

WORKING PARTY ON BALANCE OF PAYMENTS
ASPECTS OF TAX QUESTIONS

Fixed interest borrowing from abroad
By United Kingdom corporate bodies

Note by the Inland Revenue

Introduction

1. This note is concerned with interest payable on borrowings from overseas by United Kingdom companies and other corporate bodies such as the nationalised industries. It does not deal with borrowings by individuals since this is unimportant in the scale of things, but the tax treatment of interest paid abroad by individuals is substantially the same as for interest paid by companies.
2. There are two issues in the tax treatment of interest paid abroad whether income tax is to be deducted from the interest, so that it is effectively taxed in the hands of the recipient, and whether a deduction is to be allowed for the interest in computing the profits of the person paying the interest. It is necessary to stress these two aspects because the failure to recognise them has led to some confusion in the consideration of the problem over the past twelve months or so. In general, companies cannot borrow economically from certain overseas sources unless they can both obtain a deduction in computing their profits for the interest paid and at the same time pay the interest gross (that is without deduction of tax).

Present law

3. The question whether tax must be deducted from interest paid depends primarily on whether the source of the interest is regarded as being in the United Kingdom. If it is not a United Kingdom source, tax is not deductible in any case. If it is not a United Kingdom source, tax is deductible unless the interest is:-
 - a) Paid by a bank on a deposit account;
 - b) Short interest (that is, paid on a loan for less than twelve months);
 - c) Payable on certain British Government securities issued on the condition that their interest is to be free of tax if they are in the beneficial ownership of persons not ordinarily resident in the United Kingdom;
 - d) Exempt under a double taxation agreement. (Some agreements provide for interest not to be exempted but to be taxed at some low fixed rate – generally 10 or 15 per cent).
4. The question whether interest due from a United Kingdom debtor has a United Kingdom source is a matter of law. Applying the principles which are to be found in the case law on the point we would regard interest as deriving from a source outside the United Kingdom if it is paid outside the United Kingdom under a contract made abroad and governed by foreign law, provided that the loan is not secured on specific assets in the United Kingdom. Interest paid by a United Kingdom company through a London paying agent would normally therefore be regarded as having a United Kingdom source even if it was due under an overseas contract.
5. A company can deduct interest in computing its profits if:-
 - a) the interest is short interest; or

- b) the company deducts income tax on paying the interest; (this is often of no practical use to the company borrowing from overseas because of the categorical refusal by many foreign lenders to accept payment net of United Kingdom tax); or
- c) the company pays the interest to a non-resident without deduction of tax and:-
 - (i) it has income arising abroad and assessable under Cases IV or V of Schedule D out of which it can pay the interest in full; or
 - (ii) it is authorised not to deduct income tax because the recipient is exempt under the provisions of a double taxation agreement; or
 - (iii) it is carrying on a trade and under the contract under which the interest is payable the interest is to be paid outside the United Kingdom and is in fact so paid and either:
 - (A) the liability to pay the interest has been incurred wholly or mainly for the purposes of activities of the trade carried on outside the United Kingdom; or
 - (B) (if the liability to pay the interest has been incurred wholly or mainly for the purposes of activities of the trade carried on within the United Kingdom) the interest is payable in the currency of a territory outside the scheduled territories.
 - (C) was added by Section 22 of the Finance Act 1968.

Proposed relaxations of the rules

- 6. The Financial Secretary has asked the Revenue to consider the implications of extending Section 22 to cover interest payable in any currency. The

effect of this would be that a company would be entitled to a deduction in computing its profits for interest payable on a loan obtained for the purposes of a trade carried on in the United Kingdom provided that under the contract under which the interest was payable the interest was to be paid outside the United Kingdom and was in fact so paid. Suggestions have also been made that interest should be payable to non-residents without deduction of tax, even where the interest has a United Kingdom source. There has also been at least one complaint that the present provisions are inadequate in not allowing a deduction for interest paid on loans incurred not for the purposes of the borrower's trade. In the particular case said in a newspaper report to have been raised with the Financial Secretary (though we have no record of it) a property company is borrowing money in the Eurodollar market to purchase shares in a French property company but cannot obtain a deduction for the interest that would be payable because the liability would not be incurred for the purposes of its trade. (An investment trust borrowing dollars to purchase American securities could be in the same position, but in practice it might have sufficient Cases IV and V income to cover the interest (see paragraph 5(C)(I) above).

Objections of principle to further relaxations

7. In considering any further extension of the circumstances in which interest can be paid gross to a non-resident while still being allowable as a deduction in computing the profits of the payer, the Revenue is concerned both with the fiscal principles involved and with the practical dangers of legal avoidance and illegal evasion of tax. As a matter of principle there can be no objection to allowing a payer of interest a deduction in computing his profits for interest incurred in earning those profits and the allowance of a deduction has only in the past been made conditional on income tax being deducted from the interest as a matter of machinery, income tax from its origin having always been, so far as practicable, collected at source from the payer of the income.

