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The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law

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10. THE UNITED KINGDOM

Philip Baker

1. The United Kingdom's network of DTCs and the relevance of limitation of benefit provisions

The United Kingdom has the largest network of double taxation conventions ("DTCs") of any country in the world. At present, the United Kingdom has more than 100 comprehensive DTCs in force with other countries.[2] Over the past 50 years the UK has concluded more than 350 conventions, agreements, arrangements and protocols and amending arrangements or agreements, many of them containing limitation of benefit provisions or amending earlier limitation of benefit provisions. The United Kingdom's treaty practice in this area provides, therefore, an interesting source of material from which one can examine the development of limitation of benefit provisions. The United Kingdom's approach to such provisions has also clearly changed over time and this chapter will endeavour to identify how this approach has changed. The chapter will also look briefly at the compatibility of limitation of benefit provisions in the United Kingdom's DTCs and European Union law.

This chapter begins with a brief examination of the history of the UK's DTCs, then considers domestic legislation and domestic case law on tax avoidance using DTCs. The chapter then considers compatibility with EU law in general terms. The bulk of the chapter is devoted to an examination of the types of limitation of benefit provisions presently found or previously found in UK treaty practice. Finally, the chapter seeks to draw some limited conclusions as to the UK's approach to limitation of benefit provisions.

[1] The author would like to thank Prof. John Tiley of Cambridge University whose original paper on "Anti-abuse provisions in the United Kingdom" was made available to the author, and also Dev Erriah, pupil of Grays Inn Tax Chambers, who prepared some notes on the UK's network of tax treaties.

[2] See Inland Revenue, *Tax Bulletin*, No. 30, August 1997, pp. 461-463 for a full list of the UK's treaty network.

2. A brief history of the UK's practice with regard to DTCs

Though the United Kingdom now has the largest network of DTCs in the world, the UK came relatively late to the process of concluding such conventions. Before the Second World War, the United Kingdom adopted an approach to international taxation which did not require the conclusion of comprehensive treaties. With respect to countries within the British Commonwealth, the UK introduced unilateral provisions for dominion tax relief.[3] For countries outside the Commonwealth, no provisions were introduced for the avoidance of international double taxation. The only treaties concluded in the income field by the United Kingdom prior to the Second World War were limited treaties dealing with shipping profits (nine conventions concluded),[4] agency profits (six conventions concluded),[5] and air transport profits (two conventions concluded).[6] Special arrangements were also made with the Irish Free State.[7]

The UK's approach changed towards the end of the Second World War with the opening of negotiations with the United States for the conclusion of a convention, eventually concluded on 16 April 1945.

After the conclusion of the convention with the United States in 1945, the UK set about developing a treaty network at a rapid pace. In particular, a large number of "colonial arrangements" were entered into in the late 1940s and early 1950s with the British colonies and dependent territories. A small number of these colonial arrangements remain in force today.

Alongside the conclusion of colonial arrangements with the colonies and dependent territories, the UK also began to build up its network of treaties with independent Commonwealth countries and with non-Commonwealth countries. From the late 1950s, the UK became an active member of the working groups within the OECD developing draft and model DTCs. UK treaty practice has clearly had an impact on the form of the OECD draft and models.

The UK has never published a model from which treaties are negotiated. So far as one can tell, no such model exists. Instead, treaties are negotiated based upon a working text which develops from one set of negotiations to another. This process is reflected in the UK's approach to limitation of benefit provisions. In general, the recent UK treaties have been close in form to the various versions of the OECD model.

3 See Section 27 of the Finance Act 1920 and R. Toby, *The Theory and Practice of Income Tax* (London: Sweet & Maxwell, 1978), p. 11 and pp. 173-4.

4 With Denmark, Norway, Sweden, Finland, the Netherlands, Germany, Iceland, Greece and Japan - see, for example, the UK-Iceland agreement of 27 April 1928.

5 With Switzerland, Finland, Newfoundland, the Netherlands, Greece and Norway – see, for example, the UK-Switzerland agreement of 17 October 1931.

6 With the Netherlands and Germany.

7 See Section 23 of the Finance Act 1926, Section 21 of the Finance Act 1928, Section 37 of the Finance Act 1948 and Sch. 18, Part I of the Income Tax Act 1952.

3. UK domestic legislation on treaty abuse

The UK has no general legislation designed to the counter the abuse of tax treaties.

