

Double Tax Treaties (Lecture P1273 – 18.30 minutes)

Introduction

Although most of you should be familiar with the concept of double taxation, it is useful to recap the potential mischief we are facing. Subject to any exceptions, an individual is generally chargeable to income tax and capital gains tax in the UK, wherever arising (unless they are non-UK domiciled) but some income is taxed where its source is in the UK.

- Many other jurisdictions adopt the same approach so as a result a UK resident individual with income arising abroad is likely to be taxed twice on the same income, once in the country of origin and once in the UK.
- Double taxation can therefore act as a significant barrier to international trade and investment. Therefore, there are a number of methodologies adopted around the world to minimise or even eliminate the costs of double taxation and we are going to focus in this session on the use of double tax treaties
- Double tax conventions aim to eliminate the double taxation of income or gains arising in one State and paid to residents of another State. They do this by dividing the taxing rights that each treaty partner has under its domestic law over the same income and gains. It is worth noting that tax treaties are bilateral agreements made between two countries. Multilateral treaties (i.e. between many countries) are generally considered impractical as a concept. Bilateral Double Taxation Agreements are more commonly known as or referred to as treaties/conventions)
- Different mechanisms can exist whereby double tax relief is obtained by way of exempting the income from the charge to UK tax or alternatively as with the unilateral credit system credit for the overseas tax is taken against the UK Tax liability. Later we will look at the Model Treaty's provisions on this in a bit more detail.
- For many fiscal authorities, treaties serve an important function in combating loss of tax revenue through evasion, etc. Article 26 deals with exchange of information. It provides that the competent authorities shall exchange such information as necessary for carrying out the provisions of the convention or domestic law and is not restricted to those covered by the treaty. Article 27 was added in January 2003. it deals with the assistance in the collection of taxes. The article provides that the contracting states will lend assistance to each other in collecting taxes.

References to the Articles above relate to the OECD model treaty which is published as a model for countries negotiating treaties but there is no obligation on this to be used. Most of the UK treaties are based on the model although some significant ones, including the one with the USA, are different. It is always important to check the individual treaty when reviewing such matters but this module will consider the OECD model treaty to consider some of the principles it demonstrates.

The OECD model treaty

Articles 1-5 deal with the scope of the agreement, the taxes covered, definition of terms, questions of residence and the definition of a permanent establishment.

Articles 6-21 deal with the treatment of income of various descriptions, business profits, dividends, interest, royalties, employment income etc.

Article 22 deals with the taxation of capital.

The remaining articles include the provisions for the elimination of double taxation, exchange of information, non-discrimination, entry into force etc.

Article 23 A – Exemption method

Article 23 B – Credit method

Article 24 – non-discrimination

Article 25 – Mutual agreement procedure

Article 26 – Exchange of information

Article 27 – Assistance in the collection of taxes

Article 28 – Members of diplomatic missions and consular posts

Article 29 – Entitlement to benefits

Article 30 – Territorial extension

Interaction with domestic law

A double tax treaty can only make the position better for a taxpayer and it will never impose a tax charge.

For example, let's say that a treaty provides for a withholding tax ("WHT") rate of 10% to apply to dividends. This doesn't mean that that WHT will apply. First, we need to look to see the domestic position i.e. is tax applied and what rate it should be? Then, we look to the Treaty to see if this provides a better situation. E.g. if we are looking at a UK company paying a dividend to an Australian resident individual step one is to look at UK domestic law. Under UK domestic law there is no requirement to withhold tax on dividend payments. As a result, there is no need to look to the UK / Australia DTT – it will not give a better position than domestic law. It is irrelevant whether the dividend WHT rate is capped at say 10% because there is no WHT imposed under domestic law.

The provisions of a double tax agreement (DTA) entered into by the UK take precedence over domestic legislation, insofar as they provide relief from double taxation.

Article 4: residence

We need to establish where a person is resident as this is pivotal in determining the impact of the treaty and as far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax).

Most treaties have a tie breaker clause which first considers the permanent home. If this is not conclusive (i.e. there is a permanent home in both contracting States) we then consider the centre of vital interests (unless there is no permanent home in either place in which case, we skip this one). This is broadly where your family, friends, jobs and social connections are. If this is not conclusive then you need to consider the habitual abode (where you spend most of your time). If this is not conclusive then you would consider which country you are a national of. If this does not give a definitive outcome then it would be determined by mutual agreement between the countries involved.

In looking at this tie breaker it is important to acknowledge that these are not the same tests as we see for the purposes of the Statutory Residency Test. Dual residency is a particular problem for US citizens or green card holders because of the US tax system.

