Inland Revenue

tax BULLETIN SPECIAL EDITION

contents

UK/US Double Taxation Agreement

The new UK/US Double Taxation Agreement was signed on 24 July 2001 with an amending protocol being signed a year later on 19 July 2002. The treaty came into force on 31 March 2003.

Since signature the treaty has generated much comment and analysis in the professional press and we have received many enquiries about how we will interpret and apply the various articles in the treaty. Because many of these enquiries covered common ground we decided to issue a Tax Bulletin edition dedicated solely to the treaty and, in particular, to those articles in it that are new or that have been substantially altered from the corresponding articles in the previous UK/US treaty.

What follows is not intended as an exhaustive commentary on the provisions of the new treaty. It reflects the understanding of the Inland Revenue on how certain provisions will be interpreted and applied in certain circumstances. In the interests of brevity it has sometimes been necessary to paraphrase the wording of the treaty. In interpreting and applying the treaty in a particular case, it will be necessary to consider the facts of the case and the detailed wording of the treaty.

Introduction to the new UK/US Double Taxation Agreement

What does the treaty do?

The treaty seeks to eliminate double taxation of income and gains for UK and US residents, to protect those residents from fiscal discrimination, to provide them with certainty about the tax treatment of income and gains, and to prevent tax evasion and avoidance. The treaty also seeks to ensure that its benefits go to those UK and US residents that are entitled to them and it contains measures to prevent its being abused by residents of third countries who are not entitled to those benefits.

Does the treaty follow the OECD Model?

The new treaty, like the previous (1975) treaty, is firmly founded on the OECD Model Tax Convention. Consequently, a number of articles remain substantially unchanged from the previous treaty and are immediately recognisable from the OECD Model (for example the permanent establishment article (Article 5) and the associated enterprises article (Article 9)).

What has changed?

Other articles have been modernised in line with current OECD thinking. For example, the independent personal services article in the previous treaty has been deleted in accordance with the 2000 update of the OECD Model so that income derived from professional services or other services of an independent character is now dealt with as business profits under Article 7.

Other articles, whilst remaining broadly unchanged, now include additional provisions addressing issues that in the past may have led to uncertainty of treatment under the treaty. For example, the residence article (Article 4) now includes a tie-breaker for dual resident companies (residence to be determined by the UK and US competent authorities) and the business profits article (Article 7) includes new language governing the attribution of business profits to a permanent establishment ("the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment").

Some articles have changed significantly from the corresponding articles in the previous treaty. These are the articles relating to dividends, gains, pensions, mutual agreement and the exchange of information.

What is new?

Some articles and provisions are completely new: the article on pension schemes; the limitation on benefits article; the conduit arrangement provisions (defined in the general definitions article and found in the dividend, interest, royalties, and other income articles); a provision restricting relief where the tax treatment of the income is different in each country (in the relief from double taxation article); and the Exchange of Notes, which gives, for example, authoritative guidance on how the UK and the US will seek to eliminate double taxation of share option gains.

The Protocol to the Treaty

An amending protocol to the treaty was signed on 19 July 2002.

What does it do?

The protocol makes clear the date on which UK tax credits will cease to be payable under the old treaty and corrects an oversight that would otherwise have denied UK pension funds the benefit of zero withholding tax if they held US equities through certain pooled investment vehicles. It also reinstates a teachers article and amends the definition of "equivalent beneficiary" in the limitation on benefits article (Article 23(7)(d)).

Tax credits

The new treaty, as originally signed, contained a possible ambiguity over the date on which the previous treaty terminated and ceased to have effect in relation to the entitlement to tax credits of US resident recipients of UK dividends.

Article V of the protocol put the matter beyond doubt, providing that, for tax credits in respect of dividends paid by UK resident companies, the previous treaty will terminate and cease to be effective for dividends paid on or after the first day of the second month following the date on which the new treaty enters into force (Article 29(3) of the treaty as replaced by Article V of the protocol).

UK pension funds holding US equities through pooled investment vehicles

Article II of the protocol amended Article 10(4) of the treaty so that tax exempt UK pension funds entitled to zero US withholding tax on dividends paid by US companies will also be entitled to zero US withholding tax on dividends where they invest in US equities through either US regulated investment companies or US real estate investment trusts. This means that it is immaterial whether the pension fund holds the US investments direct or through these pooled investment vehicles.

Teachers article

Article III of the Protocol inserted a teachers article at Article 20A of the treaty.

The article is identical to the teachers article in the previous treaty and provides a two year tax exemption for UK and US resident professors or teachers who visit the other country for not more than two years for the purpose of teaching or engaging in public interest research at a university, college or other recognised educational institution. The exemption relates only to remuneration derived from such teaching and public interest research.

What happens if a teacher stays for more than two years?

One of the conditions of receiving the exemption is that the teacher or professor may stay in the other country for only two years. If they stay longer, they will be treated in the same way as any other group of employees, and tax will be payable for the full period, starting from the first day of the visit.

The definition of "equivalent beneficiary"

The definition of "equivalent beneficiary" at Article 23(7)(d)(ii) of the treaty was amended by Article IV of the protocol.

The definition now includes a resident of a Member State of the European Community or of a European Economic Area state or of a party to the North American Free Trade Agreement provided that resident is a specified "qualified person".

Broadly, from the UK perspective, the "qualified persons" specified by the new Article 23(7)(d)(ii) are UK resident individuals, qualified UK governmental entities, UK resident UK or US listed companies whose shares are regularly traded on a recognised stock exchange, UK resident UK or US listed entities other than individuals or companies whose units are regularly traded on a recognised stock exchange, UK pension schemes, UK employee benefit funds and UK charities.

The protocol also added a paragraph which provides that for the purposes of applying Article 10(3) (the dividends article) in order to determine whether a person, owning shares, directly or indirectly, in the company claiming the benefit of the treaty is an "equivalent beneficiary", that person will be deemed to hold the same voting power in the company paying the dividend as the company claiming the benefit of the treaty holds in such company. For details of how this provision works, see the section on Article 23.

General Scope - Article 1

"Saving clause" – Article 1(4)

Under this provision, and subject to some exceptions which are set out below, the contracting states reserve their rights to tax their residents and citizens in accordance with their domestic laws, notwithstanding anything in the treaty to the contrary.

As indicated, there are exceptions to the clause so that some of the benefits provided by the treaty are available to all citizens and residents of the contracting states.

The following are some examples:

i) the benefit of non-discrimination on the grounds of nationality;

ii) the benefit of exemptions for certain pension distributions and social security payments;

iii) the benefit of double taxation relief for certain income taxes paid in the other contracting state even where such relief may not be available under domestic tax law;

iv) the benefit of access to the mutual agreement procedure for resolving issues of taxation not in accordance with the treaty;

v) the benefit of host country exemption for the income of diplomatic agents and consular officials;

vi) the benefit of host country exemption from tax for certain income of students, business apprentices and teachers.

Special rule for former long-term residents – Article 1(6)

This rule prevents residents of either country changing their residence status in order to avoid UK or US tax liabilities. It provides that each country reserves for 10 years the right to tax former citizens and long-term residents whose loss of citizenship or long-term resident status had as one of its principal purposes the avoidance of tax.

A "long-term resident" of a state is defined in the Exchange of Notes as an individual (other than a citizen of that state) who is a lawful permanent resident of that state in at least 8 of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident.

Currently this provision has no effect in the UK.

How does the treaty fit with UK rules on residence and domicile – Article 1(7)?

Individuals who are UK resident but not UK domiciled are only taxed on non-UK income and gains to the extent that the income or gains are remitted to the UK. The provision overrides other terms of the treaty to preserve the taxing rights of the US where the effect of UK domestic law might otherwise allow double exemption. Where the provision applies, treaty relief in the US is limited to the income or gain remitted and taxed in the UK.

