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A note on recent UK tax treaty developments

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In the period between March 1, 2011[1] and November 1, 2011, the UK has signed four new comprehensive double taxation agreements (DTAs).[2] These are: with Ethiopia, signed on June 9, 2011[3] (replacing an air transport agreement dating back to 1977); with China, signed on June 27, 2011[4] (replacing the earlier comprehensive agreement dating from 1994); with Armenia, signed on July 13, 2011[5] (which is a completely new convention where the UK had no previous convention); and with Hungary, signed on September 7, 2011[6] (replacing an earlier convention of 1977).

This note discusses first certain features found in all four (or most) of these new comprehensive DTAs, then it discusses special features found in only some of the four.

Features found in the four DTAs

The tie-breaker for entities

It is interesting to note that the DTAs with China and Ethiopia both adopt the "place of effective management" tie-breaker for entities, while the DTAs with Armenia and Hungary have the alternative formulation (where cases of dual residence are determined by mutual agreement between the competent authorities). This may simply reflect the negotiating position of the other country, or it may reflect a UK concern that, in the case of certain countries, dual-resident companies with the place of effective management in the other jurisdiction are being used as a way of exiting from the UK. It seems less likely that there would be such a risk in the case of China and Ethiopia.

Article 7: business profits

The point might be noted that all four DTAs adopt the old, pre-2010 wording in the Organisation for Economic Cooperation and Development (OECD) Model for Article 7 (or a variant on that wording); none adopt the new wording which reflects the "authorised OECD approach" to the attribution of profits to permanent establishments. Since only some of the OECD member countries accept the new wording and the new approach, it is likely that it will only be the UK's DTAs with those specific countries that adopt the new wording. At present, no DTAs have been signed which have the new wording.

Real estate investment trusts (REITs)

The dividend article in all four of the DTAs contains a specific provision for dividends paid out of income derived directly or indirectly from immovable property, and provide for a 15 per cent tax to be withheld on such dividends. This reflects what now appears to be settled UK practice to provide expressly for a higher level of withholding tax for distributions paid by REITs.

Elimination of double taxation

It is interesting to note that the UK having now adopted exemption for foreign dividends, the standard wording of the article on the elimination of double taxation has been amended to reflect this. All four DTAs contain wording based upon a formula similar to:

"a dividend which is paid by a company which is a resident of [State X] to a company that is a resident of the United Kingdom shall be exempted from United Kingdom tax when the conditions for exemption under the law of the United Kingdom are met."

Because there may still be circumstances where the dividend from overseas is not exempted, the paragraph in the article continues by providing for an underlying credit in the case of dividends not exempted under UK law.

The new optional exemption for branch profits is now available as a matter of UK domestic law.[7] Presumably, future UK treaties may need to provide that, where an election is made to exempt branch profits, then credit will not be available for foreign tax on the profits attributable to the permanent establishment. One point that may also need to be considered, now that the UK has both an exemption for dividends and an optional branch exemption, is whether this is exemption with progression: that is, the exempt income is taken into account in computing the tax rate applicable to other income. Bearing in mind that the exemptions for dividends and for branches are applicable to companies, this is not particularly significant so long as there is a single, mainstream rate of corporation tax.

Arbitration

Of the four new DTAs, only one--that with Armenia--contains the new wording now found in the OECD Model (in the mutual agreement procedure article) and providing for arbitration. This suggests that the inclusion of the provision for arbitration depends upon the position taken by the other Contracting State, and some states (China is an example) do not appear to be very enthusiastic about arbitration. It is a little surprising, however, given the existence of the Arbitration Convention in the European Union,[8] that the DTA with Hungary does not provide for arbitration.

Pension funds

It is notable that recent UK DTAs have sought to clarify the position of pension schemes and their entitlement to treaty benefits. This is dealt with in three of the new DTAs: with Armenia in the protocol, with Ethiopia also in the protocol, and with Hungary in the article on the definition of a "resident" which provides that "the term 'resident of a Contracting State' includes:- a pension scheme established in that State…"[9] A "pension scheme" is defined in Article 3(1)(1).

Service PEs

The new DTAs with China[10] and Ethiopia[11] both contain provisions that the furnishing of services for a period aggregating more than 183 days will constitute a permanent establishment (PE). This is not terribly surprising since China, in particular, will usually ask for a services permanent establishment provision. What is a little surprising is there is no equivalent provision in the DTA with Armenia.

Special provisions in the new DTAs

For aficionados of DTAs, sometimes the most exciting provisions are those that are unusual (that is, not found in the model conventions). There is a smattering of such unique provisions in the four new DTAs.

Fiscally transparent persons

The Armenian DTA contains a separate article, Article 24, dealing with fiscally transparent persons. The wording, however, is not totally unique and is found in other DTAs (with the US, for example):

"An item of income, a profit or gain derived through a person who is fiscally transparent under the laws under either Contracting State shall be considered to be derived by a resident of a Contracting State to the extent that the item is treated for the purposes of the taxation of law of such Contracting State as the income, profit or gain of a resident."

It is perhaps speculative to suggest that such provisions may become regular features of the UK's DTAs.

Remittance limitation

It is a curious point to note that, of the four new DTAs, only the one with Hungary contains the standard remittance limitation[12] that has been found in most of the UK's DTAs since the early 1960s. This provides that relief under the DTA will only be granted by the other state to the extent that income is remitted and taxed in the UK. Since this is an issue for the relief granted by the other state (unless it also has a remittance basis of taxation, in which case it operates reciprocally) it is presumably a matter of the other state seeking this limitation rather that the UK proposing it.

