

# Changes to clearance processes for financial transactions

## Introduction

1. The 2007 Budget Report contained an announcement concerning thin capitalisation. Paragraph 5.92 of the Economic and Fiscal Strategy Report stated that;

The Government has agreed that HMRC can expedite its procedures for agreeing relief from UK tax on loan interest paid to non-residents, and extend the circumstances in which UK residents can enter into thin capitalisation agreements. A detailed announcement will be made later this spring.

This document sets out the changes HMRC are making and covers the following matters;

### Section A

- [a summary of the proposed changes](#)

### Section B

- [detail about the changes to the treaty clearance process](#)

### Section C

- detail about [extending the scope](#) for negotiating thin capitalisation agreements under the existing advanced pricing agreement ('APA') legislation;
- a [draft statement of practice](#) governing the use of APAs in thin capitalisation cases.

2. This note also refers to existing guidance published in the [International Manual \('INTM'\)](#).

## A. Summary

3. The treaty clearance application process will be streamlined bringing it more into line with the principles underlying self-assessment. This modernisation will reduce the timescale for obtaining treaty clearance notices and give certainty on withholding tax (WHT) issues. This announcement is relevant to non-UK resident enterprises lending funds to businesses in the UK.

4. Secondly, the scope for making thin capitalisation agreements between HMRC and a UK borrower will be extended to enable more UK and international businesses to obtain certainty about the tax consequences of particular financing arrangements. These will take the form of unilateral advanced pricing agreements ('APAs') under the existing legislation. These will be administered under the terms of a new statement of practice, a draft version of which is attached for comment.

## B. Treaty Clearance Application Process

5. Relief from UK income tax to a non-resident under a double taxation agreement ('DTA') or the terms of the EU Interest and Royalties Directive (2003/49/EC) is not automatic. A resident of a country with which the UK has a DTA may be able to get relief or partial relief at source from UK withholding tax ('WHT') on various types of income arising in the UK, by making an application to HMRC Residency. The announcement only relates to applications for relief at source on interest income.

6. The process begins when the overseas recipient of the interest sends an application to HMRC Residency, the receipt of which initiates an internal process revolving around a form referred to as a 4450/1 (described at INTM572010+).

7. Once HMRC Residency is satisfied that the non-resident person is entitled to claim treaty benefits, the 4450/1 is sent to the office dealing with the affairs of the UK business paying the interest. The local office is then responsible for recommending to HMRC Residency whether or not treaty clearance should be given and under what conditions. In most cases unconditional treaty clearance can be given and the UK business is authorised to pay the interest net of WHT at the lower treaty rate (in many cases 0%).

8. However, in a minority of cases the clearance notice is issued subject to certain criteria being met. These negotiated conditions are commonly referred to as a 'thin capitalisation agreement'. Such advance agreements differ from a

straightforward agreed interpretation based on known facts. They resemble the covenants that are found in loan agreements with banks and enable tax certainty to be given for a prescribed number of future years.

9. The effect of a thin capitalisation agreement is twofold. It restricts the extent to which the interest is deductible for tax purposes by the UK payer to the amount of interest that would have been paid if the parties to the transaction had been acting at arm's length. Compliance with these terms will also result in the interest being paid to the non-resident net of WHT at the treaty rate.

## Revised Application Process

10. From the commencement date treaty clearance notices will be issued in all cases where the application meets the appropriate criteria to be considered valid. These differ from treaty to treaty. HMRC Residency will continue to correspond with non-residents where an application is deficient in some way.

11. However HMRC will no longer automatically be considering the application of the arm's length principle under the 4450/1 process; the form will effectively become a notification to the local office that a treaty clearance notice has been issued.

12. The arm's length principle will be considered as part of the ordinary risk assessment of the payer's self assessment returns and thin capitalisation enquiries will be taken up as necessary into that return.

13. The option of entering into a thin capitalisation agreement will still be available as the legal basis for pre-return enquiries in Statutory Instrument No. 488 of 1970 is unchanged (see the summary of its provisions at INTM543010). In future it will be important for the applicant (or the UK borrower) to make it clear at the beginning of the process that such an agreement is being sought.

14. It is important to note that no change is being made to the obligation to deduct income tax under section 874 Income Tax Act 2007 (previously S349, ICTA88). Therefore the consequences of a failure to deduct WHT remain the same (INTM542030).

## Commencement date

15. Certified treaty applications received by HMRC Residency after the date of the Budget (21 March 2007) will be dealt with under the new process. Certified applications already received by HMRC Residency on or before 21 March 2007 will continue to be dealt with under the process as it was then operated. This means that pre-return enquiries will continue to be raised into the application of the arm's length principle in such cases.

## General guidance for applicants

16. This change primarily relates to Departmental processes. Anyone currently considering making a treaty application should continue to follow the published guidance and forms. Both of these will be updated over the coming months to reflect the new process. None of the changes will have any effect on any applicant's eligibility for treaty benefits, which will continue to be governed by the relevant DTA.