Fiscally transparent persons – Article 1(8)

This provision provides that income derived through a person that is a fiscally transparent entity under the laws of either the US or the UK will be treated as the income of a resident of a contracting state if the taxation laws of either country treat it as such. In those circumstances treaty benefits will be available to the resident of either the US or the UK, not the fiscally transparent entity.

The new rule addresses problems presented by fiscally transparent entities such as partnerships and certain estates and trusts that are not taxed at the entity level but rather are taxed at the level of partner or trustee.

The provision applies to any resident of the UK or US who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either State. In the US this will include, for example, general partnerships, limited partnerships (LPs), limited liability partnerships (LLPs) and US limited liability companies (LLCs) that are treated as partnerships for US tax purposes. In the UK it includes all partnerships, including UK LLPs, and certain trusts.

For example, where UK interest is paid to a US limited liability company, treaty benefits will be available to the extent that US tax law treats a US resident as deriving that income. Entitlement to treaty benefits is dependent on

various criteria such as residence, being a qualified person, and satisfying the particular conditions in the relevant income article.

The new rule does not impose a "subject to tax" test in addition to the test contained in the various income articles for obtaining benefits. It simply looks through fiscally transparent entities to the ultimate beneficial owners of the income and asks the questions relating to entitlement of them rather than of the transparent entity.

The Exchange of Notes sets out rules for taxing income, profits or gains:

- preserving the right of both States to tax income, profits or gains derived through a fiscally transparent person under the respective domestic laws of each State;
- providing that where both contracting states consider an item of income, profit or gain to have been derived by one of their residents, both States can tax that person in respect of the item of income, profit or gain;
- (in the UK) treating some items of income, profit or gain arising to a person as falling within the paragraph where another person is charged to UK tax in respect of them under specific anti-avoidance legislation.

The relevant UK domestic law is specified in the Note.

US LLCs – relief for US tax

The Revenue take the view that for UK tax purposes LLCs should be regarded as taxable entities and not as fiscally transparent. Accordingly, the UK taxes a UK member of an LLC by reference to distributions of profits made by the LLC and not by reference to the income of the LLC as it arises. If tax is paid in the US on the profits of the LLC - and irrespective of by whom that tax is paid – the UK regards that tax as underlying tax. Credit is available for it if, and only if, the member is a UK company which controls, directly or indirectly, at least 10% of the voting power of the LLC.

It follows that relief for underlying tax is not available to an individual UK member of an LLC. This is consistent with the purpose of the elimination of double taxation provisions contained in the previous treaty at Article 23. Article 23(2)(b) provides that, in the case of dividends paid by an ordinary US corporation, relief for underlying tax is only available to a UK company. There is no authority to allow relief for what is underlying tax to a UK individual member of an LLC.

There is no difference in substance between Article 23(2)(b) of the previous treaty and Article 24(4)(b) in the new treaty. Relief for underlying tax will only be available to a UK company which has at least a 10% interest in the US LLC.

General Definitions - Article 3

Article 3 contains definitions of words and phrases used in the Convention.

Conduit arrangements - Article 3(1)(n)

Introduction

Bilateral double taxation treaties provide benefits for residents of the two contracting states. The "conduit arrangement" provision is designed to ensure that the benefits of the treaty go only to those residents and not to residents of third countries who have deliberately arranged their transactions in such a way as to obtain treaty benefits to which they would not otherwise be entitled. The provision is therefore an anti-treaty abuse measure and like similar measures found in other UK double taxation treaties is transaction-based.

Whilst the UK has traditionally favoured such transaction-based measures in its double taxation treaties the US prefers entity-based rules. This treaty contains both: the "anti-conduit" rule, which focuses on transactions, and the limitation on benefits article, which focuses on entities. The two approaches are complementary, providing clear objective tests for determining entitlement to benefits and strong protection against treaty abuse.

This is the first time a UK double taxation treaty has included a limitation on benefits article and the transaction-based anti-abuse measure needed to be framed in such a way as to complement the operation of that article. The provision is therefore somewhat different from the UK's usual anti-treaty shopping provision. However, the UK will apply the new provision in a manner consistent with its practice under those other treaties. This means that a resident of a third country will be denied the benefits of the treaty if he deliberately attempts to secure them by entering into a conduit arrangement as defined in the treaty.

Whether the provision will apply in any given situation will depend on the particular facts and circumstances.

How will the Revenue apply the "conduit arrangement" rule?

Every case will be considered on its particular facts and circumstances to determine whether the transaction or series of transactions meets the definition of a conduit arrangement. The definition contains an objective test (defining a conduit) and a subjective test (a motive test). Only if both tests are satisfied so that the transactions or series of transactions constitute a conduit arrangement will the relief provided by the relevant article be denied.

When making such a determination it is important that the Revenue is able to put a transaction or series of transactions into their proper context.

It will be necessary to consider all of the arrangements involving payments between UK and US taxpayers, and between US taxpayers and a taxpayer of a third country before the true pattern and purpose of the transaction or series of transactions can be established.

When this level of understanding has been achieved, the Revenue will be able to determine whether or not the transaction or series of transactions meets the objective part of the conduit test and whether the obtaining of treaty benefits was a main purpose or merely an incidental consequence.

Given this, it is difficult to be prescriptive as to what type of transaction might constitute a conduit arrangement. But here are two examples of what might meet the definition:

1. A company resident in a country which does not have a tax treaty with the UK makes a loan to its UK subsidiary, but instead of lending the money direct it makes the loan indirectly via a wholly unconnected but accommodating US bank by providing a matching collateral deposit to the bank as security for the loan the bank then makes to the UK subsidiary company.

   The objective test contained in the definition of a conduit would be satisfied as a US resident (the US bank) entitled to zero UK withholding tax on interest under the treaty receives interest arising in the UK and pays that interest to another person (the parent company) who is not resident in either the UK or the US but who is resident in a third country which doesn't have a treaty with the UK that provides for zero UK withholding tax on interest.

   The fact that treaty benefits are available if the UK subsidiary borrows from the US bank but would not be available if it borrowed from its parent suggests that a main purpose of the transactions might be to obtain the increased benefit of the treaty. So the motive test might also be satisfied. This will have to be determined by reference to the particular facts and circumstances.

   If examination of the facts supported this interpretation, then the series of transactions would be a conduit arrangement as defined in the treaty and the relief provided for by the Interest article would be denied. Full UK withholding tax on the interest paid by the UK subsidiary company would then be due.

2. A company organised in a country that does not have a tax treaty with the UK loans £1,000,000 to its wholly-owned UK subsidiary in exchange for a note issued by the UK company. The parent company later realises that it can avoid UK withholding tax by assigning the note to another wholly-owned subsidiary in the US. Accordingly, the parent assigns the note to its US subsidiary in exchange for a note issued by the US company. The UK company note pays 7% and the US company note pays 6 3/4%.

   The loan note was assigned to avoid UK income tax on the payment of interest. The transaction constitutes a conduit arrangement as defined in the treaty as both the objective definition and the motive test at Article 3(1)(n)(i) and (ii) respectively are met.

Can a pre-existing structure constitute a "conduit arrangement"?

A "conduit arrangement" is defined as a "transaction or a series of transactions". Therefore, provided all the other criteria are met to make the provision applicable, it makes no difference whether a structure through which the transactions flow pre-dates the entry into force of the treaty.

The previous treaty contains no transaction-based provisions for addressing abusive conduit arrangements or treaty shopping. To give an "amnesty" for pre-existing structures would undermine the effectiveness of the new rule.

Where a notice has been issued allowing the UK source income to be paid gross and it is thought that the anti-conduit rule may apply, the non-resident should set out the relevant details in a letter to the Centre for Non-Residents. There is further guidance later in this article (see Entry into Force - Article 29) about directions given under the previous treaty.

How will the UK interpret "substantially all"?

In determining whether "substantially all" of an item of income has been paid directly or indirectly to a resident of a third state the Revenue will consider all the relevant facts and circumstances of the case.

