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Proposed changes to the taxation of interest in the UK

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On 27 March 2012 the UK Government published a consultation paper in which various changes to the UK taxation of interest payments were proposed. These changes are only intended to affect the UK income tax regime and they will not directly affect the UK tax liabilities of any companies that are either tax-resident in the UK or trading in the UK through a local permanent establishment. However, these proposals still have important implications for the international business community because they will potentially affect the way in which UK withholding taxes are imposed in future on any outbound payments of commercial interest, whether or not companies are involved in the process (as lender, borrower or both).

The current public consultation on the proposed reforms is due to end on 22 June 2012, and it is likely that any firm proposals for reform will be announced in the Autumn of 2012 with a view to the inclusion of suitable draft legislation in the Finance Bill for 2013.

Several potentially significant changes have been proposed, with at least some of them appearing to be rather negative developments from the taxpayer's perspective. The key proposals are as follows.

Abolition of 'short' interest

It has traditionally been the case that UK withholding tax is only applied to 'yearly' interest payments but not to any payments of so-called 'short' interest. The true meaning of 'yearly' has never been clearly established, although most UK tax advisers have tended to caution UK-based borrowers against the making of any gross payments of cross-border interest if there is an underlying debt obligation which will remain outstanding for at least one calendar year or if the relevant debt obligation is capable of remaining outstanding for at least one calendar year (taking account, where necessary, of any extensions or renewals of the original obligation).

The Government now proposes to remove any doubt about the distinction between yearly and non-yearly interest payments by simply abolishing the distinction entirely, removing the word 'yearly' from relevant tax legislation so that all interest has the same general legal character, regardless of the actual or potential duration of any particular debt obligations.

Although this would certainly simplify the technical analysis of various cross-border loan arrangements from a UK tax perspective it would also mean that one of the possible means of avoiding UK withholding tax obligations ceased to exist altogether. The Government appears to regard this particular reform as a simplification measure which will have very little financial impact upon the taxpaying community as a whole. Whilst this reform might well appear to be quite trivial or marginal in general economic and political terms it could still result in considerable increases in the UK tax burden associated with certain lending arrangements.

It would already be rather dangerous to seek to structure around UK withholding rules through the provision of some form of long term revolving or rolling credit based upon numerous short term loans (since such arrangements might well give rise to taxable 'yearly' interest even under the current withholding regime) but the formal abolition of short interest as a separate legal category would mean that genuine commercial arrangements such as isolated bridging loans or similar short term facilities would begin to fall within the general scope of UK withholding tax for the first time.

Restriction of the existing quoted Eurobond exemption

There is a general obligation on UK-based debtors of foreign creditors to deduct tax at source from outbound interest payments. But this general obligation is subject to a number of exceptions, and one of these exceptions relates to the payment of interest in respect of a debt obligation contained in a quoted Eurobond.

Since this exception effectively applies to any interest-bearing non-sterling loan that is listed on a recognised stock exchange it is possible, in principle, for connected parties to create a form of 'in-house' listed debt security which qualifies for exemption from UK withholding tax on the same basis as a 'real' quoted Eurobond of the kind that is widely held and traded by financial traders and/or investors who have no direct connection to the issuer.

There are various 'recognised' stock exchanges based in countries with attractive local tax regimes (such as the Channel Islands and the Cayman Islands), so at present a UK company can effectively obtain the benefit of tax-free group lending facilities by issuing a tranche of formal debt securities to a related company and listing such securities on a suitable stock exchange.

There is no explicit requirement under the UK's current withholding tax rules for there to be any substantial and/or regular trading of any relevant debt securities through the medium of the recognised stock exchange on which such securities are listed, so that a connected company may effectively hold the entirety of the listed debt portfolio for the entire duration of the loan. However, the UK Government now proposes that the absence of any genuine trading and/or third party participation should lead to the denial in future of the normal Eurobond exemption in cases of connected company lending.

It is not clear whether the removal of this exemption would only affect newly issued securities; there is a general presumption against retrospectivity in UK tax legislation but the Government might possibly seek to apply the new regime to all future payments of interest, including any future payments made in respect of pre-existing intra-group Eurobond issues.

