British Tax Review
2011
A note on recent UK tax treaty developments
Philip Baker
Subject: Tax
Keywords: Double taxation treaties; International co-operation; Residence
Legislation: Protocol of 2011 to the Mauritius-United Kingdom Double Tax Treaty
Protocol of 2010 to the South Africa-United Kingdom Double Tax Treaty
Bahrain-United Kingdom Double Tax Treaty 2010
Germany-United Kingdom Double Tax Treaty 2010
Hong Kong-United Kingdom Double Tax Treaty 2010
Since January 1, 2010, the UK has signed two protocols to existing double taxation arrangements (DTAs) with South Africa and Mauritius, and has signed three comprehensive DTAs with Bahrain,[1] Germany[2] and Hong Kong.[3] This note discusses certain features of these protocols and these new DTAs.[4]

Exchange of information

Clearly a significant purpose behind the protocols was to update the existing DTAs with Mauritius[5] and South Africa[6] by including an Exchange of Information article based upon the new version of article 26 of the OECD Model Tax Convention on Income and Capital (OECD Model)[7] as it was updated in 2005 to reflect the new "international consensus" on transparency and exchange of information. This was, in fact, the sole purpose of the protocol with Mauritius[8] which was needed to update the existing 1981 DTA to reflect the new international consensus.

The Exchange of Information articles, both in the two protocols and in the three new DTAs, provide for the exchange of information that is "foreseeably relevant" for implementing the convention and for administration or enforcement of domestic tax laws. They confirm that each state is required to gather information solely for the purposes of exchange with the other state, even though it has no domestic interest in obtaining that information.[9] It also reflects the international consensus that neither state may decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or fiduciary capacity, or because it relates to ownership interests in a person.[10]

Particularly interesting in the new DTAs with Germany and Hong Kong are the clarifications of the scope of exchange of information in the protocols to each of the DTAs.

The protocol with Germany contains specific safeguards where personal data is exchanged, including the obligation to inform the other state how the information was used, to inform the person concerned on application, and to delete the information as soon as it is no longer required.[11]

The protocol to the Hong Kong DTA states specifically that the article does not require information exchange on an automatic or spontaneous basis,[12] that information exchanged shall not be disclosed to any third jurisdiction, and that in the UK the information may be disclosed to certain bodies but only when investigating complaints against HMRC.[13] The ECOFIN Council has recently adopted an amended Directive on mutual administrative assistance[14] may point towards new directions for exchange of information. It requires automatic exchange, permits spontaneous exchange and allows information in certain circumstances to be passed on to non-tax authorities and to third states.

One might see the protocols to the German and Hong Kong DTAs as reflecting three current developments. First, the debate over whether the international standard on transparency and exchange of information requires automatic and spontaneous exchange, or only exchange on request. Secondly, a move (reflected in the new Directive) towards the onward transmission of information obtained by exchange either to other interested states, or to other governmental authorities (not simply those concerned with the assessment and collection of tax). Finally, as seen particularly in the protocol to the UK-Germany DTA, a concern that more extensive exchange of information requires greater safeguards, particularly where personal data is concerned.

REIT dividends

The UK-South Africa Protocol,[15] and each of the three new comprehensive DTAs, contains a provision--which now must be seen as part of the UK's regular treaty practice--to deal specifically with dividends paid out of Real Estate Investment Trusts (REITs) (defined as an investment vehicle which distributes most of its income annually and whose income from immoveable property is exempted from tax). This is a change in treaty policy necessitated by the introduction of legislation governing REITs in the UK. Since these are regarded as transparent for tax purposes, so that the shareholder is treated as if he were receiving income from the underlying land, the UK would wish to impose a withholding tax on these REIT dividends. Existing DTAs did not provide for such tax on dividends, hence the need to include specific provisions in the UK's DTAs.

Assistance in Collection of Taxes

The third feature in the South Africa Protocol is the inclusion of a new article on Assistance in Collection of Taxes.[16] A similar provision is included in the new DTA with Germany.[17] An equivalent provision was not included, however, in the new DTAs with Bahrain or Hong Kong. This suggests that the UK policy on such articles is to include them if the other negotiating state wishes to do so, but the inclusion of such an article is not, as such, a clear target of UK negotiating policy.

