Proskauer

UK Withholding Tax on Interest: HMRC Abandons Proposals to Amend Quoted Eurobond Exemption, Short Interest Exemption and Payment of Tax by PIK Notes

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In March 2012 the UK's taxation authority, HM Revenue & Customs (HMRC), released a consultation on certain aspects of the taxation of interest. Included in that consultation were proposals: (i) to remove in certain intragroup situations the exemption from the UK's 20% withholding tax on interest known as the "quoted Eurobond" exemption, (ii) to treat "short" interest as subject to withholding tax, and (iii) to require cash payment of withholding tax where interest is paid by issuing PIK (payment in kind) notes.

Following numerous responses on these points, HMRC stated on October 2, 2012 that, although it will be proceeding with some of the other matters addressed in the consultation, it will not be taking these three proposals forward.

This is good news for the private funds industry and resolves some of the recent uncertainties related to financing UK companies with debt.

Background

The UK imposes a 20% withholding tax on interest which has a UK source, but there are exceptions.

These exceptions include interest paid to UK resident companies and interest paid to certain specified recipients such as UK government and local government bodies, UK charities and UK pension schemes. Further, non-UK residents receiving UK source interest may be entitled to relief from the withholding tax under an applicable double tax treaty.

In a private funds context, the starting point is that interest paid by a UK company to a limited partnership fund will normally be subject to withholding tax, even if the limited partners are comprised only of entities which either would have been exempt had they received the interest directly or are eligible for treaty relief (although, if eligible for treaty relief, a limited partner would be entitled to file for a refund in connection with its portion of such withholding tax). That said, if the interest is paid on a "quoted Eurobond" – being debt that is listed on a designated stock exchange – the payment should be free of withholding under a specific exemption in the UK legislation.

In addition, the withholding tax is generally limited to payments of "yearly" interest, and should not therefore apply to so-called "short" interest, broadly, interest on debts with a term of less than a year.

Where interest is paid in kind in the form of loan notes (referred to as PIK notes), HMRC is obliged to accept PIK notes in payment of the tax deducted.

The March 2012 consultation

On March 27, 2012, HMRC published a consultation covering several points relating to the taxation of interest. Among those, the most notable for private funds were the proposals to abolish the quoted Eurobond exemption in the context of intragroup debt, as well as proposals to remove the exclusion for short interest and to introduce a requirement for tax to be paid in cash where PIK notes and similar are issued. None of these would have been welcome developments for the private funds industry.

Latest developments

On October 2, 2012, HMRC published its responses to the March 2012 consultation and announced that, in light of the comments received, these three proposals are not going to be taken forward.

Some changes in relation to PIK notes are still expected; for example, changes to oblige a person issuing PIK notes to issue a certificate of value in relation to the note which may affect the level of tax treated as paid. These changes will result in certain administrative burdens but they are far from the original proposal to remove altogether the ability to pay tax in PIK notes.

While the private funds industry will no doubt appreciate the retention of the status quo in relation to quoted Eurobonds, short interest and (in most respects) PIK notes, there is still potential for change in this area. In particular, in the October 2, 2012 document HMRC states its intention to consider further the circumstances in which tax is withheld from interest in a cross-border context. Since this was accompanied by an acknowledgement of the representations made in response to the March 2012 consultation, it is to be hoped that HMRC will be looking at this with a view to perhaps relaxing the scope of the withholding tax. However, this is far from clear and any changes to the rules may have the opposite effect, whether intentionally or unintentionally.

Conclusion

These latest developments relieve much of the uncertainty which arose for the funds industry as a result of the March 2012 consultation and should be welcomed. However, as HMRC has said it will be looking further into the cross-border taxation of interest, this is an area on which managers may want to keep a watching brief.

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