THE BOND AND THE SHORT OF IT

by Nikhil V. Mehta

The Government proposed to abolish the distinction between short interest and yearly interest in their Consultative Document on changes to the income tax treatment of interest published on 27th March 2012. In the same document, they also proposed to do away with the ability of UK companies to use Quoted Eurobonds for intra-group funding ("IGQBs").

The responses to the consultation were published in October 2012. Due to adverse comments from respondents, the Government decided not to proceed with either proposal. The responses were quite measured, unlike the reaction of the American colonies when the British attempted to impose stamp duties on them in the 18th century. As Alistair Cooke wrote:

> "It was the first internal tax that Britain had ever proposed and its effect was to rouse the colonists to a fury".

The relevant stamp duties disappeared as a direct result of the reaction. Similarly, short interest has remained. There are not many occasions when one gets a chance to celebrate the maintenance of the status quo after a consultation. On this occasion, I think it is worth doing so in an understated way. As someone who has become quite fond of short interest, and has come to live with IGQBs, I am pleased with the outcome, if not a little surprised.

Short Interest

Short interest is a wonderful concept. Many years ago, when I was a young student of taxation, I found its simplicity made short interest easy to grasp. When there are wonderful alliterative case names like *Bebb v Bunny* and *Corinthian v Cato* to memorise, student research really does not get much better!

There was (and, thankfully now remains) a nice fiscal Trivial Pursuit question for tax geeks: when is UK source interest not subject to (as opposed to exempt from) withholding? When it's short!

The expression "short interest" is not a statutory term. It is the opposite face of the coin that has "annual" or "yearly" interest engraved on it. With statutory consolidation and changes to the tax treatment of interest payments, "annual" has gone and "yearly" remains: see the general withholding tax provision in Section 874 of the Income Tax Act 2007. So, short interest is the opposite of yearly interest. East is east and west is west…although finding the border is not always easy, which I will discuss later.

Much of the case-law on the distinction had to do with getting tax relief for interest: see for example *Cairns v McDiarmid* (the Rossminster non-deposit scheme) and *Minsham Properties v Price* (charges on income for a corporate taxpayer). With the introduction of the loan relationships code for companies and progressive restrictions on tax relief for interest for non-corporate borrowers, the distinction between short and yearly interest became irrelevant for deductibility purposes. Its only importance lay in whether deduction of tax at source applied. Yearly interest was subject to withholding in the absence of an exemption. Short interest did not attract withholding: that Trivial Pursuit question again.

No doubt this is what prompted the Government to canvass for abolition of the distinction. Perhaps it had become an anachronism. After all, we have had the deduction of tax machinery in our tax system since 1803, with the distinction between yearly and short interest appearing three years later. Both concepts have been around long enough for the taxpaying community to get used to them, so why should short interest continue to enjoy freedom from withholding?

The answer of course is that "short interest" can arise for any period of less than a year including even a single day.

Unlike yearly interest, short interest can arise unexpectedly, for example, if a fiduciary holds funds belonging to someone else for a few days or weeks than had been intended.

To impose withholding obligations in the really short scenarios smacks of taking a hammer to crack a nut. It puts an unnecessary compliance obligation on the payer. If someone fails to withhold inadvertently and then finds himself liable to pay tax and interest on unpaid tax, that creates more difficulties both for the payer and, I suspect, HMRC. By its very nature, short interest will suffer tax in the normal course by direct assessment within a reasonable timeframe after it is paid (or not in the hands of non-residents and exempt institutions). If it is not taxable on assessment e.g. if paid to a non-resident with no other UK connections, then withholding is unnecessary: it would be counterproductive for HMRC to require non-residents to make domestic claims, let alone treaty claims, to avoid withholding or to get refunds of tax withheld.

The responses to the Consultation contained a number of examples of commercial situations where the "gross" treatment of short interest remains important today. It is worth setting these out:

- intra-group cash pooling arrangements and intra-group funding arrangements generally;
- the issue by companies of commercial paper; repo, stock lending and other collateral arrangements;
- short term bridging finance;
- late payments due under property leases;
- payments made under reinsurance agreements;
- payments of certain types of derivative;
- payments made under certain securitisation arrangements.

The examples show that the treatment of short interest is certainly not anachronistic. If anything, the circumstances in which short interest can arise have increased, and are still not complete. Short-term bridging finance is one of the most common examples where short interest can arise, and this can be incurred in a range of situations, including the funding of capital assets and working capital. A recent example was a short-term project finance loan from an offshore bank's overseas office to a UK purchaser of substantial infrastructure equipment which it was going to sell on to an overseas party. An unexpected mismatch between receipts and expenditure made the finance necessary for the UK company. The bank could not have relied on the exemption in Section 879 as the loan was made in its offshore business, and it was also not within the Tax Treaty Passport Scheme for overseas lenders. Making claims would have been unworkable while grossing-up would have been commercially unthinkable, given the inherent costs of bridging finance. Timing was another issue. The treatment of the interest as short was extremely important to the financing for both borrower and lender.