What does "at any time or in any form" mean?

An example might be US dividends received by a UK resident company in 2003 paid on to a resident of a third country in the form of interest in 2004. However, there is no presumption in the words "at any time" that the payment to the resident of the third country must take place after the payment from the source state.

Are there any plans for an advance clearance procedure for determining whether transactions constitute a "conduit arrangement"?

There are no plans for an advance clearance procedure. To obtain the benefits of the treaty a person has to make a claim. It is incumbent on that person to ensure that all the

conditions for entitlement to those benefits are met. That includes, where applicable, that the transaction or series of transactions does not constitute a conduit arrangement. However, in formulating claims, claimants can refer to published guidance.

Pension schemes definition – Article 3(1)(o)

What schemes will be entitled to treaty benefits?

Treaty benefits are for approved schemes only. As section 615 ICTA 1988 schemes, which are UK established trusts for non-residents, are not approved they do not come within the definition of "pension scheme" in Article 3(1)(o) because they are not "generally exempt from income taxation in that State". They are therefore not included in the list in the Exchange of Notes.

Are section 401(k) plans included within the definition of a pension scheme?

Yes, they are within the definition of a pension scheme in Article 3(1)(o) as they are a type of section 401(a) plan.

Interpretation – Article 3(2)

The treaty provides that any term not defined in the treaty shall have the meaning that it has under the law of the contracting state whose tax is being applied. If the term has different definitions under tax and non-tax laws in that state the treaty makes it clear that the tax law definition will apply.

But if the meaning of a term cannot be determined in this way, or if there is a difference in meaning under the laws of each contracting state that leads to difficulties in applying the treaty, the competent authorities may agree a common meaning under the mutual agreement procedure.

Residence - Article 4

Article 4 defines the meaning of the term “resident of a contracting state” for the purposes of the treaty and sets out rules for resolving the residence status of individuals or other persons who are dual resident under that definition.

The rules for dual resident individuals follow the OECD Model Tax Convention, whereas the rule for dual resident companies is that the UK and US competent authorities will endeavour to determine by mutual agreement how the treaty will apply to the dual resident. The article also provides that, if the competent authorities do not reach agreement, the dual resident person will not, with some exceptions, be able to claim the benefits of the treaty.

The previous treaty did not have a mechanism for determining the residence status of dual resident companies. The inclusion of this provision will therefore mean that such companies will now have certainty about their residence status for the purposes of the treaty.

The absence of a specific test for determining the residence status of such companies allows the two competent authorities to consider all the facts and circumstances before determining whether treaty benefits should be granted.

Application of section 249 FA 1994

A UK/US dual resident company will only cease to be resident for UK tax purposes under section 249(1) FA 1994 if the company has made a claim under the new treaty and the competent authorities have awarded residence to the US. Each case will depend on its own facts and circumstances. Whenever the competent authorities come to an agreement they will also agree the date from which residence in either the UK or the US is appropriate.

The Taxation of Business Profits – Article 7

Article 7 follows very closely the business profits article in the OECD Model Tax Convention. However it does include new language concerning the attribution of business profits to permanent establishments and the Exchange of Notes to the treaty comments on the attribution of capital to permanent establishments. Both have generated comment, particularly in the context of the measure announced in Budget 2002 and to be introduced in Finance Bill 2003 relating to the attribution of capital to branches.

Does the new language signify a change in the way the UK will attribute business profits to UK permanent establishments of US corporations?

The new language in paragraph 2 (“the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment”) does not signify a change in the UK’s current approach to attributing profits to permanent establishments. It clarifies that approach by describing the characteristic features of profit generating activity that are typically taken into account when determining attributable profits.

It also makes clear that *only* profits derived from the assets used, risks assumed and activities performed by the particular permanent establishment will be attributed to that permanent establishment.

Consequently, profits derived from assets used, risks assumed and activities performed by the head office of a US corporation or by a second UK permanent establishment of the US corporation of which the first UK permanent establishment is part, will not form part of the first UK permanent establishment’s attributable profits. Again, this does not represent a change in the UK’s current approach.

Does the treaty pre-empt the OECD discussion draft paper on the attribution of profits to a permanent establishment?

No, the treaty is a bilateral agreement between the UK and the US. But it should be of little surprise that OECD thinking is reflected in it, given that both countries have contributed to discussion of the issue at the OECD.

In view of what is said in the Exchange of Notes, will the UK now attribute capital to permanent establishments of US corporations when determining their attributable profits?

At present the UK does not have the domestic law to allow it to attribute capital to branches, in order to arrive at the profits of the branch, in anything other than a very limited set of circumstances.

However, the treaty provides that, in arriving at the amount of profits to be attributed to the permanent establishment, the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions

This does not at present impact on how UK branches of US corporations will be taxed in the UK as we do not have the domestic legislation to enable us to attribute capital in this way. Such legislation, applying from 1 January 2003, will be introduced in Finance Bill 2003 (see below).

Does the treaty pre-empt the measure announced in Budget 2002 and to be introduced in Finance Act 2003 relating to the attribution of capital to branches?

The measure announced in 2002 is about modernising the UK's rules for taxing foreign companies operating in the UK through branches, with effect from 1 January 2003. The present rules are out of line with international practice and the measure would create a level playing field between foreign companies, mainly banks, with UK branches and their UK-incorporated competitors.

The measure, if enacted in Finance Bill 2003, will provide that a UK branch of a foreign company will be assumed to have, for the purpose of determining the amount of profits for tax purposes, the amount of equity capital and loan capital that it would have if it were a distinct and separate company trading in the UK engaged in the same or similar activities under the same or similar conditions.

By contrast the treaty does not of itself create a domestic taxing right to attribute capital to UK branches of US corporations. Rather it provides that if and when the UK has that taxing right (as will be the case if the measure described is enacted) then any capital attributed to a UK branch of a US corporation for the purposes of determining branch profits will be attributed on the basis that the branch is treated as a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

Does the treaty provide a choice between a "thin capitalisation" and a regulatory capital approach to the measurement of profits attributable to a permanent establishment of a financial institution?

The treaty is not prescriptive. The Exchange of Notes cites allocation of regulatory capital as a method either country may use to determine the amount of capital to be attributed to the permanent establishment of a financial institution (other than an insurance company). But other methods, including one based on the amount of equity capital that the entity would have if it were an independent enterprise acting at arm's length, engaged in the same or similar activities under the same or similar conditions, may be used.

Zero Withholding Tax on US Dividends – Articles 10 and 23

The treaty allows both the US and the UK to tax dividends paid to a resident of the other country but, subject to certain conditions, limits the tax the source country may impose to 5% or 15% of the gross amount of the dividend. In other circumstances, it removes entirely the right of the source country to tax dividends.

As the UK does not have a withholding tax on dividends, the limitations are only applicable to US dividends beneficially owned by and paid to UK residents.

This section considers the circumstances in which such UK residents may be entitled to receive US source dividends free of withholding tax. Reference is made to Article 1 (General Scope), Article 10 (Dividends) and Article 23 (Limitation on Benefits).

Who will be entitled to zero US withholding tax ("zero") on dividends?

UK resident companies that beneficially own the dividend and that have owned shares representing 80% or more of the voting power of the US company paying the dividend for a 12 month period ending on the date the dividend is declared will be entitled to zero (Article 10(3)(a)), provided that the UK company either:

- owned those shares, directly or indirectly, before 1 October 1998 (Article 10(3)(a)(i)) and it passes either an "ownership and base erosion" test (Article 23(2)(f)) or an "active conduct of a trade or business" test (Article 23(4));

- is a company whose principal class of shares is listed or admitted to dealings on a recognised UK or US stock exchange and whose shares are regularly traded on a recognised stock exchange (Article 23(2)(c)(i));

- is a company which is at least 50% owned (by reference to the aggregate voting power and value of its shares) directly or indirectly by five or fewer such companies (Article 23(2)(c)(ii));

- is a company at least 95% owned (by reference to the aggregate voting power and value of its shares) directly or indirectly by seven or fewer "equivalent beneficiaries" and which passes a "base erosion" test (Article 23(3)); or

- is accepted by the US competent authority as being entitled to the benefits of the treaty on the basis that the establishment, acquisition or maintenance of the company and the conduct of its operations did not have as one if its principal purposes the obtaining of treaty benefits (Article 23(6)).

