

Income tax: Meaning of UK Source for Payments of Interest and Royalties

A consultation document

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1. Introduction

- 1.1 The current tests in UK law of whether, for the purposes of deduction of tax, payment of interest is made from a UK source are unclear and cause confusion. The statutory rules date back a long way and do not take account of modern financial practice. They have been subject to judicial interpretation, which has not always been easy to apply in practice.
- 1.2 The EU Interest & Royalties Directive includes a definition of where interest arises. This will be introduced in to UK law as part of implementing the Directive, but will apply only to payments of interest that are covered by the Directive. This new definition throws into relief the problems with the current approach to the question of UK source for the purposes of deducting tax from interest payments.

2. Timetable

- 2.1 Responses to the questions in paragraphs 7.1 to 7.7 below should be made by **10 February 2004**. Subject to consideration of these responses, the Government plans to issue draft clauses prior to their inclusion in FB 2004.

3. Background

- 3.1 The EU Interest & Royalties Directive contains its own definition of whether a payment of interest is made from a source within a particular Member State. It simply treats a payment as arising in a Member State if the payer is resident in that state, and is based on the definition in the OECD Model Tax Convention (Article 11¹) of where interest is deemed to arise.
- 3.2 The Government believes there would be advantages to payers of interest in adopting this definition more generally, and thinks it would be helpful and convenient to address this issue at the same time as draft clauses and legislation to implement the Directive are published.

Reason for Consultation

- 4.1 The Government would like to consult on the proposal to apply such a definition more widely than the circumstances covered by the directive. It wants to find out whether adopting a residence based definition and extending it to annuities and other annual payments would cause any difficulties for business or other payers.
- 4.2 Under current rules (see Annexe A), it is possible in theory that an interest etc payment made by a UK resident could have a non UK source. In practice no real cases have been identified, but the

¹ Article 11 of the OECD Model Treaty provides: Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

Government would like to know whether such cases do exist, and it would be helpful if details of the circumstances and of amounts of interest paid could be provided so that the difficulties the proposed definition might cause can be ascertained.

- 4.3 The OECD definition of residence would include UK Permanent Establishments [PEs] of non-resident enterprises. This raises the question of applying such a definition to them. The Government would also like to know whether it could be applied satisfactorily in the context of partnerships where some of the partners are not UK resident.
- 4.4 Another connected area is interest paid by non-residents on loans to acquire let property which is situated in the UK. The Government would like to know if in practice such interest is generally regarded as having a UK source under current rules, and what would be the effect if the definition were extended to treat interest paid on such loans as having a UK source regardless of the residence of the owner of the property?
- 4.5 The requirement to deduct income tax from interest also applies to payments of annuities and other annual payments charged with tax under Case III of Schedule D². To come within Case III of Schedule D, these payments must have a UK source. The Government believes there are advantages in introducing the same definition of UK source for these payments.
- 4.6 The Directive also applies to the payment of royalties, and provides definitions for its purposes. However, the conditions necessary to require deduction of income tax from royalty payments do not give rise to the same kind of operational uncertainties as for interest. The Government does not therefore propose any specific changes for royalties, although royalties which are also annual payments

² Section 349(1)(a) and (1A) ICTA 1988

4.7 may be affected. This consultation is therefore restricted to a definition of UK source for payments of interest, annuities and other annual payments that are within the charge to tax under Case III of Schedule D.

5. Proposed Change

5.1 The Government proposes introducing a definition of 'UK source' for the purposes of determining whether or not payers should deduct income tax when they make payments of interest, annuities and other annual payments chargeable to tax under Case III of Schedule D. The definition it has in mind is that the payment would have a UK source if the payer is resident in the UK. This follows the internationally accepted definition of where interest is deemed to arise in Article 11 of the OECD Model Tax Convention.

6. Start Date

6.1 Should consultation support the proposed change, the start date would need to be some time after a formal announcement, to give payers sufficient time to review their systems in the circumstances where the new definition would affect their obligation to deduct tax from payments.

6.2 Any start date would not be before Royal Assent, but in determining the preferred date it would be helpful if those affected by these changes would say how long they would need to be able to change their systems.

7. Responses Sought

- 7.1 Are respondents in favour of adopting a definition of UK source aligned with the OECD model tax convention (paragraph 3.1)?
- 7.2 Do respondents foresee any issues about adopting a definition based on place of residence of the payer (paragraphs 4.1, & 5.1)?
- 7.3 What problems might arise where UK residents currently pay non UK source interest (paragraph 4.2)?
- 7.4 How would the definition impact UK permanent establishments or partnerships with some non-resident partners (paragraph 4.3)?
- 7.5 What would be the effect of extending the definition to interest paid by non resident landlords (paragraph 4.4)?
- 7.6 Should the definition be extended to apply to annuities and other annual payments (paragraph 4.5)?
- 7.7 How long would payers need to adapt their systems and would a start date of Royal Assent allow sufficient time (paragraph 6.2)?

8. Summary

- 8.1 The Government thinks the kind of changes suggested will be welcomed as clarifying an area of legislation that is generally recognised as unclear and difficult. It would put in place a single test to determine UK source that would apply for both the obligation to deduct tax at source and exemption from that obligation under the Interest & Royalties Directive.

