Dear Sirs

Double Taxation Treaty Passport scheme review

Simmons & Simmons LLP is delighted to respond to the consultation document published on 26 May 2016 in relation to HMRC's review of the Double Taxation Treaty Passport ("DTTP") scheme (the "Consultation Paper"). We have discussed our proposed response with a number of clients who either use treaty passports or face counterparty lenders using treaty passports, and our response contains and reflects their input, in addition to our own observations.

In summary, we consider that the DTTP scheme is valuable for both taxpayers and HMRC and should be continued and expanded: the DTTP scheme as currently implemented is widely used and offers considerable time savings where available, but cannot be used in all contexts. In particular, extension to non-corporate borrowers and lenders would be very welcome (albeit we appreciate that additional challenges may arise in relation to tax transparent lenders such as partnerships).

In light of the very recent decision of the Court of Justice of the European Union in Brisal - Auto Estradas do Litoral SA, KBC Finance Ireland v Fazenda Pública (Case C-18/15) we note that whilst the UK remains a member of the European Union, the UK's current imposition of withholding tax on payments of UK source interest may now be contrary to EU law in relation to interest paid to lenders in other EU member states who are treated as providing services under the relevant freedom. Whilst this may have the short-term effect of depressing lender demand for UK treaty passports, the UK's intended exit from the EU would obviously counter this effect in the slightly longer term, with the result that the DTTP scheme will remain of relevance for all non-UK lenders. It may therefore be preferable for HMRC to consider its response to the Brisal case alongside this consultation.
We set out below our responses to the specific questions asked in the Consultation Paper, along with some additional observations on the scope and administration of the DTTP scheme and gross payment directions more generally.

We would be happy to discuss any of this response further with HMRC if it would be of assistance. For any queries relating to our comments on the Consultation Paper, please contact Mark Sheiham (020 7825 4146, mark.sheiham@simmons-simmons.com) or Zoe Arnautov (020 7825 3091, zoe.arnautov@simmons-simmons.com).

Question 1: Is the current DTTP scheme meeting its objective of providing an administrative simplification for corporate-to-corporate lending and should it be continued?

As demonstrated by the high level of uptake and large number of passports issued since introduction of the DTTP scheme in 2010, the DTTP scheme has been successful in reducing the administrative burden for corporate lenders who frequently lend to UK corporate borrowers.

We and our clients would like to see the DTTP scheme continued and extended so that it is available to both a larger population of lenders and in relation to a wider variety of borrowers.

Question 2: Do the current DTTP arrangements create any barriers to the making of debt-based investments in the UK?

Yes, the current arrangements do create barriers to inward debt investment, in that the DTTP scheme is not of sufficiently wide application. In particular, the DTTP scheme should be extended to apply to tax transparent borrowers and lenders such as partnerships (as to which see below). At present, tax transparent lenders are positively incentivised to use corporate subsidiaries that may access a relevant double tax treaty in order to mitigate the greater administrative burden associated with the "certified claim" procedure, which runs counter to global trends (including the OECD’s BEPS initiative).

Question 3: Is the passport renewal operating appropriately? If not, how should it work?

Renewal requirement

Some of our clients have queried whether passport renewal should be required at all. HMRC could consider imposing a change-of-status notification obligation on lenders to address any concerns about abuse of the DTTP scheme.

Passport duration

Assuming that HMRC’s view remains that a renewal requirement remains necessary, passport duration should be as long as HMRC is willing to consider, as this would further reduce compliance burdens on lenders who are entitled to be paid interest gross / with reduced withholding. Any concerns HMRC has could be mitigated via a notification requirement in relation to status change, in particular for tax transparent entities whose membership could change (as to which see below). In the case of, for example, investment funds that have a specified life, the default position should be that a passport should cover the anticipated life of the fund, typically seven to 12 years.

Please see below under “Additional Observations” in relation to the related issue of the duration of clearances granted where a passport is being used.
Renewal administration

In general, those of our clients who have held passports for long enough to experience the renewal process have felt that renewal operated smoothly. However, one comment we have received is that renewal correspondence from HMRC has sometimes not been received by the appropriate person within the lender organisation/group within a timely manner, for example because it is sent to the directors of the non-resident lender entity within a multinational bank group, when UK treaty clearances and passports are in practice handled by the UK tax/compliance team.

We note that Form DTTP1 only requests the correct "contact name", and does not appear to provide for this person to have different contact details (e.g. a UK group entity) from the lender entity. It would perhaps be helpful if Form DTTP1 were to be amended to include both (1) a contact name, postal and email address details for the principal contact (if different from the lender’s details), and (2) a statement that HMRC will (by default) use the details provided during the renewal process. HMRC should then send renewal correspondence via email to the listed principal contact. To the extent that HMRC has concerns about not contacting the lender directly about renewal (for example because of the risk of fraud), correspondence could be sent both directly to the lender entity and the specified renewal contact in parallel.