UK tax exempt pension schemes will also be entitled to zero, provided that the dividends in question are not derived from the carrying on of a business, directly or indirectly, by the pension scheme and that more than 50% of the beneficiaries, members or participants of the scheme are individuals who are residents of either the UK or the US (Article 10(3)(b) and Article 23(2)(e)).

In summary therefore, in order to obtain zero a person must be a UK resident, must satisfy the conditions at Article 10(3)(a) or (b), must satisfy one of the relevant tests in the limitation on benefits article and must satisfy all the other specified conditions for obtaining the benefit.

The 1 October 1998 ownership test and the subsequent interposition of intermediate holding companies

In order to qualify for zero under Article 10(3)(a)(i) the beneficial owner of the US dividend must be a UK resident company that has owned shares representing 80% or more of the voting power of the US company paying the dividend for at least 12 months before the dividend is declared and must have owned shares representing, directly or indirectly, 80% or more of the voting power of the US company paying the dividend before 1 October 1998.

In the case of direct ownership a UK company that owned the requisite shares before 1 October 1998 and continues to hold them will be entitled to zero when a dividend is declared by the US company.

In the case of indirect ownership, where before 1 October 1998 a UK ultimate group parent company owned the US subsidiary through an intermediate holding company and subsequently reorganises so that it assumes direct ownership of the US subsidiary, entitlement to zero is preserved because the UK ultimate parent company will be the beneficial owner of the dividend and it held the requisite shares in the US company, albeit indirectly, before 1 October 1998.

However, in the case where before 1 October 1998 a UK ultimate group parent company owned the US company directly, but subsequently reorganises so that a newly incorporated company is interposed between it and the US company paying the dividend, entitlement to zero (by virtue of this test) will not be preserved. This is because (in the case where the interposed intermediate holding company is a UK resident) although the new intermediate holding company will be the beneficial owner of a US dividend it did not hold the requisite shares in the US company before 1 October 1998, directly or indirectly, as they were held by the UK ultimate group parent company at that date.

In an alternative situation (where the interposed intermediate holding company is a US resident) the UK ultimate group parent company, whilst being the beneficial owner of a US dividend, did not hold the requisite shares in the US company paying the dividend at 1 October 1998 because this company did not exist at that date.

The "active conduct of a trade or business" test

A UK resident company seeking to obtain zero under Article 10(3)(a)(i) must, in addition to satisfying the 1 October 1998 ownership condition, satisfy either the "base erosion" and ownership test at Article 23(2)(f) or the "active conduct of a trade or business" test at Article 23(4).

The "active conduct of a trade or business" test has three main conditions: the UK resident must be engaged in the active conduct of a trade or business in the UK; the dividend derived from the US must be derived in connection with or be incidental to that trade or business; and the trade in the UK must be substantial in relation to the activity in the US.

The meaning of a "trade or business"

In the context of entitlement to zero withholding on US dividends, the terms, not being defined in the treaty, have the meaning they have in US law, in accordance with Article 3(2) (General Definitions).

The meaning of "in connection" with

In accordance with the Exchange of Notes to the treaty a dividend is to be considered as derived "in connection" with an active trade or business in the UK if the US activity that produces the dividend is a line of business which forms a part of, or is complementary to, the trade or business conducted in the UK.

A US trade or business activity will generally be considered to "form part of" a UK trade or business activity if, for example, it provides inputs to a manufacturing process carried on in the UK or if it sells the output of UK manufacturing operations or if it sells in the US the same sorts of products that are being sold by the trade or business carried in the UK.

A US trade or business activity may be considered "complementary" to a UK trade or business if its activities are part of the same overall industry and the two activities are economically and commercially interdependent.

The meaning of "incidental to"

A US dividend would be considered to be "incidental" to a UK trade or business if the dividend, though not produced by a line of business which forms part of, or is complementary, to the UK trade or business, nevertheless facilitates the conduct of the UK trade or business.

The meaning of "substantial"

To pass the "active conduct of a trade or business" test, the UK trade or business has to be substantial in relation to the trade or business activity in the US that gives rise to the dividend. Whether a trade or business activity is "substantial" will depend on all the facts and circumstances. Factors such as the nature of the activities carried on in each country and the comparative sizes of the trades or businesses carried on in each country will be taken into account.

Will a UK resident company that is owned by seven or fewer EC resident companies be entitled to zero?

A UK resident company that is at least 95% owned by seven or fewer "equivalent beneficiaries" will be entitled to zero if the company also meets a base erosion test (Article 23(3)) and satisfies any of the other specified conditions for obtaining zero.

Assuming it meets those other conditions the question is whether EC resident companies are "equivalent beneficiaries" as defined by the treaty.

What is an "equivalent beneficiary"?

An "equivalent beneficiary" is defined in Article 23(7)(d) (as amended by Article IV of the protocol to the treaty) as a resident of a Member State of the European Community or of a European Economic Area state, but only if either:

- that resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation (which includes a comprehensive limitation on benefits article) between any Member State of the EC or a EEA state and the US and would, under that convention, be entitled to zero US withholding tax on dividends or,

- that resident is a specified "qualified person".

At present the US has not entered into any other double taxation treaties with EC or EEC States which provide for zero US withholding tax on dividends. Therefore EC companies currently do not meet the first definition of "equivalent beneficiary".

Neither do they meet the various specified definitions of "qualified person" (UK resident individuals, qualified UK governmental entities, UK resident UK or US listed companies whose shares are regularly traded on a recognised stock exchange, UK resident UK or US listed entities other than individuals or companies whose units are regularly traded on a recognised stock exchange, UK pension schemes, UK employee benefit funds or UK charities).

Therefore such a UK resident company would not automatically be entitled to the benefit of zero US withholding on dividends by virtue of Article 23(3).

However, assuming the UK resident company met all the other conditions for obtaining zero, it could apply to the US competent authority for the benefit of zero under Article 23(6).

Are unquoted UK companies entitled to zero?

Assuming an unquoted UK resident company is the beneficial owner of the dividend and has owned shares representing 80% or more of the voting power of the US company paying the dividend for at least 12 months before the declaration of the dividend it may be entitled to zero US withholding tax on the dividend if it is owned by seven or fewer "equivalent beneficiaries" and it passes a so-called "base erosion" test (Article 10(3)(a)(iii) and Article 23(3)).

The definition of "equivalent beneficiaries" includes UK resident individuals (Article 23(7)(d)(ii) (as amended by Article IV of the protocol to the treaty)).

The "base erosion" test requires that less that 50% of the unquoted UK resident company's gross income for the taxable year or chargeable period in which the dividend arises is paid, directly or indirectly, to persons who are not "equivalent beneficiaries", in the form of payments that are tax deductible.

The company must, of course, also satisfy the other conditions of the dividends article.

If the company did not qualify by this route it could apply to the US competent authority for the benefit of zero under Article 23(6).

What is the procedure for applying to the US competent authority for zero under Article 23(6) and how long will it take?