The only specific legislation in the UK which relates to the limitation of benefits under DTCs is found in Section 808A of the Income and Corporation Taxes Act 1988. That provision – which was added by Section 52 of the Finance (No. 2) Act 1992 – relates to the "special relationship" provisions of the interest articles in most of the UK's DTCs.[8] The special relationship provisions have taken different forms at different times. The Inland Revenue have contended, however, that the special relationship provisions allowed them to deny the treaty relief not only where the rate of interest on a loan was different from that which would have been agreed between parties at arm's length, but also where the amount of funds lent was greater than would have been the case between parties at arm's length (in other words, that the special relationship provisions also allowed the Revenue to consider the debt:equity ratio of the parties and the issue of thin capitalization).[9] Apparently, an unreported decision of the Special Commissioners[10] threw doubt on the Inland Revenue's approach to this matter. For that reason, Section 808A was added to confirm the broader approach for which the Revenue had contended.

Section 808A(2) contains the following provision:

"(2) The special relationship provision shall be construed as requiring account to be taken of all factors, including –
  (a) the question whether the loan would have been made at all in the absence of the relationship,
  (b) the amount which the loan would have been in the absence of the relationship, and
  (c) the rate of interest and other terms which would have been agreed in the absence of the relationship."

Section 808A(3) also makes it clear that the onus is on the taxpayer to prove that there is either no special relationship or to show the amount of interest which would have been paid in the absence of the special relationship.

Section 808A is not, therefore, in itself a limitation of benefit provision. Rather it confirms the Inland Revenue's approach to the application of the special relationship provision included in the majority of the UK's DTCs.

8 These special relationship provisions are discussed further below.

9 On this, see paragraph 1229 of the Inland Revenue International Taxation Handbook.

10 The Special Commissioners constitute the first instance tax appeal tribunal.

There is, at present, discussion and consideration in the UK of the introduction of a general anti-avoidance provision into the domestic tax code.[11] If such a provision were introduced, then one issue which would need to be considered would be whether it applied to tax avoidance based upon the application of DTCs. At present, it is assumed that such a general rule would apply to all international tax avoidance, but the final answer will depend upon the form of the legislation adopted (if any).

4. Domestic judge-made anti-avoidance approaches: a general anti-avoidance approach

In the absence of a general, legislative anti-avoidance provision, the UK judiciary has developed a judge-made approach towards artificial tax-avoidance schemes. This approach is variously referred to as "the *Ramsay* principle"[12] or as "the principle in *Furniss v Dawson*".[13]

The *Ramsay* principle is not a general, "substance over form" approach. Rather, it is a specific approach to tax-avoidance schemes involving a pre-ordained series of transactions which include steps inserted for no commercial purpose other than the avoidance of taxation. The general statement of the principle is probably best found in the speech of Lord Brightman in *Furniss v Dawson:*[14]

> "...First there must be a pre-ordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end...
>
> Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax - not 'no business effect'. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result...".

The *Ramsay* principle, being judge-made, continues to evolve.[15]

The application of the *Ramsay* principle to DTCs would itself merit an article of its own. If there is a pre-ordained series of transactions with inserted steps involving the application of a DTC, the Revenue might seek to apply the judicial approach to the taxation of the transaction. So far as the author is

[11] See, for example, Institute for Fiscal Studies, *Tax Avoidance: A Report by the Tax Law Review Committee* (London, 1997).

[12] After the decision of the House of Lords in *W T Ramsay Limited v IRC* [1982] AC 300.

[13] [1984] AC 474.

[14] [1984] AC 474 at 527D to E.

[15] See, for example, the recent decisions in *Countess Fitzwilliam v IRC* [1993] STC 502 and *IRC v McGuckian* [1997] STC 908.

aware, however, this point has never yet arisen in litigation in the UK. The reason for this may be that most of the UK's DTCs contain their own limitation of benefit provisions and there remains, therefore, little room for the application of the judicial doctrine. There is also an argument that the general judicial doctrine cannot apply when there are specific limitation of benefit or specific anti-avoidance provisions in the relevant legislation.[16]

Recent judicial pronouncements[17] have indicated that the *Ramsay* principle is, in fact, an approach to the interpretation of legislation. The judicial statements on this point may be regarded as something of a camouflage to hide the fact that the doctrine is much closer to judicial legislation. However, if the doctrine is an approach to the interpretation of legislation, it does not follow that it would necessarily be applied to DTCs. DTCs, being international agreements, should be interpreted in a different fashion from purely domestic legislation.[18] It may very well be, therefore, that if the *Ramsay* doctrine is truly an approach to the interpretation of domestic legislation, then the approach should not apply to DTCs.

The possible application of the *Ramsay* principle to DTCs must await, therefore, judicial pronouncements on this point.