Question 4: Do the sanctions for misuse of the scheme need to be changed and/or strengthened?

We have no specific comments on this question – we are not aware of any lender that has been subject to sanctions.

Question 5: Is the current scope of the scheme, which mainly covers corporate to corporate lending, adequate? If expansion is advantageous, what entities should and should not be admitted to the scheme and why?

We consider that the DTTP scheme should be extended to all borrowers who are not individuals.

In addition to partnerships (as to which see Question 6 below), it would be advantageous to extend the scheme to other non-natural persons as borrowers, for example including unit trusts (including Jersey and Guernsey property unit trusts), contractual funds and other tax transparent fund entities. There is no obvious reason why loans to such borrowers should not be within the scope of the scheme, and any entity which has a duty to withhold tax on interest and account for it to HMRC should equally be capable of filing Form DTTP2.

Extending the DTTP scheme would also benefit HMRC, freeing up resources which would otherwise be devoted to more complex certified claims.

Question 6: What potential benefits and/or difficulties may arise from admitting UK partnerships to the DTTP scheme as borrowers?

In our view it would be sensible to allow the DTTP scheme to apply to partnership borrowers. There would be no obvious practical issues associated with this step, as the nature and status of partners or members of the borrower do not influence the obligation to withhold tax on interest payments made by the partnership or the entitlement of any lender facing that partnership to rely on the provisions of the relevant UK double tax treaty. As a result there should be no need to introduce a notification requirement where there is a change to the partners or members in a partnership which is a borrower under a passported loan.
Amongst our client base, passports are frequently used within multinational groups, where non-UK entities are lending money cross-border and intra-group to UK borrower entities. The extension of the DTTP scheme to partnership borrowers would provide welcome administrative simplification.

Whilst the UK’s “Quoted Eurobond” and “Qualifying Private Placement” exemptions from interest withholding tax do not apply where the borrower entity is a partnership, we would note that it is commercially much more common for loans to be made to partnerships than for partnerships to act as issuers of capital markets instruments. There is therefore a strong case for partnership borrowers to be catered for in the DTTP scheme, even though they are outside the scope of the Quoted Eurobond or Private Placement exemptions.

The same approach should be taken to other forms of tax transparent fund as is taken in relation to partnerships.

Question 7: What potential benefits and / or difficulties may arise from issuing passports to partners in overseas partnerships if they are admitted to the DTTP scheme as lenders?

This is the aspect of the review of the DTTP scheme which has been of greatest interest to our clients. In our view it would be desirable to allow partnership lenders to obtain treaty passports, albeit that some additional notification requirements may need to apply in the case of this group.

Clearly, partnership lenders may introduce greater complexity, as exemption from interest withholding tax (or entitlement to a reduced rate of withholding) under the relevant double tax treaty will depend on the identity of the partners or members, which can change over time. Consequently, this change would necessitate a more complex system for recording who the partners are at any given time and ensuring that all partners qualify for treaty exemption / reduced rate withholding (albeit that more than one treaty may be in point).

We also note that the administrative burden imposed on partnership lenders in group structures by the failure to include partnerships in the DTTP scheme can encourage partnerships to lend through corporate subsidiaries that qualify for treaty relief, purely on the basis that such vehicles can obtain a passport. Thus the failure to include partnerships in the DTTP scheme actually incentivises behaviour which runs contrary to general global trends (including the OECD’s BEPS initiative) which deprecate the use of treaty vehicles. Again the same points apply equally to other tax transparent funds as apply to partnerships.

Question 8: If partnerships were admitted to the DTTP scheme, how would HMRC police this and receive sufficient information on the parties involved to prevent abuse, whilst keeping the compliance burden low on both sides? For example, should partners’ passports have a shorter duration of one or two years and be contingent on all of the partners being either companies or individuals resident in the same jurisdiction?

We envisage that a partnership treaty passport would involve a continuing duty to file with HMRC and keep updated on an ongoing basis a list of who the partners are and their withholding tax status. This could involve a “nominated partner” role, giving a specific partner the responsibility for providing this information. In the case of our clients, partnerships are frequently used to lend money intra-group to UK entities. Such “internal” partnerships typically have a very stable membership, with the result that the need to report changes would arise only infrequently, whilst the ability to use a passport would represent a significant cost and time saving for both lenders and HMRC.

A possible model is provided by the US system. US IRS Form W-8IMY certifies beneficial ownership of income but also appends a schedule which is explicitly used for this purpose, and, in
the case of partnerships, identifies current partners, their share of income and their withholding tax status / rate of withholding under US law. Introducing a similar system on a voluntary basis would allow partnerships making infrequent loans and / or with a more volatile membership to continue to seek clearance on a certified claim basis for each loan.

