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Dear Sir

Revenue Law Committee response to Consultation Document on possible changes to income tax rules on interest

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the draft legislation on disguised remuneration has been prepared by the CLLS Revenue Law Committee.

We are grateful for the opportunity to respond to the Consultation Document. Our response below follows the various sections of the Consultation Document.

Interest included in compensation payments

We do not have strong views on this question.

Yearly interest arising in the UK

Yearly vs Short

We would agree that the position around yearly interest is not currently wholly satisfactory, not least because of the absence of clear rules as to when interest is, or

becomes, yearly in a variety of circumstances. However, we do not believe that the right answer is to abolish the distinction with the result that withholding tax becomes payable on loans of all durations.

Whatever the historic reason for the short/yearly interest distinction, it has become very important in many areas. In all these areas, if the distinction were to be abolished we suspect that practice would evolve such that withholding tax would continue not to be payable, but business (and in some cases HMRC) would suffer increased costs and administrative burdens to arrive at that result. In particular:

(a) The short term commercial paper market is an enormously important fundraising tool for many companies. This is an international market, and the imposition of UK withholding tax would greatly affect it. One possible response of the market would be to move to using quoted Eurobonds (lenders are typically unconnected to borrowers, so even if the changes discussed below are implemented the relief should be available), but this would impose an additional cost of financing for companies without raising any additional tax. At present short term commercial paper is not listed, and given its short term nature the cost (and administrative burden) of listing would in many cases not be negligible when placed in context. Alternatively, where lenders are resident in treaty jurisdictions, treaty claims might be made, although given the short term nature of the lending this would be a disproportionately burdensome outcome for non-passported lenders. Finally, discount notes might be used instead (as is sometimes the case now), but these may not always deliver the desired tax result in other jurisdictions.

(b) Many credit card businesses finance their operations through securitisations and other loan portfolio sales. These structures rely on the view (accepted by HMRC) that interest on credit card debts is not yearly interest, unless a borrower has encountered difficulties and entered into a formal long term repayment schedule under which there is an interest component. Such financing structures would again evolve, most likely using acquisition vehicles in tax treaty jurisdictions. However, the administrative burden for both financiers and HMRC in dealing with treaty claims with a large basket of underlying borrowers is material, even where a UK based paying agent is appointed. As with short term commercial paper, the result of imposing withholding tax on short interest in this sector would simply be to increase costs to business (in turn likely to be passed on to borrowers) without raising any additional tax.

(c) Short term bridge financing is often arranged on a cross border basis, whether on an intra-group or third party basis. Whilst in such cases treaty claims could often be made, where no treaty passport is in place (which is often the case, especially where the bridge is provided by a party connected in some way with the transaction for which the financing is needed but which does not have a wider lending business) the treaty claim process is unwieldy and slow, often taking longer than the life of the loan.

Generally therefore we do not see that removing the distinction between short interest and annual interest would be productive. Even if the reasons for the distinction are somewhat arcane, it is a distinction that is now relied upon every day in the raising of huge amounts of financing. Its abolition would almost certainly raise no additional tax, but would impose increased burdens on both business and HMRC. We are not therefore of the view that the distinction should be abolished.

However, we would welcome an attempt to enshrine the distinction in legislation such that greater certainty could be achieved by both taxpayers and HMRC as to whether interest was short or yearly.

Arising in the UK

We agree with your view that the question of where a loan agreement is held should not be material to the question of the source of the resulting interest payments.

We would however urge that the definition of UK source be included in the wider review of the taxation of interest. The current position, driven from the judgment in *National Bank of Greece*, is hugely unsatisfactory. We are told that there are four relevant tests, the relative importance of which will vary from case to case. Unless one satisfies (or fails to satisfy) all four, one cannot ever arrive at a position of certainty.

We suggest that a statutory definition of UK source interest should be adopted. Our preference would be for the starting point to be that it should encompass only interest paid by a UK resident person, or by the UK permanent establishment of a non-resident person. Such a definition would give certainty. It would also prevent there being any question of an entity being liable to UK withholding tax even if they are in no other respects a UK taxpayer, which would not appear to us to be a satisfactory result for either the person in question or HMRC.

On a related point, we think that this review of aspects of the taxation of interest also provides an opportunity to legislate to offer certainty as to the tax treatment of payments made by guarantors following a default by a primary borrower. At present, the question of whether such a payment retains its character as interest is not straightforward, let alone the secondary question of the source of the payment if it is of the character of interest and the guarantor is outside the UK.

Quoted Eurobonds

General points

We understand the policy concern that interest is effectively escaping the UK tax net on intra-group loans due to the availability of the quoted Eurobond exemption in relation to such loans. However, the proposal to deny the relief to intra-group bonds which are not regularly traded is fraught with practical difficulties. The quoted Eurobond market generally remains of enormous importance to the UK economy, both for companies that borrow money using it and the financial services industry that advises the issuers and buyers of the bonds. Damaging this market would have a serious detrimental effect on the UK economy, so it is critical that any measures aimed at perceived abuses are well-targeted and so do not affect the wider market.