One particular point might be noted in relation to the articles on Assistance in Collection in the UK-Germany DTA and the UK-South Africa Protocol. Both state that there is no obligation to provide assistance in the collection of taxes if the requested state considers "that the taxes with respect to which assistance is requested are imposed *contrary to generally accepted taxation principles* " (writer's emphasis).[18] This restriction on the obligation to collect taxes is not found in the OECD Model's article on Assistance in Collection. Presumably, the inclusion of this additional wording reflects the concern on the part of the UK that it might be asked to grant assistance for the collection of taxes which were not imposed under generally accepted principles. However, the wording raises the rather debateable issue of what "generally accepted taxation principles" are. One might assume, for example, that they include the principle that a state may tax its residents on their worldwide income, and non-residents on local source income. This wording might be used, therefore, to refuse assistance where the tax is being imposed on a different, novel, jurisdictional basis, and there is no nexus of either residence or source with the country seeking to collect the tax.

The definition of "Residence"

The normal definition of a resident of a Contracting State is a person who is:

"liable to tax therein by reason of his domicile, residence, placement of management, place of incorporation or any other criteria of a similar nature."[19]

However, the UK-Hong Kong and UK-Bahrain DTAs needed to tackle the problem that, in the case of Bahrain, most persons who are "resident" there (in a non-technical sense) are not liable to tax, and, in the case of Hong Kong, the tax system is based upon source in the jurisdiction and does not use the connecting factor of residence. Consequently, both DTAs had to include innovative provisions to define "residence".

The Bahrain arrangement does so by identifying as a resident of Bahrain any individual who has a permanent home, centre of vital interests, or habitual abode in Bahrain, as well as a company incorporated or having its place of effective management in Bahrain.[20] None of these terms is defined further in the DTA, and so, in principle, the terms would take their meaning from the law of Bahrain (by applying the general renvoi provision in article 3(2) of the DTA). With the exception of incorporation of a company, however, it is unlikely that the law of Bahrain has a definition or concept for tax purposes of these terms. All of them--centre of vital interests, habitual abode, for example--have a meaning in the context of the model double taxation conventions. The absence of a domestic law meaning to these terms under Bahraini tax law may be regarded as part of the context to disapply any domestic meaning. In those circumstances, the terms are likely to be given an "international fiscal meaning" consistent with the commentaries to the OECD and UN Models.

The approach taken in the UK-Hong Kong DTA[21] is slightly different and comes closer to a specific definition of residence in Hong Kong for purposes of the arrangement. Article 4(1)(a) of the UK-Hong Kong DTA defines a resident of the Hong Kong Special Administrative Region (SAR) as an individual who ordinarily resides in Hong Kong or who stays in Hong Kong for more than 180 days during a year of assessment (or more than 300 days in two consecutive years of assessment, one of which is the relevant year of assessment), a company incorporated in Hong Kong or centrally managed and controlled there, and any other person constituted under the laws of Hong Kong or (if constituted outside the Hong Kong SAR) centrally managed and controlled in Hong Kong. This rather precise definition was necessitated by the absence of a definition of residence in Hong Kong domestic tax law. More generally, this wording would function as a workable definition of individual and corporate residence for any DTA with a jurisdiction that did not utilise that concept in its domestic law, or simply had no taxes to which residents were subject.

The three new DTAs all adopt the place of effective management (POEM) tiebreaker for dual residents other than individuals.[22] The provision in the UK-Hong Kong DTA is a little unusual, however, in that it adopts the POEM tiebreaker but then states as follows:

"In cases of doubt, the competent authorities of the Contracting Parties shall endeavour to determine by mutual agreement the Party in which that person's place of effective management is exercised, and in doing so, shall take into account all relevant factors. In the absence of such agreement, that person shall not be entitled to claim any benefits provided by this Agreement, except those provided by article 21, 22 and 23."[23]

This is an interesting variant on the alternative form of tiebreaker now in general use, which is based upon determination by the competent authorities.[24] The wording in the Hong Kong DTA adopts the test of POEM, but also contemplates a role for the competent authorities in determining doubtful cases, and limits the application of the DTA where it has not been possible to apply the tiebreaker and determine a single country of residence. The writer wonders if this may become a more widely used pattern for future DTAs.

