A little-known fact

Many Indians resident in the UK, and some tax advisers, mistakenly believe that interest income arising in India is not taxable in the UK. Amit Puri and Sagar Jain set the record straight.

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It is very common among the UK's Indian community to have cash investments in India. Those newly arriving from India to live and work in the UK as well as those who have lived here for generations are widely referred to as non-resident Indians (NRIs). This does not correspond to formal citizenship in India, Indian passport holding or Indian domicile.

Misconceptions

NRIs can benefit from savings and investment products in India geared specifically to their non-residence status. For simplicity, here we focus on non-resident external (NRE) accounts, which have always tended to offer higher rates of interest than those on offer to local residents there. This made the simple fixed term deposits attractive. Investors typically do not have private banking nor wealth management relationships with the banks in India, since historically NRIs have been able to secure these accounts by simply walking into local bank branches or through correspondence.

As well as higher rates of return, NRE accounts have always been attractive since they generate tax-free returns in India for investors. India's Income Tax Act 1961, s 10(4b) states that:

> 'In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included ... in the case of an individual, being a citizen of India or a person of Indian origin, who is a non-resident, any income from interest on such savings certificates...'

Key points

- NRIs in the UK benefit from savings and investment products which are tax-free in India.
- Many Indian UK residents and their tax advisers do not know that these are taxable in the UK.
- Under the UK-India double tax treaty, non-resident external account interest taxable in the UK can receive credit for Indian tax even if this has not been paid.
- Non-resident Indians must notify their banks that they are UK-resident so the banks do not levy withholding tax at more than the 15% tax treaty rate.
- UK tax relief under the double tax treaty is only available for ten years after it is first given.

This is the Indian government's way of encouraging financial investment and economic development in India.

This type of interest income has long been mistaken as non-taxable in the UK, because investors noted the income was not taxable in India and some thought it instead needed to be remitted to the UK. However, UK tax residents are subject to UK taxation on their worldwide income and gains (readers will recognise the arising basis of taxation), subject to any remittance basis claims.

Add to this misconception the fact that many clients and professionals remain unaware that the double taxation convention (DTC) between the UK and India does not provide for double non-taxation. There is, therefore, widespread confusion – and an incorrect belief – that this income (arising in India) which has not been taxed in India cannot be taxed in the UK. It can and often is.

Observations

If the interest is taxable in the UK, under the arising basis for example, one needs to identify taxes suffered in India for the purpose of securing any double taxation relief in the UK. NRE interest income can be afforded UK tax relief even if Indian taxes have not been paid. The DTC provides for credit relief using the 'tax spared' mechanism. When preparing UK personal tax returns, practitioners should refer to Article 24(3) of the DTC, which states that Indian tax will be deemed to have been paid even when the interest income concerned was exempt:

> 'Subject to paragraph (5) of this article, for the purposes of paragraph (1) of this article the term "Indian tax payable" shall be deemed to include:
>
> a) any amount which would have been payable as Indian tax but for a deduction allowed in computing the taxable income or an exemption or reduction of tax granted for that year in question under the provisions of the Income Tax Act 1961 (43 of 1961) referred to in paragraph (4)(a) or (b) of this article'.

Clarification

For the benefit of readers we have not only checked our understanding of the tax position but we have also tested the widespread misunderstanding with HMRC's tax treaty team.

The credit relief amount is calculated through the tax spared mechanism, which deems Indian tax to have been paid at the marginal rates applicable there. The UK-India DTC notes page of HMRC's *Double Taxation Relief Manual* (at DT9553) states:

> 'The agreement provides for credit to be given for tax "spared" in India under the provisions of Indian law set out in Article 24(4).'

Tax advisers and their clients should therefore obtain and maintain supporting evidence for the Indian taxes deemed to have been paid for these purposes, and to demonstrate reasonable care was taken. This is often the first stumbling block for clients because they have either not filed Indian tax returns or have not ensured that relevant tax payable calculations were prepared (see HMRC's *International Manual* at INTM161270 – tinyurl.com/y34w9y5e).

Any relief will also need to be correctly restricted, ie to 15% if the 'tax spared' amount is higher. Clients who are non-residents of India are obliged to notify their banks of their residence status to ensure the banks do not levy withholding tax at more than the 15% DTC rate – see Article 12 of the DTC:

> '1) Interest arising in a contracting state [India] and paid to a resident of the other contracting state [UK] may be taxed in that other state [UK].
> '2) However, such interest may also be taxed in the contracting state [India] in which it arises and according to the law of that state, provided that, where the resident of the other contracting state is the beneficial owner of the interest, the tax so charged shall not exceed 15% of the gross amount of the interest.'

Also, the corresponding deduction, exemption or reduction does not necessarily correspond with the date on which an NRI first became resident in the UK. According to Article 24(5) of the DTC (which restricts Article 24(3)), the relief is available and restricted to a period of ten years after it is first given to the individual:

> '5) Relief from United Kingdom tax shall not be given by virtue of this paragraph (3) of this Article in respect of income from any source if the income relates to a period starting more than ten fiscal years after the deduction in computing taxable income or exemption from, or reduction of, Indian tax is first granted to the resident of the United Kingdom or to the resident of India, as the case may be, in respect of that source.'

Planning point

Where taxpayers have mistakenly failed to declare interest from India, an unprompted tax disclosure carries a lower penalty than a prompted one following a nudge letter from HMRC. On disclosure, do not overlook relief for 'tax spared'.

For example, if Mr X was resident in France and received the NRE interest income tax-free from India for eight years, and subsequently became UK resident, then he would only be entitled to two additional years of the 'tax spared' credit relief in the UK.

Practical points

Many individuals born and brought up in the UK and those who moved to the UK more than a decade ago, frequently find themselves falling foul of these rules. To avoid tax exposure in the UK (and to benefit from DTC relief), where applicable, they should consider identifying the tax payable (spared) amounts in India.

From experience, the vast majority of UK residents have mistakenly not declared this type of foreign income in the UK. We encourage such individuals and their advisers, where appropriate, to review their affairs and get them in order. Especially since many will have been earning this type of interest income for decades and will not be able to benefit from DTC relief.

With the continuous tightening of UK tax rules and the exchange of financial accounts information between more than 100 countries (including the UK and India), HMRC is now better placed to identify and pursue offshore tax irregularities.

Readers will recognise HMRC's nudge letters in this regard, which are usually sent out in batches of tens of thousands, prompting taxpayers to check their UK tax affairs and seek professional advice immediately. Taking action in response to a nudge letter is not the same as voluntarily addressing any historic irregularities.

Seeking tax advice early is invaluable because coming forward voluntarily and disclosing tax irregularities to HMRC results in less being payable overall: individuals may make 'unprompted' disclosures, leading to lower penalties, for example. By contrast, 'prompted' disclosures carry a penalty of at least 150% of any additional taxes payable – so act now or face the HMRC consequences.

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