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MAXIMISING THE TAX-EFFICIENCY OF PAYMENTS FROM OVERSEAS CUSTOMERS

FIVE WAYS TO IMPROVE THE POSITION

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UK companies which sell goods and services directly to customers in overseas jurisdictions need to consider the impact of withholding taxes, because this could affect the cash they receive and the profit they earn. This article looks at withholding taxes (WHTs), their features, and how relief can be obtained.

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WHT – THE BASICS

The main differences between a withholding tax and a tax on profits (arising from having a taxable presence in the overseas jurisdiction, eg by way of legal entity or a permanent establishment (PE)) are:

- The recipient of the payment does not need to register with the overseas tax authorities in order for WHT to apply
- No assessment is necessary for WHT to apply
- WHT is applied to the payment (not to the profit)
- The payer is held responsible for the collection of WHT by the overseas tax authorities, and
- Therefore the payer is obliged to deduct WHT unless the recipient takes steps to disapply WHT, eg by claiming under a double tax agreement (DTA).

The UK tax system operates a relatively small number of WHTs on payments made to non UK residents, eg annual interest and royalty payments made by companies. However, other tax jurisdictions can operate WHT on a wider range of payments, eg technical fees.

WHT – THE PROBLEM

When a UK company invoices an overseas customer it normally expects to receive cash equal to the amount invoiced. However, this may not happen if the payer deducts WHT.

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EXAMPLE ONE

A UK company issues an invoice for services performed in the UK for £100 (ignoring any VAT implications) to an overseas customer. There is no relevant DTA in force.

A WHT rate of 20% applies, so the UK company will receive cash of £80. The overseas customer will deduct and pay £20 WHT to its local tax authority.

If the UK company modelled its operations on a pre-tax profit margin of 10% it has suffered a £10 'cash loss' at the time of payment. If the WHT cannot be claimed as a credit against UK taxes, the 'cash loss' will result in an actual pre-tax loss of £10.

WAYS TO AVOID, REDUCE OR MITIGATE THE IMPACT OF WHT

1. TAKE ADVANTAGE OF DOUBLE TAX AGREEMENTS

A DTA gives a country taxing rights over income, and often reduces WHT in respect of certain types of income, eg dividends, interest and royalties to a rate that is lower than that stipulated in the overseas country's domestic tax legislation. A DTA can reduce WHT to nil by giving the country where the recipient is tax resident sole taxing rights in respect of the income.

Each DTA will allocate taxing rights in respect of each type of income that is included in the DTA. Therefore each DTA needs to be considered in order to confirm whether it offers any relief from WHT that is attributable to that type of income.

The payer will need to be satisfied that the recipient is entitled to relief under the DTA, and will normally ask the recipient to supply a tax residence certificate issued by HMRC. In addition, the payer may request confirmation that the recipient does not have a PE in its jurisdiction.

UK partnerships, including LLPs, may experience difficulty in securing relief under a DTA, as they are often not a recognised person, as defined, in the DTA.

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2. LOCAL PROCEDURES REMOVING PAYMENTS FROM WHT

An overseas jurisdiction may have its own specific domestic WHT legislation, which removes a WHT obligation.

EXAMPLE TWO

The US has a Federal 30% withholding tax rate on a wide scope of payments to non-US persons.

It should be possible to receive payment without WHT being applied in respect of non-US source income, provided the UK company has filed Form W8BENE with the US payer. The form is retained by the payer (it is not submitted to the IRS) as evidence that they have complied with US domestic law and can therefore make the payment without WHT.

3. INSERT A GROSSING UP CLAUSE IN CONTRACTS

Where a UK person contracts with an overseas person in a territory which does not have a DTA with the UK, a grossing up clause in the contract may provide some protection against WHT, especially where the service is supplied from the UK, ie the service is not performed in the overseas jurisdiction.

If the contract states that any WHT is the liability of the payer, this means that the UK recipient will receive the cash as demanded on its invoice, with any WHT being borne by the payer.

EXAMPLE THREE

If a UK company invoices £100 (ignoring any VAT consequences) and the local WHT is 20%, the customer will pay £100 to the UK company and £25 to its tax authority.

Under the grossing up clause £100 is the amount the UK company wants to receive and is therefore net of WHT. The customer must gross up the £100 to calculate the WHT.

As a 20% withholding tax may cause an increase in the cost of the UK company's services by 25%, such a clause should be openly negotiated with the customer to avoid any surprises.

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4. CLAIM WHT AS A CREDIT AGAINST UK TAX

If WHT is applied to a payment it may be possible to claim the WHT as a credit against UK tax on the same income.

When considering a claim for credit against UK taxes it is important to determine that the source of the income is an overseas source.

DTAs set out rules for determining the source of income for credit purposes. The credit article in a DTA often states that a source of income is deemed to arise in the overseas country, which clearly helps establish the income as having an overseas source for the purposes of claiming WHT as a credit against UK taxes.

The more difficult position arises when there is no DTA and the UK person is relying on the UK domestic legislation to claim WHT as a credit against UK taxes, ie unilateral relief. In these circumstances the income will have an overseas source provided the income has been earned in respect of services/activities carried on in the overseas country. Therefore where services/activities are all UK based it is very unlikely that the income will have an overseas source, and thus unilateral relief will not be available.

Assuming a tax credit is available, the WHT may not be fully recovered, because the credit is limited to the lower of the overseas tax and the UK tax attributable to the double-taxed income. Therefore it is quite possible for the WHT to be greater than the UK tax.

Any claim for a credit will need to be supported by an overseas tax certificate showing the overseas oncome and tax deducted therefrom.

5. CLAIM WHT AS AN EXPENSE

Where claiming a tax credit is not to the UK company's advantage or it is simply not available, the UK company can write off the WHT, and claim the WHT as an expense.

This is not as beneficial as claiming a credit for WHT, as UK tax relief is only secured on the WHT at the UK rate of tax.

EXAMPLE FOUR

A UK company invoices £100 (ignoring any VAT consequences) and the local WHT was 20%. If WHT was available as a credit against UK taxes, the WHT would have settled the UK tax assuming the UK tax was not less than £20. The after-tax profit is £80.

If WHT is claimed as an expense the income liable to UK tax is £80 and the UK tax liability is £16, assuming a 20% tax rate. The after-tax profit is £64.

The UK company is worse off by £16, because the WHT has only secured tax relief of £4 as opposed to receiving a credit of £20.

SUMMARY

The question of whether withholding taxes are applicable should be addressed as early as possible in order to:

- Confirm whether there is any relief that can be claimed to reduce WHT eg under a DTA
- Confirm whether relief for WHT can be recovered as credit against UK taxes
- Identify whether a grossing up clause in the contract is worth negotiating
- Confirm that the trade will produce a post-tax cash return and profit as expected and that the trade should go ahead.

An offer by advisers to carry out a 'WHT health check' for clients with overseas customers may well highlight inefficiencies and enable possible solutions to be suggested.