A taxpayer that is not otherwise entitled to benefits under Article 23 but believes it may be entitled to such benefits under the discretionary provision of Article 23(6) should submit that request to:

Director International
Internal Revenue Service
Attn: LM:IN:TT
1111 Constitution Avenue, NW
Washington, DC 20224

For guidance in preparing requests for discretionary benefits, taxpayers should consult the U.S. Treasury Technical Explanation of Articles 10 and 23 of the Treaty (see http://www.ustreas.gov/offices/tax-policy/library/teus-uk.pdf), and the U.S. Internal Revenue Service's Revenue Procedure 2002-52, with particular reference to Sections 3.08 and 4 (see http://www.irs.gov/individuals/article/0,,id=96945,00.html). The IRS Internal Revenue Manual Exhibit 4.60.3-3, at http://www.irs.gov/irm/page/0,,id%3D21706,00.html#ss57, provides detailed guidance regarding information that should be submitted in connection with any request for a discretionary determination.

The US has provided assurances that the competent authority office will consider any requests received as expeditiously as possible. In the case of a favourable determination, benefits will be allowed retrospectively to the later of the effective date of the relevant treaty provision or the time of establishment of the structure in question.

On what basis will the US competent authority decide whether a UK resident company is entitled to zero?

Zero will be granted if the US competent authority is satisfied that the establishment, acquisition or maintenance of the UK resident company and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

The Exchange of Notes to the treaty sets out in some detail, with reference to specific circumstances, how the US competent authority will approach this task.

What is the purpose of the consultation requirement?

The US competent authority is required to consult the UK competent authority before refusing zero to a UK resident under Article 23(6). This requirement gives the UK competent authority the opportunity to provide any further facts, arguments or interpretations in favour of the claimant that might be material to the determination of the claim.

However, it is for the US competent authority to have the final say.

Can a UK resident company that is treated as fiscally transparent for US tax purposes obtain zero?

Assuming all the other conditions for obtaining zero are met, a UK resident company which is treated for US tax purposes as fiscally transparent due to a “check the box” election will be entitled to zero in respect of a dividend paid by its wholly owned US company if, and to the extent that, the UK treats the dividend as the income of a UK resident.

The rule governing how the treaty applies to persons who are regarded as fiscally transparent by either the UK or the US is at Article 1(8).

Taxation of Gains – Article 13

Generally the previous treaty allows each country to tax gains in accordance with its domestic laws. As such it offers no protection against the double taxation of gains.

By contrast, the new treaty provides that gains will be taxable only in the country in which the person disposing of the property is resident, except for gains arising from the disposal of real property situated in the other country or from the disposal of the business property of a permanent establishment, in which case the country in which the real property or permanent establishment is situated has the primary right to tax.

Relief from double taxation will therefore be afforded by the award of exclusive taxing rights to the residence country or, where the source country taxes the gain, by the residence country giving credit relief.

The article is based on the OECD Model article but includes additional provisions to deal with specific types of gains such as those arising on the disposal of shares deriving their value or the greater part of their value from real property situated in the UK or the US (the “securitised land” provision) and those realised by temporary non-residents.

The "securitised land" provision

In accordance with the OECD Model Tax Convention the article provides that the UK has the primary taxing right over gains arising from the alienation of real property situated in the UK. Thus, a US resident individual owning real property in the UK would, under the terms of the treaty, be taxable in the UK on any gain arising from the sale of that property.

However, if that US resident individual arranged for the property to be held by a company in which he was the sole shareholder and then arranged for the sale of the shares in that company, the OECD Model wording would give the result that any gain on the sale of the shares would be taxable only in the country of which he was a resident – the US.

To prevent this, the Article provides at paragraph (2)(c)(i) that shares which derive their value or the greater part of their value directly or indirectly from real property situated in the UK will be treated as real property situated in the UK, thereby preserving taxing rights over gains substantively derived from real property. The provision is reciprocal.

The "temporary non-residents" provision

Paragraph 6 of the article aligns the treaty with the UK's rules in section 10A of the Taxation of Chargeable Gains Act 1992.

Those rules aim to stop long term UK residents avoiding UK capital gains tax by becoming temporarily non-UK resident and realising gains while abroad before resuming UK residence.

The provision works by allowing the UK to tax gains arising to US residents who were previously UK residents and who, after having realised gains while being temporarily US resident, return to the UK.

This does not prevent the US taxing the gains of its residents. The primary taxing right always remains with the residence country. But it allows the UK to tax such gains as well, giving credit for US tax paid on those gains.

Stock Options – Article 14 Exchange of Notes

This is the first time the UK has specifically covered share/stock options in a treaty and we believe this clear statement of mutual practice will be very valuable. The circumstances itemised cover the most frequently found situations and will inform the majority of cases we see.

In line with existing practice "*that proportion of the option gain*" will normally be determined by reference to the periods of employment in each country using a straight-line time apportionment. This is simple, clear and avoids distortions arising from short-term fluctuations in share values. More details of UK current practice, together with examples, can be found in Tax Bulletins 55, 56 and 60.

The Exchange of Notes represents the views of both the UK and the US that a gain in the value of share options granted while in employment before those options are exercised is correctly within the income from employment article. Occasionally time-apportionment or other circumstances may not produce an appropriate result and the Exchange of Notes provides that the competent authorities will then endeavour to resolve the difficulty.

Pensions and Pension Schemes – Articles 17 and 18

Article 17

Article 17 is a fairly standard pensions article, which provides for the taxation of pensions and other similar remuneration only in the state of residence of the beneficial owner. There are two provisions that have generated particular interest.

- Paragraph 1(a) sets out the general rule above. For this purpose, a payment is treated as a pension or other similar remuneration if it is a payment under a pension scheme, as defined at Article 3(1)(o).

  However, the residence state, under paragraph 1(b), must exempt from tax any amount of such pensions or other similar remuneration that would be exempt from tax in the State in which the pension scheme is established if the recipient were a resident of that State. Thus, for example, a distribution from a US "IRA" to a UK resident will be exempt from tax in the UK to the same extent the distribution would be exempt from tax in the US.

- Under the previous treaty, a lump-sum payment from a pension scheme was taxable only in the country of residence. So if an individual moved from the US to the UK before receiving a lump sum from a US pension scheme, they would be taxable on the lump sum neither in the US (because of the treaty) nor in the UK (which does not tax lump sums anyway).

  The new provision prevents this occurring by providing that a lump-sum payment derived by a resident of one State from a pension scheme established in the other State shall be taxable only in that other State.

  The provision preserves the exemption from income tax of a lump sum relevant benefit where it is paid by a UK approved pension scheme to a beneficial owner who is a US resident. However, Article 1(4) will apply in respect of US citizens as the provisions of Article 17(2) are not amongst those listed at Article 1(5).

Article 18

This article is concerned primarily with the tax treatment of contributions to pension schemes. It also touches on the taxation of the income, profits and gains accruing to pension schemes. As indicated in the note on Article 17 the term "pension scheme" is defined for the purposes of the treaty at Article 3(1)(o).

It is a feature of several recent UK treaties that pension contributions made in one country are recognised for tax purposes in the other.

If a member of a pension scheme established in one country goes to work (as an employee or in a self-employed capacity) in the other country, the state of residence will not tax the scheme member on income earned by the scheme unless it is paid to him (or for his benefit). Nor will tax be payable if income is transferred to another pension scheme until the benefits are actually received.

Contributions to the scheme by that member (or those paid on his behalf) shall be tax-deductible in the state of residence. In the same way, benefits accrued under the scheme, or employer contributions to the scheme, will not be treated as part of his taxable income and those contributions will be tax-deductible for the employer. The reliefs available cannot exceed those allowed by the state of residence for contributions of the same amount to a scheme established in the state of residence.

The conditions for getting the relief are as follows

- contributions were made by or on behalf of the individual or (in the case of an employee) his employer to the pension scheme (or to a similar scheme for which it was substituted) before the individual began to exercise an employment or self-employment in the other contracting state, and

- the competent authority of the other State agrees that the pension scheme generally corresponds to a pension scheme established in that other State.

Where someone comes to work in the UK we will regard the first condition as having been met if the individual was a member of the US scheme before beginning to exercise an employment or self-employment in the UK.

The types of scheme that would be accepted as "generally corresponding" are those listed in the Exchange of Notes.

