FOREWORD

BY THE MINISTER OF STATE, TREASURY, JOHN WAKEHAM MP

A vital part of the Government's economic strategy has been to remove unnecessary restrictions and inhibitions on British industry and commercial activity. Exchange controls have been abolished, as have controls on pay, prices, and dividends. In the field of corporate taxation, a particular source of concern to industry and commerce has been that the present rules do not enable UK companies to pay Eurobond interest gross to non-residents. The main purpose of this paper is to see whether an acceptable and early solution to this difficulty can be found. The document thus follows up the announcement made last Spring by my colleague , the Financial Secretary, that there would be consultation on the tax treatment of interest paid by UK companies on foreign loans.

We would welcome views on the possible legislative changes discussed in the document, if possible before 22 February. I hope the response will give us a fuller picture of the likely impact of the changes envisaged and of how they might operate most satisfactorily in practice.

JOHN WAKEHAM

TAX TREATMENT OF INTEREST PAID BY COMPANIES TO NON-RESIDENTS

Introduction

1. This consultative document is concerned with some aspects of the present rules on deduction of tax at source from interest paid by UK companies to non-residents, in particular the effect of the present rules on the ability of UK companies to issue Eurobonds. It also refers to the provisions giving tax relief to UK companies for interest paid to non-residents. These two sets of rules are inter-related because the borrower's relief for interest paid to non-residents normally depends on tax being deductible at source from the interest. The present rules have developed over many years and the Government has felt it right to consider certain aspects of the way they work.

Present position

2. The requirement to deduct tax at source depends on the interest having a UK rather than a foreign source. In the case of a simple contract debt it is settled law that the source is where the debtor is resident. Before the ending of exchange control, the Revenue was normally able to accept that interest paid abroad in a foreign currency under a foreign specialty contract (ie a contract under seal governed by foreign law) to a non-resident could have a foreign source, even though the payer was a UK resident company. The abolition of exchange control has meant that a transaction in the form of a foreign specialty contract can now take place entirely between UK residents. The Revenue therefore now generally has to regard interest paid by a UK borrower as having a UK source, whatever the nature of the contract, with the result that deduction of

tax is required (unless the interest is payable in the UK on an advance from a bank carrying on a bona fide banking business in the UK).

3. A UK borrower may still, however, be able to pay interest gross if the lender is resident in a country with which the UK has a double taxation agreement which provides for the exemption of interest in the country in which it arises. If such a country does not impose tax under its domestic law on interest going to non-residents, interest can pass from the UK through a lender resident in that country to third countries without deduction of tax.

Possible changes in present deduction of tax rules

4. The present rules pose a particular problem for companies wishing to issue Eurobonds. The Eurobond market deals in bearer bonds and interest is paid gross. This means that at present UK companies wishing to issue Eurobonds have to do so through an overseas subsidiary. Amending the tax law to allow UK borrowers to pay certain types of interest gross to non-residents should enable UK borrowers to get better terms from foreign lenders, and UK companies to make Eurobond issues in London without the cost and inconvenience of setting up a foreign finance subsidiary.

5. The Government is therefore considering the possibility of legislation in this year's Finance Bill to make a limited relaxation in the deduction at source rules to enable UK public companies to issue Eurobonds, with interest paid gross. This raises some questions on which the Government would welcome views. They are the following:-

a. Definition

It would be necessary to define the bonds on which payment gross would be allowed. So far, no satisfactory definition of Eurobonds for this precise purpose has

been found. The definition in Section 57, Finance Act 1982 (bond washing) is not apt as it stands because payment gross is itself included as one of the tests in the definition. It would therefore probably be necessary to apply any new rule to bearer bonds more generally.

b. Safeguards

Recent US legislation provides for safeguards for the US Treasury against evasion of tax by US residents on Eurobond issues; these safeguards take the form of sanctions applying in certain circumstances to holders or issuers. The same issue of safeguards arises in the UK. Payments gross to UK residents could also lead to a failure to declare income. One response to this might be to make payment gross dependent on the lender, or someone on his behalf, making a declaration of non-residence. There are precedents for this. Such a requirement would however make it difficult to attract lenders in the Eurobond market. An alternative possibility would be to confine payment gross to interest on bearer bonds paid by overseas paying agents. It may also be necessary to consider the relevance of the recent US legislation referred to above.

c. Limitation to public quoted companies

If the problem in practice concerns Eurobond issues by public companies, it would seem appropriate to limit any extension of payment gross to Eurobonds issued by public quoted companies (other than close companies).

d. Relief for interest paid gross

Under the rules giving relief for interest paid to non-residents (Sections 248 and 249 ICTA 1970), interest paid by a UK company to a non-resident qualifies for relief if it is subject to deduction of tax (or would be but for a double taxation agreement), or if it meets various other tests. If payment gross to non-residents was allowed in certain circumstances under domestic law, the interest would still qualify for relief under present law if -

i. it was payable out of foreign source income liable to tax under Case IV or V of Schedule D - Section 248(4)(c); or,

ii. it was payable and paid abroad on a loan raised for the purposes of activities of the borrower's overseas trade - Section 249(1)(c)(i); or,

iii. it was payable and paid abroad in foreign currency on a loan raised for the purposes of activities of the borrower's trade at home or abroad - Section 249(1)(c)(ii) - but not if the interest was payable to an associated company - Section 249(2).

The Government is prepared to consider early legislation to remove the requirement, which dates from the period before the abolition of exchange control, that loans raised for the borrower's UK trade should be in foreign currency (see iii. above) if they were to qualify for relief. Subject to that amendment, the rules would remain unchanged. Interest on borrowing which could not meet any of the three tests set out above would not in practice be able to take advantage of

payment gross under domestic law, but it would still be able to qualify under double taxation agreements and companies would retain the option to issue Eurobonds through an overseas subsidiary (paragraph 4 above). Such interest would thus be no less favourably treated than it is now.

Conclusion

6. The Government believes that the changes discussed in this paper would deal with an immediate source of concern to industry and commerce.

7. Comments and views are invited on the issues discussed in this paper - in particular those in paragraph 5. Comments should be sent to the Inland Revenue, Room 131, New Wing, Somerset House, London WC2, by 22 February .