5. The compatibility of limitation of benefit provisions with EU law – the UK position

The issue of the compatibility of the limitation of benefit provisions in the UK's DTCs with restrictions imposed by European Union law has not been raised in any reported litigation. Nor, so far as one is aware, has it been discussed extensively in any periodicals. This may well be because it is generally considered that the provisions are compatible with EU law. It is also relatively recently that the issue has been discussed extensively within the EU.

In general, the Inland Revenue have taken the view that most – if not all – provisions of UK domestic income tax law are compatible with EU law. Since the UK joined the European Community at the start of 1973 there have been few amendments to UK income tax law which have been directly motivated by the need to comply with EC or EU norms. So far as one can tell from UK treaty practice, no changes have been made to the wording of DTCs or to the approach of negotiators arising from membership of the EU. Certainly there are no obvious changes which one could identify as having been influenced by EU norms.

16 See, for example, the comments by Lord Browne-Wilkinson in *Fitzwilliam v IRC* [1993] STC 502 at 536f-h.

17 See *IRC v McGuckian* [1997] STC 908 at 915 to 916 (Lord Steyn) and 920 (Lord Cooke).

18 With regard, in particular, to the provisions of Articles 31-33 of the Vienna Convention on the Law of Treaties.

On the issue of compatibility, one particular point arises from the fact that many of the UK's existing DTCs pre-date accession to the Treaty of Rome. Article 234 of the Treaty provides:

> "The rights and obligations arising from agreements concluded before the entry into force of this Treaty between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty.
>
> To the extent that such agreements are not compatible with this Treaty, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established...".

The UK acceded to the Treaty of Rome with effect from 1 January 1973. Article 5 of the Act of Accession annexed to the Treaty of Accession provides that Article 234 of the Treaty of Rome shall apply to agreements concluded before accession. Thus, with regard to pre-1973 DTCs, the UK has only the duty comprised in the second paragraph of Article 234 to take appropriate steps to eliminate inconsistencies with EU law. Of the UK's 100-odd DTCs, 29 pre-date accession.[19] For the post-accession DTCs, the issue of compatibility directly arises.

In the discussion of specific limitation of benefit provisions below, some provisional comments are made about the compatibility with EU norms.

6. Treaty limitation of benefit provisions[20]

This chapter now turns to consider the limitation of benefit provisions found in the UK's DTCs. It looks both at provisions commonly found in recently negotiated DTCs, as well as provisions that were found in earlier DTCs and that appear no longer to be a part of UK treaty negotiating practice.

It might be commented at this point that, so far as the author is aware, there have been no reported decisions of the UK tribunals or courts on the interpretation of any treaty limitation of benefit provisions. There has, therefore, been no judicial guidance as to how the courts might approach the interpretation of these provisions.

The limitation of benefit provisions in the UK's DTCs are discussed under a number of headings.

[19] Of these, seven are with other Member States and 22 with non-members.

[20] For a general view of the UK attitude towards treaty limitation of benefit provisions, see J. Avery Jones, "Anti-treaty shopping articles – a United Kingdom view", *Intertax* 1989/8-9, p. 331.

6.1 A uniquely British provision: the remittance limitation

Somewhat more than half of the UK's DTCs currently in force contain a limitation of benefit provision which is unique to UK treaty practice. This arises out of a provision of UK domestic tax law (found also in a small number of Commonwealth and other countries). This provision is the remittance basis of taxation for certain individuals.

Under provisions of UK domestic tax law originating in 1914,[21] individuals who are resident but not domiciled in the United Kingdom enjoy a privileged basis of taxation. On certain categories of income originating outside the United Kingdom these individuals are subject to income taxation only on the amounts remitted to or otherwise received in the United Kingdom.[22] When capital gains tax was introduced in 1965, the remittance basis was also applied to that tax so that individuals resident but not domiciled in the United Kingdom are subject to capital gains taxation on the disposal of assets situated outside the UK only if the proceeds are remitted to this country.[23]

It seems to have been appreciated relatively early on that individuals benefiting from the remittance basis would be able to claim treaty benefits in the other Contracting State without necessarily being subject to tax in the UK. If they did not remit the income to the UK, they would nevertheless have been entitled to claim treaty benefits in the other state, without being subject to UK income taxation.

Provisions to prevent income taxed on the remittance basis from enjoying treaty benefits were introduced from a relatively early stage. The first example of a remittance limitation appears to be paragraph 2(2) of the double taxation arrangement with British Guiana concluded in 1947. Under this provision, where an individual was taxable in the UK on the remittance basis, any exemption from tax in the other state was only to be enjoyed to the extent that the income in question was remitted to or received in the UK (and hence taxed in the UK).

