PKF FRANCISCLARK

Chartered accountants & business advisers

Withholding Taxes

The imposition of withholding tax is a common concept. The payer (the company making the payment) is required to withhold an amount from the sum that is paid to a non-resident person or company. This amount is then passed over to the local tax authority and the payer issues the payee with a certificate of withholding.

Ordinarily the payee will include the receipt in their tax return, and then seek a credit for the foreign tax to ensure that the same profits are not taxed twice.

Withholding tax is commonly applied to dividends, interest and royalties. However, increasingly developing countries are also imposing withholding tax on the provision of technical services.

Together with the increased use of the technical service withholding tax, most jurisdictions use a much wider definition when considering whether a payment is a royalty. This will typically include payment of any kind for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark, plan, secret formula or process, design or models, or for information concerning industrial commercial or scientific experience. As a result payments for consultancy, installation fees, software related services, and management charges are at risk of withholding tax.

The main challenge with a withholding tax is that it is levied on the amount of the gross payment made, however it is typical for the double taxation credit to be capped against the amount of tax due on net income, calculated after an apportionment of associated expenditure on a just and reasonable basis. It is not uncommon therefore for the foreign tax suffered to exceed the amount of foreign tax credit available – in which case the excess foreign tax unrelieved becomes a cost and ceases to be merely a cash-flow issue.

It is therefore important that withholding tax on royalties and technical services in particular is kept to a minimum where possible. Often the double tax treaty in place between the UK and the counterparty jurisdiction will provide for a lower rate of withholding tax than would otherwise be the case according to local domestic law. Sometimes this lower rate will be zero.

It is common that in order for the payor to withhold the treaty rate the payee must provide the payor with a certificate of UK residence to demonstrate that they are entitled to the benefits provided by the treaty.

In particular jurisdictions the completion of specific paperwork is required by the payor before a payment can be made without the imposition of withholding tax. In the US for example, the form that is required is a W8-BEN. This form is effectively a declaration by the payee that the UK company is a UK resident, and is the beneficial owner of the income in question. It also provides the IRS with information about the recipient so that further enquiries may be made if necessary.

Most tax authorities place the responsibility of withholding the correct amount with the payor, and there are penalties for those who do not take the appropriate steps to ensure that they have withheld correctly.

We therefore recommend that UK companies doing business abroad consider what steps can be taken well in advance of the date of payment to ensure that withholding tax is minimised. These steps typically include:

- Agreeing a commercial contract that provides for a fee to be paid net of any local withholding taxes
- Applying for a certificate of UK residence
- Deal with any local forms (such as W8-BEN in the US)
- Model the likely outcome of any double tax relief computation

Withholding taxes are managed best by planning in advance. UK SMEs doing business abroad, particularly in South America, Africa, the Far East, India, and China, will need to get up to speed on local withholding taxes as a matter of urgency.

Francis Clark is advising an increasing number of UK SMEs on how to minimise their exposure to foreign withholding taxes, and ensure the maximum amount of foreign tax credit is obtained.

Contact us

If you would like information or advice on how we can help you, please contact:

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PKF Francis Clark has eight offices in the South West: Exeter, New Forest, Plymouth, Poole, Salisbury, Taunton, Torquay and Truro. Please visit www.pkf-francisclark.co.uk for contact details of your nearest office.