If withholding were extended to short interest, the specific exemptions from withholding on yearly interest paid to banks and other specified classes of lender in ITA 2007, Chapter 15, Part 3, would presumably have to be extended to all interest. But that would not be sufficient to deal with the range of lenders and investors now involved in "short" lending including investment funds and high net worth individuals. Indeed, there is something to be said for extending the "yearly" exemptions: due to the state of the financial markets in recent years, the sources of finance from conventional banking providers have diminished, and new categories of lenders and investors have emerged in areas like syndicated lending which traditionally were the exclusive province of banks. But that is another debate as it relates to yearly interest.

The grey area is the crooked dividing line between short and yearly interest. In what circumstances can short interest become yearly? In the October 2012 document, HMRC said:

"HMRC will make changes to its guidance in the Savings

> and Investment Manual (SAIM) to set out more clearly its view of 'short' loans that are repeatedly rolled over."

Recently, HMRC published their proposed changes to the Savings and Investment Manual in draft. At the time of writing, the draft is subject to comments. So far as rollovers are concerned, HMRC have proposed a new opening paragraph in SAIM 9076. It is worth setting out the whole of SAIM 9076 with the new draft opening paragraph, which appears below in bold:

> "Applying case law principles
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> **This [the previous paragraph in SAIM 9075 discusses Cairns v McDiarmid and the focus given to the intention of the parties] will be the case in particular where a loan has a duration of less than 12 months but is 'rolled over', once or more than once, to a second year. HMRC's view is that in the absence of evidence to the contrary, the intention of the parties will have been for the loan to have lasted more than 12 months.**
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> It is always a question of fact whether, in any particular case, interest is yearly or short. The intention of the parties will be the most important factor in deciding the question (see SAIM9075).
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> The question of whether interest is short interest, from which the payer has no obligation to deduct tax, is most likely to arise in the context of payments made by a UK resident to a person whose usual place of abode is outside the UK. If the interest is short, there is no need for the recipient to apply under a relevant Double Taxation Agreement to receive the interest gross (or with tax withheld at a reduced rate). There is guidance at INTM505010 onwards.
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> A UK resident may make a series of loans, each of less than a year, to a non-resident, and claim that the interest is short. HMRC staff should refer to the guidance at INTM542010 in such cases.

> Uncertainty may also arise as to whether there is a duty to deduct tax from interest in circumstances comparable to that in Bebb v Bunny (SAIM9075) – where a sum of money remains outstanding for a period that may, or may not, be longer than a year. For example, a manufacturer might guarantee to refund the purchase price, with interest from the date of claim, if a product proves faulty: such claims may normally be processed speedily but, in disputed cases, may drag on for over a year.
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> Where the parties intend at the outset that monies due will not be left outstanding longer than 12 months, the interest will be short – even if, in a few cases, there are delays which prolong the period over which interest accrues. If however the parties anticipate at the beginning that the debt will exist for more than a year, or appear to be indifferent as to whether it will or not, the interest is likely to be yearly.
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> Where the payer of the interest is uncertain about whether it is short or yearly, they may in practice 'play safe' by deducting tax. If the recipient of such interest objects to the tax deduction, HMRC staff should advise him or her to take up the matter with the payer, see SAIM9180.
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> If, conversely, the payer decides that interest is short and pays it gross, HMRC staff should not challenge that view unless
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> - the decision appears to be completely unjustified on the facts and in the light of relevant case law, or there is reason to suspect a definite intention of avoiding the payment of withholding tax; and
> - material sums of tax are at risk"

I doubt if there will be changes made to this part of the draft guidance as a result of comments from interested parties. HMRC clearly have a difficult task in laying down safe harbour rules under which short interest should not be treated as yearly interest in a rollover situation. In my view, the key words in the new draft paragraph are “in the absence of evidence to the contrary”. If the parties intend at the outset that interest should be rolled over, then it is clear that the interest should be yearly interest as in *Cairns v McDiarmid*. But as in that decision itself, any attempt to dress up yearly interest as short is likely to arise in an avoidance context and, if so, is unlikely to succeed given the anti-avoidance arsenal available to HMRC. However, given the many reasons in today’s financial world why interest is rolled over, a genuine decision taken by the parties to rollover prior to the short-term maturity of the loan, should result in the interest remaining short. Of course, if this is done on more than one occasion, in practical terms the onus on the interest payer becomes greater to show the interest remains short.

HMRC’s view in their draft wording is that, in a rollover situation, there is a rebuttable presumption that the interest is yearly. The key to rebuttal is ensuring there is written evidence to support the intention of borrower and lender. One problem with standard loan documentation provided by the lender is that there is no scope for amending that with nice recitals to show what is happening and why. The borrower usually does not have the negotiating power, no matter how strong the business relationship with the lender, to amend the document in this way. But there is ample scope outside the loan itself to achieve this-for example, unilaterally in the borrower’s board minutes and also in exchanges of letters between the parties. It is important to take the trouble to do this and not just sign up to the extension agreement with nothing telling the right story.

