BERKELEY LATAM

TTN International Tax Conference
Tax Efficient Investor Lending to UK Companies

Colin Maltby

Universidad Torcuato Di Tella, Buenos Aires

BERKELEY LATAM

SUMMARY

Overseas investors can lend to any UK resident entity or individual, whether a company, partnership, other trustees or beneficiaries in two highly beneficial ways from a UK tax perspective.

Such debt structures can be used successfully as part of financing any UK assets in which an investor has an equity interest or owns outright, including UK private or public (listed or not) companies and commercial property structures.

Debt/equity splits are increasingly popular.

BERKELEY LATAM

The most useful of the two is a ‘Deep Discounted Security’ or ‘Deep Discounted Bond’; the less useful, due to its limited time horizon, is a short-money loan.

A short-money loan is a loan with a repayment date of less than one year, which is accordingly UK withholding tax free.

This planning are not schemes based on opinion/interpretation of the statutory or common law, as the rules are laid down in legislation. Clients therefore have a much greater degree of certainty, and the planning does not need to be cleared in advance with HM Revenue & Customs.

BERKELEY LATAM

What are deep discounted securities ("**DDS**")?

Bonds issued by a UK entity or individual at a significant discount to their redemption value.

What are their benefits?

The profit or 'interest' element of the DDS is UK tax-free in the hands of the holder or 'lender'. The issuer or 'borrower' is able to claim a deduction of the profit cost against their own UK tax bill.

BERKELEY LATAM

The issue of a deep discounted security to raise money instead of sourcing a loan can be very attractive, because the discount which is paid on the redemption of the security is not treated as interest for tax purposes and can thus be paid gross by a UK resident ‘person’ to the non-UK resident lender. The discount in the hands of the non-resident lender is generally tax free under the disregarded income provisions, even though the discount is UK source.

The discount is tax deductible for UK tax purposes, if the funds were raised for (i) the purposes of a trade, or (ii) a UK commercial or residential property let. The deep discounted security (a “DDS” or “Deep Discounted Bond”) has been found to be a highly attractive tool in an investor’s armoury.

BERKELEY LATAM

The general rule:

A security is a DDS where the amount payable on redemption (A) exceeds (or may exceed) the issue price by more than:

A x 0.5% x Y

where Y is the lower of (i) 30 and (ii) the number of years between issue and redemption (*section 430, Income Tax (Trading and Other Income) Act 2005*).

Where securities have an original issue maturity of less than one year, (unlikely in practice) the 0.5% per annum figure is reduced pro rata.

BERKELEY LATAM

If the redemption period is not a number of complete years, any incomplete year is expressed for these purposes in twelfths, treating each complete month and any remaining part of a month as one twelfth. 'Redemption period' means the period between the date of issue and the date of the occasion of redemption.

Any interest payable on an occasion of redemption is ignored in determining for this purpose the amount payable on that occasion.

The test for deep discount is carried out in the currency of issue.

BERKELEY LATAM

Example

Company A issues a 12-month security for £950. It is redeemable for £950 at maturity or, depending on events, for £1,000 after 6 months.

The occasion of early redemption is not disregarded.

The difference between the issue and early redemption prices is more than £2.50 (£1,000 x 0.5% x 6/12).

The security is therefore a DDS.

BERKELEY LATAM

Exceptions - the following are not relevant discounted securities for these purposes:

(1) shares in a company;
(2) gilt-edged securities that are not Strips;
(3) life assurance policies; and
(4) capital redemption policies.

‘Strips’ stands for “Separate Trading of Registered Interest and Principal Securities”. This is a zero-coupon bond that is sold at a discount to the nominal value. Strips are separately traded non-interest bearing bonds with all the return derived from the capital appreciation that results as the bond reaches maturity. All gains from Gilt Strips are effectively taxed as income on an annual basis.

BERKELEY LATAM

Case Law

The courts have held that a DDS is a security under which a ‘borrower’ agrees to pay monies on a particular date to the holder of the security. The borrower is, as a legal construct, selling that security. The subscriber (‘lender’) is not making a loan of money, rather he is purchasing a bill or security. In the case of *Torrens v IRC 18 TC 262*, the issue was whether a bank which purchased a promissory note was in effect making an advance of money to the seller/issuer.

Best LJ: “*There is no difference in principle, in this connection, between the discounting of bills and the discounting of promissory notes and, in my opinion, it follows that the bank in this case did not make an advance to the Appellant, that he did not pay interest to the bank on such advance*...”

BERKELEY LATAM

Where a qualifying DDS is issued to an overseas subscriber, there is no withholding tax on the profit element in the hands of the subscriber, and therefore there is no UK income tax liability.

The issuing company does however get the benefit of the deduction of the ‘interest’ or profit costs for UK corporation tax purposes.

BERKELEY LATAM

The discount can be paid gross because it is not treated as ‘interest’ under law. There are no provisions requiring tax to be deducted at source from a discount.

In the UK, the requirement to withhold tax from a payment applies only to payments of an income nature where the legislation requires a withholding to be made.

UK law does not require any withholding to be made from a payment of a capital nature.

BERKELEY LATAM

Warning - any issues relating to "*disguised interest*".

