

## Chapter 7

### Bi-lateral tax treaty issues

by  
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#### Bi-lateral tax treaty issues

##### **Introduction**

**[7.1]** This chapter discusses the inter-relationship between the reforms of the taxation of foreign profits and the UK's existing network of double taxation conventions. It considers what impact (if any) the reforms will have on the network of tax treaties, and what restrictions (if any) apply to the reforms as a result of the existing network. The chapter also contains a discussion of certain tax treaty developments that have taken place at the level of the OECD which are relevant both for branch exemption and for the new (post-2012) CFC legislation.

**[7.2]** Of the four elements that made up the reforms enacted in FA 2009, neither the interim amendments to the CFC legislation nor the introduction of the system of reporting international movements of capital were likely to have had any double taxation convention implications. Branch exemption and the new, post-2012 CFC legislation is discussed under the OECD Model discussion. It seems entirely clear that the post-2012 CFC legislation will not conflict with provisions contained in the UK's double taxation conventions because of the description of the CFC charge. TIOPA 2010 s 371BC(1) Step 5 defines the CFC charge as "a sum equal to ... corporation tax at the appropriate rate ... is charged on the chargeable company as if it were an amount of corporation tax ..." It is clear, therefore, that the CFC charge is not corporation tax. The UK's double taxation conventions apply only to taxes listed in the conventions (generally in Article 2), and corporation tax is now always listed as such a tax. The CFC charge is not corporation tax, however, so will not fall within the scope of the conventions<sup>1</sup>.

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<sup>1</sup> This confirms the pre-2013 position under the decision of the Court of Appeal in *Bricom Holdings Ltd v IRC* [1997] STC 1179. The only counter-argument is, in respect of pre-2013 conventions, that the CFC charge is a "substantially similar" charge to corporation tax introduced after the convention was concluded. While this position is not unarguable, it is unlikely to succeed.

**[7.3]** So far as the international movement of capital provisions are concerned, it is hard to see that the abolition of the Treasury Consent regime has any double taxation convention implications whatsoever. It might be argued

that, with a general move towards more effective exchange of information under double taxation conventions, under tax information exchange agreements and under other administrative arrangements, the system of reporting international movements of capital is unnecessary. The obvious counter-argument is that the UK would not necessarily be aware of a transaction, which might lead them to request information from another revenue authority, unless there was the obligation to report large capital movements.

[7.4] The two areas of the FA 2009 reforms that are most likely to have implications for the UK's double taxation convention network are the dividend/distribution exemption and the debt cap provisions. These are discussed below.

#### ***The dividend/distribution exemption and the UK's tax treaty network***

[7.5] It is worth reminding oneself what a fundamental change has been made to the UK system of taxing foreign dividends. Prior to 1 July 2009, all dividends received by UK residents from a non-resident company were liable to UK tax, with a right to a foreign tax credit – both a direct tax credit for foreign tax on the dividend itself, and, in some cases, an indirect tax credit for the underlying tax on the profits out of which the dividend was paid. After 1 July 2009, the vast majority of dividends received by UK-resident companies from non-resident companies are exempt from UK tax. The entire network of the UK's tax treaties since 1945 has been negotiated on the basis that foreign dividends were taxable, and every tax treaty contains a provision for the elimination of double taxation through the credit method, equivalent (broadly) to Article 23B of the OECD Model. It will take years for the UK to negotiate changes to the articles of all its double taxation conventions to replace the existing wording that provides for relief by credit<sup>1</sup>. The new form that the "elimination of double taxation" article in the UK's double taxation conventions will take is discussed below.

<sup>1</sup> It would be an extremely ambitious taxpayer who tried to argue that they were still entitled to a foreign tax credit – both for direct tax and for underlying foreign tax – on a dividend which is exempt as a result of CTA 2009 Part 9A. Presumably the taxpayer would argue that, in not granting the foreign tax credit (even of the exempt dividend), the UK was not acting in accordance with the double taxation convention. The chances of that argument succeeding are negligible.

