The City of London Law Society

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By email to: simplifyingtreatyreliefconsultation@hmrc.gov.uk

Dear Sir or Madam

City of London Law Society's Response to "Simplifying Treaty Relief from Withholding Tax on Interest Paid Overseas"

Please find below The City of London Law Society's ("**CLLS**") response to the HM Revenue & Customs ("**HMRC**") consultation document with the above title (the "**Consultation Document**").

INTRODUCTION

The CLLS represents over 22,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the Consultation Document has been prepared by the CLLS Tax Committee.

The current members of the Tax Committee are listed at https://clls.org/committees/tax.html

INITIAL COMMENTS

We welcome the consultation as it shows genuine willingness to reduce friction in an area where the administrative costs outweigh the tax collected. There is clear potential for a win-win for HMRC and taxpayers alike. The UK is an outlier in terms of interest withholding tax. Most jurisdictions either do not impose withholding on interest at all, impose withholding only on payments to "black-listed" jurisdcitions or (for example Ireland) start from the proposition that there is withholding tax on interest but have such a broad range of domestic exemptions that the treaty has only residual significance.

We feel that there is a really straightforward answer, which is to allow borrowers to self-assess (as you suggest at question 3) whilst retaining the existing processes for formal clearance which we expect would be used less frequently but perhaps not all that much less frequently (as evidenced by lack of uptake for the QPP regime).

For many of the large international finance transactions CLLS members see, we would expect not much to change, at least initially. The risk allocation in market-standard contracts such as the Loan Market Association (**"LMA"**)'s standard documentation is already well understood internationally and processes are established. In this third-party lending context, we would regard reform of the QPP regime to probably be just as fruitful in reducing the burden on HMRC as introducing the treaty self-assessment regime. If the QPP regime were made simpler and more robust in a third-party lending context, increased adoption of QPP should reduce the burden on HMRC of evaluating applications for DTTPs and certified claims for treaty relief.

The QPP regime was a move in the direction of the US-style self-certification by lenders without involvement of HMRC and we understand that commercial parties have been wary to use it (in large part owing to continued technical uncertainty as to its scope), preferring to minimise risk by getting HMRC directions. Full self-certification by borrowers would overlap with the QPP regime but we suspect for similar reasons may not be relied on for the large commercial loans we see. If self assessment of interest withholding tax was to be implemented (which we strongly support), a simplification to the QPP regime would be an obvious counterpart. The technical concerns with relying on the QPP regime are well understood but require legislative reform to resolve – helpful guidance in HMRC's manuals has not given the market sufficient comfort. The CLLS Tax Committee would be glad to meet with HMRC to discuss these technical issues in detail if helpful.

We respond to the consultation questions below.

1. **To what extent do the current processes for obtaining treaty relief on interest create delays, costs, or administrative burdens? Which specific aspects cause the most difficulty? Please provide examples or evidence where possible.**

1.1 **Background**

In the past (before the global financial crisis) banks, often UK ones, were regularly the mainstream lenders to UK borrowers. The UK's unusual position of imposing withholding tax on interest payments with relatively limited exemptions and requiring formal applications for treaty relief did not create as much friction for UK business then as it does now because;

(a) often no treaty claim was needed because the lender was a UK bank and

(b) overseas lenders were typically overseas banks, requiring a simple, single treaty clearance with which bank personnel were familiar.

International financial markets have moved substantially. Funds are increasingly parties to finance transactions both as lenders and borrowers. This has given rise to complications:

(a) funds can have a complex structure of transparent entities meaning that the underlying beneficial owners of interest are many and varied; and

(b) where funds are borrowers, for example under facilities to cover capital calls on their investments, the "UK source" element of the borrowing could be constantly changing, unknown, unknowable and ranging from zero to 100 percent.

1.2 **Delays**

Current UK treaty relief processes delay transactions.

