COUNTRY EXPERIENCES IN DEFINING INTEREST, BENEFICIAL OWNERSHIP

(Note by the United Kingdom)

This note is submitted FOR INFORMATION to the Informal Study Group under item II b) of the Agenda of their meeting to be held on 10 October 2000.

For further information please contact: Mr. John Neighbour, Tel: (33 1) 45 24 96 37, Email: john.neighbour@oecd.org or Ms. Grace Perez-Navarro, Tel: (33 1) 45 24 18 80; Email: grace.perez-navarro@oecd.org, Fax: (33 1) 44 30 63 51.
OECD INFORMAL STUDY GROUP ON TAXATION OF CROSS-BORDER INTEREST FLOWS

Country note by the United Kingdom

Delegates of the Study Group have been requested to share how they have addressed or intend to address at the national level issues related to the definition of interest and verification of beneficial ownership. In advance of the meeting on 10 October 2000, delegates have been asked to submit notes on these topics. This note gives an outline of the scope of the various legislations in the UK dealing with interest and interest-type flows.

A. EXPERIENCES IN DEFINING INTEREST

General outline of the UK regime

The UK regime seeks to tax all returns to investors in respect of debt and financial instruments.

- For individuals returns in respect of debt instruments are generally taxed (income tax) as income on an arising basis. Under the Accrued Income Scheme an individual selling a bond cum-div is taxed on accrued interest as income, the charge arising when the interest would have been received. A person buying a bond is given relief for the interest accrued at purchase, to set against any charge on a sale or against interest actually received on the bond. For financial traders, purchases and sales of bonds are taken into account (in accordance with normal accounting principles) in computing the profits of the trade. Other gains from dealings in debt instruments are generally taxed as capital (capital gains tax).

- Returns to individuals from dealings in financial instruments are taxable as income if they are trading profits (as for bond etc traders). The tax treatment of other returns will depend on the nature of the financial instrument. But, in very broad terms, returns from market dealings and other option and future type contracts will be taxed as capital (capital gains tax) unless specifically brought within income tax.

- For corporates all returns will generally be taxed (corporation tax) as income on an accruals or mark to market basis.

Under domestic law an obligation to withhold income tax generally only arises in respect of payments of yearly interest, and only in certain circumstances (for example, bank/building society deposit interest paid to UK individuals). There is generally no withholding requirement in respect of other returns on debt and financial instruments. There are special tax deduction arrangements requiring paying agents and collecting agents to deduct tax from certain payments or receipts of foreign interest, and interest on quoted Eurobonds made to or received on behalf of persons in the UK, but these have been abolished for payments and receipts after April 2001. UK public revenue interest (including interest on gilts and National Savings bonds) generally flows gross.
As far as the debtor is concerned, returns to investors are generally relieved against income if they constitute a trade expense (individuals and corporates) or a non-trade expense (corporates).

The UK’s information gathering powers in relation to interest consist of powers:

- to obtain routine (“automatic”) information on interest payment from third parties on an annual basis (Section 17 and 18 Taxes Management Act 1970); and
- powers to obtain information from a taxpayer or third party on request (Section 20 TMA 1970);

At present, the “automatic” information powers cover only actual payments of interest (i.e. not including accrued but unpaid interest or discounts, nor returns of any kind on derivative instruments), and are generally used only to obtain information on bank and building society interest and other forms of deposit interest. The powers were extended in the Finance Bill 2000 to cover foreign dividends and redemption proceeds of certain securities. From April 2001 they will be applied to obtain information on a wider range of interest payments than previously (including payments of interest on bonds) and to obtain information on interest distributions of UK collective investment vehicles.

Whilst these general principles apply to both domestic and cross-border transactions, there are some special provisions (outlined below) which refine the rules in cross-border cases.

**Withholding Tax**

For individuals beneficially entitled to UK bank and building society interest, tax is deducted under the Tax Deduction Scheme for Interest (TDSI) arrangements unless the individual is not ordinarily resident in the UK or, in the case of a UK resident, is not liable to UK tax (because the income is exempt or covered by an individual’s personal tax allowances). The paying and collecting agent rules – described above – are also aimed at deducting tax only from payments to which UK residents are beneficially entitled.

