The income tax rules on interest

One of the more surprising and unwelcome consultation documents to follow the 2012 Budget was the document entitled Possible changes to income tax rules on interest issued on 27 March 2012. This had followed a comparatively bland announcement on Budget Day, which had given little hint of the smorgasbord of changes to be proposed. These ranged from proposals to provide a regime for the deduction of tax at source from payments of interest included in compensation payments to proposals to abolish the exemption from withholding tax on ‘short’ interest and a severe curtailment of the quoted eurobond exemption where the eurobond was issued to a member of the same group.

On 2 October, HMRC released a summary of responses to the consultation process which closed on 22 June. Advisors will breathe a sigh of relief that the government has listened to many of the greater concerns voiced by business and the tax community and is dropping some of the proposed changes. Some are only being pursued in a modified form.

The fact that the measures which looked likely to cause the biggest commercial problems for business have been withdrawn is a vindication of the consultation process, even if it has meant a nervous summer has been spent by many organisations, waiting to see if their voices would be heard.

Short interest

The two proposed changes which elicited greatest comment from respondents were, unsurprisingly, the proposals on ‘short’ interest and the quoted eurobond exemption. The government had originally proposed that the ‘somewhat archaic’ distinction between short and yearly interest should be abolished, ostensibly due to supposed difficulties in determining the intention of the parties as to the duration of the loan. The need to determine the intention of the parties as to the duration of the loan at its outset reflects the judgment in Cairns v MacDiarmid (56 TC 556).

If the loan is intended to be ‘short’ (or of less than a year’s duration), the obligation to withhold tax from interest payments under the loan does not arise under ITA 2007 s 874.

However, the tidy-minded desire of HMRC to sweep away this apparently problematic distinction overlooked the widespread use made of the short interest rules by multi-national groups. The fact that the interest on such loans does not attract withholding tax enables groups to enter into cash pooling arrangements and intra-group current accounts without the need, for example, to obtain clearance under an applicable double tax treaty to pay the interest without withholding. The short interest rules are also frequently relied upon in bridging finance arrangements, as well as repo, stock lending and other collateral arrangements.

The removal of the short interest distinction would have resulted in a considerable additional compliance burden for business and the dropping of this measure is to be welcomed. HMRC apparently intends to amend the guidance in its Savings and investment manual to make clear its view on ‘short’ loans which are repeatedly rolled over. This change should be welcomed, but it would come as no surprise if such arrangements were challenged unless it can clearly be shown that the original intention was for short-term lending.

Quoted eurobonds

The proposal to restrict the quoted eurobond exemption is also to be dropped. The quoted eurobond exemption from withholding tax applies where interest is paid on a security which is issued by a company and the security is listed on a recognised stock exchange. Recognised stock exchanges include those in the Channel Islands and Cayman Islands. The consultation document had considered implementing rules to prevent the exemption applying where the eurobond was issued to another group company and listed on a stock exchange on which there was no substantial or regular trading.

The government appears to have recognised that the changes to the eurobond exemption would not have raised the ambitious £200m p.a. set out in the consultation document. The likelihood is that the rule changes would simply have added significant compliance costs for businesses who would have had to restructure their arrangements (by, for example, greater use of discount notes, moving group lending functions to other jurisdictions, such as Luxembourg or, where available, making treaty clearance claims).

The proposed changes also ran oddly against the grain of legislative changes of the last decade which have ostensibly had the intent of making the UK a more attractive holding company jurisdiction. These have included the introduction of the substantial shareholdings exemption, the dividend exemption for foreign dividends and changes to the CFC rules. The one area where the UK continues to lag behind some of its competitors in this regard is...
the imposition of withholding tax on yearly interest, but that issue could always generally be managed, where necessary, by the use of a quoted eurobond. It is to be welcomed that this is to remain the position.