There is a substantial workstream on most international finance transactions settling and agreeing risk allocation on withholding tax between the parties. Many jurisdictions don't impose withholding tax on interest at all. Many only withhold on payments to tax havens. Some have a general rule of withholding but a wide range of exceptions and reliefs. The key mainstream jurisidictions which cause issues are the US and the UK.

The US treaty-relief process is relatively straightforward and does not involve the IRS. It is similar to the UK's QPP process where the lender provides a self-certification of beneficial entitlement to the interest (US form W8-BEN) but without all the limitations of the QPP process.

So where a US borrower borrows from a UK lender, the borrower just needs a self-certification from the lender in order to pay gross, which could in theory be completed on the same day the loan facility is signed, introducing no delay.

By contrast where a UK borrower borrows from a US lender, unless QPP applies, the IRS need to be involved either in certifying US tax residence for the lender for a DTTP scheme passport, or in doing the same thing for a full treaty relief claim using the HMRC forms. This is known to take more than a few months – in some cases more than a year. That is before HMRC start their part of the process, which can also involve months of delay.

A classic feature of commercial loans involving UK source interest is the “long first interest period”. This is a provision in the contract which says that the first interest payment date is delayed if HMRC treaty clearance has not yet been obtained by the borrower. The fact that this is common practice is clear evidence of the delays experienced by market participants – the worst of which (as explained above with the IRS as an example) are out of HMRC’s hands.

1.3 **Costs and administrative burdens**

Borrowers have to pay for at least their own lawyers (and sometimes the cost of the lenders’ lawyers are also passed on to borrowers). The LMA gross-up provisions are perhaps over-complicated but with UK lenders or non-UK bank lenders their negotiation is well understood and straightforward. Banks make profit on their margin and pass all other risks on to borrowers. However with a market movement towards debt-fund lenders, private equity fund sponsored borrowers take more aggressive positions and negotiation of these provisions can be a meaningful cost for both sides.

The limits typically imposed on treaty relief in the letters issued by HMRC giving the borrowers directions to pay gross provide an administrative burden for borrowers. Some of the conditions which deny the continuing application of treaty relief which has been granted, such as a “change in business details” are difficult to translate into actionable monitoring processes for borrowers.

1.4 **Who has the withholding obligation?**

The scheme of the legislation making every person “by or through whom” payments are made liable for the withholding is unsatisfactory and UK tax lawyers spend a disproportionate amount of their time worrying about it (including an exercise, seemingly unique to the UK, of including gross-up clauses in every document to try to allocate the risk). Whilst perhaps straying from the core of this question, the broad joint-and-several liability for withholding tax seems a disproportionate protection for HMRC against something which in most other jurisdictions, as explained above, is just not really a thing. This creates costs, friction and sometimes surprises for UK borrowers.

2. **How well does the current process for obtaining directions in advance of payments of interest allow easy and certain access to treaty relief?**

The current process is good and the HMRC delays are often the least time consuming part of the process as mentioned above. The HMRC treaty team are responsive and helpful and at least historically it was often possible to speak to an actual person and get useful and timely input.

One aspect of the process which seems unnecessary is the requirement for a signed facility agreement before an application can be made. Usually the details required for a treaty claim (identity of the parties, maximum amount of the loan, beneficial ownership of the interest etc) would all be known at the beginning of the negotiation of the loan facility, and it would be helpful if a treaty claim or DTTP2 application could be made at that stage, perhaps following up with a final version of the loan facility later for completeness.

The certainty provided by HMRC clearance is much valued by lenders and borrowers alike and is baked into established industry-standard documentation. As explained in the initial comments we think the existing procedures should be retained and in our view would be likely to still be used in the same way on a majority of large commercial loans.

3. **Should UK payers of interest to lenders in jurisdictions with whom the UK have a double taxation agreement be permitted to apply treaty relief on interest payments without prior HMRC clearance? What would be the benefits and risks of this?**

Yes. See Initial Comments section above.

3.1 **Benefits**

The delays mentioned above would be avoided, but ultimately we expect many commercial borrowers would require the certainty of the current clearances so would continue to use the DTTP process unless the QPP regime was made more attractive.