[7.6] Up until 2009, in the case of foreign tax credit granted under the terms of a double taxation convention, the credit for foreign tax has been granted by domestic law in combination with the "elimination of double taxation" article in the relevant tax treaty<sup>1</sup>. Where no tax treaty applied, credit was granted unilaterally on the basis of domestic legislation which operated as if a notional tax treaty existed with the territory in question<sup>2</sup>. The dividend/distribution exemption is granted under domestic law. It has not been necessary, therefore, to amend the UK's network of tax treaties to grant the exemption. The position is likely to remain for many years, therefore, that many tax treaties provide expressly for relief by credit, while UK domestic law provides for relief by exemption in the case of most foreign-source dividends.

<sup>1</sup> Under TIOPA 2010 s 2 (formerly TA 1988 s 788, in combination with the elimination of double taxation article in the treaty and the provisions of the “credit code” in TIOPA 2010 s 18ff (formerly TA 1988 s 792ff)).

<sup>2</sup> See TIOPA 2010 s 8ff (formerly TA 1988 s 790).

### “Subject to tax” provisions

[7.7] One particular issue that arises from the introduction of the dividend/distribution exemption concerns a limited number of existing tax treaties where the reduced withholding tax on dividends paid from the other country is dependent upon the dividend being “subject to tax” in the UK. CHAPTER 1 of the 2009–10 edition of this work contains a list of those existing tax treaties, as at 1 July 2009, where there was a restriction on the availability of the reduced foreign withholding tax dependent upon the dividend being subject to tax in the UK.

[7.8] Clearly, there were too many of these treaties for the UK to try to renegotiate them before the dividend/distribution exemption came into force. Instead, one of the reasons for introducing the election that a distribution should not be exempt in CTA 2009 s 931R was to ensure that such dividends/distributions might be subject to tax. In principle, this is only a transitional solution, but given the number of double taxation conventions that contain a subject to tax limitation, it may be transitional for some considerable time.

[7.9] The election to waive exemption is a pragmatic solution, but may be less than ideal for several reasons. The most important is that it remains to be seen whether the other country is prepared to accept that a dividend is subject to tax where it would have been exempt from tax, but, by exercising an election to waive exemption, the taxpayer has chosen to make the dividend/distribution taxable. It is quite possible that some countries will consider that a tax liability where the taxpayer has chosen to waive exemption is not a true tax liability but a voluntary payment.

[7.10] Aside from the fact that these countries may, as a matter of principle, conclude that a voluntary waiver of exemption is not a charge to tax in principle, these countries have an incentive to refuse to reduce their withholding tax. In principle, these countries will have agreed to reduce their withholding tax on the basis that the dividend would have been taxable in the UK with a foreign tax credit, and they will have agreed to drop their normal withholding tax on dividends in order to share the tax receipts with the UK and to ensure that the amount of their withholding tax did not exceed the UK tax liability so that there was an overspill problem. If the dividend would now be exempt in the UK (but for the election under CTA 2009 s 931R) why should those countries reduce their withholding tax?

[7.11] Another difficulty with the election under s 931R concerns the timing of the election. An election must be made on or before the second anniversary of the end of the accounting period in which the distribution is received<sup>1</sup>. In principle, there is nothing to prevent the election being made *before* a

distribution is received. If, however, the election is made after the distribution is received, then at the time it is paid the distribution will, in principle, be exempt and not subject to tax: the normal withholding tax in the country of source should apply. On a subsequent election, an application would have to be made for repayment of the excess withholding tax.

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<sup>1</sup> CTA 2009 s 931R(3).

[7.12] In general, it remains to be seen how the other countries concerned which have treaties with these "subject to tax" provisions will react. It is possible that in some cases the countries will refuse the reduced withholding tax and the overall result of the dividend/distribution exemption will be to shift tax receipts to the country of source.

#### **Future provisions in the UK's double taxation conventions**

[7.13] It is interesting to note what changes have been made to the UK's double taxation conventions in the light of the dividend exemption. There are two articles that need to be considered: the dividend article and the elimination of double taxation article.

[7.14] So far as the dividend article is concerned, the UK's position is that it imposes no tax on outbound dividends<sup>1</sup>, and hence has no withholding tax to reduce or eliminate. So long as the dividend tax credit continues to exist, the UK may be willing to extend that to residents of the other contracting state, but existing treaties then impose a tax charge on the dividend plus tax credit which results in no payment being made in respect of the tax credit to a resident of the other contracting state. The only advantage is that, for residents from states applying the credit method of relief, there is now a UK tax charge in respect of which credit can be claimed. In principle, similar provisions could continue to apply, at least with respect to countries that continue to relieve from double taxation by the credit method.