After the introduction of capital gains tax in 1965, it seems not to have been immediately appreciated that, with regard to capital gains provisions in a DTC, an individual resident but non-domiciled could enjoy the advantage of exemption without taxation in the UK. More recent limitation of benefit provisions have, however, covered both income remitted to the UK and also capital gains. The current version of the remittance limitation of relief provision in the UK's DTCs follows this format:[24]

[21] Section 5 of the Finance Act 1914.
[22] See Section 65(5) of ICTA 1988.
[23] See Section 12 of TCGA 1992.
[24] Taken from Art. 24 of the UK-Argentina DTC of 1997.

"(1) Where under any provision of this Convention any income is relieved from tax in a Contracting State and, under the law in force in the other Contracting State a person, in respect of that income, is subject to tax by reference to the amount thereof which is remitted to or received in that other Contracting State and not by reference to the full amount thereof, then the relief to be allowed under this Convention in the first-mentioned Contracting State shall apply only to so much of the income as is taxed in the other Contracting State.

(2) Where under Article 13 of this Convention any gain is relieved from tax in a Contracting State and under the law in force in the other Contracting State a person is subject to tax in respect of that gain by reference to the amount thereof which is received in that State and not by reference to the full amount thereof, that Article shall apply only to so much of the gain as is taxed in that State."

It is interesting to note that, though the remittance limitation of benefit provision was introduced as early as 1947, a significant number of the UK's DTCs do not contain a limitation of benefit provision dealing with the remittance basis, or only contain a provision dealing with income and not with capital gains.

So far as compatibility with EU norms are concerned, it seems highly unlikely that the remittance limitations would be regarded as incompatible in any sense. These provisions operate to deny treaty benefits to persons resident but not domiciled in the UK who apply to be taxed on the remittance basis. Domicile is independent of nationality. While the provisions are more likely to affect persons of foreign nationality, they may equally apply to persons of British citizenship who are resident in the UK but claim that their permanent home is outside the UK. Anyone seeking to show that this operated in a discriminatory fashion against them would be facing an uphill struggle.

6.2 Exclusion of tax-privileged entities

A small number of the UK's DTCs adopt the exclusionary approach and exclude from the application of the treaty certain specified, tax-privileged entities.

The first example of such an exclusion seems to have been Article 30 of the 1968 DTC between the UK and Luxembourg which excludes "holding companies entitled to any special tax benefit under the Luxembourg laws of 31 July 1929, or 27 December 1937, or any similar law enacted by Luxembourg after the signature of the Convention". This was followed soon after by an amendment to the arrangement with Jamaica to exclude Jamaican international business companies.[25]

[25] Article XVIIIA of the double taxation agreement with Jamaica of 2 April 1965 as amended by the amending agreement of 9 May 1969.

Current exclusionary provisions seem to take a number of forms. The first type identifies specifically the entities which are excluded from the treaty and denies those entities either the benefit of the entire treaty or of certain selected provisions. For example, Article 24A of the 1974 DTC with Cyprus excludes certain Cyprus individuals and companies from the benefits of the dividend, interest and royalty provisions of the Convention.

A second, more flexible form of exclusion can be seen, for example, in Article 23(2) of the 1994 Convention with Malta which provides as follows:

> "(2) The provisions of this Convention shall not apply to persons entitled to any special tax benefit under:
> (a) a law of either one of the Contracting States which has been identified in an Exchange of Notes between the Contracting States; or
> (b) any substantially similar law subsequently enacted."

On the day that the Convention with Malta was signed, the Governments of the UK and Malta agreed an Exchange of Notes identifying the legislation to which this provision referred.[26]

Finally, a small number of recent conventions have contained a general exclusion provision which does not identify the legislation to which it refers. An example is Article 25(2) of the convention with Mongolia of 1996 which provides as follows:

> "(2) Notwithstanding the provisions of any other Article of this Convention, a resident of a Contracting State who, as a consequence of domestic law concerning incentives to promote foreign investment, is not subject to tax or is subject to tax at a reduced rate in that Contracting State on income or capital gains, shall not receive the benefit of any reduction in or exemption from tax provided for in this Convention by the other Contracting State if the main purpose or one of the main purposes of such resident or a person connected with such resident was to obtain the benefits of this Convention."

This change in practice appears to reflect a view that it is very hard to keep up with the possible developments of domestic tax law in the other treaty state and that, therefore, a self-executing exclusion may be more flexible in this context.

Again, it is very hard to see how these exclusions can be regarded as incompatible with EU norms. They exclude these tax-privileged entities regardless of the nationality or residence of the persons who have established these entities.