3.2 **Risks**

The risk to the UK exchequer is that some payments could go unreported and could be within the mischief explained in the Consultation Document. The counterpoint to that is that there is currently a lot of reporting, and individual treaty clearances for loans is perhaps an anachronistic requirement where, in particular, UK borrowers will be providing information on interest paid in corporation tax returns made electronically in order to claim tax deductions on the interest. If tax deductions are not being claimed the "interest stripping" mischief explained in the Consultation Document is less of a concern. If corporation tax returns are not currently identifying interest payments, we would suggest that adding a requirement for more detail on that in the annual return would be more appropriate than requirements for case-by-case clearances for each loan. We expect HMRC has satisfied itself that the self-assessed UK-to-UK exemption now found in section 930 ITA 2007 is not the risk it was perceived to potentially be when it was introduced at the turn of the millennium. (We are not aware of any directions under section 931 ITA ever having been given). Extending the same approach to treaty relief but retaining the certainty of the existing clearance system would be simply a logical extension of that approach.

4. **How would moving to self-assessment of treaty relief benefit your business (such as time saved, reduction of fees, cash-flow improvements, greater certainty)?**

Self-assessment would benefit our clients by hopefully removing the "long first interest payment" practice referred to above and treating the HMRC directions as certainty which can be obtained after the event, rather than a pre-condition to being able to pay interest gross. It would put UK borrowers on a similar footing to borrowers in most other major jurisdictions in the international financial markets.

5. **Do you have a view on how interest payers would satisfy themselves that all the requirements for treaty relief are met before applying treaty relief to payments? What experience do you have in other jurisdictions where self-assessment of treaty relief is possible? How well does this work?**

The LMA standard loan facility is typically used for large commercial and syndicated loans. Under that documentation the lender indicates its status. Where the (self-assessed) UK-to-UK withholding exemption applies, borrowers rely on the lender status confirmations given under the documentation. For these sorts of loans the same could apply to confirmation of Treaty Lender status.

In other jurisdictions there is typically either not withholding tax on interest at all or there are broad exemptions which do not require self assessment of treaty entitlement. One example is Ireland where there is a domestic exemption for corporate lenders in treaty jurisdictions which means actually having to rely on the treaty is rare. However where the treaty is needed there is a self-assessment regime which (similar to the self-assessment of the UK-to-UK exemption under s.930 ITA). We aren't aware of it having given rise to any issues.

6. **Should self-assessment of treaty relief only be available where the risk of base erosion is low because the payer is subject to other effective restrictions on interest deductibility? If so, what would be a good basis for a threshold (such as being subject to transfer pricing rules, having net finance costs exceeding the de minimis for Corporate Interest Restriction, being subject to Pillar 2, or some combination of these)?**

   We are strongly of the view that there should be no tests or other hurdles for self assessment to apply, similarly to the UK-to-UK exemption. We believe the risk of base erosion is adequately covered by the many layers of other rules mentioned in the question.

7. **Would it be necessary or helpful to introduce a facility for interest-payers to obtain certainty in advance of paying interest that HMRC agrees treaty relief is available? How might such a facility work? Are you aware of other jurisdictions providing such a facility?**

   As mentioned above we are strongly of the view that the existing treaty clearance mechanisms should be retained. This would avoid disruption to existing transactions which assume the current processes. Introducing a different process to achieve the same aim would be entirely unhelpful.

8. **Are there other jurisdictions you have experience of where the administrative burden to obtain treaty relief is low, but the regime still provides effective protection against base erosion using interest? What are the requirements in such jurisdictions when paying cross-border interest? How is protection against base erosion achieved (particularly for owner-managed businesses)?**

   Most European jurisdictions do not impose a general withholding tax on interest at all, yet achieve satisfactory protection against base-erosion using the same mechanisms which also apply in the UK – targeted anti-avoidance rules, general anti-avoidance rules, disclosure rules, transfer pricing, anti-hybrid rules, the corporate interest restriction, Pillar 2 etc. As mentioned above the US simply requires a self-certification from lenders and other recipients of US-sourced payments which is in many ways similar to the UK's QPP regime.