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<sup>1</sup> The exceptions are dividends paid by Real Estate Investment Trusts (REITs) and Property-Authorised Investment Funds where the UK imposes a withholding tax equal to income tax on distributions (see CTA 2010 s 548 and the withholding obligation under ITA 2007 ss 973 and 974). Recent UK double taxation conventions have been amended to provide for a maximum 15% withholding tax on distributions from REITs and other funds distributing income from immovable property.

[7.15] So far as the position in the other contracting state is concerned, it will be interesting to see how other countries react to the UK dividend exemption. The traditional approach in the past was for the foreign country to reduce its normal withholding tax on dividends on the assumption that the dividend would be taxed in the UK, with credit for the foreign tax and the ultimate tax burden on the dividend would be shared between the source country and the UK. Now that the UK exempts the vast majority of dividends it will be interesting to see whether other countries refuse to reduce their domestic withholding tax, or whether they match the UK exemption by dropping completely any withholding tax they would impose on the outbound dividend.

The offer to extend to residents of the other country the one-ninth dividend tax credit (subject to a UK withholding tax) is unlikely to be a major bargaining chip in the hands of the UK negotiators. More effective will be the prospect that investment from the UK into that country will be deterred, by comparison with investment into countries which impose no withholding tax, so that profits can be repatriated entirely free of tax. Countries that already offer an attractive environment for investment from the UK (eg China, India, etc) may think that removing a disincentive to repatriate profits is not a good policy option, and may decide to maintain a higher withholding tax on dividends<sup>1</sup>.

<sup>1</sup> The new 2011 double taxation convention with China maintains a 5% withholding tax where dividends are paid to a company owning 25% or more of the payer, and 10% in all other circumstances (and 15% for REITs and their equivalent).

**[7.16]** The other provision where new wording has needed to be developed is the “elimination of double taxation” article. This article will need to be more complex in the future than in the past. This is partly because the UK is maintaining its credit system for foreign-source income other than dividends, moving to exemption for the vast majority of dividends, but will still need to relieve by credit those dividends that do not benefit from an exemption or where the election to waive exemption in CTA 2009 s 931R has been chosen by the taxpayer. Thus, relief from credit would still be needed, for example, for: business profits from a permanent establishment; interest; royalties; and capital gains sourced in the other state. The vast majority of dividends would be exempt in the UK, so that any provisions dealing with credit for dividends would only apply if the dividend was taxed in the UK.

**[7.17]** Some examples of the “elimination of double taxation” article are now available. Whilst those articles negotiated in the period before 2012 referred only to exempt dividends<sup>1</sup>, the latest versions cover both dividend exemption and branch exemption. For example, Article 21(2) of the new, UK-Barbados convention provides as follows:

2. Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom or, as the case may be, regarding the exemption from United Kingdom tax of a dividend arising in a territory outside the United Kingdom or of the profits of a permanent establishment situated in a territory outside the United Kingdom (which shall not affect the general principle hereof):

- (a) Barbados tax payable under the laws of Barbados and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within Barbados (excluding in the case of a dividend tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the Barbados tax is computed;
- (b) a dividend which is paid by a company which is a resident of Barbados to a company which 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;

- (c) the profits of a permanent establishment in Barbados of a company which 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;
- (d) in the case of a dividend not exempted from tax under sub-paragraph b) above which is paid by a company which is a resident of Barbados to a company which is a resident of the United Kingdom and which controls directly or indirectly at least 10 per cent of the voting power in the company paying the dividend, the credit mentioned in sub-paragraph a) above shall also take into account the Barbados tax payable by the company in respect of its profits out of which such dividend is paid.

<sup>1</sup> See the conventions with Hong Kong, Armenia, Hungary, Bahrain, Ethiopia, China and Singapore.

[7.18] This new-style article makes provision for general relief by credit (paragraph (a)), dividend exemption where the conditions of UK domestic law apply (paragraph (b)), branch exemption also where the conditions under UK domestic law apply (paragraph (c)), and for an indirect credit for underlying tax in the case of non-exempt dividends paid to a UK-resident company which has the appropriate percentage shareholding (paragraph (d)).