Annexe A: Current Rules for UK Source

1. In some circumstances, payers of interest are obliged to deduct income tax from payments of interest etc. A necessary condition is that the interest etc. is chargeable to tax under Case III Schedule D. This condition includes payments that are payable within or outside the UK, and requires them to have a UK source.
2. There is no definition of UK source for these purposes, although there is guidance in case law³ on the factors to take into account when deciding the source of interest. Of these, some of the most important are:
 - the residence of the debtor: that is, the place in which the debt will be enforced,
 - the source from which interest is paid,
 - where the interest is paid, and
 - the nature and location of the security for the debt.
3. If all of these are located in the UK then it is likely that the interest will have a UK source. But the guidance in case law does not say if any of the factors are more important than others, nor if any are necessary or sufficient conditions for determining UK source. This can make it difficult in practice to determine the precise tax treatment, as some factors may point one way and some another.
4. Under the current rules, some payments made by non-residents do have a UK source. It is also possible in theory that an interest etc. payment made by a UK resident could have a non-UK source.

³ Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA 46 TC 472

Annexe B: Partial Regulatory Impact Assessment (RIA)

Meaning of UK source

Purpose and Intended Effect of the Measure

The policy objectives

1. To provide a definition of UK source for the purposes of deducting tax from payments of interest and royalties. This will provide certainty for people who have to make the decision on whether to deduct or not.

Background and introduction

2. Payers of interest and royalties have to deduct tax on payment in certain circumstances. The criteria in deciding whether to deduct is based in part on old case law, and this can be difficult to apply to modern business circumstances.
3. The EU directive on interest and royalties has to be introduced from 1 January 2004, and provides a definition of source state for the purposes of that directive. The opportunity is being taken to align the definition for general purposes with the definition in the directive.

The risks being addressed

4. The uncertainty for both the payer and the Inland Revenue (IR) as to whether tax deduction should be applied to a payment of interest or royalty. This can cause delays and additional compliance problems in borderline cases and especially where the IR asserts after the event that tax should have been deducted.

Options

5. Do nothing. The current regime operates reasonably well, but does cause problems at the margins in the difficult cases. Providing certainty would remove those problems.

Provide a definition of UK source in the tax legislation. This will put the matter beyond doubt in all cases, thus providing certainty for all parties. The danger is that additional payments are unintentionally brought into the tax deduction net by the new rules, for instance where UK residents currently pay non UK source interest.

Business Sectors Affected

6. Any business which pays interest or royalties to non residents is potentially affected. This measure will provide certainty for decision and thus reduce compliance effort and risk. It is expected the main impact will be in relation to complex financial transactions.

Issues of equity and fairness

7. The new legislation will apply to anyone (individual, company or business) who pays interest or royalties in circumstances where deduction of tax is required (usually where the recipient is outside the UK). As such, it does not apply differently to any particular sector or class of persons. It is not considered that this measure adversely affects equality of opportunity under Section 75 of the 1998 Northern Ireland Act.

Benefits

8. The new legislation will provide certainty to people paying interest or royalties. It will help prevent people failing to deduct tax in error and having to pay the costs of rectifying that error. There should be no effect on other people.

Policy costs

9. There should be a small reduction in compliance costs for payers where there is uncertainty under the current regime.

Implementation (compliance) costs

10. None expected, as the decision on whether to deduct tax will be clearer and the administrative costs of actual deduction will unaltered.

Exchequer effect/distributional impacts

11. There may be a small reduction in yield where the requirement to deduct tax is removed in a few cases. Otherwise no exchequer effect.

Small Business impacts

12. There may be a reduction in small business costs in a very few cases where there is currently uncertainty. It is thought that most small businesses do not borrow from abroad. The IR would like to hear what benefits from reductions in compliance costs small business considers might arise from this initiative.

Other costs and benefits (public & private sector)

13. No additional costs expected, but a reduction in IR monitoring and checking in the difficult cases.

Unintended consequences

14. That a liability to deduct tax might arise where none currently exists. This would most likely be where a UK resident currently claims to pay non UK source interest.

Other impacts

15. None identified.

Devolution

16. No issues identified.

Human Rights

17. The proposal only clarifies the existing law and does not fundamentally change circumstances requiring deduction of tax, and so no HR issues arise.

E-policy

18. None identified.

Environmental impacts and rural proofing

19. None identified.

Competition assessment

20. The competition filter test shows that the policy is not expected to give rise to competition issues, as it applies in the same manner to all payers of interest and royalties whose circumstances are similar.

Securing Compliance

21. There may be a few cases where payers are not deducting tax because of unfounded arguments under the current case law and where action is needed to secure future compliance. But this is not expected to be material.

Consultation

22. Consultation is needed to ensure there are no significant sets of cases where a new requirement to deduct tax is imposed. In particular with the foreign banking sector on how the definitions will impact on UK branches of overseas banks.

Monitoring and evaluation

23. The circumstances requiring deduction of tax at source are not expected to change materially. A reduction in taxpayer compliance burdens at the margin is expected where the definition provides certainty of treatment, and can be estimated by savings in IR time in dealing with enquiries.

Summary and recommendation

24. The policy change is expected to leave the circumstances in which deduction of tax at source is required essentially unchanged. The Revenue would like to know if anyone considers that not to be the case, and what the costs/impact of any such additional requirement would be. The Revenue would also like to know what, if any, compliance cost savings there might be for small business.

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Annexe C: about the consultation process – code of practice on written consultation

Consultation Criteria:

- B.1 Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
- B.2 It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
- B.3 A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
- B.4 Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.
- B.5 Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
- B.6 Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.
- B.7 Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

The Inland Revenue confirms that, where possible, these consultation criteria have and will continue to be followed.

With reference to criterion 5, the consultation period for this document is 9 weeks, from 10 December 2003 to 10 February 2004. This is because the legislative process does not allow for the normal 12 week period.

If you have any complaints about any element of the consultation process leading from the issue of this document, please contact:

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