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UK Tax Alert. Update on Possible Changes to Withholding Tax Rules.

The UK Government has announced that it does not intend to proceed with a number of the significant extensions to the withholding tax rules mooted in March 2012. Most importantly:

- the “quoted Eurobond” exemption may still apply to bonds issued intra-group and listed on a stock exchange on which there is no substantial or regular trading in them; and
- the concept of “yearly” interest will not be abolished, so UK withholding tax on interest will continue generally only to apply where the interest is “yearly” (as opposed to being “short”).

Certain other changes are still intended to be made, however. These confirmations are set out in a [Summary of Responses](#) published by HMRC on 2 October 2012 following a [Consultation Document](#) dated 27 March 2012. For further details of this consultation (and a separate consultation regarding possible changes to the rules on manufactured payments) see our UK Tax Alert [Possible Changes to Rules on Interest and Manufactured Payments](#) dated 28 March 2012.

On the whole, the proposed changes likely to have caused taxpayers the greatest concerns have been dropped. However, developments regarding “short” interest, “funding bonds” and interest-like returns remain on the cards.

Current UK Withholding Tax Rules

The UK rules regarding deduction of tax at source from payments of interest (“withholding tax”) are set out in Part 15 ITA 2007. Leaving aside the rules on deposits with banks and building societies, the main withholding obligation is in Chapter 3 and applies to payments by companies of “yearly interest arising in the UK”. This is subject to a number of exemptions.

Proposed Changes to the Quoted Eurobond Exemption

One of the exemptions from withholding tax applies where the interest is paid by a company on securities admitted to trading on a “recognised stock exchange” and included in the UK Official List or officially listed outside the UK in accordance with provisions corresponding to those generally applicable

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in EEA states (“**quoted Eurobonds**”). This is a particularly important exemption in the context of capital markets transactions.

The March 2012 Consultation Document had proposed that the exemption for quoted Eurobonds would not apply where the bonds are issued intra-group and listed on a stock exchange on which there is no substantial or regular trading in the bonds. The Summary of Responses confirms that this change will no longer be made.

It was always difficult to see how the limits to this proposal could be clearly defined. As a result, it is to be welcomed that the Government now no longer intends to restrict the quoted Eurobond exemption in this way.

Proposed Changes to the Rules on Yearly Interest

As noted above, currently, withholding tax under Chapter 3 applies only to “yearly” interest and not to “short” interest, i.e. on short-term debt (generally less than one year). In the Consultation Document, HMRC had invited views on the removal of references to “yearly” interest throughout Chapter 3 so that withholding tax would apply in all cases where UK source interest paid by a company is not otherwise exempted.

During the consultation, we raised a number of concerns regarding the potentially wide-reaching implications of this proposal, in particular for short-term capital markets instruments such as interest-bearing commercial paper issued by UK companies.

The Government has now announced that it does not intend to proceed with the abolition of the concept of “yearly” interest, a move which will be welcomed by taxpayers and their advisers.

HMRC will, however, make changes to its guidance regarding the position where “short” loans are repeatedly rolled over. This perhaps suggests that there will be greater scrutiny by HMRC in this area.

A further aspect of the consultation related to the rules on whether interest “arises in the UK” (i.e. whether it has a “UK source”). In particular, there are currently arguments that interest paid on debts arising “under seal” or “specialty debts” does not have a UK source where the loan agreement is physically held outside the UK (rather than needing to consider the residence of the debtor, the place of payment and the security for the debt etc. as would usually be the case).

To clarify the law in this area, the Government has confirmed that it will propose legislation in Finance Bill 2013 to make it clear that whether interest is interest “arising in the UK” is determined without reference to the location of any agreement or deed evidencing such a debt. This change to the rules on UK source is very much around the fringes rather than seeking to give greater certainty generally in this area by, for example, limiting the definition of UK

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source interest to cases where the borrower is UK resident or is borrowing via a UK permanent establishment or branch as some had suggested.

Proposed Changes to the Rules on “Funding Bonds”

Where shares or loan notes (“**funding bonds**”) are issued by a debtor to pay interest on a loan, under the current rules, the issue of the funding bonds is treated as a payment of interest for withholding tax purposes and the withholding tax may be paid by delivering to HMRC the appropriate number of the funding bonds (rather than in cash). The Consultation Document had proposed that the rules be amended such that withholding tax in respect of payments of interest by way of funding bonds would have to be paid in cash. This would have created funding difficulties as the cash would often not be available to pay the tax.

The Government will not now proceed with this proposal either. It instead intends to introduce a requirement on the issuer of a funding bond to state its valuation on issue.

The move to this more limited change to the funding bonds rules will be welcomed by the private equity industry, which sometimes uses funding bonds (or “PIK notes”) in acquisition finance structures. However, such structures will still need careful implementation to maximise the prospect of achieving the desired tax result.

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Proposed Changes to the Rules on Manufactured Payments

In a second Consultation Document also dated 27 March 2012, HMRC proposed changes to the rules on manufactured payments. The outcome of this consultation is yet to be announced. However, if the proposed changes go ahead, the corporation tax treatment of manufactured payments relating to shares will be simplified and withholding tax on “manufactured overseas dividends” (including the “reverse charges”) will be abolished.

Other Changes

The Summary of Responses indicates that the Government will proceed with the proposed introduction in Finance Bill 2013 of a “disguised interest” rule for income tax purposes (which will be modelled broadly on the current corporation tax provisions). This rule will be designed to address arrangements which produce a return that is economically equivalent to interest but which would not be otherwise taxable as income. This will enable certain other sets of rules, which achieve similar results in specific circumstances, to be repealed.

The Government also intends to publish a consultation document on the simplification of the deeply discounted securities and accrued income scheme rules, following the introduction of the disguised interest rule. Any resulting legislative changes are not expected until Finance Bill 2014.

Although the Summary of Responses is not clear on the point, there are indications that the proposed “disguised interest” rule will not go as far as deeming such interest-like returns to be payments of interest for the purposes of withholding tax. Assuming this is correct, payments in respect of the “discount-element” of debt issued at a discount, for example, should generally remain free of withholding tax.

Changes to the tax treatment of interest included in compensation payments and interest paid in kind (e.g. by way of goods or vouchers) are also planned.

Intriguingly, the Government has also indicated that it will consider further the current circumstances in which tax is withheld from interest in a cross-border context. There may therefore be some relaxation of these rules in the future.

Further Information

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This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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