8. The surrender of the right to charge income having a United Kingdom source is a more difficult issue. In general the United Kingdom, like other countries, seeks to tax all income arising within its borders (and in addition to charge the overseas income of United Kingdom residents). It is true that this right is given up in many double taxation agreements in relation to investment income (and pensions), but this is always subject to reciprocity by the other country and on the understanding that the other country will in general tax the income in full. In the case of interest we have gone further and surrendered unilaterally our right to tax short interest, bank deposit interest and certain interest on government securities going abroad. But notwithstanding these exceptions, it still seems right that we should not lightly give up our claim to tax income arising within our borders, except on the basis of reciprocity. Admittedly it is only possible to borrow from some overseas sources on free-of-tax terms, but in other cases a tax deduction would be accepted, and to refrain from taking our tax in such circumstances is to impose an unnecessary charge on the balance of payments. Some deduction of United Kingdom tax may, in particular, be acceptable to the lender if he is resident in a country with which we have a double taxation agreement since he will then, in many cases, be able to credit his United Kingdom tax against his own country's tax charge. If, in these circumstances, we give up our tax we are simply making a present to the other country's Revenue. Some of our agreements provide for interest to be taxed in the country in which it arises at some low fixed rate – usually 10 or 15 per cent. The tax we should give up in these cases would quite certainly be money down the drain since claims to a partial repayment of our 41¼ per cent charge on interest have to be made through the other country's Revenue and it can therefore be assumed that these particular lenders are not concerned to remain anonymous from their own Revenue.

9. A more general consideration is that any change in the tax treatment of interest paid to non-residents would effectively be a very long term, if not a

permanent one. It is in practice very difficult ever to reverse a relaxation once made in the tax field. We should therefore if we made the change find ourselves saddled with it, possibly long after the time when balance of payments considerations make increased overseas borrowing desirable. There must in any case be limits to the extent to which, in the long-term interests of the economy, we can afford further to increase our overseas borrowing and too general a relaxation on the tax treatment of interest might produce a higher rate of overseas borrowing than was desirable in the long or even the medium term.

10. Even if, notwithstanding the foregoing arguments, it was thought desirable to make some further relaxation in the treatment of interest, the right to pay interest to non-residents gross should presumably be confined to borrowings of monies which will be used for trade purposes. While taxpayers are given effective relief for payments of annual interest on borrowings for non-trade purposes it would seem undesirable to allow them to borrow abroad on free-of-tax terms for such purposes. Overseas borrowing of money which will be used in a United Kingdom business and thus tend to strengthen the whole United Kingdom economy is one thing. Borrowing abroad and thereby placing a continuing burden on the current balance of payments for the purpose of, say, buying overseas shares or a villa at Cannes is quite another.

Administrative objections

11. Even if the difficulties of principle could be overcome there remain the serious dangers of avoidance and evasion of tax if the treatment of interest going abroad is liberalised further. The avoidance danger is that profits earned in the United Kingdom will be siphoned out of the country without suffering any corporation tax, through the creation of artificial loan liabilities. Thus a company can lend money to an overseas associate (on interest-free terms) and the associate can lend the money back to another

United Kingdom member of the group which then incurs a liability to pay interest abroad. If the associate is resident in a tax haven part of the profits of the group have been effectively been taken out of the United Kingdom tax net, provided that the interest can be paid to the associate without deduction of tax. It is true that this can be achieved even under the existing law, but the scope for such avoidance schemes is considerably restricted by the fact that the associate either has to be in a non-sterling country (when exchange control comes into operation) or a double taxation agreement has to be invoked to enable the interest to be paid gross – and there are provisions in double taxation agreements designed to prevent the reliefs allowed under them being exploited for avoidance purposes. If interest could be paid gross to a sterling area country (for example, a Wet Indian tax haven) without deduction of tax, such avoidance provisions similar to those appearing in our double taxation agreements could of course be included in the necessary legislation, but these might well be ineffective, since it would be difficult for Inspectors to link up a chain of associated lending operations designed to take advantage of the concession. We should not then be able, as in the case of reliefs given under agreements, to consult the other country's revenue to confirm that the relief was not being abused.