[26] Exchange of Notes of 12 May 1994 – the principal exclusions are persons entitled to benefit under the Malta International Business Activities Act of 1988 and the Offshore Trusts Act of 1988 and similar subsequent legislation.

6.3 Current, standard limitation of benefit provisions: beneficial ownership limitations

Current UK treaty practice follows relatively closely the terms of the OECD Model and adopts many of the limitation of benefit provisions contained in that Model. This is true, for example, of the beneficial ownership limitation which is now found in the dividend, interest and royalty provisions of most recent UK DTCs. Interestingly enough, the UK is also beginning to introduce a beneficial ownership limitation into the "other income" article.

References to beneficial ownership in UK DTCs have a relatively long history. The first example of a reference to beneficial ownership seems to be in Article 6(2) of the 1946 Agreement between the UK and Canada. Occasional references to beneficial ownership are found in conventions concluded in the 1950s, but the application of a beneficial ownership limitation on a regular basis seems to have become part of UK treaty practice around the mid-1960s.

Despite the regular use of the beneficial ownership limitation, the exact meaning and impact of this limitation is far from clear.[27] To date, the author is not aware of any reported UK cases on the meaning of the beneficial ownership limitation. Litigation was due to have commenced earlier this year which would have elucidated the meaning of the provision. Sadly, the case was settled before the litigation commenced.

This particular issue arises because of the technical meaning in UK domestic law of "beneficial ownership". In domestic law, beneficial ownership is contrasted with legal ownership. In the context of a trust, in particular, the trustee is the legal owner of trust property, but the beneficial owner is the beneficiary. It remains an open issue whether the beneficial ownership limitation in the UK's DTCs has a narrow scope to exclude only those who, though the legal owners of property, are required to hold the income from that property for the benefit of another person, or whether the limitation has a wider scope.

This contrast can be illustrated by the circumstances which very nearly gave rise to litigation earlier this year. A company in liquidation in its foreign state of incorporation sought the benefit of reduced withholding tax on interest received from the UK under the relevant UK DTC. It is an established rule of UK domestic law that a company in liquidation ceases to be the beneficial owner of its property[28] (since the company must now hold its assets for the benefits of its creditors and, if available, for its shareholders). The Inland Revenue sought to deny the benefits of the tax treaty on the grounds that the company in liquidation was not the beneficial owner of the interest received. The argument for the company would have been that beneficial ownership does not have its technical meaning under UK domestic law, but must be given a

[27] The best discussion of this issue is found in J. Avery Jones, "The treatment of trusts under the OECD Model convention" [1989] B.T.R. 41 and 65, at pp. 68-71.

[28] See *Ayerst v C&K (Construction) Limited* [1976] AC 167.

meaning consistent with its use in international conventions based upon the OECD Model and concluded with countries which do not recognize the distinction between legal and beneficial ownership.

Sadly, this issue will not now be ventilated in this litigation. The meaning of the beneficial ownership limitation in UK DTCs remains, therefore, a matter of some uncertainty.

It seems highly unlikely that the inclusion of a beneficial ownership limitation could be regarded as incompatible with EU norms since such a limitation operates regardless of the nationality or residence of the beneficial owner. Such beneficial ownership limitations are also found in the OECD Model: their inclusion may be compatible with the sovereignty of Member States in tax matters.[29]

6.4 Current standard limitation of benefit provisions: special relationship provisions

The UK generally follows the OECD model in including a "special relationship" provision in its interest and royalty articles. The UK is also somewhat ahead of the OECD in including a special relationship limitation in certain of the "other income" articles of recent DTCs.[30]

The earliest special relationship provision included in a UK DTC appears to have been in the original Article 7(4) of the UK-Switzerland Convention of 1955 which provided as follows:

> "(4) Where there is a special relationship between debtor and creditor or both debtor and creditor have a special relationship with a third person or persons, and in consequence the amount paid is greater than would have been agreed upon if debtor and creditor had been at arms length, the exemption provided by this Article shall not apply to the excess."

> The wording of the special relationship provision has clearly been refined over time. The current wording applied in UK practice follows that of Article 11(6) and Article 12(4) of the OECD Model, subject to one very important change in wording. Taking the UK-Singapore DTC of 1997 as an example, Article 11(8) begins as follows:

> "(8) Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds, *for whatever reason*, the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship ...".

[29] See *Gilly v Directeur des Services Fiscaux*, 12 May 1998 (Case C-336/96), paragraphs 24 and 31-32.

[30] See, for example, Article 21 of the UK-Argentina DTC of 1997.

The OECD Model, Article 11(6), of course, uses the wording: "the amount of the interest, *having regard to the debt claim for which it is paid*, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship...".