[7.19] One of the UK's recent conventions – that with Hungary in 2011 – also contains a provision for exemption with progression. Article 22(4) states:

(4) Where in accordance with any provision of the Convention income derived by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income.

Interestingly, neither the UK dividend exemption nor the branch exemption apply exemption with progression: dividends are simply exempt from tax, and branch profits are removed from taxation by way of an exemption adjustment. No account is taken of the impact of the exemption on the tax rate applicable to other (chargeable) income. Given that UK corporation tax is not imposed at progressive rates (if one ignores small company rate), this can hardly be seen as a significant breach of the principle of horizontal equity.

#### ***The debt cap and the UK's network of double taxation conventions***

[7.20] One of the difficult questions about the debt cap legislation is how it will inter-relate with the UK's network of double taxation conventions. Those conventions reflect – in a number of aspects – the arm's-length principle. This is most clearly seen in provisions relating to associated enterprises and based upon Article 9 of the OECD Model. However, the arm's-length principle is also reflected in Article 7, relating to business profits and the attribution of profits to permanent establishments. It is also reflected in the "special relationship" provisions in, for example, the interest article<sup>1</sup>.

<sup>1</sup> See Article 11(6) of the OECD Model Tax Convention for an example of a "special relationship" provision.

[7.21] To take Article 9 of the OECD Model as a starting point, this provides as follows:

'Article 9 – Associated Enterprises

1. Where

- a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

[7.22] Article 9(2) contains a provision for a corresponding adjustment where one state adjusts profits to reflect the arm's-length provision, and the other state is then obliged (if it agrees with the basis of the arm's-length adjustment) to make a corresponding adjustment to relieve any international double taxation.

[7.23] Article 9 is the basis for transfer pricing adjustments based upon the arm's-length principle. However, the debt cap legislation is not based on the arm's-length principle. An amount of finance expense may be disallowed as a deduction for UK tax purposes under the debt cap provisions, even if the terms of the transactions between members of the worldwide group are on arm's-length terms, so no adjustment would be made under Article 9. The debt cap provisions are not the equivalent of arm's-length thin capitalisation provisions: they make specific provision for the disallowance of an amount of finance expense which is regarded as excessive by the legislation.

[7.24] This raises some fundamental issues as to the compatibility of the debt cap provisions with the arm's-length principle enshrined in the UK's existing network of tax treaties.

[7.25] On one view, the debt cap provisions adjust the amount of finance expense between associated enterprises in a fashion not consistent with the arm's-length principle. On that view, the debt cap provisions should be overridden by any relevant UK double taxation convention<sup>1</sup>.

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<sup>1</sup> The author has been very much helped in preparing this section of this chapter by a draft note by Mark Persoff of Clifford Chance. Though the author reaches a different conclusion from Mr Persoff, the arguments in the (unpublished) note are cogent and represent the alternative position very well.

[7.26] On another view, however, the debt cap provisions are not transfer pricing provisions but simply a cap on the amount of deductible interest. They are not within the scope of Article 9, or other arm's-length provisions in tax treaties.

**[7.27]** If one focuses on the wording of Article 9 of the OECD Model, it is hard to say that the debt cap provisions fall within the specific wording of that article: Article 9(1) requires there to be conditions made or imposed between two enterprises which differ from those which would be made between independent enterprises. The debt cap provisions operate irrespective of whether the amount of debt or the amount of financing charge is the arm's-length amount. It is possible for UK members of a worldwide group to be able to show that their financing arrangements are consistent with the arm's-length principle, and yet they are subject to a restriction in the deduction of financing expenses under the debt cap (which is exactly the reason why there are those who say that the debt cap provisions are inconsistent with the arm's-length principle). However, the issue on the strict wording of Article 9 is whether there are conditions made or imposed which differ from those which would be made between independent enterprises. The answer to that on the strict wording is "no".

**[7.28]** A possible counter-argument to this is to say that the debt cap provisions contain an implicit transfer pricing/thin cap provision. The debt cap provisions work in relation to members of a worldwide group – ie associated enterprises – and on the basis that parties at arm's-length would not agree a higher level of finance expense for the UK members of the group than under the debt cap. The difficulty with this argument is that it is hard to find support for it in the wording of the debt cap provisions.