17. The rest of this section is given over to guidance concerning a number of issues. In particular, what impact the announcement has on;

- the legal framework
- transfer pricing
- beneficial ownership
- treaty claims
- the Provisional Treaty Relief Scheme
- the EU Interest and Royalties Directive

## Legal framework

18. As none of the existing legislation is being amended if a UK business deducts no WHT from a payment of interest without treaty clearance then the assessment policy described at INTM542030 would still apply.

19. Similarly, the provisions in SI1970/488 concerning cancellation of treaty clearance (regulation 6) and recovery of WHT not deducted (regulation 9) are unaffected.

## Transfer pricing

20. The question of how much debt an enterprise could take on at arm's length, and what the price would be, can be addressed under the transfer pricing rules in schedule 28AA, ICTA88. One of the purposes of the new process is to enable deferral of such enquiries into the self-assessment framework in order to facilitate applications by non-residents.

21. Issuing a treaty clearance notice in respect of a particular loan will not constitute an acceptance by HMRC that it represents an arm's length provision for the purposes of schedule 28AA. The interest due on the loan may still therefore be subject to enquiry and disallowance under the UK's thin capitalisation rules. The wording of treaty clearance notices will be amended to reflect this.

## Beneficial ownership

22. Beneficial ownership is effectively self-assessed under the current process, subject to review at the application stage. This will continue in the future taking account of recent developments.

## Treaty claims

23. This section is concerned with applications by non-residents for relief at source from UK income tax. Treaty benefits may also be accessed by making a claim for repayment of income tax that has already been deducted. Repayment claims are governed by self-assessment rules set out in schedule 1A, TMA70 and the guidance at INTM331000 and following.

24. Under the 'process now, check later' approach to self-assessment a decision has to be taken by HMRC whether or not to pay such a claim or to ask the claimant for further information before deciding whether the claim is allowable. This will continue to be done under the SA enquiry provisions.

## Provisional Treaty Relief Scheme

25. The background to the Provisional Treaty Relief Scheme ('PTRS') is described at INTM338510; it typically applies to UK corporates borrowing from a group of lending banks with the syndicate manager applying for clearance on behalf of the syndicate members. The PTRS will continue to be available.

## EU Interest and Royalties Directive

26. Where a claim is made under the Directive, once HMRC Residency is satisfied that it has received a valid application for relief from WHT it has three months within which to issue either an exemption notice or a formal refusal.

27. The legislation implementing the Directive clearly states that the exemption applies only to so much of the payment as does not exceed the arm's length amount. If enquiries aimed at establishing the arm's length amount have not been concluded at the expiry of the three month time limit, it is made clear to the UK payer that the issue of the notice does not constitute an acceptance by HMRC that the relevant interest is the arm's length amount and does not preclude the application of the transfer pricing rules to restrict the interest deduction.

28. The new process has no impact on claims under the EU Directive. However these changes align the administration of treaty applications under SI 1970/488 more closely with those to which the Directive applies.

## C. Extension of scope for Thin Capitalisation Agreements

29. Currently a UK borrower can only enter into a thin capitalisation agreement where the overseas lender makes a treaty application. Some instruments, such as discounted bonds, do not carry interest with the result that WHT cannot arise under S349; no treaty claim can therefore be made. A similar situation arises with quoted Eurobonds which, although interest bearing, are specifically excluded from the WHT provisions. The second part of the announcement in paragraph 5.92 of the 2007 Budget Report announced an extension of the scope for thin capitalisation agreements.

30. Thin capitalisation agreements typically last for between three and five years and enable a business to forecast the tax effect of its borrowing over that period with the same accuracy as it can forecast profits. In extending the range of situations in which thin capitalisation agreements can be made HMRC's intention is to provide greater scope for certainty. These thin capitalisation agreements will be APAs utilising existing legislation but subject to a new, separate statement of practice.

## Advance Pricing Agreements

31. Legislation covering APA's was introduced at sections 85-87, Finance Act 1999. An APA is a binding agreement with a UK business covering the transfer pricing issues arising from specified goods or services provided by or to associates. The existing APA process is described in Statement of Practice 3/99 (SP3/99), which also provides detailed guidance on applying for an APA. Nothing in this note, or the accompanying draft statement of practice, has any impact on the existing APA programme. SP3/99 continues to apply as before.

32. Under S85(3), FA99 the effect of having an APA is that the terms laid down in the agreement override any other possible constructions that might be reached in respect of the transactions in question under schedule 28AA, for the duration of the APA.

33. APAs have previously not been entered into in thin capitalisation cases and are typically bilateral. APAs dealing with financing arrangements will be unilateral and administered on the basis described in the attached draft statement of practice. Using this new statement provides a separate gateway to utilising the existing APA legislation and has been agreed with Ministers.

34. In general HMRC's approach is to replicate the current practice in thin capitalisation cases within the APA framework. Thus the guidance published at INTM540000+ will remain relevant and the form of the agreements will be in line with the guidance at INTM582010+.

## Statement of practice

35. [Statement of practice 04/07 \(PDF 89K\)](#) deals with thin capitalisation agreements and is attached as an appendix to this note.

## Contacts

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