9. **Do you have any comments on the potential impacts of these changes on tax receipts or avoidance/evasion behaviour? We are especially interested in how businesses and lenders might respond to changes.**

   Amongst matters which CLLS member firms work on we would not anticipate any change at all to tax receipts.

10. **What reporting requirements are imposed in other jurisdictions in which you have significant operations/investments?**

    No comments.

11. **Would it be significantly burdensome to report payments made with complete relief (so that no UK tax is due) in the CT61, alongside payments made without relief or with partial relief? Would it be preferable instead to report them alongside treaty rated cross-border royalty payments in the CT600H? Why?**

    No comments.

12. **What sanctions are imposed in other jurisdictions in which you have significant operations/investments?**

No comments.

13. **What would be a proportionate but effective set of sanctions for non-compliance in this area? How should this apply in the following circumstances?:**

- ***where treaty relief is applied but the conditions for relief being available are not met***
- ***where treaty relief is applied, the conditions for relief are met, but there has been a failure to comply with any requirement in advance of the payment (such as to obtain a certificate of residence or creditor certificate)***
- ***where treaty relief is applied, the conditions are met, but there has been a failure to comply with reporting requirements after the payment***

Sanctions should be consistent with other interest and penalties imposed in the case of other tax failings. We are strongly of the view that where treaty relief is available it is wildly disproportionate and unreasonable to expect taxpayers to pay the withholding and then reclaim it. Many CLLS member firms' clients have been distressed by the suspension of HMRC's longstanding practice not to require payment of the withholding tax where treaty relief was available but administrative failings were made. We note the Consultation Document expressly flags that this is out of scope but would nevertheless like to draw attention to this. An early resolution to that issue would be very much appreciated.

14. **Are there any other options or ideas for simplifying the withholding process on interest that you believe the government should consider? This could include international examples not mentioned above, or innovative uses of technology or data sharing.**

The Irish model, already referred to above, could be helpful, as it is similar to the UK one but with much reduced administrative friction. The model in Luxembourg and the Netherlands of generally not withholding on interest at all would clearly help simplify matters a lot. The French approach of only imposing withholding on payments to tax havens would also be a huge step forward for simplicity compared with the UK approach. However it should be noted that most European jurisdictions do impose withholding tax on dividends and generally impose withholding on interest if it is a disguised dividend so it is perhaps unfair to criticise the UK approach which does the opposite.

15. **Do you have any other comments in relation to changes which could be made to the current system for withholding on payments of interest and how these would impact (positively or negatively) to your/your clients' organisation? This may be in the form of time saved per transaction, reduction in fees, cash-flow.**

The UK's system gives rise to lots of questions which are difficult to answer, for example whether payments have a "UK source." Because of the way other jurisdictions treat withholding on interest, the "source" problem is often less of a concern, and the "source" of dividend payments is a much easier question to answer. We mention above the problem of deciding who is liable for withholding. In practice many payments are made through long chains of intermediaries and in our experience many of those are unlikely to be aware of the rule that the person "by or through" whom interest is payable is liable for withholding. It should surely be the case that the primary liability lies with the person "by" whom the payment is made (ie the borrower), with others only having a secondary liability (and perhaps a right of recovery against the borrower?).

As mentioned above if our recommended approach is adopted it would make sense to simplify and streamline the existing QPP regime, which we feel would still be relevant (in particular for the small number of jurisdictions which don't provide for full withholding tax relief).

CONCLUDING COMMENTS

We welcome this consultation and see treaty relief as an area where HMRC can save time and costs as well as reducing friction for taxpayers without any loss of revenue. The CLLS Tax Committee would welcome any discussion with HMRC on this topic – please don't hesitate to contact us.

CONTACT DETAILS

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Yours faithfully

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