Whilst in theory it should be possible for such an extension to the DTTP scheme to apply to partnerships whose members qualify for a range of different treaty rates (pursuant to different treaties), if HMRC considers this to be too complex then a welcome first step would be to extend the DTTP scheme to partnerships comprising exclusively partners who are all entitled to full exemption under their respective jurisdictions’ treaties with the UK. (We understand that the US system described above encompasses “mixed” partnerships, and does not require every partner to be entitled to full exemption.) This would allow the DTTP scheme to extend beyond partnerships in which every partner is resident in the same jurisdiction.

Assuming that a notification requirement would apply, there should be no need for partnership passports to be issued for a shorter duration. Once again, the same points apply equally to other tax transparent funds as apply to partnerships.

**Question 9: Are there any obstacles to prevent sovereign investors and overseas pension funds being admitted to the DTTP scheme, such as issues of liability to tax and entity characterisation?** Admittance to the DTTP scheme would also require publication of their names in the public register of passported lenders.

In our view it would be beneficial to permit sovereign investors and overseas pension funds to obtain and use treaty passports.

In the case of sovereign investors, arguments exist for extending the DTTP scheme to cover investors benefitting from sovereign immunity outside the treaty context, rather than limiting this to the narrower circumstances where sovereigns are explicitly entitled to treaty relief pursuant to the terms of a double tax treaty. This would give such investors the benefit of relief at source, and would relieve both investors and HMRC of the burden of tax being withheld at source by the borrower only to be reclaimed by the sovereign investor (as this currently appears to be the only method for claiming sovereign immunity from UK withholding tax on interest). Any investor concerned about the public nature of the passported lender register could simply choose not to apply for a passport.

Also very welcome would be an additional withholding tax exemption for entities which do not currently benefit from treaty relief (e.g. because they are tax resident in a non-treaty jurisdiction), but are wholly-owned by exempt sovereigns. In the realm of the OECD’s common reporting standard and US “FATCA” such entities are treated as “good” exempt beneficial owners, and it seems to us that the UK should consider taking an equivalent approach in relation to withholding tax.

In the case of overseas pension funds, identical entity characterisation issues would arise as is currently the case with certified claims made for individual loans – we see no reason why this determination cannot be made up-front in the context of passport issue. To the extent that HMRC has concerns in this area, a compromise could be to make passports available to entities which HMRC has already recognised as QROPS (though in our view this narrower approach should not be necessary, and it should be possible for all EU pension funds to obtain a passport).
Question 10: Other than those detailed in the Consultation Paper, what investment structures are typically used by sovereign investors and pension funds, and are these suited to the mechanics of the DTTP scheme?

In addition to the structures detailed in the Consultation Paper we have also seen sovereign investors use UK limited liability partnerships (LLPs) or equivalent entities under local law which are tax transparent but have legal personality. Provisions in the LLP agreement typically permit streaming of UK source income directly to the sovereign investor.

Alternatively, sovereign investors sometimes lend through subsidiary SPVs incorporated in jurisdictions with a suitable tax treaty with the UK – again, the result is that lending through corporate subsidiaries is incentivised even though the ultimate investor should actually be entitled to receive interest gross of UK withholding tax.

The extension of the DTTP scheme would therefore also be welcomed by sovereign investors (as to which please see above).

Additional observations

Timing of clearance taking effect

In relation to timing of a clearance taking effect, an additional welcome change would be a reversal of the current position that the UK borrower must deduct withholding tax from payments made after the filing of a Form DTTP2, but prior to the issue of a notice by HMRC to the borrower pursuant to Regulation 2 of the Double Taxation Relief (Taxes on Income) (General) Regulations (SI 1970/488).

As an alternative, where a Form DTTP2 has been filed borrowers could be permitted to make payments gross (or subject to a lower rate of withholding, as applicable) provided that they have a "reasonable belief" that the relevant lender is entitled to relief under the relevant treaty, unless and until HMRC issues a notice stating that treaty exemption not available – i.e. following the approach applicable to the "excepted payments" regime for exemption from UK withholding tax for UK non-bank recipients of interest. Where relief under the relevant treaty is not available, a notice from HMRC could (preferably) apply withholding tax from the date of the notice (replicating the approach of the Qualifying Private Placement exemption) or, failing that, retrospectively require the borrower to pay the tax that should have been withheld but wasn't (following the approach of the "excepted payments" regime).

The lenders most likely to benefit from this change are the smaller lenders with less strong bargaining power, as such investors may not be able to arrange the deferral of the first interest payment date (which is the approach commonly taken to deal with this problem). This change would also benefit HMRC as well as lenders, as it would remove the need to process repayments of tax previously withheld from interest payments made during the period between Form DTTP2 filing and issuing of a notice.

