Analysis

Double taxation treaty passport scheme: expanding the scope

Speed read

HMRC has published updated terms and conditions and guidance for the double taxation treaty passport (DTTP) scheme, which expands the scope of its application. The DTTP scheme previously applied only to corporate lending. However, from 6 April 2017 borrowers who are individuals, partnerships or charities, and lenders who are partnerships, pension funds or sovereign wealth funds can also use the DTTP scheme. This is good news for borrowers and lenders operating in the UK market, as the DTTP scheme offers a swifter and simpler route for obtaining relief under UK double taxation treaties than the traditional 'certified claim' method.

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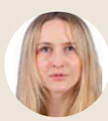

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A borrower which makes a payment of UK source interest to an overseas lender is required to withhold on account of UK income tax at the rate of 20% (ITA 2007 s 874(2)) unless an exemption applies. The overseas lender will often be resident in a jurisdiction with which the UK has a double taxation treaty and which entitles it to a full or partial exemption from UK withholding tax.

In the case of withholding tax imposed in a number of European jurisdictions, an overseas lender is often able to self-certify its entitlement to treaty benefits, which means that the zero or reduced rate applies immediately upon entering into the loan. However, with respect to UK withholding tax, the borrower cannot make payments at the zero or reduced rate unless and until it has received a direction to that effect from HMRC in accordance with the Double Taxation Relief (Taxes on Income) (General) Regulations, SI 1970/488. It is only possible to apply for a direction after the parties have entered into the loan. Therefore, in order to protect the cash flows of the loan, it is often critical to obtain a direction from HMRC as quickly as possible.

Prior to the introduction of the DTTP scheme, the only way to obtain a direction was via the 'certified claim' method. This requires the overseas lender to obtain proof of its tax residence from its home tax authority and then submit this to HMRC, together with a completed form DT-Company and a copy of the loan. This process can result in delays of months (and in some cases, years) and must be repeated for each loan made by an overseas lender. In the meantime, either the overseas lender has received its interest payments net of UK withholding tax, or the borrower has been required to 'gross up' on account of such withholding tax; and in either case, this is an unsatisfactory result.

The DTTP scheme was introduced in September 2010 to streamline the procedure for obtaining a direction. Under the DTTP scheme, an overseas lender which is able to benefit under a double taxation treaty with the UK can apply for a 'treaty passport'. It does this by completing a form DTTP1 and submitting it to HMRC, together with proof of tax residence. Once HMRC has granted a treaty passport, the overseas lender provides its passport information to a UK borrower upon entering into a loan. The borrower then informs HMRC of the details of the loan by submitting a form DTTP2, which HMRC uses to issue a direction to the borrower in respect of interest payments made to the overseas lender on that loan.

HMRC usually provides a direction within 30 days of receipt of the form DTTP2, which represents a significant timing advantage given the delays often encountered with the certified claim method. In addition, an overseas lender only needs to renew its treaty passport every five years.

The DTTP scheme as originally implemented only applied where both the borrower and the lender were bodies corporate

Why update the DTTP scheme?

The main limitation with the DTTP scheme as originally implemented was that it only applied where both the borrower and the lender were bodies corporate. In the case of borrowers, this meant that only UK and non-UK corporate borrowers were eligible. In some sectors, such as real estate, it is common for borrowers to be unit trusts, such as Jersey property unit trusts (JPUTs), and partnerships. As transparent entities were excluded from the DTTP scheme, it was therefore often more onerous, and sometimes more expensive, for overseas lenders to lend to such borrowers.

Further, an overseas lender established as a partnership was unable to obtain a treaty passport – even if each of its partners was entitled to benefit under a relevant double taxation treaty. Perhaps more controversially, both pension funds and sovereign wealth funds were also unable to obtain treaty passports. This was often seen as anti-competitive and confusing – it is unclear why, for example, a Canadian pension fund represents a greater tax risk for HMRC than a European debt fund.

HMRC launched a consultation on 26 May 2016 to seek views on whether the DTTP scheme was meeting the needs of UK borrowers and foreign investors. The result of this consultation was the publication of the terms and conditions and guidance of the DTTP scheme on 6 April 2017 (available via www. bit.ly/2qI8CgE; see DTTP30000 et seq).

For the most part, the terms and conditions and guidance merely consolidates the information previously contained in the original terms and conditions and the technical questions and answers (both updated in April 2013). It is helpful that the rules of the DTTP scheme can now be found in one place. However, the new terms and conditions and guidance also set out some significant and helpful changes to the scope of the DTTP scheme.

How has the DTTP scheme changed for borrowers?

The main change from the perspective of borrowers is that all persons who are required to withhold on account of UK income tax on loan interest payments are now able to use the DTTP scheme. This includes unit trusts, partnerships, charities and individuals (see DTTP30010).

