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UK Tax Authorities Perform U-turn on Possible Changes to UK Withholding Tax Rules; Quoted Eurobond Exemption to Remain Unamended for Now

In March 2012 the UK tax authorities, HM Revenue & Customs (“HMRC”), published a consultation document proposing significant changes to the rules requiring UK tax to be withheld from interest. This included, among other things, proposals to disapply the quoted Eurobond exemption – that allows interest on listed debt securities to be paid free of UK withholding tax – in the case of certain intra-group transactions, and 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 less than a year.

HMRC have released a summary of responses to the consultation document, together with the UK Government’s revised proposals. The revised proposals represent a significant U-turn in some key areas; most notably, the UK Government no longer intends to implement the proposals relating to the quoted Eurobond exemption or on short interest. Further details are provided below.

Quoted Eurobond Exemption

The quoted Eurobond exemption allows interest on a listed debt security issued by a UK corporate borrower to be paid free of UK withholding tax. The UK Government had proposed, in the March consultation document, 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.

The proposal was met with strong opposition. The quoted Eurobond exemption is, for now at least, to remain in place in its current form. However, the UK Government does propose to consider further the question of the extent to which UK tax is to be withheld from interest in a cross-border context. It is clear that one of the arguments that was used against the proposal was the fact that it would be possible to achieve the same result using discounted notes. It is good news for taxpayers that the UK Government has decided to drop the proposal; this saves the cost of potentially significant restructuring. However, the wider matter of UK withholding tax on intra-group debt is likely to be revisited, both in relation to the quoted Eurobond exemption and discounted notes.

Short Interest

UK source interest may be paid by a UK corporate borrower free of UK withholding tax where it is “short” interest. Broadly, interest on a debt obligation 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. In the March consultation document, the UK Government proposed to remove this rule and to bring short interest within the normal UK withholding tax rules. Once again, this proposal was met with strong opposition; many respondents argued that the proposals would have a significant impact on a wide range of normal commercial practices which currently rely on the exemption for short interest, such as certain types of bridge finance, cash pooling structures, and the commercial paper market.

As a result of such opposition, the UK Government no longer intends to remove the rule that allows UK source short interest to be paid free of UK withholding tax. This result is again good news for taxpayers.

Other Revised Proposals

Among other revised proposals, the UK Government no longer intends to require UK tax that must be withheld from interest paid in kind on funding bonds – which includes most PIK (“payment in kind”) notes – to be paid in cash. Instead, any UK tax that needs to be withheld will continue to be paid by retaining and tendering to HMRC a portion of the bonds issued. The UK Government does intend to implement legislation which requires a person paying interest by means of the issue of a funding bond to issue a certificate as to the value of the bond, whether or not the recipient requests it.

Where Does this Leave Us?

The contents of the response document are without doubt good news for taxpayers, particularly the news that the proposals relating to the restriction of the quoted Eurobond exemption and the abolition of the short interest rules have now been dropped. It is apparent the UK Government is looking closely at the question of when UK withholding tax should apply to interest payments (particularly in an intra-group situation). It is hoped that the UK Government will continue to listen to taxpayers and will actually expand the scope for interest to be paid free from UK withholding tax, rather than restrict it. Such an outcome is by no means guaranteed, and this is certainly going to be an area to watch over the coming period.

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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