

UK withholding tax on interest paid to non-residents

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THE UK IS NORMALLY REGARDED AS AN ATTRACTIVE location for the holding company of an international group given its wide participation exemption for inbound dividends and its recently extended substantial shareholding exemption for capital gains arising on share disposals. Also, the UK is one of the few European jurisdictions that applies no withholding taxes to dividends paid to non-residents (whether corporations or individuals).

However the UK does still have one significant disadvantage namely the 20% withholding tax imposed by UK domestic law on “*yearly interest*” that arises in the UK is paid to persons whose “*usual place of abode*” is outside the UK (i.e. broadly non-UK residents) under Section 874 (1) (d) Section 874 (2) Income Tax Act 2007. Where this provision applies then the payer is obliged to deduct from the interest payment a sum equal to basic rate income tax for the year in which the payment is made (currently 20%). The UK position can be contrasted with that of two of its holding company competitor jurisdictions, the Netherlands and Luxembourg, neither of which have interest withholding tax provisions in their domestic law.

Several significant points need to be addressed in order to determine whether a tax deduction is actually required - the meaning of the terms “*payment*”, “*yearly interest*” and “*arises in the UK*” (UK source).

Payment - The obligation to deduct arises only if interest is paid or treated as paid. There is no obligation to deduct income tax where interest has accrued but not actually been paid. At its simplest, interest is paid where one person makes an unconditional transfer of cash to another to extinguish an obligation to pay interest. Payment can also be by book entry but this should record the set off of an obligation to pay interest by the borrower against an obligation by a lender to pay an amount to the borrower.

Yearly Interest - Case law shows that interest will be yearly interest if the parties intend the loan to subsist for more than one year (e.g. a fixed term of five years) or if the loan is capable of being outstanding for more than a year (e.g. a demand loan with no fixed repayment date).

UK Source - There has been much debate but limited case law on whether or not interest has a UK source. The term is not defined by legislation, so much reliance has

been placed on HMRC guidance that states that whether interest has a UK source is fact dependent. The following relevant factors are derived from the leading source case *Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece SA* 46 TC 4572 (1970):

- **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.**

The recent Court of Appeal case of *Ardmore Construction v HMRC* [2018] EWCAA 1438 held that the National Bank case had established that a multifactorial assessment is required but that the correct approach was “*acutely fact sensitive*”. In this case because the links to the UK were stronger than the links to Gibraltar, the interest in Ardmore had a UK source and the company should have deducted income tax from the interest payments.

The UK connecting factors were the physical source of funds for paying the interest, the location of the assets on which any judgement given would be enforced, the location of Ardmore’s business and bank accounts and therefore the place from which the interest was paid. All of these were in the UK.

It is often possible to work around UK interest withholding tax in one of several ways:

Short Interest - interest payable under a loan that is not capable of being outstanding for more than a year is known as “short interest”. As short interest is not annual interest the withholding obligation does not apply.

Double Taxation Agreements - The UK has the widest double taxation agreement network of any country and most of these agreements contain an interest article. In many cases this interest article will eliminate the UK domestic law 20% withholding tax entirely - see for example [Article 11 of the 2001 UK/US double taxation agreement](#).

EU Interest and Royalties Directive - If a UK borrower is related to a lender resident in another EU

Member State then it may be possible to use the Directive (2003/49/EC) to pay interest gross, provided that the lender owns at least 25% of the capital of the UK company paying the interest/ borrower.

Note here that following the end of the transitional period post Brexit (on 31st December 2020), the UK may lose all access to the Directive.

Eurobond - The obligation to deduct income tax from an interest payment under Section 874 does not apply to interest paid on a *quoted Eurobond*.

The term “quoted Eurobond” means a security (including a share) that is issued by a company, is listed on a stock exchange and carries a right to interest. A listing on, say the Channel Islands or the Cayman Islands Stock Exchange can be arranged quite easily for costs of around GBP 50,000.

There is no need for any active market in the Eurobond as the simple fact of listing is enough to enable interest to be paid gross.

Discount - It may 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 (the discount). As no interest is being charged no withholding tax can be applied even though, economically, the return ultimately received by the investor is the same as if he had received interest.

We have wide ranging experience of assisting clients with interest withholding tax issues covering all of the areas referred to in this article including double tax treaty advice, Eurobond issues and structures involving short interest.

For further information regarding this topic or any other UK domestic or international corporate tax matter please contact [Andrew Terry](#) - Partner or [Elena Solovyeva](#) - Corporate Tax Manager. ■

