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UK Tax Authorities Consult on Possible Changes to UK Withholding Tax Rules

The UK tax authorities, HM Revenue & Customs (“HMRC”), have issued a consultation document on possible changes to the rules requiring UK tax to be withheld from interest. Among other changes, the UK Government is proposing to disapply the quoted Eurobond exemption from UK withholding tax on interest where debt securities are issued intra-group and listed on a stock exchange on which there is no substantial or regular trading in the securities; it also proposes to remove the rule that allows UK source interest to be paid free of UK withholding tax where it is “short” interest (i.e. payable on a debt with a term of less than a year). We briefly examine the scope of the proposed changes and highlight some of the issues that arise.

Quoted Eurobond Exemption

The quoted Eurobond exemption currently allows interest on a listed debt security issued by a UK corporate borrower to be paid free of UK withholding tax. The UK Government proposes to remove the quoted Eurobond exemption for debt securities that are issued to a group company and listed on a stock exchange where there is no substantial or regular trading in the securities.

If implemented, this proposal would mean that interest on listed intra-group debt issued by a UK corporate borrower would have to be paid subject to UK withholding tax (in the absence of any other exemption). This is unlikely to have a significant impact on normal capital markets issues, but could significantly affect intra-group, private equity and other transactions where, to date, debt has been listed to avoid UK tax having to be withheld from interest payments.

Discounted notes generally do not attract UK withholding tax on the discount element, however, and so it may be possible to structure funding in this way in order to mitigate UK withholding tax issues should this proposal ultimately be implemented.

Short Interest

Currently, UK source interest may be able to be paid by a UK corporate borrower free of UK withholding tax where it is “short” interest. Broadly, interest on a loan will be short interest if the underlying debt owed by the UK corporate borrower is intended to have a term of less than a year. The UK Government is proposing to remove this rule. From the consultation document, it seems that this proposal is driven by a desire to allow UK tax to be withheld from the interest component of certain types of statutory compensation, and from a belief that the rule is archaic. However, if implemented, this proposal could have a serious impact on the UK commercial paper market, on the ability of non-UK lenders to offer daylight facilities, and on certain other types of bridge finance (bridge finance provided in connection with high-yield bond issues tends not to rely on this rule, however, and is therefore unlikely to be significantly affected by the proposed change).

Changes to the Treatment of 'PIK' Interest

PIK ("payment in kind") notes typically allow interest on the notes to be paid either in cash or in kind by the issue of further notes. Where UK tax is required to be withheld from interest paid in kind on PIK notes, that UK tax is generally paid by retaining and accounting to HMRC for a portion of the notes issued. The UK Government proposes to require the UK tax that needs to be withheld from interest paid in kind to be paid in cash to HMRC, and to require the amount of cash tax payable to be calculated by reference to the "grossed-up" amount of interest in certain circumstances.

Scope of UK Source Interest

UK tax is generally only required to be withheld from interest that has a UK source. The UK Government proposes to ensure that the location of the loan documentation relating to certain types of debt (particularly debts under seal and specialty debt) is irrelevant when considering whether the interest on that debt has a UK source and so comes within the ambit of the UK withholding tax regime.

Grandfathering and the Consultation Period

The consultation document currently makes no mention of any proposed grandfathering rules. However, it would be surprising if grandfathering, particularly for any intra-group quoted Eurobond issued before any change to the quoted Eurobond exemption took effect, were not ultimately provided for.

Several of these proposals could have a significant impact beyond their anticipated scope and HMRC should expect many comments. The consultation period ends on 22 June 2012, following which we may see draft legislation on those proposals which the UK Government wishes to take forward.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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