UK Tax– Double Tax Relief – New Arrangements Make it Easier to Minimise Withholding Tax

Isobel d'Inverno, Director of Corporate Tax at law firm, Brodies LLP, considers how the introduction in the UK of a new Double Taxation Treaty Passport Scheme can be used by Chinese lenders to minimise or even avoid UK withholding tax on loan interest payments by UK borrowers.

Introduction

The UK government tax authority, HM Revenue and Customs (HMRC), has recently introduced a Double Taxation Treaty Passport (DTTP) Scheme to streamline access to the benefits which are available under the UK's wide network of double taxation agreements. Banks and other organisations based in China should consider applying for a DTTP, if they are considering writing loan business in the UK which will result in the receipt of interest payments from UK borrowers. The cash flow benefits to both borrower and lender from minimising (or even avoiding) UK withholding tax are likely to be significant.

Withholding tax

Most countries apply withholding tax to interest payments made to overseas banks or corporations, and the UK is no different. A UK borrower paying interest to a bank or corporation in another country has to deduct tax, currently at 20%, from the interest payments it makes and to pay this over to HMRC. This means that for every £100 of interest paid, the lender would only receive £80.

Double Taxation Treaty relief

Whilst loan agreements generally require the borrower to "gross up" the payment so that the lender actually receives the amount of interest it would have received but for the withholding tax, clearly the effect of "grossing up" has cost implications for the borrower and it is generally in everyone's interests to minimise withholding tax exposure. This why double taxation treaties are important as they generally reduce the rate of withholding tax, or remove it altogether. Under the Double Taxation Treaty between the UK and the Peoples Republic of China[1] (UK/China Treaty) treaty relief reduces the rate of withholding tax from the usual 20% to 10% for interest payable by a UK borrower to a lender resident in China.

[1] SI1984 No1826 and Protocol – available at http://www.legislation.gov.uk/uksi/1984/1826

In addition, Article 11 (3) of the UK/China Treaty provides complete exemption from withholding tax for interest paid to state owned or controlled bodies as follows:-

"…interest arising in a Contracting State and derived by the Government of the other Contracting State, a political sub-division or local authority thereof, the Central Bank of that other Contracting State or any agency of that Government, or by any other resident of that other Contracting State with respect to debt-claims of that resident which are financed, guaranteed or insured by the Government of that other Contracting State, a political sub-division or local authority thereof, the Central Bank of that other Contracting State or any agency of that Government, shall be exempt from tax in the first-mentioned Contracting State."

Making a claim for treaty relief

Relief under UK double tax treaties is not automatic. The UK borrower cannot just rely on the wording in the UK/China Treaty and deduct tax at 10% or even at 0%. Until the introduction of the new DTTP Scheme, the Chinese lender had to make an application for treaty benefits to HMRC on a loan by loan basis, using the relevant UK/China Treaty claim form. Once HMRC had considered and accepted the claim, it issued a direction for that particular loan to the UK borrower. The UK borrower could then start to deduct withholding tax at the reduced 10% rate (or at the 0% rate if the Article 11(3) exemption was available).

Whilst HMRC dealt with applications as quickly as possible, there were inevitably delays as the application could only be made once the loan agreement had been signed, as the original loan agreement had to be sent to HMRC with the application form. The result was that the UK borrower might have to make several interest payments paying withholding tax at 20% before HMRC issued a direction allowing the borrower to start to apply the reduced rates which were available under the UK/China Treaty.

The Double Taxation Treaty Passport Scheme

The UK DTTP Scheme aims to cut through this bureaucracy. The scheme allows any overseas corporate entity (or concern treated by its country of residence as a corporation for tax purposes) to apply to HMRC for recognition as a DTTP holder, and to be entered on the DTTP register. The DTTP holder gets the benefit of the UK/China Treaty in the same way as previously except that the benefits apply to all interest payments being made to it by UK borrowers and are not restricted to specific loans.

To apply for a treaty passport, a Chinese corporation would need to complete an application form DTTP1 and send this to HMRC. The form is available at the following link http://www.hmrc.gov.uk/cnr/dttp-application.pdf. The application form is relatively short, but includes a certificate of tax residency from the tax authorities in China. The treaty passport can be applied for before a loan has been drawn down.

Once a Chinese corporation has been included on the DTTP register, the double tax treaty benefits will apply to all loans made by the Chinese corporation to UK borrowers without individual applications having to be made to HMRC on a loan by loan basis. Instead, the Chinese lender would inform the borrower that it is a DTTP holder, and give the borrower its DTTP number, and the UK borrower can deduct withholding tax at the reduced treaty rates from the outset. Note that the UK borrower must advise HMRC of the passported loan once the loan agreement has been entered into.

The advantages of holding a DTTP are quite clear, and many organisations have already applied for DTTP holder status. We have advised one Chinese organisation on obtaining DTTP status. The DTTP register which contains the list of DTTP holders can be accessed via the following link: - http://www.hmrc.gov.uk/cnr/dttp-register.pdf. Chinese organisations contemplating loans to UK borrowers should consider making an application for DTTP holder status at an early stage, to make their loan arrangements in the UK are as tax efficient as possible.

This article is for informational purposes only and does not constitute legal advice. Should you have any questions on issues reported here or on other areas of law, please contact Isobel D'Inverno - isobel.dinverno@brodies.com; +44 (0) 131 656 0122, international relations partner, Grant Campbell – grant.campbell@brodies.com; +44 (0) 131 656 0115 or your usual Brodies' contact.