Relief will be restricted where contributions to a pension scheme are deductible or excludable in computing a person's taxable income in the host country if he is subject to tax there not on his total income but only on amounts remitted to that country. Relief is available only on a corresponding proportion of the pension contributions.

An example

Individual's total income, profits and gains - £100,000

Income, profits and gains remitted to the UK - £90,000

Individual's contributions to US pension scheme - £5,000

Contributions deductible in computing individual's UK taxable income - £4,500 (i.e. 90% of individual's total contributions)

Guidance on the procedures for claiming relief from UK income tax on contributions to US pension schemes under Article 18 will be provided in an Update that will be issued by the Inland Revenue's Audit and Pension Schemes Services in the near future.

Limitation on Benefits - Article 23

This is the first time the UK has included a limitation on benefits article in one of its double taxation treaties, though such articles are a common feature of recent US treaties.

The purpose of the article

The purpose of the article is to ensure that UK and US residents benefit from the treaty, whilst ensuring that residents of third countries who establish legal entities in either the UK or the US, not for legitimate commercial and economic reasons, but with the principal purpose of obtaining benefits under the treaty, do not benefit.

To achieve this the article poses a number of tests for UK and US residents, one of which must be satisfied if entitlement to treaty benefits is to be established.

The Technical Explanation to the US Model Income Tax Convention of September 20, 1996 comments that the assumption underlying each of these tests "is that a taxpayer that satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other contracting state (e.g. a resident individual) to warrant benefits even in the absence of a business connection, and that this business purpose or connection outweighs any purpose to obtain the benefits of the treaty." In other words, the assumption is that a taxpayer who satisfies one of the tests is not "treaty shopping".

As such, any UK or US resident who satisfies one of the tests in the article will, provided they satisfy any other specified conditions for obtaining the relevant benefit, be entitled to treaty benefits.

How it works

The article provides that residents of the UK and the US are entitled to all the benefits of the treaty only if they are a "qualified person" (paragraph 2). If a resident is not a "qualified person" they may be entitled to benefits in respect of specific items of income, profits or gains under the "derivative benefits test" (paragraph 3), the "active conduct of a trade or business" test (paragraph 4) or at the discretion of the competent authority of the country that is giving up its taxing right under the treaty (paragraph 6).

For the majority of UK residents the article will provide clear rules and certainty of treatment about entitlement to treaty benefits without recourse to either the Inland Revenue or the US Internal Revenue Service.

"Qualified persons"

In broad terms, a "qualified person" is a UK or US resident who is either:

- an individual;
- a qualified governmental entity (as defined in Article 3);
- a publicly traded company (listed in the UK or US);
- a 50%+ subsidiary of five or fewer publicly traded companies (that are listed in the UK or US);
- a publicly traded trust (listed in the UK or US);
- a trust 50%+ owned by publicly traded companies or by publicly traded trusts (that are listed in the UK or the US);
- a pension scheme (where more than 50% of beneficiaries, members or participants are individuals who are UK or US resident);
- a tax exempt employee benefit scheme (where more than 50% of beneficiaries, members or participants are individuals who are UK or US resident);
- a religious, charitable, scientific, artistic, cultural or educational organisation;
- a legal entity that satisfies an ownership and a "base erosion" test;
- a trust, or trustee of a trust in their capacity as such, if the trust is more than 50% owned by certain "qualified persons" or by "equivalent beneficiaries" provided it satisfies a "base erosion" test.

These tests, which determine whether a particular category of UK or US resident is a "qualified person", are all based on the concept that a substantial commercial and economic connection must exist between the taxpayer and the UK or the US to warrant entitlement to treaty benefits. If the standard set by any one of the tests in paragraph 2 is met, then entitlement to all treaty benefits is established (subject to conditions in the articles dealing with the type of income concerned being met).

How is the "base erosion" test satisfied?

The base erosion test is satisfied if less than 50% of the person's gross income for the relevant taxable or chargeable period is paid or accrued, directly or indirectly, to persons who are not UK or US residents in the form of payments that are tax deductible for the purposes of the taxes covered by the treaty in the country in which the person is resident.

The "derivative benefits" test

Paragraph 3 of the article provides that, even if a company is not a "qualified person" as defined by the treaty, it shall nevertheless be entitled to the benefit of the treaty with respect to an item of income, profit or gain, if it satisfies any other specified condition for obtaining such benefit, and it is at least 95% owned by seven or fewer persons who are "equivalent beneficiaries" as defined by the treaty, and less than 50% of the company's gross income for that period is paid to non-UK or non-US persons in the form of tax deductible payments. The conditions set out in paragraph 3 of the article are commonly known as the "derivative benefits" test, though this is not a term employed in the treaty.

Passing this test relies on the third country resident owners of the UK company being "equivalent beneficiaries". From the UK perspective, broadly, an "equivalent beneficiary" is a resident of a Member State of the European Community (EC) or of a European Economic Area (EEA) state, but only if either:

- that resident is entitled to all the benefits of a comprehensive treaty for the avoidance of double taxation (which includes a comprehensive limitation on benefits article) between any Member State of the EC or a EEA state and the US and would be entitled under that treaty to a rate of tax with respect to the particular class of income for which the benefits are being claimed under the UK/US treaty that is at least as low as the rate applicable under the UK/US treaty or;
- that resident is a specified "qualified person".

The definition of "equivalent beneficiary" is at paragraph 7(d) of the article as amended by Article IV of the protocol to the treaty.

Paragraph 7(d) also provides, that for the purposes of applying Article 10(3) (the dividends article), in order to determine whether a person, owning shares, directly or indirectly, in the company claiming the benefit of the treaty is an "equivalent beneficiary", that person will be deemed to hold the same voting power in the company paying the dividend as the company claiming the benefit of the treaty holds in such company

The purpose of the provision is as follows. Suppose a UK company (UKCo) receiving dividends from a US subsidiary company (USCo) is 80 per cent owned by a company (ECCo) resident in an EC or EEA state that also has a comprehensive tax treaty with the US that provides for zero on dividends. Under Article 23(7)(d)(i), ECCo will be an "equivalent beneficiary" and, the other conditions being met, UKCo will receive its dividends from USCo free of US withholding tax. That is the result achieved by the treaty as originally signed, and is not changed by the protocol.

But suppose instead that UKCo was owned 50:50 by another UK company and ECCo. Without this protocol provision, UKCo could not get zero. ECCo is not an equivalent beneficiary because, had it owned USCo directly, it would hold less than the 80 per cent required by Article 10(3). But by deeming ECCo to own the same proportion of USCo that UKCo owns, the 80 per cent test is satisfied, and UKCo can receive its dividends from USCo gross.

The provision therefore prevents the anomalous situation where a UK resident company that owned 80% of the voting power in the US company paying the dividend would be denied zero on US dividends because its joint owners owned individually less than 80% in it, despite the fact that together they owned 100% of it and both the UK treaty with the US and the EC/EEA country treaty with the US provided for zero withholding tax on dividends.

At present, the provision has no effect because no EC or EEA country has a comprehensive double taxation treaty with the US that provides for zero US withholding tax on dividends.

What is the rationale for the "derivative benefits" test?

This is best demonstrated by an example.

If a UK resident company in receipt of income from the US is substantially owned by residents of a third country and that third country has a tax treaty with the US that provides for the same benefits for that type of income as the treaty between the UK and the US, then there should be no objection to those third country residents getting that benefit indirectly under the UK/US treaty as opposed to directly under the third country/US treaty.

This is because (i) the US in this instance has, as a matter of policy, already decided that the residents of the third country should receive that benefit and (ii) prima facie the residents of the third country are not treaty shopping through the UK as the same benefits are available in their home country.

Which individuals can be "qualified persons" under Article 23(7)(d)(ii)?

As it relates to individuals, the term "equivalent beneficiary" is defined in Article 23(7)(d) as including "a resident of a Member State of the European Community or of a European Economic Area state or of a party to the North American Free Trade Agreement but only if that resident … is a qualified person by reason of sub-paragraph (a) … of paragraph 2 of this Article".