**[7.29]** The better view seems, therefore, that the debt cap provisions do not fall within the strict wording of Article 9<sup>1</sup>. By contrast, the debt cap provisions are domestic restrictions on the deductibility of interest, and not arm's-length transfer pricing provisions at all<sup>2</sup>.

<sup>1</sup> Where the debt cap provisions apply to a permanent establishment in the UK of a company resident in a state with which the UK has a tax treaty, the provisions in the relevant tax treaty equivalent to Article 7(3) of the pre-2010 OECD Model Tax Convention may provide a better argument against the debt cap (at least on the pre-2010 wording of Article 7(3)). This is because Article 7(3) contains an express provision dealing with the deduction of expenses. See the discussion at paragraph 7.35 below.

<sup>2</sup> On this view, the debt cap provisions are no different from any other domestic provision which limits the deductibility of an expense for the purposes of computing the tax base. A provision which precluded deduction of an expense incurred partly for the purposes of an associated enterprise (and so not wholly and exclusively for the purposes of the trade of the enterprise incurring the expense) would not be incompatible with Article 9 simply because it made reference to associated enterprises.

**[7.30]** This has several consequences. First, there is no basis for challenging the debt cap provisions on grounds that they are incompatible with arm's-length provisions in tax treaties. Second, and perhaps more significant, there is no provision for corresponding adjustment under Article 9(2). Where UK members of a worldwide group suffer a restriction in the deduction of their finance expenses, there is no current provision under a double taxation convention which would require the state of the other party to the finance provision to exempt from taxation an amount of non-allowable finance expense. In fact, the recognition that there is no provision for corresponding adjustments under double taxation conventions explains the provisions in



TIOPA 2010 s 299ff (formerly FA 2009 Sch 15 Part 5) dealing with the exemption for certain finance income received from EEA countries, which provide a measure of corresponding adjustment but only in the context of EEA countries. For other countries, there is no measure of relief. If the UK disallows part of the finance expense, the result will be a higher charge to UK tax, without any adjustment in any other country in which the worldwide group operates.

**[7.31]** In those circumstances, it is hard to see how an overseas parent of the group, for example, could claim that the group was not being taxed in the UK in accordance with the convention and initiate competent authority procedure under the equivalent of Article 25 of the OECD Model with any prospect of relief from the resulting double taxation. Thus, there is a real prospect that application of the debt cap may lead to an effective double taxation as a result of the disallowance of part of the finance expense of the UK.

**[7.32]** No doubt in years to come the issue of whether the debt cap provisions are compatible with the arm's-length principle enshrined in the UK's double taxation conventions will need to be resolved by litigation. It may also be that the UK will try to seek to include specific provisions in its double taxation conventions for a corresponding adjustment similar to that in TIOPA 2010 s 299ff but concluded with non-EEA countries.

**[7.33]** There are two or three further points to make about the debt cap and double taxation conventions. First, the disallowance of an amount of finance expense under the debt cap does not have as a result that any payment ceases to be interest for purposes of the double taxation convention<sup>1</sup>.

<sup>1</sup> See Article 11(3) of the OECD Model Tax Convention for the definition of interest in the Model. The debt cap legislation does not re-characterise disallowed interest as a distribution, for example.

**[7.34]** Second, there may be some scope for application of the ownership non-discrimination provision in the equivalent of Article 24(5) of the OECD Model. If, for example, the overseas parent of a group with a UK company can show that it is subject to the debt cap, but there would have been no application of the debt cap had the parent of the group been a UK company, then it may be that the UK subsidiaries to whom the debt cap restriction is applied can raise a valid argument that they are suffering more burdensome taxation by virtue of the fact that they are owned by a resident of another country, as opposed to being owned by a resident of the UK.

**[7.35]** Third, a challenge to the application of the debt cap may have more chance of success in the context of a UK permanent establishment of a non-resident company than in the case of a UK subsidiary. This is because of the specific expenses provision in the pre-2010 version of Article 7(3) of the OECD Model (see below). The disallowance of part of the finance cost of a UK permanent establishment in accordance with the debt cap provisions may be seen as infringing this specific rule<sup>1</sup>. By contrast, there is no express equivalent provision dealing with the deductibility of interest of a UK-resident subsidiary.

<sup>1</sup> Even then, the matter is not conclusive as Article 7(3) would not override a general rule of domestic law requiring certain conditions to be fulfilled before an expense is deductible, or limiting the amount of the expense which can be deducted (see the new Commentary to Article 7(3) of the 2010 OECD Model).

