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In Practice

Author Charlotte Sallabank

Latest issues on UK withholding tax

Charlotte Sallabank reviews the latest statutory and case law developments in UK withholding tax.

NEW STATUTORY REFERENCES

The UK Tax Law Rewrite Project has been under way for a number of years. The aim is to rewrite UK tax legislation in plain English. The latest enactment, the Income Tax Act 2007 ('ITA 2007') includes a rewrite of the withholding tax on interest provisions. So familiar references in loan documentation to s 349(2) of the Income and Corporation Taxes Act 1988 ('ICTA 1988') will no longer appear. Instead of 'bank' being defined by reference to s 349(3AA) ICTA 1988 or s 840A TA 1988, it will be defined by reference to
s 878 (interest paid by banks), s 879 (interest paid on advances from banks) or s 991 (meaning of 'bank') ITA 2007.

The language has changed but the law has not. The obligation to withhold interest and the exceptions from the requirement to withhold remain the same. Instead of the basic withholding requirement arising where 'any yearly interest of money … chargeable to corporation tax under Case III of Schedule D is paid' (s 349(2) ICTA 1988), it now arises when 'a payment of yearly interest arising in the UK is paid' (s 874 ITA 2007). As the meaning of yearly interest 'arising in the UK' is the same as the old words in s 349(2) ICTA 1988 'chargeable to corporation tax under Case III of Schedule D', the old tests as to whether interest has a UK source are still applicable when determining whether interest is 'arising in the UK'.

NEW DEFINITIONS

The term 'quoted Eurobond' for the purposes of the quoted Eurobond exemption from withholding tax is now defined in s 987 ITA 2007 (formally s 349(4)ICTA 1988) to mean 'a security … that (a) is issued by a company; (b) is listed on a recognised stock exchange; and (c) carries a right to interest'.

The meanings of 'recognised stock exchange' and 'listed on a recognised stock exchange' for the purposes of the quoted Eurobond definition are now contained in s 1005 ITA 2007. This section was amended in the Finance Act 2007 with effect from 19 July 2007. The definition now provides that a recognised stock exchange is any market as is so designated by HM Revenue & Customs ('HMRC') for the purposes of s 1005(1) ITA 2007. For markets in the UK, the market must be a 'recognised investment exchange'. That restriction does not apply to markets outside the UK. The term 'recognised investment exchange' has the same meaning as in s 285 of the Financial Services and Market Act 2000. The UK Alternative Investment Market ('AIM') is not a recognised investment exchange and therefore cannot be a recognised stock exchange. The latest list of recognised investment exchanges is available on the FSA website at http://www.fsa.gov.uk/register/exchanges. Since 19 July 2007 the London Stock Exchange qualifies by being included in HMRC's list of recognised stock exchanges, rather than by being named in the statute. The up-to-date list of recognised stock exchanges is available on the HMRC website at http://www.hmrc.gov.uk/fid/rse.htm. The new definition of 'recognised stock exchange' ensures that UK stock exchanges other than the London Stock Exchange can come within the definition.

Section 1005(3) ITA 2007 also defines what is meant by 'securities listed on a recognised stock exchange'; they are securities which are:

(a) admitted to trading on that exchange; and
(b) either:
- (i) included in the official UK list, or
- (ii) officially listed in a qualifying country outside the UK in accordance with provisions corresponding to those generally applicable in EEA states. A country is a qualifying country for these purposes if that country has a recognised stock exchange.

WITHHOLDING TAX AND DOUBLE TAX TREATIES

HMRC has recently published guidance on its views on the application of the recent case of *Indofoods International Finance Limited v JP Morgan Chase Bank NA, London Branch* [2006] EWCA Civ 158 ('*Indofoods*') to claims under the interest article of double tax treaties.

The facts of the case briefly are that PT Indofoods (the Parent), a company incorporated in Indonesia, wished to raise capital by the issue of loan notes on the international market. If the issue had been out of Indonesia, a 20 per cent withholding tax would have applied

> "The obligation to withhold interest and the exceptions from the requirement to withhold remain the same."

to the interest payable to the note holders. So, instead, the issue of the loan notes was made by a wholly owned subsidiary incorporated in Mauritius, Indofoods International Finance Limited (the Issuer), and the capital on lent to the Parent on terms that complied with the conditions specified in the Indonesian/Mauritian Double Tax Agreement (the Mauritius 'DTA'). The withholding on interest payable by the Parent to the Issuer was reduced to 10 per cent and there was no withholding tax in Mauritius on interest payable by the Issuer to the note holders. JP Morgan Chase Bank NA (the Trustee) was appointed principal paying agent and trustee to the note holders. The notes were issued on 18 June 2002 and were

