Analysis

Brisal: a matter of withholding

Speed read

In *Brisal and KBC Finance Ireland*, the CJEU ruled that imposing withholding tax on interest paid to EU financial institutions was contrary to TFEU article 56, unless the financial institutions could claim a deduction for their financing costs and other expenses. The decision may mean that some businesses currently incurring withholding tax in the EU are able to obtain a refund.

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The question in *Brisal-Auto Estradas do Litoral SA and another v Fazenda Pública* (Case C-18/15) was whether withholding tax on (gross) interest paid to a non-resident lender was permissible under EU law, whereas tax that was collected later (and not via withholding) from resident lenders, albeit at a higher rate, was only taken from their net (after expenses) profit. More precisely:

- whether deducting tax at source infringed the non-resident lender's freedom to provide services;
- whether a non-resident's freedom was infringed because the domestic law prevented non-resident lenders deducting attributable costs in computing the amount on which tax was paid;
- whether the tax base for non-residents being higher was compensated for by their being subject to tax at the lower rate than resident taxpayers; and
- whether there was any justification for the restriction on the non-resident's freedom.

What did the CJEU decide?

Unsurprisingly, in line with case law such as *JBGT Miljoen and others v Staatssecretaris van Financien* (Case C-10/14), *FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel* (Case C-290/04) and *Belgian State v Truck Center SA* (Case C-282/07), the CJEU concluded that a withholding tax was permissible in order to collect tax from non-residents, provided that choosing to collect tax via withholding could be justified, as compared with the way in which tax was collected from resident lenders.

Again unsurprisingly, the court concluded that non-resident lenders and resident lenders should be in a similar position with regards to the deduction of business expenses, both directly connected with the activity being taxed and also as a proportion of overheads.

Further, consistent with the decision in *Gerritse v Finanzamt Neukölln-Nord* (Case C-234/01), it was not permissible to argue in the case that the lower rate (specified as 15%, based on the treaty with Ireland where the lender was based) compensated for the higher tax base on which that lower rate was imposed, as compared with a resident lender being taxed on its net profit, albeit at a higher rate (25%).

Finally, none of the arguments seeking to justify differential treatment of non-resident lenders could be sustained.

What is the impact of the ruling on the UK?

In practice, at least as regards interest, *Brisal* may have little impact on outbound payments here because the UK already has a large number of treaties that remove withholding tax on interest payments from the UK. Furthermore, where the lender is based in an EU jurisdiction under which the UK imposes a lower rate of withholding (rather than zero), a taxpayer may well have chosen to rely on the Interest Directive or on the quoted eurobond exemption.

However, some EU lenders might attempt to argue that they are entitled to refunds if net expenses are allowable, unless HMRC could show reasons (such as uncooperative behaviour on the part of the lender or its tax authorities with regards to information provision), or some other factor that justified the continuation of a withholding tax. Similarly, some UK-based lenders might make claims against other EU member states, although, depending on local tax rates, reduced net overseas liabilities could increase UK tax payable as tax credits were reduced.

What is perhaps more interesting from a UK perspective is that, if there are other types of payment received in or paid from the UK that are subject to local withholding (for example, on certain IP, royalties or rental payments where withholding may have applied to gross amounts), there may also be scope for claims.

However, whether HMRC would wish to be seen to change domestic legislation at this particular juncture in order to permit EU lenders to recover UK tax (if they could adequately demonstrate the level of costs incurred in making loans) is another matter.

The uncertainty surrounding Brexit muddies the water further. If the UK ceases to be a member of the EU, it will not be obliged to give effect to the 'four freedoms', at least concerning future claims, unless (which seems relatively likely) the UK manages to agree with other member states, under whatever form of relationship is finally negotiated, not to discriminate against EU lenders in return for some form of UK market access to the remaining EU member states.

Action points for advisers

Advisers should discuss with their clients whether to make claims (and how to quantify them), including protective claims in case legislation is introduced that later limits the scope of making claims (i.e. time limits). The claims may be against the UK as regards overseas lenders, or in other jurisdictions regarding UK lenders, or other service providers. To the extent that tax credits are reduced, would-be claimants would have to assess whether a net saving would occur, or if a successful refund claim would just lead to additional tax in the country where the lender or their service provider is established, even allowing for any (compound) interest available.

A significant unanswered question currently is whether the freedom of movement of capital claims might be made by third country lenders (on which the CJEU did not need to comment in *Brisal*). ■

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▸ Cases: *Brisal & KBC Finance Ireland* (26.7.16)