For other payments of interest, legislation at Section 349 ICTA 1988 imposes an obligation on the payer of cross-border interest to deduct and account for withholding income tax at the rate of 20%. The scope of the legislative provision is quite narrow in that it only applies in respect of “yearly interest of money chargeable to tax under Case III of Schedule D”. The requirement does not therefore apply to interest-type payments (such as discounts or innovative financial instruments).

There are a range of circumstances where withholding is not required (for example, interest on Eurobonds, gross paying gilts etc as well as payments made by banks in the ordinary course of banking business).

What is and what is not “yearly” interest is largely determined on the basis of case law precedents, but the definition ordinarily excludes interest paid on short-term debt.

The requirement that the interest has to be “chargeable to tax under Case III of Schedule D” has the effect of applying the withholding obligation to all yearly interest that has a UK source, whether or not it is paid by a UK resident.

The income tax accounted for is the UK liability of the recipient of the interest; the withholding requirement is purely the mechanism for collection of the non-resident’s liability. In practice, of course, a payee’s entitlement to treaty benefits is frequently given at source. Payers of interest can be authorised to withhold at a lower (treaty) rate or, where appropriate, can be exempted from the withholding obligation altogether if a treaty application on behalf of the recipient has been submitted and approved in advance.
UK CORPORATION TAX PROVISIONS – APPLICATION TO CROSS-BORDER TRANSACTIONS

The scope of the various legislative provisions is as follows:-

- **Loan Relationships – Finance Act 1996**

  The loan relationships legislation relieves/taxes all the costs of/profits arising from borrowing/lending, including interest (short and yearly) and some other interest-type payments (e.g. discounts and premiums) as well as interest which arises not from lending but in respect of other money debts. But the legislation does not apply to financial instruments (swaps and options) for which there is specific legislative provision. It applies to corporates on either an accruals or mark-to-market basis.

  Under the loan relationships legislation, corporation tax deductions are not available for accrued interest where cross-border interest payable to a connected party (not within the loan relationships regime in respect of the interest receivable) remains unpaid twelve months after the end of the year in which it was accrued. Instead, the deduction only becomes available as if the interest had accrued during the year of payment.

  Deductions are also restricted on a “just and reasonable” basis in the case of loans that have an “unallowable purpose”.

- **Financial Instruments (“FI”) Legislation**

  Specific legislation was enacted in the Finance Act 1994 in respect of financial instruments (specifically interest rate or currency swaps or options). In general the legislation seeks to tax/relieve all profits gains and losses deriving from FIs as measured in accordance with an acceptable accounting method – either accruals or mark-to-market. Profits on “boxed” options and guaranteed returns on transactions in futures and options are all treated as income.

  Tax relief for losses on such swaps or options is restricted where the counter-party is a non-UK resident, but the restriction does not apply if either:-

  1. the UK counter-party is a financial trader, or
  2. the non-resident counter-party is in a territory with which the United Kingdom has a Double Taxation Agreement which makes provision in relation to interest on the lines of OECD Model Article 11.

  The broad effect of the legislation is to deny relief for losses incurred by non-financial traders in respect of swaps and options with haven-based counter-parties.

- **Transfer Pricing**

  The UK’s domestic legislation on transfer pricing (Sch 28AA ICTA 1988) can potentially impact on the taxation of cross-border interest and interest-type payments where the “actual provision” differs from the “arm’s length provision”. But the scope of the transfer pricing legislation does not extend to financial instruments (or foreign exchange gains and losses). The regimes dealing with these have their own arm’s length rules. In the case of financial instruments, to the extent that the arrangement differs from what
would have happened at arm’s length, any losses are disallowed but any gain taxed. (The foreign exchange rules restrict the availability of losses on financial assets or liabilities which depart from an arm’s length result so that they may only be set against future exchange gains on the same asset or liability.)

• **Distributions Legislation**

Interest and interest-type payments can be re-characterised as a distribution of a company where the return to the investor is linked in some way to the company’s shares or profits or where a debt is functioning in substance as equity (for example in cases of thin capitalisation).