This reform would remove an attractive and relatively straightforward way of avoiding exposure to UK withholding tax in the case of offshore lending by a connected party based in a tax haven or other low-tax jurisdiction. However, such a reform would not necessarily make any difference to cross-border lending arrangements involving connected lenders based in other EU jurisdictions (since the EU's Interest and Royalties Directive will often provide relief from withholding tax in such situations) or any lenders based in any non-EU jurisdictions with which the UK has concluded a comprehensive double tax treaty (although it should always be borne in mind that some comprehensive tax treaties do not in fact reduce interest withholdings to nil in all cases).

Reformed treatment of interest payments in kind

The UK already operates some special withholding tax rules relating to arrangements under which interest obligations are satisfied through the issue or transfer of additional securities to a creditor instead of cash payments. But these existing rules are somewhat eccentric and unwieldy because they generally require a proportion of relevant securities to be handed over to the UK tax authorities, so that the tax as well as the underlying interest is subject to payment in kind. And these current rules only apply to particular types of financial instrument, not to payments in kind generally (such as the offering of vouchers, the rendering of services or the transfer of physical goods to a creditor).

It is now proposed that all withholding tax obligations in respect of interest payments in kind should be discharged in cash and that special valuation rules should be introduced in order to make clear how this is to be achieved. Generally speaking, the value of any goods or services provided in lieu of money would be regarded as a net-of-tax payment of interest, so that an amount of tax would then be payable in cash in respect of the "grossed up" value of whatever the debtor actually provided to the creditor instead of money when making any interest payments in kind.

It is proposed that, for withholding tax purposes, the relevant value of any goods or services offered in lieu of monetary interest payments would be the highest of three possible measures of value, namely the face value of the subject matter, the maximum retail price of anything possessing such a price and the cost to the supplier of obtaining whatever was supplied. The special valuation rules would not be applied to cases involving the use of financial instruments as a form of payment in kind but the same general approach would be adopted towards the discharge of withholding tax obligations, so that any relevant UK withholding tax would be accounted for in cash by the person making a relevant payment of interest in kind by means of company shares or debt securities.

Clarification of the source rules for interest payments

The UK Government wishes to put beyond doubt that a UK-oriented loan arrangement cannot be regarded as giving rise to non-UK interest just because the interest obligation is embodied or recorded in a deed or other formal loan document that is executed or held offshore.

It seems that some taxpayers and their advisers have sought to argue that the execution of a 'specialty' instrument (such as a deed executed 'under seal') causes interest payments to have their legal source in the place where such an instrument is physically located. This would enable UK withholding tax to be avoided through the simple expedient of holding a suitable written debt instrument in an offshore location.

The UK Government does not accept the validity of the above argument but it now intends to clarify the position through legislation which prevents such an argument being advanced in any future disputes about the legal source of any particular interest payments. It is proposed that the UK's withholding tax rules will be amended so that any issues as to the legal source of an interest obligation are expressly stated to be determined without regard to the location of any relevant document.

Other reform proposals

Although it will usually be of less interest to the international business community, it should also be noted that the current consultation also addresses the possible reform of the UK taxation of compensation payments, so as to ensure that any interest element in a compensation package is properly identified for UK tax purposes. This reform would potentially affect both general internal taxation and withholding taxes.

And views have been invited as regards the possible introduction of a more general tax avoidance rule into the UK's income tax code in relation to schemes or arrangements involving an element of "disguised interest" – that is, a financial return which corresponds to interest in general economic terms without actually being classified as interest for legal or fiscal purposes.

It is not immediately clear whether this aspect of the consultation is intended to apply to withholding tax on outbound interest payments as well as to the general taxation of internal or inbound payments, although the current UK tax legislation mentioned in this part of the consultation paper does not relate to withholding taxes (and it should be borne in mind that general UK income tax charges on interest-like amounts are not always fully harmonised with corresponding withholding tax rules; for example, discounts are generally charged to income tax as deemed interest but withholding tax provisions concerning interest do not generally apply to discounts).

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