By way of background, we would also query the £200m estimate of the amount of tax which would be raised by this measure which is included within the consultation document. If one assumes an interest rate of between 6% and 7% (realistic for intra-group financing where the transfer pricing rules would operate to render materially higher rates pointless in most cases), that would in turn assume that the entirety of the £15 billion of quoted Eurobonds on the Grand Cayman and Channel Islands Stock Exchanges are intra-group Eurobonds. Our expectation would be that only a small proportion of those £15 billion of quoted Eurobonds would potentially fall within the scope of the new measure.

Given the increasing number of non-bank lenders which have entered the mezzanine finance market in particular over the last few years, a large number of those Eurobonds will be held by lenders who are unconnected with the borrowers. A significant further amount will be held by lenders with some connection with the borrowers which falls well short of amounting to a group relationship as we might understand it. Many of the quoted Eurobonds will be held by lenders in treaty jurisdictions. Even where the quoted Eurobonds are held by group members in circumstances where the new rules might apply, there will in most cases be alternative means by which withholding tax can be prevented from arising, albeit potentially at greater cost to the borrower than listing.

This wider issue is key to the policy here. Many other major jurisdictions do not impose withholding tax on interest at all. For the great majority of cross-border financings into the UK, the imposition of withholding tax on the financing return would prevent the financing from proceeding. In order for the UK to maintain its position as a competitive international financial centre, it is critical that in practice it is possible to pay financing costs out of the UK without withholding tax. Given the wide variety of available structures which enable a financing return to be paid out of the UK without withholding tax arising, it seems to us curious to focus on what is an extremely small part of the overall picture (ie intra-group quoted Eurobonds). We would also note that structuring flexibility is rather greater in an intra-group context than otherwise, as there is no need to protect the commercial positions of each party to a loan in the same way as would be the case in a third party situation. In our view it is inevitable that groups would find alternative ways to achieve the same result as an intra-group quoted Eurobond if this measure was introduced, most likely by using notes issued at a discount.

Ultimately, therefore, our view is that any tax raised as a result of this measure is likely to be negligible, unless its scope is broadened, and it is accompanied by other measures, to such an extent that it amounted to a complete reconstruction of the UK withholding tax rules of a type that would have a massive detrimental effect on the availability of international funding to UK business. Such an approach might conceivably raise £200m per annum in withholding tax (although equally it might well not do, given that as noted above the imposition of withholding tax is generally a deal-breaker on a cross-border financing), but the collateral damage would be immense and would massively outweigh the tax raised. A limited measure such as the one proposed will deliver no results bar a slightly increased cost of putting intra-group funding arrangements in place, and the creation of a sense of uncertainty as to whether further, more broadly targeted measures may follow, which will damage the competitiveness of the UK. As we discuss below, we also anticipate that if despite the likely ineffectiveness of the measure it was decided to proceed, the resulting legislation would need to be complex.

A further point is that many single holder Eurobonds (whether held by persons grouped with the issuers or not) have been put in place to address concerns other than the immediate imposition of UK withholding tax on the debts they represent. A large number have been issued following the publication of HMRC's guidance on the *Indofoods* case, which stated (in summary) that HMRC would not seek to take the point that the payee of interest relying on a double tax treaty did not beneficially own the interest if that payee had funded itself with quoted Eurobonds. Secondly, many have been issued to achieve certainty where there is doubt under the *National Bank of Greece* tests as to whether interest paid by a non-UK taxpayer might nonetheless be UK source. This latter point could be addressed if our above recommendations as to a statutory test of the source of interest are adopted. If the availability of the quoted Eurobond exemption were to be restricted, policy in each of these areas would need to be addressed.

Our comments below are predicated on it being ultimately determined to proceed with this measure. However, for the reasons set out above, we do not believe that the measure should be adopted.

A "regularly traded" test

Some kind of "regularly traded" test is probably not viable. The great majority of quoted Eurobonds which are issued to entities unconnected with the issuers are not regularly traded – their nature is that they are usually acquired by institutions for the purposes of holding long term. Many recognised stock exchanges on which the bonds are listed do not even have the infrastructure to permit trading of the bonds. When they do change hands, they do so by private treaty and their listed status is incidental. In consquence, the extent to which bonds are traded does not appear to us to be a basis for denying the quoted Eurobond exemption, or a useful tool in distinguishing between "good" and "bad" Eurobond issues, either on its own or in conjunction with another test.

Testing by reference to group status

We also do not believe that a simple test of the bonds being held by a fellow group member is workable. Clearance systems are not set up such that they can cope with a single tranche of bonds having payment arrangements that differ between holders.

