Technical services: withholding tax

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My client is a UK company providing consultancy services to a variety of clients all around the world. Certain customers deduct local withholding taxes before making payment. Are these deductions permissible, and can my client get a refund or a credit for the foreign tax suffered?

Under the domestic law of some countries, a company may be required to deduct withholding tax from payments to suppliers for the provision of 'technical services', in the same way that withholding tax can be deducted on dividends, interest and royalties.

Technical services will typically include consultancy, architectural work and design fees, and can include intra-group management charges. Each country will have its own slightly different view on what amounts to a 'technical service'.

Examine the treaty

If there is a tax treaty between the UK and the country with which your client is dealing, a review of that treaty is necessary to determine the correct treatment from a withholding tax perspective. This may afford a lower rate than that which would otherwise apply under the domestic legislation.

Typically, a treaty will confirm that business profits (article 7) of an enterprise in one state will only be taxed by the other state if there is a permanent establishment (article 5) in that other state – unless the income can be included in another article of the treaty.

Sometimes a royalty article in a treaty can be written widely so as to incorporate the provision of a technical service. If that is the case, the withholding tax rate within the royalty article is applicable, subject to the parties qualifying for treaty benefits more broadly.

Certain treaties will include a specific technical services article. If one is present in the treaty, then clearly the rate provided will need to be used. If the service being provided is not within the royalties article and there is no specific technical services article, the position is covered by articles 7 and 5; i.e. if there is no permanent establishment, there is no exposure to local withholding taxes.

Clearly, it is therefore important that every royalty article is read carefully to determine what is considered to be a royalty for the purpose of that particular treaty – not all treaties will be the same. It is worth noting that withholding tax on technical services is more likely to apply in developing countries. The advantage for the developing country is twofold. Firstly, the tax will be higher, as it is based on the gross amount of fees; and secondly, it will be difficult for the foreign provider to limit their exposure to tax by attributing only a small amount of margin to the fees in intra-group transactions.

In addition, whether a payment made is in respect of a royalty or a service will therefore be a crucial question in assessing the tax treatment here.

Royalty or service?

In practice, the distinction between a contract for the use of know-how and a contract for the provision of services often comes down to who has carried out the work. In a contract for know-how, the customer utilises the information received for his own benefit; whereas in a services contract, it is the service provider who carries out the work for the client. However, in many situations both parties will work together on a project, at which point determining whether the payment is for know-how or for a service becomes difficult to determine.

Paragraph 11.3 of the OECD commentary on article 12 provides some guidance for use in determining services from payments in respect of know-how:

1. Contracts for the supply of know-how concern information of the kind described in para 11 above – both for the supply of information that already exists and the supply of that type of information after its development or creation – and include specific provisions concerning the confidentiality of that information.
2. In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
3. In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending upon the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities, or payments to subcontractors for the performance of similar services.

The commentary also gives some examples of payments which should be considered to be made for services:

- as consideration for after sales services rendered by a seller to a purchaser under warranty;
- for pure technical assistance;
- for a list of potential customers when developed specifically for the payer from generally available information (a list generated from confidential information would constitute know-how);
- for an opinion given by an engineer, advocate or accountant; and
- for advice provided electronically, for electronic communication with technicians or for accessing through computer networks a troubleshooting database, such as a database that provides users of software with non-confidential information in response to FAQs or common problems that arise frequently.

The matter of 'confidentiality' would appear to be an important consideration when undertaking the analysis; however, it cannot determine whether or not a payment is for the supply of know-how.

In terms of reducing the potential withholding tax, it is important to first consider whether the local customer has reached the correct conclusion, or whether

it is arguable that the payment is for a service which falls under article 7 of the treaty.

In practice, many contracts will be a mixture of services and know-how, which should be allocated between the two on a just and reasonable basis. However, the local customer will often wish to adopt a prudent approach and, if in doubt, deduct withholding tax on the full amount. It may be hard to dissuade the customer from this stance as a result. At this juncture, it is worth noting that HMRC will only give double tax relief (DTR) (discussed in more detail below) if the foreign tax is properly incurred. If the UK company has paid the tax even though the treaty provides that it should not, technically no DTR should be given.

The next step

If withholding tax is properly due, the next step is to ensure that it is being deducted in accordance with the lowest rate available under the terms of the treaty. If this is the case, usually the local customer will require that the UK company provides some evidence of UK tax residence before making the payment at the reduced rate of withholding. Typically, a certificate of residence (referencing the relevant tax treaty) issued by HMRC is required. This is something different from the basic local HMRC office correspondence which we have seen some clients trying to pass off as a certificate for these purposes. It should be noted that it can take one to two months to secure a proper certificate of residence from HMRC (and perhaps longer if the customer has to seek clearance from their own tax authority). To avoid any issues with cash flow, this should be considered when the contract for the work is signed, not when payment becomes due. Furthermore, it may be necessary for an up-to-date certificate to be requested from HMRC and provided to the customer annually.

Once it has been established that the withholding tax is due, the next issue is to consider whether any credit can be claimed against the UK tax paid by the company. Credit will be given for the foreign tax, but only against UK tax on the corresponding UK tax liability. This means that the maximum amount of DTR available is capped at the UK liability. In calculating the cap, a mini tax computation must be undertaken in respect of that specific income stream to calculate the UK tax liability on the net profits, having taken into account direct and indirect costs on a just and reasonable basis (see HMRC's *International Manual* INTM168010). The challenge here is that withholding tax is usually levied on gross income, whilst the DTR is calculated with respect of net profits. Thus even though a withholding tax rate is low, if there is little margin in respect of a specific project, the DTR mechanics may operate to create an economic loss.

Because it is possible for the imposition of withholding tax to create an economic loss, it is important that the UK company considers the position before signing a contract with the customer. In an ideal world, the UK company might impose a 'net of withholding tax' clause. This means that the minimum figure required to create the anticipated profit is guaranteed whether withholding tax is applicable or not. The effect of such a clause is to pass the risk and cost of the withholding tax on to the customer and this may or may not be commercially acceptable to them. If such a mechanism is not appropriate, the UK company should take advice before signing each contract to determine what withholding tax is due and the likely impact upon profitability. This should allow the company to take steps to adjust the price as necessary before agreeing a final contract. ■

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