Article 23(2) defines the term "qualified person" by listing seven categories of person who will automatically be a "qualified person" for the purposes of the treaty. Individuals are included at paragraph 2(a).

As provided by the opening words of paragraph 2, only a resident of one of the two contracting states can be a "qualified person" by reason of paragraph 2(a). It follows that only such residents can be qualified persons for the purpose of the definition of equivalent beneficiary in Article 23(7)(d).

The "active conduct of a trade or business" test

What conditions does a UK resident have to fulfil to pass this test?

Paragraph 4 of the article provides that even if a UK resident is not a "qualified person" as defined by the treaty it shall nevertheless be entitled to the benefit of the treaty with respect to an item of income, profit or gain, if it satisfies any other specified condition for obtaining such benefit, and it is engaged in the active conduct of a trade or business in the UK.

Paragraph 4 (a), (b) and (c) set out the conditions for passing the "active conduct of a trade or business" test and guidance on the meaning of some of the specific terms used in the paragraph is provided in the Exchange of Notes to the treaty. Essentially however, there are three main conditions: the UK resident must be engaged in the active conduct of a trade or business in the UK; the income derived from the US must be derived in connection with or incidental to that trade or business; and the trade must be substantial in relation to the activity in the US.

Comment on the meaning of "trade or business", "in connection with", "incidental to" and "substantial" is given in the section entitled "Zero Withholding Tax on US Dividends – Articles 10 and 23" earlier in this Tax Bulletin.

What is the rationale for the "active conduct of a trade or business" test?

To quote again from the Technical Explanation to the US Model Income Tax Convention of September 20, 1996, the assumption underlying this test "is that a third country resident that establishes a 'substantial' operation in the other State and that derives income from a similar activity in the US would not do so primarily to avail itself of the benefits of the treaty; it is presumed in such a case that the investor had a valid business purpose for investing in the other State, and that the link between that trade and or business and the US activity that generates the treaty-benefited income manifests a business purpose for placing the US investments in the entity in the other State. It is considered unlikely that the investor would incur the expense of establishing a substantial trade or business in the other State simply to obtain the benefits of the Convention."

In such circumstances there can be no objection to granting entitlement to treaty benefits in respect of the relevant item of income, profit or gain.

Competent authority discretion

Paragraph 6 provides that a UK or US resident who is neither a "qualified person" nor entitled to treaty benefits with respect to an item of income, profit or gain under the "derivative benefits" test or the "active conduct of a trade or business" test shall nevertheless be granted treaty benefits by the competent authority of the other country if the competent authority determines that the establishment, acquisition or maintenance of the person claiming the benefit and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

The Exchange of Notes to the treaty sets out in detail, with reference to specific circumstances, how the competent authority will approach this task.

Why have competent authority discretion in addition to the other tests?

The tests at paragraphs 2, 3 and 4 of the article, whilst providing clarity and certainty regarding entitlement to treaty benefits, are nevertheless essentially mechanical and cannot account for every situation.

As such, competent authority discretion allows taxpayers who do not meet the objective criteria set by those tests, but who were nevertheless not engaged in treaty shopping, to obtain the benefits of the treaty. (For details on how to apply to the US Competent Authority see Zero Withholding Tax on US Dividends – Articles 10 and 23 and to the UK Competent Authority see Entry into force – Article 29)

Mutual agreement procedure – Article 26

This article authorises the competent authorities of the two countries to endeavour, by mutual agreement, to resolve cases of taxation not in accordance with the treaty and to settle points of doubt or difficulty in its application or interpretation.

Specifically it provides that, where a person considers that the actions of one or both countries will result in taxation not in accordance with the treaty, he may present his case to the competent authority of the country of which he is a resident or national. This right applies irrespective of any remedies provided by domestic law.

Time Limits

The article sets out time limits for the presentation of a case: a case must be presented within three years of the first notification of the action resulting in taxation not in accordance with the treaty or, if later, within six years from the end of the taxable or chargeable period in respect of which that taxation is imposed or proposed. This provides certainty and consistency of treatment for applicants and contributes to the effective administration of the mutual agreement procedure.

The time limits in the treaty are compatible with the time limits in UK law. Section 815AA(6) ICTA 1988 provides that cases may be presented for consideration under the mutual agreement procedure before the expiration of 6 years following the end of the chargeable period to which the case relates.

Implementation of agreements reached

Agreements reached between the competent authorities will be implemented notwithstanding the countries' domestic time limits or other procedural limitations (except such limitations as apply for the purposes of giving effect to such an agreement).

This time limit is the 12 month period stipulated in UK law for making a claim to relief following mutual agreement (section 815AA(3) ICTA 1988).

The presentation of a case for consideration under the mutual agreement procedure does not in itself constitute a claim to relief. In the absence of a claim the Revenue cannot give relief. Section 815AA(3) ICTA 1988 provides that once mutual agreement has been reached by the competent authorities a claim to relief may be made within 12 months of the notification.

Exchange of information and administrative assistance – Article 27

The article provides that the UK and US competent authorities will exchange information and assist each other administratively for the purposes of carrying out the provisions of the treaty and their respective domestic tax laws.

Can information relating to residents of third countries be exchanged?

Generally, unless otherwise provided for in the treaty, the treaty only applies to residents of either or both the UK and the US (Article 1(1)). However, paragraph 1 of the exchange of information and administrative assistance article provides that the exchange of information is not restricted by Article 1(1) of the treaty. Therefore the UK and the US competent authorities may exchange information relating to residents of third countries.

For example, the US competent authority will be able to ask the UK competent authority for information relating to the UK source income of a US national (who may be taxable in the US in respect of that income) even though that person may be resident in a third country.

Another example might be where a company, resident in a third country, has a permanent establishment in the US which is transacting with UK taxpayers and the UK competent authority wants information about those transactions in order to determine the profits of the UK taxpayers concerned. The article permits the US competent authority to exchange information about the US permanent establishment even though the company of which it represents a part is not a US resident.

Exchanging information about residents of third countries in this way is in line with OECD thinking and reflects the wider and growing international consensus that effective exchange of information represents one of the best ways of combating tax avoidance and evasion - particularly in view of increasing economic and commercial internationalisation.

What is the extent of the obligation imposed by the article on the UK competent authority to obtain and exchange information?

Paragraph 2 of the article provides that if one of the competent authorities requests information, the other competent authority will obtain that information in the same manner and to the same extent as it would for its country's own tax purposes.

This reflects the fact that the powers that exist under UK domestic tax law to call for documents relevant to liability to UK income tax, corporation tax or capital gains tax (section 20 TMA 1970) may, by virtue of section 146 of Finance Act 2000, be used in a case where the liability is to the tax of a treaty partner provided that tax is covered by the relevant treaty.

What safeguards are there to protect those about whom information is exchanged?

Information may only be exchanged between the US and UK competent authorities and the exchange must:

- be necessary for carrying out the provisions of the treaty or of UK or US domestic tax law;
- relate to the taxes covered by the treaty; and
- be treated as secret.

The obligation to exchange information does not require either country to carry out administrative measures at variance with its existing practice; or to supply information that is not obtainable under domestic law; or to supply any information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or whose disclosure would be contrary to public policy.

Entry into Force – Article 29

From when does the treaty have effect?

The instruments of ratification were exchanged on 31 March 2003 and the treaty entered into force on that date. It will have effect for UK taxes covered from the following dates:

taxes withheld at source	1 May 2003
income tax and capital gains tax	6 April 2003
corporation tax	1 April 2003
petroleum revenue tax	1 January 2004

For the purposes of Article 29(2)(b)(iii), "financial year" is defined at section 834 ICTA 1988. It is the 12 months commencing on the 1 April in any given calendar year, so the financial year 2003 is the year beginning on 1 April 2003.