The special relationship provision of the royalties article also uses the term "for whatever reason" in place of the wording in Article 12(4) of the OECD Model (which employs the expression "the amount of the royalties *having regard to the use, right or information for which they are paid*, exceeds the amount which would have been agreed upon...").

The UK approach on these provisions is clearly intended to broaden the scope of the limitation of benefit provision and to allow the treaty provision to be disapplied where the interest or royalties exceeds *for whatever reason* the amount which would have been agreed upon between parties at arm's length. This is clearly intended to allow the Revenue to disregard interest and royalties where no loan or a lesser loan would have been made between parties at arm's length, or no royalty might have been paid between parties at arm's length.

Reference has already been made above to section 808A of the Income and Corporation Taxes Act 1988 which was intended to make clear that, in giving effect to the special relationship provisions in interest articles, the Revenue were to take account of a range of factors and not simply the level of the interest rate. The UK also includes a reservation to Article 11(6) of the OECD Model (though not, interestingly, to Article 12(4)). This reservation provides that the UK

> "[reserves the right] to include after 'exceed' the words 'for whatever reason' in place of 'having regard to the debt claim for which it is paid'. This permits interest and other payments in respect of certain loans to be dealt with as distributions in a range of circumstances provided for in its domestic law, including those where the amount of the loan or the rate of interest or other terms relating to it are not what would have been agreed in the absence of a special relationship".[31]

It seems inherently unlikely that any of these special relationship provisions could be regarded as incompatible with the UK's obligations under EU law. They clearly operate regardless of nationality or residence.

6.5 A new British invention: the main purpose limitation

As well as adopting the OECD's beneficial ownership and special relationship limitation provisions in most of its recent DTCs, the UK has also begun to follow a practice of regularly including a limitation of benefit provision which is

[31] Paragraph 46 of the Commentary to Article 11 of the OECD Model.

not found in the OECD Model. The UK commonly provides in its recent dividend, interest, royalties and, sometimes, the other income articles that:

> "The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment."[32]

The inclusion of this main purpose provision has been raised critically with the Inland Revenue by certain professional bodies. The view of the professional bodies is that a provision which looks to the purpose of the parties leads to uncertainty as to whether or not the convention would apply. Take, for example, a multi-national group with a UK group member. The UK group member requires debt funding. It is decided to fund the debt from one of the other group members in another country in part because of the advantageous DTC between the UK and that country. Can it be said in those circumstances that the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim was to take advantage of the DTC article?

Despite criticism of the introduction of this main purpose limitation, it now appears to have become part of the regular practice of the UK treaty negotiators. It is hoped, however, that the UK is not able to influence the OECD working party to introduce this as part of the OECD Model.

Once again, such provisions operate regardless of residence or nationality and it is hard to see how they could be regarded as incompatible with EU norms.

6.6 Special limitations of benefit

The limitation of benefit provisions mentioned above are ones found in a wide range of UK DTCs. By contrast, however, there are certain provisions found only in one, or a very small number, of the DTCs.

A good example of this is Article 16 of the current DTC between the UK and the United States of 1975.[33] This article was clearly inserted at the request of the US negotiators. It represents a comparatively mild provision by contrast with the more extensive and more onerous limitation provisions generally found in recent treaties with the United States. It seems likely that, if the United Kingdom were to re-negotiate its treaty with the United States, one of the objectives of the US negotiators would be to achieve a much more extensive limitation of benefit provision.

[32] Or similar wording with regard to dividends, royalties or other income.

[33] As amended by the Exchange of Notes of 13 April 1976.

Article 16 of the current treaty provides as follows:

"The provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) of this Convention shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest or royalties arising within the other Contracting State if:

(a) (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or

(ii) the corporation is a resident of the United States and receives more than 80 percent of its gross income from sources outside the United States as determined by and for the period prescribed in Sections 861(a)(1)(B) and (a)(3)(A) of the United States Internal Revenue Code of 1954, as they may be amended from time to time in minor respects so as not to affect their general principle; and

(b) 25 percent or more of the capital of such corporation is owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

(2) Nothing in this Article shall however prevent a claim under the provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) by a United States corporation where more than 75 percent of the capital of that corporation is directly or indirectly owned:

(a) by a United States corporation which receives 20 percent or more of its gross income from sources within the United States as determined by and for the period described in sub-paragraph (1)(a)(ii) of this Article; or

(b) by a corporation (other than a United States corporation) which by reference to the provisions of Section 283 of the United Kingdom Income and Corporation Taxes Act 1970 (as it may be amended from time to time without changing the general principle thereof) would not fall to be treated as a close company; or

(c) by a corporation which is a resident of the United Kingdom and in which more than 50 percent of the voting power is controlled, directly or indirectly, by individuals who are residents of the United Kingdom."