Any “interest or other distribution out of assets of the company in respect of securities” is regarded for tax purposes as a corporate distribution where there is a 75+ per cent connection between the parties. The scope of the term “any interest or other distribution out of assets” is particularly wide but is limited by the “in respect of securities” requirement which limits the provision to securities in the nature of debt (where money has been advanced).

• **Repurchase Agreements**

The difference between repurchase and sale prices in a repurchase (“repo”) agreement for securities is treated as interest. This extends to sell/buyback arrangements unless both the prices are dependent on market values of the securities. If the arrangement is long-term, the deemed interest may be yearly interest and subject to withholding tax.

• **Payments Representative of Interest**

If a payment is made under an agreement to transfer UK securities that represents interest arising on those securities, the payment is treated as if it were interest. If the interest on the securities would have been paid under withholding tax, tax must be deducted from the representative payment.

**OTHER DEFINITIONS**

Finance Act 2000 introduces a tax regime for the shipping industry known as Tonnage Tax. The relevant legislation includes a rule for allocating finance costs between shipping and non-shipping activities. It defines “finance costs” as “the costs of debt finance” and specifically provides for the following to be taken into account where they constitute any part of the costs of debt finance:-

- Loan relationships;
- Interest rate and currency contracts;
- Foreign exchange gains and losses;
- Finance leases;
- Debt factoring or similar transaction;
- Anything which would be considered, on normal accounting principles, to be a financing transaction.
B. VERIFICATION OF BENEFICIAL OWNERSHIP

Verification of Beneficial Ownership for Withholding Tax Purposes

Payments of bank and building society interest within the Tax Deduction Scheme for Interest can be made without deduction of tax to individuals not ordinarily resident in the UK only if the bank or building society holds a declaration of entitlement to gross payment. At present, the declaration can be signed either by the person beneficially entitled to the interest, or by another person to whom the interest is paid, without identifying the name and address of the “beneficial owner”, but from April 2001 the name and address of the “beneficial owner” must be given. Before paying interest gross the deposit taker must check whether it has any information in its possession suggesting that the investor is or may be ordinarily resident in the UK. For accounts held by individuals ordinarily resident in the UK who are non-taxpayers, the deposit taker must hold a registration form giving the name and permanent residential address of the individual beneficially entitled to the interest. There are similar arrangements for payment of interest distributions by fund managers of UK collective investment funds.

Under the paying and collecting agent rules referred to above (abolished with effect from April 2001), non-resident persons are entitled to receive payments gross if they beneficially own the foreign holdings or Eurobonds on which the income arises, and they are beneficially entitled to the income arising on them, or if they are persons entitled to receive the payments and have no reason to believe that the beneficial owner is resident in the UK. A beneficial owner receiving the income directly is required to provide a declaration which includes his full name and principal residential address as well as other details about the payment and his entitlement to gross payment. However, where the income is paid to another person (such as a nominee), that person can make a declaration claiming gross payment without disclosing the name and principal residential address of the person beneficially entitled to the interest.

In other cases, beneficial ownership is ordinarily verified in the context of claims to treaty benefits by way of a declaration by the recipient which is certified (as to the tax resident status) by the respective overseas fisc.

As stated in the UK responses to the questions addressed to the SSIFT in October 1998, the UK believes that it would only be possible to verify beneficial ownership beyond doubt in all cases by combining a system of certification by the interest recipient’s tax authority with some provision enabling exemption to be denied in the event of abuse (such as routing) being discovered and with the source country having the right to investigate cases which give grounds for considering abuse may exist.

Verification of Beneficial Ownership for Information Reporting Purposes

With the exception of information reporting requirements relating to UK resident non-taxpayers receiving deposit interest, the UK’s third party “automatic” information gathering powers in relation to interest have not to date required details of “beneficial ownership” (by which we mean details of the person beneficially entitled to interest) to be reported.

For interest paid or received from April 2001, the legislation is extended to allow reporting of the name and address of the person beneficially entitled to interest to be required more widely. Initially, from April 2001, this will generally be applied only in relation to those individuals claiming gross payment of deposit interest (or interest distributions from UK collective vehicles) for which – as described above – they are required to produce a declaration giving their name and permanent residential address.