Funding bonds and interest in kind
The proposal to introduce rules to determine the value of interest paid in kind (such as through goods, services and vouchers) and to require payment of withholding tax in cash in respect of that interest are to be enacted. The valuation of the interest paid will be determined by reference to the retail or market price of the goods or services provided. Where a voucher is issued, the interest will be valued at the face value of the voucher or the cash equivalent of the goods or services for which the voucher can be exchanged.

However, the requirement to pay interest in cash will not now apply to funding bonds. Any issue of a funding bond (broadly any bonds, stocks, shares, securities or certificates of indebtedness) to a creditor is treated by ITTOIA 2005 s 380 as a payment of interest by reference to the market value of the funding bond at the time of issue. Funding bonds include payment in kind (PIK) notes, where interest is met by a further issue of a note to the creditor. At present, companies are entitled to issue funding bonds to HMRC as satisfaction of the obligation to pay withholding tax. This makes sense as PIK notes will often be used by companies which do not expect to be cash generative for a time or which are in financial difficulty. The obligation to pay cash to HMRC instead could cause cash flow problems for such companies and potentially favour HMRC over other creditors.

Issuers of funding bonds will however be obliged to provide a certificate of valuation of the bond at the time of its issue. It is not yet clear what requirements will need to be satisfied in order to provide this certificate. Directors will need to be comfortable that they are able to accurately value the funding bond. If this results in the need to obtain a professional valuation every time a funding bond is issued, it is unlikely to be rapturously welcomed.

Interest arising in the UK
HMRC is considering introducing legislation to clarify when interest ‘arises in the UK’ and thus has a UK source. In particular, HMRC does not accept that interest on a specialty debt held outside the UK arises outside the UK for these purposes and thus does not carry any obligation to withhold. The government will legislate to clarify this in Finance Bill 2013. It is proposed that the meaning of ‘arising in the UK’ will be calculated without reference to the location of any agreement or deed evidencing such a debt.

The determination of whether interest has a UK source is typically made by reference to the menu of factors set out in Westminster Bank Executor and Trustee Co (Channel Islands) Ltd v National Bank of Greece (46 TC 472). HMRC acknowledges that this gives rise to a lack of clarity, and will consider further whether a statutory interpretation could be introduced which is not incompatible with double tax treaties. The focus of the OECD model is where the borrower is resident and this remains the most important test, according to HMRC. Any further clarification would be helpful.

Among the factors cited in National Bank of Greece are the place where the contract is performed and the place of the governing law and competent legal jurisdiction of the contract. Borrowers will need to consider whether the proposed changes to combat the use of specialty debt held outside the UK will cut across these factors.

Advisors will breathe a sigh of relief that the government has listened to many of the greater concerns voiced by business

Disguised interest rules and compensation payments
The proposed introduction of a disguised interest rule for income tax which broadly mirrors that introduced for corporation tax in FA 2009 has largely survived the consultation process. As with corporation tax, the proposal is to tax returns which are ‘economically equivalent to interest’. There is clearly some sense in lining up the income tax and corporation tax rules.

There is to be a repeal of targeted anti-avoidance provisions which have a similar effect in respect of the disposals of futures and options involving guaranteed returns and repos and quasi stock lending rules. Both of these regimes will be subsumed into the more general rule.

Other rules which seek to tax returns as income, such as the deeply discounted securities (DDS) rules and the accrued income scheme (AIS) rules will rank ahead of the proposed disguised interest regime. However, it is also proposed that the government will consult on a ‘simplification’ of the DDS and AIS rules with a view to amendments being introduced in Finance Bill 2014, to try to reduce the level of overlap.

Finally, the consultation document proposed certain legislative changes to ensure that the interest elements included within compensation payments should be subject to deduction of tax at source. Not all of the original proposals are to be introduced and there will be no obligation to deduct tax where the interest could be classified as ‘short’. However, a general rule to deduct tax from yearly interest which is included within a compensation payment will be introduced and will also apply to a payment made by a bank in the ordinary course of its business.

The summary of responses to HMRC’s consultation on possible changes to income tax rules on interest is available via www.lexisurl.com/interest.