Though this provision is significantly milder than Article 26 of the US-Netherlands Convention of 1992, for example, there may be more of an argument here for saying that the provision is incompatible with EU norms. Article 16(1)(b) would exclude a UK company which enjoyed a lower effective rate of tax and had more than 25 per cent non-UK resident shareholders. This would

therefore impact on companies whose shareholders came to a significant extent from outside the UK, including other EU Member States. Such a company would be unlikely to be protected by Article 16(2)(b) or (c). This seems the only possible candidate of the limitation of benefit provisions discussed so far for which it might be said that there was a potential argument of incompatibility.

This issue is unlikely to arise for decision in practice, however. At present, it is hard to identify any UK companies which would satisfy Article 16(1)(a)(i) – one of the reasons why Article 16 is presently regarded as of little practical significance. Thus, there may in theory be an argument for incompatibility, but no discrimination in practice.

Leaving aside the specific provision with the United States, there are also special provisions found in a small number of other UK treaties. The UK treaty with the Netherlands of 7 November 1980, for example, in the dividend article, contains a unique provision[34] to the effect that:

> "... no tax credit shall be payable where the beneficial owner of the dividends is a company, other than a company whose shares are officially quoted on a Netherlands stock exchange, provided that the conditions for admission to such quotation, and in particular those covering the minimum value of the shares to be admitted, the transferability and the dispersion of the shares, are in conformity with the conditions set out in Schedule A to the Directive of the Council of the European Communities dated 5 March 1979 No. 79/279/EEC, unless the company shows that it is not controlled by a person or two or more associated or connected persons together who or any of whom would not have been entitled to a tax credit if he had been the beneficial owner of the dividend".

This "look through" or derivative benefits approach is not found in quite the same form in any other of the UK's DTCs. There are, however, similar but not identical provisions found in a small number of other UK DTCs.[35] The most recent UK DTCs have not contained a derivative benefits provision of this nature. It appears that this form of limitation of benefit provision is unlikely to be a continuing feature of UK treaty practice.

Again, there may be an argument that such a provision is incompatible with EU norms. Where the recipient of the dividend is a non-quoted Dutch company, the controlling shareholders would have to show that they would be entitled to a tax credit if they had been the beneficial owners of the dividends. The UK extends the dividend tax credit under many – but by no means all – of its tax treaties. Within the EU, the treaties with Germany, Greece and Portugal do not extend the dividend tax credit to residents of the other state. Unquoted

[34] Article 10(3)(d)(i).

[35] See, for example, Article 10(4)(d) of the Convention with Norway, Article 10(3)(d) of the Convention with Luxembourg and Article 10(3)(d) of the Convention with Switzerland.

Dutch companies controlled by shareholders resident in those states would be disadvantaged by comparison with companies controlled by shareholders from other states. In essence, this is a basis for a potential argument of incompatibility: whether such an argument would be successful remains to be seen.

6.7 Former limitation of benefit provisions

Aside from looking at the provisions which are currently employed in some of the UK's DTCs, it is also rather interesting to see provisions that were previously employed but no longer appear to be part of UK treaty practice.

6.7.1 Subject to tax provisions

The vast majority of the early DTCs concluded by the UK provided that relief from tax on dividends, interest and royalties (if the convention covered all of these categories of income) would only apply if the taxpayer was subject to tax in the other treaty state. Examples of this may be found, for example, in Articles 6 and 7 of the former convention with the Netherlands of 1950. Around the mid-1960s, however, the UK began to drop the "subject to tax" requirement, at roughly the same time as it began to adopt the beneficial ownership formulation of the OECD Model. This may simply have been a move to follow the OECD format (which does not contain a subject to tax limitation) or the result of a decision that a taxpayer may be entitled to treaty benefits even though the taxpayer is not subject to tax in the other state on that particular income. The UK Revenue appear to accept as a general principle that a resident of a treaty state may be entitled to the benefit of a DTC, even though that person is not in fact subject to tax on that particular income.

Though the subject to tax limitation is no longer regularly employed in new DTCs by the UK, it is still sometimes found in DTCs negotiated which replace earlier conventions which followed that wording.

6.7.2 Arm's-length provisions

A number of the UK's earlier DTCs limited the benefit of certain articles only to an arm's length, or a "fair and reasonable", amount of interest or royalties. An example is paragraph 7(1) of the arrangement with British Guiana of 1947 which provides as follows:

> "but no exemption shall be allowed under this paragraph in respect of so much of any royalty as exceeds an amount which represents a fair and reasonable consideration for the rights for which the royalty is paid".