Under market standard loan facility tax provisions, a borrower is often obliged to 'gross up' on account of any tax it must withhold on interest payments made to an overseas lender in the period before it has received a direction. There is little incentive for an overseas lender to agree to reverse this position where the only reason that the DTTP scheme does not apply is because of the nature of the borrowing entity. Notwithstanding that the overseas lender is generally required to pass on the benefit of any refund it obtains with respect to such withholding, this requirement to gross up can represent a significant cash flow cost for the borrowers, given the delays that can be encountered using the certified claim method. Therefore, the ability for such non-corporate borrowers to access the DTTP scheme is welcome news, as it means that it is likely the relevant directions will be received before the first interest payment date, thus eliminating the need to gross up.

How has the DTTP scheme changed for lenders?

One of the main changes from the perspective of lenders is that pension funds and sovereign wealth funds may apply for treaty passports where the ultimate beneficial owners of the income received are each entitled to the same benefit under the same UK double taxation treaty (see DTTP30140). In practice, this will involve the trustees of a pension fund making an application for a treaty passport in their capacity as representatives of the fund's members, together with a copy of the pension trust deed (see DTTP30150). This is great news for such lenders, as it offers them parity of position in the UK lending market with corporate overseas lenders.

Other transparent entities, such as partnerships, can also participate in the DTTP scheme if all the ultimate beneficial owners of the income are entitled to the same treaty benefits under the same treaty. The partnership will need to nominate a partner to be responsible for corresponding with HMRC with respect to the passport and any relevant changes (see DTTP30130). Although this is a welcome change, the membership of overseas partnerships may not be sufficiently uniform or indeed sufficiently static for the use of the DTTP scheme to make sense as a practical matter.

Once a passport is granted, any material changes to the membership, including changes in its underlying constituent membership, will need to be notified to HMRC or else HMRC may suspend or revoke the passport (DTTP30410).

What are the other changes?

Under the original terms and conditions, HMRC stated that unless a form DTTP2 is filed at least 30 working days before the first interest payment date, it would not give any assurance that a direction would be issued in time to be applied to a particular interest payment. The updated terms and conditions and guidance now only makes reference to the need to file a form DTTP2 before the first interest payment date (DTTP30640). At present, we do not see this change as a commitment on the part of the DT Treaty Team to issue directions any more quickly than 30 working days. In our experience, the workload of the DT Treaty Team can vary dramatically and so it is still best practice to file the form DTTP2 at least 30 days before the first interest payment date in order to be sure of a direction being issued in good time.

How has the DTTP scheme not changed?

As part of the consultation process, there were some calls to permit borrowers to pay interest at the treaty rate immediately following submission of the DTTP2 or else to provide for the automatic electronic issuance of directions. Given that so many jurisdictions either do not impose withholding tax at all on commercial loans, or indeed operate withholding tax on an entirely self-certification basis, this would have been a welcome change indeed.

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The updated terms and conditions and guidance set out that a borrower who submits the form DTTP2 online may, if it so wishes, provisionally withhold at the relevant treaty rate in advance of receiving a formal direction (DTTP30610). The intention behind this statement is not entirely clear, as it appears to be a departure from established HMRC practice on this point, i.e. that in all cases the borrower must wait to receive a direction (DTTP30640). However, given that HMRC would still be able to recover from the borrower any amounts that were not properly withheld from an interest payment, it is our view that this apparent concession will not prompt borrowers to depart from current practice in this regard in most cases.

HMRC also rejected extending the DTTP scheme to include entities with sovereign immunity (as opposed to a sovereign wealth fund benefiting from a tax treaty exemption); such lenders will need to continue to use the 'certified claim' method.

When do the changes come into effect?

HMRC published the updated terms and conditions and guidance of the DTTP scheme on 6 April 2017 and the changes have effect from this date. A loan entered into on or after 6 April 2017 will be governed by the new rules, whereas a loan entered into between 1 September 2010 and 5 April 2017 will still be subject to the old terms and conditions (DTTP30500). This means that overseas lenders who advanced loans to non-corporate UK borrowers before 6 April 2017 must continue to use the 'certified claim' method. However, if a loan was advanced before 6 April 2017 but is subsequently sold or assigned, HMRC will treat the date of sale or assignment as being the date the loan commenced, such that the updated terms and conditions will apply to that overseas lender in respect of the loan (DTTP30420). ■

For related reading visit www.taxjournal.com

- News: Revised DTTP terms (19.4.17)
- The double tax treaty passport scheme (Alex Chadwick & James Smith, 28.6.10)
- Mitigating UK withholding tax on debt (Ben Jones & Deepesh Upadhyay, 10.8.11)