[7.36] Again, many of these issues are ones that can be highlighted, but will ultimately need to be resolved by litigation.

### **Concluding comments**

[7.37] It is undesirable that the compatibility of the debt cap provisions with the UK's existing network of double taxation conventions remains uncertain. This is likely to require litigation in future years. Unfortunately, there is no other way of coming to a position of certainty on this point, unless the debt cap provisions were expressed to operate notwithstanding anything contained in any arrangements for the relief of double taxation.

### **The OECD Background to Branch Exemption and the post-2012 CFC provisions: The Authorised OECD Approach ("AOA")**

[7.38] This section of this chapter explains some of the OECD developments over the past 15 years which have provided some of the backdrop to the detailed working of the branch exemption and post-2012 CFC provisions. Both of these new sets of legislation draw upon the OECD work on the attribution of profits to permanent establishments, and the "authorised OECD approach" ("AOA") as an element in the legislation.

[7.39] The starting point here is Article 7 of the OECD Model dealing with business profits, which in the version prior to 2010 was worded as follows:

#### *Article 7*

#### *Business Profits*

- (1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
- (2) Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

- (3) In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.
- (4) Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
- (5) No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
- (6) For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
- (7) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

[7.40] As is apparent from reading the provisions, the host state may tax a resident of the other contracting state if it derives business profits from a permanent establishment, but only so much of the profits as are attributable to that permanent establishment.

[7.41] The pre-2010 version of Article 7(2) determined the attributable profits by applying the “separate enterprise” approach and the “arm’s length” principle. That is, the profits attributable to the permanent establishment were those that would have been earned if the permanent establishment were a separate enterprise dealing at arm’s length with the rest of the enterprise of which it was part. There is some evidence that this approach led to different interpretations in different countries and some difficulty over the profits attributable in certain circumstances<sup>1</sup>.

<sup>1</sup> See “*The attribution of profits to permanent establishments*” (2006) 91B Cahiers de Droit Fiscal International, especially the General Report by Baker and Collier.

[7.42] Starting in the late 1990s the OECD began a project to standardise the approach of attribution of profits to permanent establishments. This work began with a working hypothesis that it might be possible to hypothesise the permanent establishment as a separate enterprise, with its own functions, assets and risks and then to apply the OECD Transfer Pricing Guidelines to determine the profit attribution based upon correct pricing of dealings between the permanent establishment and other parts of the enterprise. This hypothesis gradually metamorphosed into the Authorised OECD Approach.

[7.43] As part of this approach, it became clear that a simple change to the Commentary to Article 7 would not be sufficient, and a new version of the wording of Article 7 would be necessary. This new wording was adopted and inserted in the OECD Model in 2010 and is as follows:

Article 7

*Business Profits*

- (1) Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
- (2) For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
- (3) Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
- (4) Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

[7.44] At the same time as adopting the new wording for Article 7, the OECD also compiled a publication of the different reports on the attribution of profits to permanent establishments and published that in 2010 as well<sup>1</sup>.

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<sup>1</sup> OECD, *The Attribution of Profits to Permanent Establishments* (OECD, Paris, 2010)

[7.45] It is something of a debateable issue how far the OECD post-2010 AOA differs from the approach to attribution of profits under pre-2010 versions of Article 7. The new AOA certainly requires the identification of functions, assets and risks of the permanent establishment and of the remainder of the enterprise. It also requires the identification of all dealings within the enterprise, and the pricing for any goods or services supplied within the enterprise. Thus, for example, under the pre-2010 version it was not necessary to identify internal interest payments (except in the case of financial enterprises) nor were other internal payments necessarily recognised.

[7.46] The new branch exemption legislation and post-2012 CFC legislation have both been enacted utilising some of the concepts of this OECD work.

[7.47] First, the branch exemption provides in CTA 2009 s 18A(6) that the “relevant profits amount” in relation to a relevant foreign territory is either:

- in the case of a territory with which the UK has a full tax treaty containing a non-discrimination clause, the profits attributable to the permanent establishment for the purposes of the credit article in that treaty; or
- in the case of any other territory (i.e., one with which there is not a “full treaty” containing a non-discrimination article) the profits attributable to the permanent establishment under the term of the OECD model.