Specific income sources

Income from immovable property

The model treaty allows this to be taxed in the place where it is situated as well as the state in which beneficial owner is resident. Income from land will therefore typically give rise to double taxation but this will be relieved by the ability to claim double tax relief.

Dividend income

This is where we see withholding taxes being applied and where the double tax treaty will restrict the amount of WHT which can be deducted. The actual model treaty states: 'Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State **may be** taxed in that other State.' Because it states 'may be', whether or not it is taxed in the other state will depend on domestic law.

The model treaty then goes on to say that there will be a limit on the WHT in the company's state of residence to 5% if the owner of the shares has at least 25% of the shares and 15% in all other cases. These figures do vary in individual tax treaties.

Put in simple terms, dividends are taxed in the country of residence of the shareholder but they may also be taxed in the country in which the company is resident but the tax rate is limited.

Interest

The same basic principle applies as it does for dividends where interest may be taxed where the recipient is resident and/or where the interest arises but WHT is limited to 10% (in the model treaty). Note that interest which may be exempt under domestic rules (e.g. UK ISA interest) may still be taxable in the other country.

Income from employment

Article 15 of the OECD Model governs the taxation of income from employment. It is complex and gives rise to many issues.

The basic principle underlying the Article is to award the right to tax to the country where the employment is exercised. However, there is a second part which reverts the allocation of the taxing rights back to the State of residence, regardless of the fact that the employment has been carried out in another State. The purpose of the provision is to facilitate international short-term secondments of employees.

Three conditions have to be met for this to apply:

1. The individual is present in the state where the employment is exercised in aggregate for less than 183 days in any twelve-month period;
2. The remuneration is paid by, or on behalf of, an employer who is not a resident of the other state (i.e. the one where the employment is exercised);
3. The remuneration is not borne by a permanent establishment which the employer has in that other state.

It is clearly going to be important to ensure that these conditions are met. It is also a clause where there are deviations from the model treaty in some of the more important UK treaties for example:

- UK/India - (c) the remuneration is not deductible in computing the profits of an enterprise chargeable to tax in that other State;
- UK/Hong Kong – (d) the remuneration is taxable in the first-mentioned state according to the laws in force in that State;
- UK/Singapore – (c) the remuneration is subject to tax in the first-mentioned Contracting State; and (d) the remuneration is not directly deductible from the profits for tax purposes of a permanent establishment or a fixed base in the other Contracting State.

Pensions

Very few treaties with the UK give any kind of relief for pension contributions paid in the UK but some significant ones do, including the US, France, Ireland, Canada and South Africa. Relief may be available in the UK for foreign pension contributions provided the schemes would be qualifying pension schemes for UK tax purposes.

Pension receipts are typically only taxable in the country of residence although you need to be careful as some treaties cover the pension only and not the lump sum and sometimes there is a dispute over whether something is a pension or not (e.g. if a UK individual takes their whole pension pot in one lump, is this a pension?).

Other income

Other income not covered by one of the other articles is typically taxable only in the state of residence.

Other provisions

Remittance clause

There is often a remittance clause even though it is not part of the model treaty.

Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State.

For example, gains taxed in the UK on a remittance basis are relieved from tax in the US but any gain not remitted can be taxed in US. This can cause problems because what if it is remitted at a later date and taxed in UK? The US tax cannot be repaid automatically and so you would get a tax credit in the UK unless it is in time to amend the overseas return, in which case the expectation is that the overseas return will be amended.

Double taxation

There are two means by which a Treaty may eliminate double taxation – the exemption method or the credit method. In practice, both methods are used in actual negotiated treaties, although the credit method is used more extensively.

Articles 23A and 23B deal with double taxation where the same income or capital is taxable in the hands of the same person by more than one State. International double taxation may arise in three cases:

1. Where each Contracting State subjects the same person to tax on his worldwide income or capital.

E.g. where a company is resident in two Contracting States and thus subject to tax in both states, Article 4 provides a tie break clause giving preference to one country which will have full taxing rights (or mutual agreement under the new model)

2. Where a person is resident of a Contracting State and derives income from, or owns capital in, the other Contracting State and both States impose tax on that income or capital.

This can be resolved by allocating the exclusive right to tax between the Contracting States - this is generally the state of residence, however there are exceptions.

3. For other items of income or capital, the attribution of the right to tax is not exclusive, and the relevant Article then states that the income or capital “may be taxed”.

In such cases the State of residence must give relief so as to avoid double taxation.

Contributed by Ros Martin