Will HMRC decide to treat a discount as disguised interest? There is nothing to indicate that that approach is to be adopted by HMRC, and they state that the proposed new disguised interest provisions are to be modelled on the corporation tax provisions in Chapter 2A of Part 6 of CTA 2009 and those rules do not seek to treat a discount properly so called as interest.

As a matter of practice, when agreeing the terms of the Deep Discounted Bond, it is important not to make the profit element too closely linked mathematically to an interest calculation based on a notional interest rate.

BERKELEY LATAM

Example

£100,000 made available as the cash sum to the issuing company on date of issue for a period of 3 years. In reality, most clients will negotiate by reference to prevailing interest rates in the relevant market.

In this example where the issuer is a high risk company a typical agreed position would be that the profit should effectively be, say 12% p.a., compounded say annually.

£1,000,000 + 12% compounded for 3 years = £1,404,928

BERKELEY LATAM

It would be advisable to agree a redemption figure not directly linked to the mathematical calculation. I usually act for the investor, so I would suggest a redemption figure of £1,450,000!

In this scenario, the issuer would be able to claim a tax deduction of **£450,000**, whilst the overseas subscriber would save **£90,000** in UK withholding tax.

BERKELEY LATAM

The Accruals Basis for Deductions

The general rule is that only those debits which are recognised for the purposes of determining the company's profits or losses under generally accepted accounting principles are accounted for on the accruals basis, rather than, for a DDS, solely on redemption.

However, if there is a connection between the subscriber and the issuer of the Deep Discounted Bond, the generally accepted accountancy practice rules do not apply and a debit "is brought into account for the accounting period in which the security is redeemed".

BERKELEY LATAM

As to whether there is a connection between the parties is determined under conditions A and B of section 408 Corporation Tax Act 2009. There is a connection between the companies if condition A or B is met.

- **Condition A** is that there is a time in the period when one of the companies has control of the other, or a major interest in the other.

- **Condition B** is that there is a time in the period when both companies are under the control of the same person.

BERKELEY LATAM

A has such a major interest in B if-

a) A and one other person (C) when taken together, have control of B; and

b) A and C each have interests, rights and powers representing at least 40% of the holdings, rights and powers of the company. A and C are therefore taken to have control of B.

BERKELEY LATAM

Practice Note:

In order to get the equivalent effect of the accruals basis of deduction where both parties are connected, DDSs can simply be issued in a series.

For example, annual issues on the same term, so annually occurring redemptions.

BERKELEY LATAM

SHORT- MONEY LOANS

Withholding tax is applicable to payments of yearly interest unless an exemption applies.

Unless an exemption applies, where a payment of yearly interest has a UK source, an amount equal to the UK basic rate of income tax (currently 20%) of the payment must be withheld and, subject to set off, be paid to HMRC.

BERKELEY LATAM

Broadly, yearly interest is any interest on a loan or debt obligation that has a term of, or is intended to last for, at least a year and includes any loan the duration of which is shorter than a year but which is capable of being rolled over into one or more successive loans which, together, could exceed a year.

The intention of the parties to a loan or debt obligation is key to determining whether or not interest is yearly interest and therefore whether or not UK tax must be deducted from the payment.

BERKELEY LATAM

The exemptions commonly relied on to ensure that UK source payments made by companies can be made free from withholding tax include:

- ensuring that the interest is short interest, i.e. that it is not yearly interest – so a loan of 364 days maximum.

Practice note*: any provision in the loan agreement which may be capable of extending the repayment date, for example, by reference to the repayment date under a 364 day loan falling on a weekend and accordingly having to be repaid on the following Monday, will mean that the interest is yearly interest.*

BERKELEY LATAM

• the quoted Eurobond exemption, which enables interest to be paid without deduction of UK tax in respect of bonds listed on a recognised stock exchange;

• the UK to UK exemption, where at the time of making the payment, the payer reasonably believes that the recipient beneficially entitled to the payment:

a) is a UK tax resident company; or

b) is a non-UK tax resident company for which the interest is within the charge to UK corporation tax in respect of its UK permanent establishment; or

c) is a partnership, each member of which is either a UK tax resident company or a UK permanent establishment of a non-UK tax resident company.

BERKELEY LATAM

- the exemption for interest paid by banks in the ordinary course of their business, which does not include interest on borrowings which relate to a bank's capital structure or are primarily attributable to a tax avoidance intention; and

- relying on a relevant double tax treaty to provide that interest can be paid gross to the relevant recipient.

BERKELEY LATAM

I have implemented such structures for overseas investors many times over more than 15 years, typically around 10 financings a year, and have seen no problems to date.

These debt structures (DDS’s and short-money loans) must be entered into using bespoke legal documentation to ensure that the relevant tax rules are not inadvertently broken, rendering the structures ineffective.

BERKELEY LATAM

Colin Maltby T.E.P. Solicitor, Consultant **Berkeley LatAm** Fourth Floor 19 Berkeley Street Mayfair London W1J 8ED	T: +54 (11) 5984 4001 M: +54 (911) 49 46 27 25 T: +44 (0) 208 123 7050 M: +44 7795 032080	colinmaltby@berkeley-latam.com www.berkeley-latam.com

Colin Maltby is a qualified UK lawyer who is based in London and Buenos Aires, as Berkeley LatAm's representative in the region. Colin specialises in international investment structuring, commercial work and succession planning for international investors, particularly family offices. He is a member of the Society of Trust & Estate Practitioners.