How will US residents be able to claim relief?

The Centre for Non-Residents (CNR) in Nottingham is the office primarily responsible for giving relief from UK income tax to residents of the USA in receipt of relievable UK source income tax under tax treaties.

The main types of income that may be relieved under the treaty are interest (Article 11), royalties (Article 12) and pensions, annuities, alimony, social security and child support entitlements (Article 17). The other income article (Article 22) may operate to relieve items of income not dealt with under any other article of the treaty, but specifically excludes from its scope any income paid out of trusts or the estates of deceased persons in the course of administration.

Article 10 deals with dividends. Unlike its predecessor, the article does not contain a provision granting US residents entitlement to tax credits in respect of UK dividends. And as there is no withholding tax on UK dividends, there will generally be no relief for a US resident to claim under this article.

A claim for relief from UK tax may be made in two ways. A US resident can claim repayment of tax already deducted from UK source income. It is also possible to make an application to CNR asking it to direct that future payments of income be made without deduction of tax (or after deduction of tax at the rate specified in the treaty).

Which form should a US resident use to claim relief?

Individuals will need to complete form US/Individual 2002.

All other types of claimant will need to complete form US/Company 2002.

How do I obtain a form to claim relief?

Both forms can be downloaded from CNR's website at http://www.inlandrevenue.gov.uk/cnr/app_dtt.htm or by contacting CNR by telephone on 0845 070 0040 or from outside the UK on +44 151 210 2222. Each form has a set of guidance notes attached.

The forms follow the pattern of those published in 2001 for claims under the previous treaty, but with appropriate additions and amendments.

How do I claim relief?

The method of claiming relief has not altered with the introduction of the new treaty.

The completed form should be sent to the US Residency Certification Unit of the IRS (whose full address is given on the form), which will certify the claimant's US tax status and forward the form direct to CNR. It is not CNR's practice to process a form that has not been certified by the IRS in this manner, although it is open to claimants to send CNR an advance copy of their claim, and CNR may consider it without prejudice, dependent upon receipt of the certified form.

Why does the form have so many questions?

The questions on the forms are designed to ensure that CNR has all the information necessary to determine whether the claimant is entitled to treaty benefits. But as the new treaty contains provisions not found in the previous treaty (such as the "conduit arrangement" provision in the dividends, interest, royalties and other income articles and the provisions in the limitation on benefits article) there are inevitably more questions than on the previous claim forms. But we have done all we can to keep the number of extra questions to a minimum consistent with the need to ensure that a claimant establishes entitlement to treaty benefits.

How do I make a claim under Article 23(6)?

There is no form or set form of words for making a claim under the competent authority discretion provision at Article 23(6). Claims, detailing the reasons why the claimant thinks they are entitled to treaty benefits, should be made by letter to either of the UK competent authority contacts listed at the end of this Tax Bulletin. In addition claimants should complete the appropriate CNR claim form and send it in the normal way to the United States Internal Revenue Service (see 'How do I claim relief?' above). Please attach a copy of the competent authority contact letter to the claim form.

How do I claim repayment of UK tax that was deducted before the new treaty came into effect?

You should complete the claim form appropriate to the previous treaty. This form can be downloaded from CNR's website at http://www.inlandrevenue.gov.uk/cnr/app_dtt.htm or by contacting CNR by telephone on 0845 070 0040 or from outside the UK on +44 151 210 2222. Each form has a set of Guidance Notes attached.

Will Directions under the previous treaty for interest or royalties to be paid gross continue to apply under the new treaty?

Some people may already have received clearance from the Inland Revenue for interest or royalties to flow gross between the UK and US following an application under the previous treaty. Clearance under the previous treaty will normally have been granted for the duration of the loan or licensing agreement or until a review date has been reached. With the introduction of the new treaty, some of these clearances may need to be reviewed to ensure that the claimant continues to be entitled to the benefit of the interest or royalty article.

The Revenue expects both the UK payer and the overseas applicant to consider whether they are still entitled to make and receive the payments without deducting income tax. If they believe they might not be, they should tell CNR.

What if a claimant is fiscally transparent?

Article 1(8) deals with entities that are "fiscally transparent" for taxation purposes and directs the taxation authorities to "look through" such concerns to establish eligibility to relief. This is not so different from the provisions of the previous treaty, and CNR will apply broadly the same tests as it did with partnerships, LLCs and similar concerns that made claims under the previous treaty. (See Tax Bulletin 29 available at www.inlandrevenue.gov.uk/bulletins/tb29.htm)

With partnerships and LLCs (where the latter are taxed in the US on a non-corporate basis), CNR will continue to take claims in the name of the transparent concern signed by a senior, general or managing partner or member, as appropriate. However, the claim should be accompanied by particulars of all the individual beneficial owners of the income, whether natural or legal persons. In the first instance, the name and address (residential or registered business addresses only are acceptable) may be given, subject to enquiry and verification.

If any participants are not US residents, the schedule of beneficial owners should show each beneficial owner's percentage share of the income.

Where there are multiple layers of investors, especially if some of them are themselves transparent concerns, CNR will look sympathetically at the compliance difficulties the above procedure may cause claimants, and if necessary will consider specific proposals to provide adequate and effective verification arrangements.

In cases of multiple ownership or where a non-US element is involved, CNR will need to decide whether to authorise relief at source. In such cases, relief may be possible only by way of meeting discrete payment claims made after a UK-source payment has been made, and tax deducted from it.

What is Grandfathering?

"Grandfathering" (though not a term found in the treaty itself) is the process whereby a claimant can elect, under the provisions of Article 29(3), to have the provisions of the previous treaty apply in their entirety for a period of 12 months from the date on which the new treaty otherwise would have effect under Article 29(2). A claimant may wish to make such an election because the previous treaty provides them with greater benefits than they would be entitled to under the new treaty.

There is no form or set form of words provided for such an election. Instead, CNR will consider the provision invoked only where the claimant has expressly asked for it to apply, or has demonstrated a clear and unmistakable intention that it is to apply. The question will need to be determined on the making of the first claim to relief to which Article 29(3) could have relevance. If such an election is made, it will apply to all of the income arising in that 12-month period.

A claimant making such an election will need to make any claim to which it relates using the appropriate form for the previous treaty. These forms will continue to be available on CNR's website, or obtainable from them on request, until the statutory time limit for making a claim under UK tax law (section 43 TMA 1970) expires. Claims relating to income paid in the period from 1 May 2003 to 5 April 2004 will have to be made no later than 31 January 2010; claims for the period from 6 April to 30 April 2004 will have to be made no later than 31 January 2011.

Where can I find out more?

Visit CNR's website at http://www.inlandrevenue.gov.uk/cnr/app_dtt.htm to find out more about how it processes claims for relief under the UK's tax treaties.

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CONTENT

The content of Tax Bulletin gives the views of our technical specialists on particular issues. The information published is reported because it may be of interest to tax practitioners. Publication will be six times a year, and include a cumulative index issued on an annual basis.

- You can expect that interpretations of the law contained in the Bulletin will normally be applied in relevant cases, but this is subject to a number of qualifications.
- Particular cases may turn on their own facts, or context, and because every possible situation cannot be covered, there may be circumstances in which the interpretation given here will not apply.
- There may also be circumstances in which the Board would find it necessary to argue for a different interpretation in appeal proceedings.
- The Bulletin does not replace formal Statements of Practice.
- The Board's view of the law may change in the future. Readers will be notified of any changes in future editions.

Nothing in this Bulletin affects a taxpayer's right of appeal on any point.

Letters on any article appearing in Tax Bulletin should be sent to the Editor, Mr Shell Makwana, Room G7, New Wing, Somerset House, Strand, London, WC2R 1LB or e-mail Shell.Makwana@ir.gsi.gov.uk. We are sorry though that neither he nor our contributors will normally be able to enter into correspondence about Tax Bulletin or its contents.

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