Introducing this "automatic clearance" would have the effect of making treaty clearance stand more on all fours with other exemptions from withholding tax, rather than (as is currently sometimes the case) operating as a fall-back option because of the additional procedural burden of a requirement to receive a treaty clearance from HMRC before exemption from withholding tax applies.
Duration of clearance

Many of our clients feel that the five-year duration of clearances (which is not affected by whether a passport is being used) is too short, as many loans and loan notes have a duration longer than five years. Whilst we understand that HMRC might be reluctant to grant open-ended clearances, it would be very welcome if clearances could be given for the duration of the relevant loan if this matures up to three years (or perhaps even longer) beyond the five-year point. This could be subject to the relevant passport remaining valid / being renewed as appropriate during the intervening period.

Availability of HMRC guidance on existing DTTP scheme

We note that following the migration of materials and guidance from hmrc.gov.uk to gov.uk it is now very difficult to locate online either the Terms & Conditions of the DTTP scheme or the Technical Questions & Answers (reproduced at Annexes B and D respectively of the Consultation Paper).

It would be extremely helpful if links to these materials could be included on the main page on gov.uk which concerns the DTTP scheme (and currently contains links to Forms DTTP1 and DTTP2, as well as the register of passported lenders): https://www.gov.uk/guidance/double-taxation-treaty-passport-scheme.

Any additional guidance published as a result of the current consultation should also be linked from this page.

Clarifications regarding current scope of the DTTP scheme

Non-UK corporate borrowers

Whilst it is clear from Condition 9 of the Terms & Conditions of the DTTP scheme that a lender may already use a passport when facing a non-UK corporate borrower (for example where lending to a non-UK resident SPV which owns UK real estate in circumstances where the interest paid to the lender is considered to have a “UK source”), in our experience there is considerable confusion among lenders in practice as to whether it is possible to use a passport in relation to a non-UK corporate borrower paying “UK source” interest.

This confusion may in part arise from the wording of some other Conditions: for example Condition 1 refers only to interest payments made by “a UK corporate borrower”, and the titles of Conditions 10 and 11 both refer to “UK borrowers”.

In addition, in the past we have had to consult HMRC to determine how Form DPPT2 should be completed by a non-UK corporate borrower paying “UK source” interest from a practical perspective, as Form DTTP2 was clearly designed with UK corporates in mind, and does not lend itself to the context of a non-UK borrower paying UK source interest.

In our view it would be helpful if HMRC would consider clarifying the Terms & Conditions of the DTTP scheme and any guidance associated with Form DTTP2 to make clear throughout that the DTTP scheme applies to non-UK corporates paying “UK source” interest, as this would ensure consistency and remove potential confusion. A possible additional step would be to introduce an alternative version of Form DTTP2 for use by non-UK corporates paying “UK source” interest.

Finally, we understand that HMRC’s current policy is that it will not grant treaty clearance in relation to loans to non-UK borrowers unless the borrower confirms it views the interest as UK source and would apply UK withholding tax in the absence of a treaty clearance. Since the UK
has no statutory definition of "UK source", in our experience it is frequently the case that some doubt may exist as to whether interest payments from a non-UK borrower are UK source. In the context of HMRC’s policy, at present borrowers typically view the process of obtaining treaty clearance as a definite concession that the relevant interest payments have a UK source. In such cases, assuming that the relevant lender would be entitled to exemption / a reduced rate of withholding under the relevant double tax treaty, in our view it would be beneficial if HMRC would consider granting clearance even if there is uncertainty as to whether interest has a UK source. There would be no loss of tax revenue from granting such clearance.

Securitisation structures

Q&A 11 of HMRC’s Technical Questions & Answers makes clear that passports can be used by securitisation companies in treaty jurisdictions to provide exemption from withholding tax when a UK corporate acts as servicer and collects interest received from individual UK borrowers under loans purchased by the issuer under a single transaction, and pays the interest on to the passported securitisation company. This should be enshrined in the Terms & Conditions and made clearer to lenders via guidance. It should also be clearly stated that where HMRC has issued a direction to the servicer, the underlying borrowers (and any other persons in the payment chain) are also relieved (under HMRC’s general management powers) of any liability to operate withholding tax on interest paid via that servicer.

In addition, we are not aware of any HMRC guidance confirming that the “certified claim” procedure can be used in such circumstances in relation to a UK corporate servicer by a lender which does not hold a passport under the DTTP scheme. This seems to us to be a lacuna which should be addressed, as the certified claim procedure should always be available where a passport could be used by a lender.

Yours faithfully

Simmons & Simmons LLP