribunal held that in both cases the interest had a UK source as factors 2 and 3 were considered to be insignificant when compared with the residence of the borrowers and the location of the assets against which any judgement would be enforced (factor 1).

These two first instance decisions were later the subject of a consolidated appeal to the Upper Tribunal, where the original decisions in favour of HMRC were upheld (although it is not clear whether all aspects of HMRC's published guidance on this subject are consistent with the views recently expressed by the Upper Tribunal).

2.4 Usual place of abode

This expression is not defined in the legislation and its meaning is quite obscure. It seems clear that the phrase is not the same as residence for tax purposes although a non-resident with no specific connection with the UK would normally be treated as having a usual place of abode outside the UK. HMRC will normally treat a company that has its principal place of business outside the UK as having its 'usual place of abode' outside the UK unless the company is UK resident for corporation tax purposes.

3. Potential solutions to the UK withholding tax issue

Clearly the imposition of a 20% UK interest withholding tax on UK source interest is a major and expensive issue for a UK borrower. Almost inevitably, under the loan agreement with a foreign lender, the borrower will be obliged to gross up the payments that it makes to the lender so that the lender is placed in exactly the same position as if the withholding had not been made. There are several potential solutions to the withholding tax issue and we examine these below:-

3.1 Short interest

As noted above, yearly interest is interest that is payable on a loan that is capable of being outstanding for more than one year. By contrast, if interest is payable under a loan that cannot be outstanding for more than one year, then this interest cannot be yearly interest and is commonly referred to as short interest. When a borrower makes a payment of short interest to a lender there is no obligation to make any deduction from the payment so the interest payments will be made gross.

In principle, interest payable under a loan for any term of a fixed period of up to 364 days should be short interest and not yearly interest. However, any arrangement under which the same borrower and the same lender enter into consecutive loans for periods of 364 days over several years may well find such an arrangement coming under attack from HMRC on the basis that, in reality, the arrangements between the parties amount to one long continuous loan in respect of which the interest arising is actually yearly interest.

3.2 Double taxation agreements

The UK has the widest network of double taxation agreements of any country and most of these agreements contain an article that deals specifically with interest. In many cases the interest article will, subject to various conditions, completely remove the 20% UK domestic law withholding tax and in other cases reduce the rate of withholding from 20% to 12.5%. 10%, 7.5%, 5% or zero. For example, under Article 11 of the UK/US Double Taxation Agreement of 24th July 2001 the rate of withholding tax on payments of interest made by a UK borrower to a US lender is usually reduced to zero.

Unfortunately, the double taxation agreements that the UK has concluded with its 'close by' Crown Dependencies (Isle of Man, Jersey and Guernsey) are not comprehensive and do not contain a specific article dealing with interest. Although each of these agreements does contain a business profits article, the view of HMRC is that this article cannot be used to claim relief from UK interest withholding tax unless the recipient of the interest is a bank.

It is important to note that HMRC do not regard the provisions of interest articles in the UK's double taxation agreements as being applicable automatically. A lender will be required to make a specific application under the relevant double taxation agreement before it is authorised to receive interest gross or at a lower rate of withholding tax. The procedure requires that the lender attest that it is the beneficial owner of the interest. In cases where a company has been inserted between a UK borrower and an offshore party purely to act as the lender because of a favourable double tax treaty provision with the UK, it may be difficult in practice for the lender to declare validly that it is the beneficial owner. The position in this respect will be assisted if it can be shown that the company has a good degree of substance and that its existence is not purely tax motivated.

Since 2010, HMRC has operated a 'double tax treaty passport' scheme. Under this scheme an overseas company that is resident in a country that has an interest article in its double tax treaty with the UK can apply for a treaty passport that is valid for a five-year period. The main advantage of the passport is that it does away with the need for the lender to make a separate treaty application for each loan that it is a party to provided that it continues to comply with the detailed rules of the scheme. This scheme can only be utilised where both parties to a loan are corporate bodies.

3.3 EU Interest and royalties directive

If the lender and the borrower are related and are both resident in a Member State of the EU, then it may be possible to use the provisions of the Directive in order to pay interest gross.

The Directive can apply where a company established in another Member State beneficially owns a UK company paying interest as to at least 25%. Relief under the Directive does not apply automatically and the non-UK company receiving the interest needs to make a specific application to HMRC in order for the relief to apply.

Some aspects of the Directive regime are more restrictive than the corresponding rules of domestic UK law relating to corporate grouping issues; for example, the Directive does not apply to indirect ownership between a lender and borrower, nor does it apply to entities created under non-EU systems of company law.

3.4 Eurobond

The obligation to deduct income tax from a payment of interest under 874 ITA 2007 does not apply to interest that is paid on a quoted Eurobond (Section 882). Section 987 ITA 2007 gives the meaning of the term "quoted Eurobond". The term means a security (including a share) that is:-

- issued by a company;
- is listed on a recognised stock exchange; and
- carries a right to interest.

It is possible to achieve a Eurobond listing on, for example, the Channel Islands or the Cayman Islands Stock Exchanges relatively easily although costs of approximately GBP 50,000 may be incurred in the process. There is no need for any active market to exist for the Eurobond. The simple fact of listing is sufficient to satisfy the conditions for interest to be paid gross. The Eurobond route is a well-recognised one for the funding of UK insurance and reinsurance companies with Bermuda parents, as there is no tax treaty between the UK and Bermuda that might otherwise have dealt with the position.

Whilst the Eurobond route currently remains open, it is worth noting that it has incurred a considerable amount of negative publicity recently as part of the public drive against tax evasion and avoidance. Therefore, it is quite possible that it will come under attack again in the future.

3.5 Discount

It may sometimes be possible to structure a loan in the form of a deeply discounted bond. In this scenario the borrowing company issues the debt in the form of a security promising to repay the full amount of the loan. However, the amount advanced by the lender to the borrower is considerably less than the face value of the loan debt (the discount). Because no interest is being charged, no withholding tax can be applied although economically the return ultimately received by the investor is the same as if he had received interest.

The discount route potentially results in avoidance of UK interest withholding tax and it does not require any application to HMRC to obtain this benefit. However, it might well be argued by HMRC in an appropriate case that the whole of the purported discount element of a bond with no interest provisions is, in substance and reality, nothing more than an amount of deferred and accumulated interest, which remains fully liable to withholding tax once the "discount" element has actually been paid. Such arrangements do at least defer the point at which a withholding tax is payable but this comes at the expense of a corresponding deferral of the receipt of (taxed) interest. Whether or not a discounting arrangement is effective in relation to withholding tax mitigation, it leads to deferral of the lender's return, and so discount may not be attractive commercially to an investor who wishes to receive regular interest payments.

4. Conclusion

In conclusion , the UK's interest withholding tax regime on payments to non-UK residents represents a slightly irritating feature of the UK tax code when compared to jurisdictions such as the Netherlands or Luxembourg that have no interest withholding. Over the years there has been some lobbying directed towards the abolition of the current system in order to improve the UK's international position as a viable group finance company location. However, in the current climate this seems unlikely to be successful. With careful planning it is often possible to overcome the basic UK domestic law position by using one of the strategies described above, although the Eurobond route does generate some significant costs.

For more info on the matter or other related matters please contact one of the authors or click here.

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