

## Double tax treaty issues (Lectures B1342/ B1343 – 19.16/ 19.06 minutes)

### *Introduction*

One function of a double tax treaty is to avoid dual residency if possible. Treaties contain a 'tie-breaker' clause where the national rules of two States are in conflict so that a person (i.e., an entity or an individual is treated as resident in both States under their national laws).

This would normally lead to one State having the overriding authority to tax. However, it may not always prevent a source being taxed in both States if none of the tie-breaker clauses operate.

### *Corporate residence under a double tax treaty*

A company might be UK resident, for example, because it is incorporated in the UK but resident in another jurisdiction under its laws, for example because it is centrally controlled and managed there.

The OECD model treaty tiebreaker talks about the following factor determining residence:

"The place where key management and commercial decisions are made...necessary for the conduct of the business....in substance are made....by directors or senior management"

However, each country can have different factors determining residence.

Place of management	Croatia, Czech Republic, Germany, Switzerland
Day to day management	Denmark
Central control and management	Australia, Canada, Cyprus
Head office location	Japan, Slovenia
Place of effective management	Turkey, Austria, Belgium, France, Italy, Spain, Netherlands, Norway, Portugal
Management office	Poland
Where the main activity occurs	Israel
Where controlling shareholders reside	Guernsey

In determining the residence status of a company, it is therefore vital to understand how each jurisdiction would determine residence. If this results in the company being resident in one of the jurisdictions, then this is its place of residence.

If it would result in the company being resident in both jurisdictions, reference must be made to the double tax treaty to see if the tie-breaker clause can determine a single place of residence. If it does, then the company is said to be 'treaty-resident' in that jurisdiction and 'treaty non-resident' in the other jurisdiction.

### *Basic principles of a treaty*

The country in which the entity is resident normally has the right to tax the entity's worldwide income and the treaty gives credit for tax suffered on income sourced in the other country (or exempts that other source income from tax).

The other country has limited taxing rights which would only be applicable to specific sources of income and gains which arise in that other country.

### *Income categorisation issues*

It is possible that certain items of income might be categorized in one way in Country A but as a different type of income in Country B. In this situation, the country in which the entity is resident may not give credit for the tax suffered on the income in the other country.

For example, Country A might treat a certain finance payment by an entity as a distribution and subject it to withholding tax. If the income is received in Country B by an entity resident in that country, it might treat it as interest income and subject it to tax as such in Country B.

Because Country A treated the amount as a distribution and Country B treated it as interest, Country B might not give credit for the tax suffered by the receiving entity.

### *Power of double tax treaties*

Double tax treaties are international agreements between two jurisdictions. As such, they override domestic law where necessary.

### *Important words*

When reading treaties, it is important to read the wording carefully. If it uses the word 'may' this means the State can tax the income or gain but may not choose to do so (we would need to check the domestic law to see if this is the case).

If the treaty uses the word 'exempt' it means the State cannot subject the income or gain to tax, irrespective of what its domestic law might prescribe. It is not uncommon for countries that grant exemption over certain income in a double tax treaty to tax other income more heavily.

While a lot of treaties look the same (generally they have the same content in identically numbered Articles), they do differ in wording. It is imperative to read the relevant treaty carefully to ensure it is applied properly to the specific client situation

Treaty reliefs must be claimed, they are not automatic, so a claim should be made in the relevant return, if in time, or else separately in a letter to HMRC where it is too late to amend a return.

### *The UK/USA double tax treaty*

This treaty stands out as being more complicated than other treaties. This is partly because US tax law requires all US nationals to return their worldwide income and account for US tax on it, irrespective of their place of residence. We are setting out some of the main provisions of the treaty below, but there is no substitute for reading the relevant articles themselves.