12. There is no particular difficulty for a company engaged in this type of operation to make the interest an overseas source and the possible further relaxation of allowing interest with a United Kingdom source to be paid gross to non-residents would not further facilitate this type of avoidance; it would simply make the creation of artificial overseas sources unnecessary.
13. The scope for evasion of tax on interest received by individuals resident in this country would be extended if interest could be paid gross to sterling area countries and would be still further extended if the interest did not have to be made an overseas source before it could be paid gross. An individual may seek to evade surtax on his investment income by having it held by a nominee or trustee resident abroad. If the income is not paid under

deduction of tax he may also be able to escape paying standard rate income tax on it. If his arrangements are sufficiently complicated he may indeed ensure that the income is not legally his for tax purposes, but he will then normally be caught by the provisions of Section 412 of the Income Tax Act 1952 (see B.P.T. (58)8). In that case he cannot legally avoid the tax, but if he omits the income in question from his tax return he may be successful in illegally evading the tax. Dividends and interest from an overseas source paid through a United Kingdom paying agent or collected by a United Kingdom paying agent or collected by a United Kingdom collecting agent are subject to our “foreign dividends” machinery; interest on British Government securities payable gross to persons not ordinarily resident here is policed in a similar way. This machinery ensures that where dividends or interest are paid direct to a United Kingdom resident, tax is deducted and accounted for to the Revenue by the paying or collecting agent. To evade tax on such income, therefore, a United Kingdom resident has either to make it appear that the income is payable to a non-resident or he has to keep it entirely outside the paying and collecting agency machinery – either by retaining the income abroad or by having it remitted to this country in a form which does not bring it within the taxing machinery. If the income is left abroad we are not likely to find out about it (unless we learn of it indirectly, for example in the course of a back duty investigation or from an exchange control source). Often, however, the individual will want to use the income here and this is difficult to arrange without coming within the taxing machinery, particularly if the income is in a non-sterling currency.

14. While, therefore, evasion of tax on foreign dividends and interest is possible under existing arrangements, the scope for it is restricted. Furthermore, many individuals will prefer to buy bonds of United Kingdom companies rather than foreign companies. Allowing interest to be paid gross by United Kingdom companies therefore substantially increases the field in which evasion can take place. Admittedly United Kingdom residents can already

buy Eurodollar bonds issued by United Kingdom companies but for this purpose they must either pay the investment currency premium (which would make the investment unattractive) or evade the exchange control. Bonds issued in sterling currencies by United Kingdom companies would be more attractive to United Kingdom residents and it would be much more difficult to counter evasion of tax on interest on such bonds.

15. The foreign dividends machinery does not at present apply to interest paid by United Kingdom companies, even where the interest is paid outside the United Kingdom. There would be no difficulty in principle in extending this machinery to United Kingdom companies so that interest collected by a collecting agent for a United Kingdom resident would be taxed. Equally, if interest with a United Kingdom source were to be allowed to be paid gross to non-residents so that interest could be paid through a London paying agent the extended machinery could also apply to this paying agent. The fact would remain, however, that the field open to United Kingdom residents over which this machinery was open to attack would be considerably extended.
16. We have considered the possibility of giving United Kingdom companies a right to pay interest gross to non-residents subject to prior approval in each particular case by the Treasury (which would consult the Revenue). This is what the French do: French companies and other institutions may issue special bonds abroad with permission for the paying agent to refrain from withholding tax on the interest in cases where the Minister of Finance, taking advice from the Director-General of Taxes and the Director of the Treasury, so approves. If such a scheme were introduced here it would seem desirable to extend it to borrowings in non-sterling and sterling currencies although this would, so far as non-sterling and sterling currencies although this would, so far as non-sterling borrowing was concerned, represent a restriction on the relief allowed by this year's Act. If such a provision were thought to be politically acceptable it would go a

considerable way towards preventing avoidance by the creation of artificial loans by international groups. It would not, however, be effective in stopping evasion by United Kingdom residents because the control would have to be restricted to ensuring that the initial borrowing was genuinely in other currencies. It could never effectively ensure that the ultimate holder of the foreign currency was not a United Kingdom resident, nor could it prevent a United Kingdom resident from acquiring bonds (which are generally bearer) after the initial issue.

17. One further practical objection to giving up unilaterally our right to charge United Kingdom source interest going abroad is that it would then be more difficult to secure in double taxation agreements a reciprocal exemption of interest payable to this country from abroad.

Conclusion

18. In the foregoing we have indicated that exchange control gives us some protection in relation to borrowing from the non-sterling area. If exchange control were extended to the sterling area the dangers of evasion would be considerably reduced, but the effect on avoidance by international groups would be relatively small. In the longer terms exchange control must surely disappear or at least be relaxed, and we shall then be much more vulnerable. In theory we could tighten up the tax provisions again when exchange control was relaxed, but in practice it is always very difficult politically to go back on a tax concession that has once been allowed.

19. Because of the dangers both of legal avoidance and illegal evasion of United Kingdom tax we remain opposed to any further relaxation of the provisions relating to the taxation of interest payable abroad. We would, in addition, oppose on grounds of principle any provision for the unilateral payment of interest with a United Kingdom source gross to residents of other countries.