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redeemable at par on 18 June 2007 but could be redeemed earlier if there were a change of law in Indonesia whereby the withholding tax on the interest exceeded 10 per cent. In that event the Issuer might redeem the loan notes early if, but only if, '… such obligation cannot be avoided by the Issuer … taking reasonable measures available to it'. In May 2004 the Indonesian government gave notice to determine the Mauritian DTA with effect from January 2005. The consequence of this was that the Parent would then need to deduct 20 per cent withholding from interest payments. In addition, interest and exchange rates had moved against the Parent to such an extent that it was in the commercial interest of the Parent, but not of the noteholders, that the loan notes should be redeemed as soon as possible. On 24 August 2004 the Issuer gave notice to the Trustee of its intention to redeem the loan notes: it certified that there was no reasonable measure that the Parent could take to avoid the liability to withholding tax at 20 per cent. The Trustee refused to give its approval as the Trustee was not satisfied that there was no reasonable measure available whereby the increased liability for withholding tax could be avoided. The Trustee argued that it would be possible to insert another SPV, NewCo, resident in the Netherlands for the purposes of the Indonesia/Netherlands double tax treaty ('the Netherlands DTA'), with the result that withholding tax on interest under that treaty would be reduced either to 10 per cent or 0 per cent, depending on the term of the loan.

The case came before the Court of Appeal to decide, *inter alia*, whether NewCo would be the beneficial owner of the interest payable by the Parent Guarantor under the Netherlands DTA; whether NewCo would be resident in the Netherlands for the purposes of the Netherlands DTA and whether, assuming the answer to each to be in favour of the Trustee, it would be reasonable for the Parent to interpose NewCo. The Court of Appeal decided that the interposition of NewCo meant that NewCo would not be beneficial owner of the interest paid to it by the Parent. The court reached its decision by considering the terms of the Netherlands DTA and the various commentaries on the Organisation for Economic Co-operation and Development ('OECD') Model Treaty. The court considered that this conclusion was consistent with the purpose of the Netherlands DTA and the Mauritius DTA, namely the avoidance of double taxation and the prevention of fiscal evasion.

The court considered that the meaning of the phrase 'beneficial owner' in the interest article was not to be limited by a technical and legal approach. Regard had to be had to the substance of the matter. Because in both commercial and practical terms the Issuer and NewCo would each be bound to pay to the principal paying agent that which it received from the Parent, neither could be said to be a true beneficial owner since they did not have the 'full privilege to directly benefit from the income'. The court viewed that legal, commercial and practical structure behind the loan notes as being inconsistent with the concept that the Issuer or NewCo could enjoy any privilege to directly benefit from the income.

HMRC take the view that the judgment is persuasive authority in the context of the interpretation of UK double tax treaties. HMRC will therefore apply an international fiscal meaning to the term 'beneficial ownership' when interpreting double tax treaties. HMRC state in their guidance that if the application of the international fiscal meaning results in a different conclusion on beneficial ownership from that which would be reached under UK domestic law, they will only deny treaty benefits if the use of the treaty is contrary to the object of the double tax treaty of preventing fiscal evasion. For example, if by interposing a company in a favourable treaty jurisdiction, withholding tax is avoided, then HMRC will apply the international fiscal meaning and deny treaty relief. Treaty benefit will not, however, be denied in circumstances where, had the SPV not been introduced, there would be no withholding anyway, eg if the SPV is issuing a quoted Eurobond or if the investors in the SPV's notes are resident in a jurisdiction with which the UK has concluded a double tax treaty. The guidance places emphasis on the objective effects of the arrangements rather than on their purpose or aims.

"A practical consequence of this new approach is that treaty claims are taking longer to be processed."

HMRC's view is that treaty abuse will not normally arise when the interposition of an intermediate lender would not improve the withholding tax position of interest paid by the UK borrower, when compared with the withholding tax that would have arisen had that intermediate lender not been interposed. However, by applying the international fiscal meaning HMRC are seeking to strengthen the anti-abuse provision already in the interest article in the OECD treaty which is intended to stop the use of agents, nominees or conduits as mere fiduciaries.

A practical consequence of this new approach is that treaty claims are taking longer to be processed. Additional information is required, namely a full structure diagram and explanation of capital and interest flows plus an explanation why the SPV is considered to be the beneficial owner within the 'international fiscal meaning' or if not the beneficial owner an explanation why the structure does not abuse the treaty under with the claim is made, either by reference to the examples given in the HMRC guidance or otherwise.

Where circumstances allow, it may be better to submit a claim under the Interest and Royalties Directive as under this directive claims have to be determined within three months of application. Because of this time limit HMRC are understood to be processing these claims ahead of DTA claims. ■

The views set out in this article are the personal views of the author and do not necessarily reflect those of Jones Day.