Business Profits--the use of old article 7

Perhaps one should not attribute too much weight to the fact that all of the three new DTAs adopt the "old" wording of the Business Profits article, based upon the article contained in the OECD Model prior to the 2010 update. The new version of article 7 of the OECD Model was, of course, only adopted in July 2010, but the draft wording of the new article had been in circulation for some time previously and, one might have anticipated that the new wording would be used, for example, in the DTA with Germany at least.

It would certainly be too much to assume from the use of the old form of wording that the UK intends to continue using the old form and not the new wording of article 7 in future DTAs. In fact, contrary indications are that the UK will use the new wording, at least with those other OECD member countries that are willing to adopt it.

However, the fact that in 2010 the UK is using the old wording of article 7 in new DTAs indicates that it may be many decades to come before the new wording (and the new basis for attribution of profits to permanent establishments) will be found in the majority of the UK's DTAs.

Pension schemes

One policy decision that seems to come out clearly from all of the recent negotiating activity is the intention to ensure that pension schemes benefit from the DTAs, even though they may not be liable to tax on their investment income. The protocol to the Hong Kong DTA defines pension schemes for the purposes of the arrangement[25] ; both the Hong Kong and the Bahrain DTAs provide that interest beneficially owned by a pension scheme is exempt from tax at source.[26]

The UK-Germany DTA contains a number of indications that pension schemes are intended to enjoy the benefits of the arrangement. The German arrangement also contains an unusual provision on the taxation of income from pensions as follows:

"(3) Notwithstanding the provisions of paragraph 1 [which provides for taxation only in the stage of residence of the recipient of the pension], such a pension, similar remuneration or annuity arising in a Contracting State which is attributable in whole or in part to contributions which, for more than fifteen years in that State,

(a) did not form part of the taxable income from employment, or

(b) were tax-deductible or

(c) were tax-relieved in some other way

This provision thus retains for the state which gave tax relief on the build-up on the pension fund the exclusive rights to tax that pension. It does not reflect standard DTA wording, but it will be interesting to see if it begins to feature more frequently in the UK's DTAs.

Arbitration

The new DTAs with Bahrain and Germany both follow the post-2008 version of the OECD Model in providing for the arbitration of competent authority proceedings where the authorities have been unable to resolve the issue within two years (in the case of Germany) or three years (in the case of Bahrain) of the commencement of the proceedings.[27] Though there is no equivalent provision for arbitration in the Hong Kong arrangement, it is reasonable to draw the inference that the inclusion of an arbitration provision is now part of UK treaty policy, at least if the other negotiating party is willing to agree to it. As a new development, this will no doubt be followed by the establishment of procedural rules and panels of arbitrators willing to serve in cases of such disputes.

Innovative features of the UK-Germany DTA

And finally, there are some rather interesting and innovative features in the new UK-Germany DTA, specifically in the protocol.

First, there is a specific provision dealing with triangular cases. This applies where an enterprise of Germany derives dividends, interest or royalties from the UK, but that income is attributable to a permanent establishment which the German enterprise has in a third state. In theory, the payment would be made from a source in the UK to a resident of Germany. However, Germany might exempt the profits of the permanent establishment in the third state, and an unintended reduction in overall taxation would result. For that reason, the protocol provides that, if the combined taxation in Germany and the third jurisdiction is less than 60 per cent of the tax that would have been payable in Germany, then the UK should apply a rate not exceeding 15 per cent to the dividends, interest or royalties. This ensures, therefore, a minimum level of source taxation in the UK if the income is not subject to significant taxation in Germany and the third state.

Finally, the UK-Germany DTA was accompanied by a joint declaration which contains the following understanding:

"1. Improper use of the Convention

Having regard to paragraph 7-12 of the Commentary to article 1 of the OECD Model Tax Convention, it is understood that this Convention shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance where those provisions are used to challenge arrangements which constitute an abuse of the Convention.

It is further understood that an abuse of the Convention takes place where a main purpose for entering into certain transactions or arrangements it is to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions of the Convention."