### Corporate residence tiebreaker

- Both States must endeavour to determine the status by mutual agreement
- If they cannot, the person cannot use the benefits of the DTT (apart from the DT relief, non-discrimination, and mutual agreement Articles)

### Permanent establishment (PE)

- Follows OECD model

### Income from immovable property

- May be taxed in the State where the property is located

### Business profits

- Only taxable in State where the enterprise is resident unless conducted through a PE in the other State
- The other State may tax the PE profits on the assumption it is a separate and distinct entity – this can lead to interest disallowance where the PE is deemed to have notional capital
- There is specific reference to US excise tax on insurers
- Income attributable to a PE can be taxed where it was situated, notwithstanding that it has ceased to exist
- Profits from international travel are only taxable in the State where the entity is resident (e.g., British Airways plc profits are only taxed in the UK, even though it has flights departing from US airports and has offices in the US)

### Associated enterprises

- If transactions take place other than at arms' length, adjustments to an arms' length basis can be made by either State
- If the profits are taxable in both States and arms' length adjustments are made in the second State, the other State must make an 'appropriate' adjustment to the tax it charges on the profits

### Dividends

- Residents of one State are taxable on dividends derived from the other State
- Up to 5% WHT can be charged where the recipient is a company owning at least 10% of the votes of the payer
- Up to 15% WHT can be charged in other cases
- 0% WHT where the company has owned 80%+ of votes since 1998 and throughout the year before the dividend is declared, and is not disqualified by the 'limitation of benefit article' (see later)

- Special rules apply to dividends paid by pooled investment vehicles investing in financial assets (Art 10(4))
- Art 10(7) discusses income from a PE in another State and 'dividend equivalents' that can be subject to additional WHT of up to 5%
- No anti-avoidance rule in this Article but there is a general limitation on benefits from the treaty (see later)

### Interest

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### Royalties

- Generally, only taxable in country of residence of the recipient, unless connected to a PE in other State
- If excess royalties are paid, the excess amount can be taxed in both States
- No WHT is mentioned

### Capital gains

- Gains on land and buildings can be taxed by the State where they are located
  - Also applies to UK unlisted shares, partnership or trust deriving more than 50% of their value from UK land and buildings
  - Applies to a US 'real property interest'
- Gains on assets forming part of a PE can be taxed by the State where the PE is established
- Gains on ships, aircraft or trains operating international routes only taxable where the owner is resident

- Any other gains only taxable in the State where the owner is resident
- If a person has been resident in a Contracting State for the past 6 years, that state can also tax any gains arising on that person

#### Limitation of benefits

- Companies are generally only able to benefit from the DTT if
  - Listed (and regularly traded) or
  - More than 50% of the voting power and value is owned by 5 or fewer listed companies
- Unlisted companies can benefit if at least 95% of voting power and value is owned by 7 or fewer “equivalent beneficiaries” and less than 50% of the gross income for a period is paid to non-equivalent beneficiaries which are tax deductible
  - Equivalent beneficiary = resident of EEA or member of NAFTA subject to conditions
- Art 23(4) indicates that other companies that have a trade in one of the States (not investment companies other than banks, registered securities dealers, and insurance entities) can also benefit from the DTT
  - If it trades in the other State, its trade in the first State must be ‘substantial’ (not defined)
  - Include partnership trades in which the company is a partner and connected parties (a more than 50% test)
- Benefits of the DTT not be available if the main purpose or one of the main purposes of the creation or existence of a resident or of the transaction undertaken by him, was to obtain benefits under this Convention
- If a company or its parent has a class of shares with terms entitling the holders to a portion of income or gain derived from the other State than without the entitlement and 50% or more of the voting power and value is owned by non-equivalent beneficiaries
  - The benefits of the DTT only apply to the proportion of income or gains that would apply in the absence of those terms
- A resident will be able to benefits from the DTT if the competent authority of the other State determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have, as one of its principal purposes, the obtaining of benefits under this Convention
  - i.e., it is written in a positive sense unlike other treaties

### Other articles

- Double tax relief is specifically provided for, though there is a restriction on PRT double tax relief (Art 24(3))
- There is a non-discrimination clause (so the US is a qualifying territory for certain corporation tax provisions such as the late-paid interest rules in Part 5, CTA 2009)

*Contributed by Malcolm Greenbaum*