This wording seems to have been dropped, with the adoption of the special relationship provision in its place.

6.7.3 Pre-acquisition dividends

During the mid-1960s a large number of the existing UK DTCs were amended, and new DTCs were concluded, to contain wording which denied the benefits of the dividend article to dividends paid out of pre-acquisition profits. An example of this is found in Article 6(4) of the UK-Switzerland Convention which provided as follows:

> "(4) If the beneficial ownership of a dividend is not subject to tax in respect thereof in the territory of which he is a resident and owns 10% or more of the class of shares in respect of which the dividend is paid, then neither paragraph (1) or paragraph (2) of this Article shall apply to the dividend to the extent that it can have been paid only out of profits which the company paying the dividend earned or other income which it received in a period ending 12 months or more before the relevant date. For the purposes of this paragraph the term 'relevant date' means the date on which the beneficial owner of the dividend became the owner of 10% or more of the class of shares in question. Provided that this paragraph shall not apply if the beneficial owner of the dividend shows that the shares were acquired for bona fide commercial reasons and not primarily for the purpose of securing the benefit of this Article."

This provision, denying treaty benefits for dividends paid out of pre-acquisition profits, appears to have disappeared from recent UK treaty practice.

6.7.4 Disposal of debts

Similar to the provisions on dividends out of pre-acquisition profits were provisions relating to debt-claims which had been disposed of. An example of this is Article 9(6) of the 1967 agreement with Trinidad and Tobago which provided as follows:

> "(6) The provisions of paragraph (1) of this Article shall not apply to interest on any form of debt-claim dealt in on a Stock Exchange where the beneficial owner of the interest –
> a. is not subject to tax in respect thereof in the territory of which it is a resident; and
> b. sells (or makes a contract to sell) the debt-claim from which such interest is derived within three months of the date on which such beneficial owner acquired such debt-claim."

Presumably the type of arrangements with which this provision is concerned would now be excluded by the "main purpose" limitation discussed above.

Looking at these various types of limitation of benefit provision formerly included in the UK's DTCs, it is hard to see that any of them might be regard-

ed as incompatible with EU norms. They all operate regardless of residence and nationality, and would be unlikely to be regarded as incompatible with the fundamental freedoms of the EU.

7. Some conclusions: the UK's general approach to limitation of benefit provisions

One may now venture a few conclusions with regard to the UK's approach to limitation of benefit provisions.

The initial concern of the UK seems to have been that DTCs should function to avoid double taxation and should not operate to benefit a person not subject to tax in both treaty states. Hence the inclusion of a "subject to tax" limitation in virtually all of the early DTCs concluded by the UK. Hence, also, the introduction from an early date of the remittance limitation to prevent a person taxable only on a remittance basis from enjoying the benefit of the treaty without being subject to tax in the UK.

During the 1960s, however, the UK seems to have become more concerned with the possibility that taxpayers were arranging their affairs specifically to obtain the benefit of DTC provisions. At that time one sees the appearance of limitations on dividends paid out of pre-acquisition profits, and interest where the debt-claim has been temporarily acquired.

The major concern of the UK with regard to limitation of benefits came about, undoubtedly, with the extension of dividend tax credits to persons resident in the other treaty state. The first of the UK DTCs to contain such a provision was the 1975 convention with the US. One sees, following this, dividend articles containing more elaborate limitation of benefit provisions. An example is the UK-Netherlands provision discussed above.

Current UK practice is to protect the operation of the treaties by a number of limitation of benefit provisions, many of them of relatively wide and general scope. Thus the UK regularly includes special relationship provisions with a formulation that is wider than the OECD formulation, as well as including main purpose limitations.

In the absence of litigation, however, the exact scope of some of these limitation provisions remains to be determined. This is true, particularly, of the beneficial ownership limitations found in a large number of the UK's DTCs.

Few, if any, of the UK's limitation of benefit provisions could be regarded as serious candidates for an argument that they were incompatible with the norms of the EU. Most operate against a particular form of treaty abuse, regardless of residence or nationality of the persons seeking to employ the DTC. The only exceptions to this are the specific provisions included in the dividend articles of a small number of DTCs. Of these, it is perhaps Article 10(3)(d)(i) of the Netherlands Convention which provides the most likely target of such an attack since it may operate to deny the dividend tax credit to companies owned by persons resident in certain EU Member States.

For a country with a wide network of DTCs, it is surprising how much uncertainty remains over the scope of the limitation of benefit provisions included in this network of DTCs. This uncertainty is likely to be reduced only by litigation clarifying the meaning and scope of the limitation of benefit provisions.