The writer is tempted to speculate that this provision on improper use of the Convention was requested by Germany, but it is interesting to find such a provision on improper use of a DTA concluded by the United Kingdom. This is not a general recognition of the concept that a DTA cannot be relied upon in an abusive context, but rather a clarification of the interrelationship between provisions of the DTA and domestic anti-avoidance legislation. It will be interesting to see, however, whether similar provisions start to appear in other DTAs concluded by the United Kingdom.[28]

Philip Baker

B.T.R. 2011, 2, 125-131

1.Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Kingdom of Bahrain for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains (this agreement has not yet entered into force) (UK-Bahrain DTA). Available at: *http://www.hmrc.gov.uk/international/bahrain.pdf.* [Accessed March 18, 2011.]

2.UK/Federal Republic of Germany Double Taxation Convention (UK-Germany DTA). Available at: *http://www.hmrc.gov.uk/international/germany.pdf.* [Accessed March 17, 2011.]

3.UK/Hong Kong Double Taxation Agreement and Protocol (UK-Hong Kong DTA). Available at: *http://www.hmrc.gov.uk/international/hong-kong-uk-dta.pdf.* [Accessed March 17, 2011.]

4.This note does not discuss the tax information exchange agreements (TIEAs) which the UK has signed during this time, nor the air transport agreement with Brazil signed on September 2, 2010.

5.Protocol between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Mauritius to amend the convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on February 11, 1981, as amended by the protocols signed at Port Louis on October 2, 1986 and March 27, 2003 (this protocol has not yet entered into force) (UK-Mauritius Protocol). Available at: *http://www.hmrc.gov.uk/international/mauritius-uk.pdf.* [Accessed March 18, 2011.]

6.Protocol between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of South Africa to amend the convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains, signed at London on July 4, 2002 (this protocol has not yet entered into force) (UK-South Africa Protocol). Available at: *http://www.hmrc.gov.uk/international/uk-sa-dta.pdf.* [Accessed March 18, 2011.]

7.OECD Model Tax Convention on Income and on Capital. Available for download at: *http://www.oecd.org/document/37/0,3343,en_2649_33747_1913957_1_1_1_1,00.html.* [Accessed March 17, 2011.]

8.UK-Mauritius Protocol, above fn.5.

9.OECD Model, above fn.7, art.26(4).

10.This reflects, of course, the wording of the OECD Model, above fn.7, art.26(5).

11.UK-Germany DTA, above fn.2, protocol, para.4.

12.Similar statements have been included in protocols or exchanges of notes to a small number of other recent DTAs: see, for example, Switzerland, available at: *http://www.hmrc.gov.uk/international/uk-switzerland-dta.pdf* [Accessed March 18, 2011] and Austria, available at: *http://www.hmrc.gov.uk/international/uk-austria-itc1969.pdf* [Accessed March 18, 2011].

13.UK-Hong Kong DTA, above fn.3, protocol, para.4.

14.See Press Release 6514/11 of February 16, 2011. This is now Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC [2011] OJ L64/1.
15.UK-South Africa Protocol, above fn.6.
16.UK-South Africa Protocol, above fn.6, new art.25A.
17.UK-Germany DTA, above fn.2, art.28.
18.UK-South Africa Protocol, above fn.6, art.25A(8)(e), and UK-Germany DTA, above fn.2, art.28(8)(e).
19.OECD Model, above fn.7, art.4.
20.UK-Bahrain DTA, above fn.1, art.4(1)(a).
21.UK-Hong Kong DTA, see above fn.3.
22.UK-Germany DTA, above fn.2, art.4(3); the UK-Bahrain DTA, above fn.1, art.4(4); and the UK-Hong Kong DTA, above fn.3, art.4(3).
23.UK-Hong Kong DTA, above fn.3, art.4(1)(3). These are the articles dealing with elimination of double taxation, non-discrimination and mutual agreement procedure.
24.See, for example, Commentary on article 4 of the OECD Model, above fn.7, para.24.1.
25.UK-Hong Kong DTA, see above fn.3, Protocol [3].
26.UK-Bahrain DTA, above fn.1, art.11(3)(a)(v) and the UK-Hong Kong DTA, see above fn.3, art.11(3)(a)(iv).
27.UK-Germany DTA, above fn.2, art.26(5), and of the UK-Bahrain DTA, above fn.1, art.23(5).
28.Double taxation treaties; International co-operation; Pension schemes; Real estate investment trusts; Residence; Tax administration; Tax information exchange agreements