**[7.48]** For this purpose, the OECD model is defined in CTA 2009 s 18S as the model published in July 2010. That is, it is the new version of Article 7, published to give effect to the AOA, which is to be employed here.

**[7.49]** This creates, in effect, three possible measures of the profit attributable to the permanent establishment (which may be exempt under the branch exemption):

- (1) where the permanent establishment is located in a full treaty territory *with the old form of Article 7*, the profits attributable will be those attributable to the permanent establishment under the old pre-2010, pre-AOA approach;
- (2) where the permanent establishment is located in a territory with which the UK has a new-style, post-2010 version of Article 7, the exempt profits will be those attributable to the permanent establishment in accordance with the wording of that convention applied in accordance with the AOA;
- (3) where the permanent establishment is located in a territory with which the UK does not have a full treaty, the exempt profits will be those attributable to the permanent establishment in accordance with the wording of Article 7 of the OECD model applied in accordance with the AOA (which may not necessarily be the same as (2) above, if the treaty contains any wording different from the OECD model).

**[7.50]** In a sense the logic is clear. If the UK has a tax treaty with the territory of the permanent establishment then the profits that are exempt from tax in the UK should be the profits that are taxable in the host state of the permanent establishment. This will, of course, depend upon the exact wording of the particular treaty in question, specifically the business profits article of that treaty. If the UK has no tax treaty with the territory, then the OECD model provisions will apply.

**[7.51]** At the time of writing this chapter (September 2012) none of the UK’s double taxation conventions in force contain the new wording in Article 7 of the post-2010 OECD model. All existing double taxation conventions contain wording based upon the pre-2010 version of Article 7. It is likely that for many decades to come, many of the UK’s double taxation conventions will contain the old wording.

**[7.52]** There are two reasons for this. First, the relatively slow rate at which double taxation conventions are renegotiated on a convention-by-convention basis. Secondly, the fact that many countries do not accept the AOA and the new wording of Article 7 and will wish to continue using the old wording.

[7.53] At the time of writing, only two pending conventions (not yet in force) contain wording based upon the 2010 OECD model. These are the conventions with Barbados (which was probably a mistake on the part of the Barbadian negotiators to accept that wording) and the convention with Liechtenstein. There are, at present, no conventions with major trading partner jurisdictions that have the new wording of Article 7.

**The CFC provisions and the use of the AOA in the Chapter 4 gateway**

[7.54] Turning to the post-2012 CFC legislation, this too employs an element of the new OECD approach to attribution of profits. While there is some logic in the branch exemption using the attribution of profits to a permanent establishment, it is very hard indeed to see why the draftsman of the new CFC legislation used this approach. The “CFC charge gateway: profits attributable to UK activities” in TIOPA 2010 Pt 9A Ch 4 identifies the gateway profits that are subject to the CFC charge. For this purpose, TIOPA 2010 s 371DB identifies the steps that are to be taken to determine the CFC’s profits falling within the gateway. Section 371DB(1) provides that the steps are to be taken in accordance with the principles set out in the OECD Report, and s 371DA(3) defines that report as the OECD Report on the Attribution of Profits to Permanent Establishments dated 22 July 2010. Thus, for the purposes of this gateway, the AOA is to be applied regardless of whether the CFC is located in a territory with which the UK has a double taxation convention which does or does not follow the new wording of the post-2010 OECD model. The working of the CFC charge gateway based upon profits attributable to UK activities is explained in CHAPTER 5 of this book on the CFC legislation.

[7.55] One can only speculate as to why the draftsman of the CFC legislation decided to follow an approach to the attribution of profits which is both immensely complex and not accepted by the vast majority of countries. There seems to be some view held within HMRC that anti-avoidance legislation based upon arm’s length transfer pricing is immune from challenge under EU law. There is some authority that might support this approach<sup>1</sup>. That may possibly explain why a transfer pricing approach has crept in to the operation of one of the more significant gateways to the UK CFC legislation.

<sup>1</sup> See *SGI v Belgium* (Case C-311/08)

[7.56] Both the CFC provisions in TIOPA 2010 s 371DA and the branch exemption provisions in CTA 2009 s 185 embrace the possibility that subsequent documents published by the OECD may be designated as applicable to the operation of the CFC gateway and the branch exemption respectively.