

The HMRC Double Taxation Treaty Passport Scheme – what corporate borrowers need to know

HMRC recently announced the launch of a long-awaited Double Taxation Treaty Passport (“DTTP”) scheme for overseas corporate lenders who rely on a double tax treaty for relief from withholding tax on interest payments by or from UK borrowers (“Treaty Lenders”). When the DTTP scheme becomes operative on 1st September 2010, the process of obtaining DT clearance should become considerably simpler in relation to Treaty Lenders who have applied for and obtained a DTTP. The impact of the DTTP scheme will depend on the number of Treaty Lenders who participate. The existing clearance process will continue to apply to Treaty Lenders who do not hold a current DTTP.

This Briefing outlines the background to HMRC's proposal, its main features and its implications for corporate borrowers and loan documentation.

BACKGROUND

The tax provisions of the LMA facility agreements operate on the basis that in general, any deductions on account of withholding tax on payments to lenders are for the account of the borrower. If a tax deduction is required to be made, the borrower must make the required deduction but must also gross-up the payment due to the relevant lender. Lenders who are entitled to the benefit of this gross-up obligation are known as “Qualifying Lenders”.

Treaty Lenders have become more prevalent in the UK syndicated loan market over the last decade. For some years, the LMA facility agreements have included Treaty Lenders as an optional category of “Qualifying Lender”.

The current system of claiming relief from withholding tax under a double taxation treaty requires the Treaty Lender to obtain a direction from HMRC in relation to each loan in which it participates. In spite of efforts to speed things up in recent years, the timetable for clearance is variable, not least because before a direction can be issued, the Treaty Lender needs to file the direction application with its home tax authority and obtain confirmation of its tax residence.

If Treaty Lenders are included in a lending syndicate on the basis envisaged by the LMA, in the event that a direction is not forthcoming prior to the first interest payment date under the facility, the borrower is likely to need to gross-up payments to the Treaty Lender pending receipt of the direction. With the Treaty Lender's co-operation, the tax withheld can be reclaimed once the direction is issued, but the uncertain time frame means the cashflow disadvantage for the borrower can be significant. As a result, many borrowers seek to amend the LMA's tax provisions to mitigate this risk or seek to exclude Treaty Lenders from the definition of “Qualifying Lender” (and thus the benefit of the gross-up) altogether.

THE DTTP SCHEME

The main features of the DTTP scheme are (in summary) as follows:

- Treaty Lenders may (but are not required) to apply for a passport which confirms their eligibility for treaty relief.

- Passports will be valid for 5 years and will cover all loans that the passport holder enters into in that period¹.
- A register of passported lenders, each identified by a unique DTTP reference number, will be made available to the public on the HMRC website.
- When a passported lender enters into a loan, the passported lender must inform the borrower of the need to file a DTTP direction application.
- The borrower has 30 working days from the date of the lender's entry into the loan to notify HMRC and request a direction in respect of that lender (if it does not, the DTTP scheme will not apply to the loan).
- Once HMRC has issued the requested direction, the borrower may apply the Treaty rate of withholding tax to payments.

The DTTP scheme is due to be launched (in the sense that the register of passported lenders will be published on HMRC's website) on 1st September 2010. HMRC is already accepting passport applications.

IMPLICATIONS FOR LOAN DOCUMENTATION

The launch of the DTTP scheme may have implications for loan documentation for borrowers who include Treaty Lenders as Qualifying Lenders for the purposes of tax gross-up provisions.

Timeframe for receipt of directions

The expectation is that obtaining a DTTP direction will be a speedier process than the current system (not least because the confirmation of residence required from the lender's home tax authority will have been obtained at the passport application stage). According to HMRC, it is "committed to issuing directions as soon as practicable" under the new scheme, but "until the new system is up and running and the take up of

passports is known, no specific commitment on turn around time can be made"². Prior to the launch of the DTTP scheme, HMRC indicated informally that it is aiming to process applications within 2-3 weeks.

It appears that borrowers will be unable to apply the Treaty rate of withholding tax in reliance on lender's DTTP passport status as shown on the on-line register prior to receipt of a direction³. As a result, it will remain advisable for borrowers to protect themselves against the risk of being required to gross-up a DTTP lender pending receipt of a direction (in other words, to address the concerns that apply under the current system to Treaty Lenders generally).

DTTP passport status confirmation

Borrowers can search the HMRC database of DTTP lenders to determine whether particular lenders hold a DTTP. This should be reasonably straightforward in relation to the primary syndicate and in circumstances where the borrower's consent is required for subsequent transfers or assignments of participations in the loan (as in each case, the borrower will know the identity of the lender prior to its entry into the syndicate). Further, the HMRC terms and conditions oblige DTTP lenders to make borrowers aware of their obligation to apply for a DTTP direction in relation to the loan within 30 working days. However, the terms and conditions do not specify any time limit within which the borrower must be notified, so in some circumstances, the borrower may not have the information needed to conduct a search or file the direction application on a sufficiently timely basis.

Borrowers may prefer to obtain confirmation directly from each lender as to its DTTP status on the date each lender joins the syndicate. This can be achieved by adding a confirmation from each lender that it holds (or does not hold) a current, valid DTTP both to the tax provisions of the loan agreement and to any agreed form of transfer/assignment certificate⁴.

¹ Subject to HMRC reserving the right not to apply the DTTP to a particular loan or a particular borrower.

² See HMRC FAQs arising from DTTP launch meeting.

³ See HMRC FAQs arising from DTTP launch meeting.

⁴ It is assumed that each time a syndicated loan participation is sold to a DTTP lender, the borrower becomes subject to the obligation to apply for a direction within 30 working days.

DTTP lenders might also be asked to repeat in the loan agreement for the borrower's benefit, the undertaking they are required to make to HMRC by the DTTP terms and conditions, namely that a DTTP holder will only use its DTTP where "(to its certain knowledge and belief) all conditions for relief under the relevant double taxation arrangements are present". This might help protect the borrower against any risks arising as a result of the DTTP holder misusing its passport.

DTTPs are issued for a term of 5 years (part of which may have already run on the date upon which the lender enters a particular loan). Directions are usually given for a maximum of 5 years. The expiry of a passport will not affect a direction already given (unless HMRC also withdraw that direction)⁵. However, if a loan has a term of more than 5 years (and so will or may be outstanding beyond the term for which HMRC will issue a direction), it may be appropriate to seek undertakings from DTTP lenders to renew their passports on a timely basis, to facilitate the process of obtaining a new direction.

COMMENT

It is disappointing that HMRC was unable to implement a full passport scheme along the lines proposed by the LMA and the Association of Corporate Treasurers in 2008. It remains necessary to obtain a direction from HMRC on a loan by loan basis in relation to a Treaty Lender with a DTTP passport and it will not be clear until the scheme is in operation how long the process will take. Nonetheless, the DTTP scheme is a step in the right direction and as such, a welcome development from the borrower's point of view, provided that lenders are minded to make use of it.

FURTHER INFORMATION

The DTTP scheme terms and conditions, forms and other information are available on the HMRC website: www.hmrc.gov.uk.

A general commentary on the tax aspects of the LMA facility agreement is included in the ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers⁶.

⁵ See HMRC FAQs arising from DTTP launch meeting.

⁶ Available from your usual contact at Slaughter and May or via www.slaughterandmay.com.