Most favoured nation

The protocol to the DTA with Armenia[13] contains a form of "most favoured nation" (MFN) provision which applies to interest arising in Armenia. If in a subsequent convention Armenia agrees with a Member State of the OECD to provide a lower rate of tax than the one in Article 11(2) of the DTA with the UK (which is 5 per cent), then that lower rate will apply to interest paid to a resident of the UK. These types of MFN provisions are quite common in DTAs generally, but not especially common in DTAs signed by the UK.

Miscellaneous rule on DTAs and anti-avoidance measures

Article 23 of the convention with China contains a "miscellaneous rule" dealing with the relationship between the DTA and domestic anti-avoidance provisions. It states as follows:

"Nothing in the Agreement shall prejudice the right of each Contracting State to apply its domestic laws and the measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement".[14]

Provisions of this nature, preserving the effect of domestic anti-avoidance measures so they are not overridden by DTAs, have begun to appear in the treaty practice of several other states: it is common to find them in recent treaties concluded by Israel, for example.[15] While the underlying intention of these provisions may be relatively clear, it is not helpful that this particular wording states that the domestic laws concerned with the prevention of tax evasion and tax avoidance "whether or not described as such" shall prevail: that makes it somewhat unclear as to what domestic law will prevail. It is also unhelpful that they prevail provided that "they do not give rise to taxation contrary to this Agreement". If the effect of the domestic law is that a relief from tax granted by the DTA is to be denied, then it is very hard to see how the domestic law does not give rise to taxation contrary to the DTA.

Tax sparing

It is understood that the usual policy approach of the UK is not to support tax sparing by giving credit for tax which has been waived by the other state in connection with legislation to encourage investment in the country. However, the convention with Ethiopia, in Article 22(3), does contain a provision for a shadow credit for Ethiopian tax which has been waived under specific incentive legislation. In keeping with practice where such tax sparing is granted, by Article 22(4) the shadow credit is limited to income or profits arising in the first 10 years after the date on which the DTA entered into force and only for incentive schemes where the income arises within the first 10 years after the grant of the exemption.[16]

Triangular provisions

Those with a particular interest in DTAs can become very excited when discussing "triangular cases". Those are situations where three states are involved: income arising in one Contracting State is paid to a PE in a third state of a resident of the other Contracting State. The UK-Hungary DTA contains, in Article 23(2), a specific provision dealing with such triangular cases.[17] In general, the state of source is not required to reduce its taxes in accordance with the DTA if the combined tax in the state of the PE and the state of residence of the recipient enterprise is less than 60 per cent of the tax that would have been payable if the income were derived directly by the recipient and not attributable to the PE. A similar triangular provision was included recently in the UK-Germany DTA.[18] It is too early to say whether this will become a regular feature of UK treaty practice.[19]

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This is the second in a series of notes by the writer that will discuss recent UK tax treaty developments. The first in the series was published in [2011] BTR 125.

B.T.R. 2011, 6, 626-630

1.The previous note on recent UK tax treaty developments covered developments from January 1, 2010 to March 1, 2011.

2.This note does not discuss the UK-Switzerland co-operation agreement signed on October 6, 2011. That agreement (or rather, complex of separate agreements and memoranda) merits a separate discussion all of its own.

3.UK-Ethiopia Double Taxation Convention, signed in London on June 9, 2011. Available for download at: *http://www.hmrc.gov.uk/taxtreaties/signed.htm* [Accessed November 9, 2011].

4.UK-China Double Taxation Agreement, signed in London on June 27, 2011. Available for download at: *http://www.hmrc.gov.uk/taxtreaties/signed.htm* [Accessed November 9, 2011].

5.UK-Armenia Double Taxation Convention, signed in London on July 13, 2011. Available for download at: *http://www.hmrc.gov.uk/taxtreaties/signed.htm* [Accessed November 9, 2011].

6.UK-Hungary Double Taxation Convention, signed in Budapest on September 7, 2011. Available for download at: *http://www.hmrc.gov.uk/taxtreaties/signed.htm* [Accessed November 9, 2011].

7.Under the Finance Act 2011 s.48 and Sch.13.

8.Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises 90/436/EEC [1990] OJ L225/10.

9.UK-Hungary DTA Art.4(2), above fn.7.

10.UK-China DTA Art.5(3)(b), above fn.5.

11.UK-Ethiopia DTA Art.5(4), above fn.4.

12.UK-Hungary DTA, above fn.7, Art.23(1).

13.UK-Armenia DTA, above fn.6.

14.UK-China DTA, above fn.5, Art.23.

15.And there is a similar provision in the joint declaration accompanying the UK-Federal Republic of Germany DTA, available for download at: *http://www.hmrc.gov.uk/taxtreaties/in-force/g.htm* [Accessed November 9, 2011] and which was discussed in [2011] BTR 125, above fn.1, at 130 to 131.

16.UK-Ethiopia DTA, above fn.4.

17.UK-Hungary DTA, above fn.7.

18.UK-Federal Republic of Germany DTA, above fn.16, and commented on in [2011] BTR 125, above fn.1, at 130.

19.Armenia; China; Double taxation treaties; Ethiopia; Hungary