Secondly, most Eurobond issues contain a provision that they can be called at par in the event that withholding tax is imposed. Frequently this call applies to the entire tranche of bonds, even if the withholding tax applies to only a small proportion of the issue. Where this is the case, if the proposals were implemented, it would mean that if a group held some only of its bonds, a requirement to repay them all could be triggered. Transitional arrangements would be particularly key to this point, as we would acknowledge that an appropriate carve-out could be included in the tax call provisions of future bonds to deal with it. No such change could necessarliy be made in respect of existing bonds.

We note that the consultation document refers to the new rules applying when quoted Eurobonds are *issued* to a group member. Clearly in practice each of the above two points will be less likely to be an issue if the rules do not apply when a group member acquires quoted Eurobonds from a third party. However, if the rules are limited to the case where bonds are first issued to a group member, how would the legislation prevent avoidance by issuing bonds to a third party but with the intention that they would subsequently be acquired into the group? Or if the bonds were issued to an orphan special purpose company, which was in turn lent to by a group member?

One approach would be to allow the exemption in full to any tranche of bonds that was originally marketed and sold to unconnected investors, even if any of those bonds subsequently became owned by a member of the same group as the issuer. However, whilst attractive in theory, this would be challenging from a definitional perspective, and it might again be difficult to address avoidance by way of initial sales to unconnected parties, with understandings in place that the bonds would be on-sold into the group.

Our view is that if a measure of this sort is to be introduced, the appropriate grouping test to adopt would be that in the loan relationships code (ie the current s.335(6) CTA 2009).

Transitional provisions

If a measure of this type is introduced, transitional arrangements will be of very great importance. Many quoted Eurobonds have long lives – years, if not decades. Our preferred result would be that existing bonds should be fully grandfathered, although

given the long-dated nature of many quoted Eurobonds, we would understand if some future cut off date was imposed after which the new rules would start to apply to pre-existing bonds.

Interest in kind and funding bonds

Interest in kind

The proposals in relation to interest in kind appear to us to be broadly sensible. In contrast to the position with funding bonds, it must be correct that HMRC must receive withholding tax in cash, since whatever benefit is received by the lender in place of cash may very well be incapable of being turned to value in HMRC's hands.

Once one reaches the conclusion that requiring cash payment of withholding tax is correct, our view is that it follows logically that the gross up formula must be used as set out in the document. The basis of valuation of the non-cash consideration also appears sensible.

We suspect that most arrangements where loans contemplate that interest can be paid in kind are of a short-term nature, and borrowers will be able to adjust their terms in the event that this measure is introduced to take account of the new withholding obligation. However, if the decision is taken to retain the short/annual interest distinction, we suspect for the same reason that the measure will have little practical consequence.

Funding bonds

The position in relation to funding bonds is different, and this no doubt explains the historically different tax treatment. Here, if payment in kind is made to HMRC, HMRC receives a security – an asset which it can reasonably expect to turn to value in due course. It is therefore much less obvious to us that as a policy matter it is correct to require cash payment by the borrower.

Our experience is that businesses are very keen not to issue securities to HMRC (particularly so where the securities in question are equity securities which may carry votes or, even if they do not, may give HMRC a say in accepting any eventual offer to take over the issuer). Where securities are issued to HMRC, it is done as a last resort where for other reasons it is necessary to pay accrued interest by the issue of funding bonds and the issuer has no cash to fund the withholding obligation. In particular, funding bonds in the form of equity shares are often issued in the course of restructuring the borrowings of over-indebted companies, at times when the borrowers have no spare cash and the value of the funding bonds is clearly less than the amount.of the interest treated as paid.

In many such rescue situations it will be possible to conclude that the value of the funding bonds is nil and so, under the proposed new rules as now, no withholding tax would be due. However, there will also be situations where this is not the case and a requirement to find cash to pay to HMRC will prejudice the restructuring.

We would reiterate our two key points: firstly, companies do not as a rule want to find their securities held by HMRC and so even under the current rules they will pay withholding tax in cash if they can, and secondly, funding bonds are most typically issued because a borrower does not have the cash to pay interest. These factors suggest to us that it would be wrong to amend the rules on funding bonds to require the payment of withholding tax in cash since to do so would impose a need to find cash on businesses which lack it.

Disguised interest

We agree that it would be conceptually coherent if the income tax rules for individuals contained a similar regime dealing with disguised interest to the corporation tax rules for companies.

We welcome the suggestion of a review of the accrued income scheme, but would suggest that this should be a priority regardless of the progress of any proposal on disguised interest. The accrued income scheme delivers many anomalous results which should be addressed regardless of any other measures relating to the taxation of interest.

Yours faithfully,

Bradley Phillips
Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

Individuals and firms represented on this committee are as follows.

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