There are other techniques available which have the effect of making withholding unnecessary. For example, properly structured, a zero coupon security issued at a discount does not give rise to withholding tax when it matures, as a discount is not subject to withholding tax. The recent decision of the Upper Tier Tribunal in *Pike v Revenue and Customs Commissioners* is a timely reminder that the distinction between interest and premium/discount is not easy, particularly where the security carries no periodic interest. But in a commercial situation where the debt is properly drafted and the parties have a genuine intention that nothing should accrue or be payable until maturity, the discount route remains viable. Of course, if the real driving intention is to avoid withholding, then that is vulnerable.

IGQBs

The Quoted Eurobond exemption was announced in the 1984 Budget in what was called the "Corporate Finance Package". It was a watershed year for changes to the UK's corporate tax system. Apart from Quoted Eurobonds, the Finance Act 1984 introduced deep discount securities, qualifying corporate bonds and controlled foreign companies. The Quoted Eurobond exemption was a direct response to UK companies' grievance that they were unable to tap the Euromarkets directly for finance as withholding tax put them at a financial disadvantage. With the removal of exchange controls in 1979, it was incongruous that there was no straightforward tax-efficient way for UK companies to issue Eurobonds. The technique employed was to use a Dutch finance vehicle to issue the Eurobonds, coupled with an onloan back to the UK parent: the finance vehicle claimed exemption from UK withholding from interest on the onloan under the double tax treaty. The fiscal cost of this was a negotiated taxable turn in the Netherlands. While this route was tried and tested, it did not prevent HMRC looking at treaty-shopping aspects. But the new exemption did away with the use of Dutch finance vehicles and enabled UK companies to issue Eurobonds directly.

But the original version of the exemption had a couple of twists to it. It was not sufficient for the bonds to be "quoted". In addition, the interest had to be paid by an overseas paying agent or the bonds had to be held in a recognised clearing system. These additional requirements were inserted to reflect what HMRC had been told about the workings of the Euromarkets: they were not tax restrictions as such. But they implied that the exemption was intended to apply to public issues of bonds in the Euromarkets in the conventional way and not much else.

IGQBs first came to the fore when the original version of the exemption with the two twists was still in force in the 1980s. The first time I came across an IGQB was an issue of unlisted securities by a Cayman subsidiary, which onlent the proceeds under an IGQB to its UK parent. The interest on the IGQB was paid by an overseas paying agent as it made no sense for the bond to be held in a recognised clearing system, given that there would be no trading in it. As time went on, the two twists disappeared and the definition of "quoted" was confined to simple listing, as is the case today in Section 987 of the Income Tax Act 2007. That made IGQBs much easier to structure. If HMRC did not like the use of IGQBs, they could have tightened up, not relaxed, the "quoted" requirement. The change to straightforward listing was seen as an acceptance of the use of IGQBs.

That being the case, it was strange that the March 2012 Consultative Document raised this issue again and invited comments on proposals to restrict the exemption for IGQBs where there was no substantial or regular trading in the IGQB. Given the nature of the beast, how could an IGQB be allowed to trade by the issuing group?

Not surprisingly, the responses to this proposal were also negative. They included the following:

> "The well-established Eurobond market in the UK could be undermined. This would weaken London's competitive position, reduce inward investment in the UK, and put the UK at a disadvantage compared to competing jurisdictions.

- The change would add to compliance costs, as businesses sought to restructure existing arrangements.
- Clearing and paying agents' systems would need to be re-designed to manage withholding tax arrangements, and an exemption would be required for quoted Eurobonds held on trading account by a holding company
- Redemption of existing quoted Eurobonds could be triggered, and grandfathering rules would be needed to provide certainty and stability to existing arrangements.

> On the specific proposal that the restriction would apply where intra-group bonds are listed on stock exchanges where there is no 'regular or substantial trading', a number of respondents said that such instruments are often part of a chain of bonds through which third party finance is raised, and are listed on such exchanges to take advantage of lower regulatory costs. It was argued that a 'regular or substantial trading' test would be difficult to frame, hard to administer, and impose a compliance burden.
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> Some respondents felt that the concept of an 'intra-group' quoted Eurobond would be difficult to define; many favoured a narrow wording based on an existing statutory definition such as that used capital gains."

The underlying theme of the responses was that the legislation permitted the use of IGQBs and many issues had gone ahead on that basis. If it ain't broke, why fix it?

It will be appreciated that we have come a long way from the original rationale for Quoted Eurobonds back in 1984. But that is not surprising: the financial markets have evolved considerably, so why should tax legislation and practice not follow suit? If there is perceived avoidance, then that can be addressed, but not at the expense of the broader market which has used the generosity of the current exemption for structuring unlisted issues, whether on a private placement basis or otherwise.

The Government announced in the October 2012 paper that they would consider the question of the extent to which withholding tax should be withheld in the cross-border context further. The logical conclusion on IGQBs is the same as that in 1984 for bond issues by offshore finance vehicles: do away with the need for them, but with the substitution of a better alternative. Just as with the Mark 1 exemption for Quoted Eurobonds, what is now required is a broad exemption from withholding tax on interest for finance raising by UK companies, subject to anti-avoidance measures. The IGQB could then be put out to grass, but with an honourable track record!