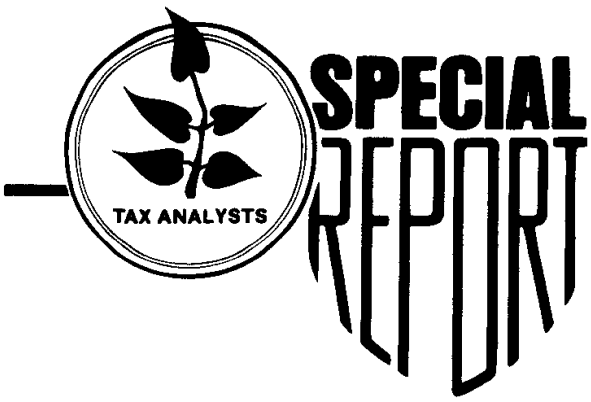

HIGHLIGHTS OF THE NEW U.S.-U.K. TAX TREATY

By Philip R. West

Philip R. West (philip.r.west@us.andersen.com) is a partner at Andersen. Before joining Andersen, he was the International Tax Counsel at the U.S. Treasury Department.

On July 24, 2001, U.S. and U.K. officials signed a new tax treaty. The new treaty, when brought into force after legislative approval in both countries, will replace an existing tax treaty, which has been in force since April 25, 1980. Perhaps, West believes, the most notable feature of the new treaty is that it contains, for the first time in any U.S. treaty, a complete exemption from withholding taxes on some dividends. It also contains in West's view significant and/or novel provisions regarding conduit arrangements, limitation on benefits, cross border arbitrage, business profits, stock options, pensions, exchange of information, mutual agreements, offshore activities, and capital gains. This article provides a brief and general overview of some of the more notable provisions of the new treaty.

Table of Contents

I. General

On July 24, 2001, U.S. Treasury Secretary Paul O'Neill and U.K. Chancellor Gordon Brown signed a Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion (referred to hereinafter, together with the accompanying diplomatic notes, as the new treaty or, simply, the treaty). The new treaty, when brought into force, will replace an existing tax treaty between the two countries that has been in force since April 25, 1980. The following is a brief and general description of selected significant provisions of the new treaty.[1]

II. Effective Dates

The new treaty will enter into force after it is approved by the legislatures of the two governments and instruments of ratification are exchanged through diplomatic channels. The treaty will apply to U.S. and U.K. withholding taxes on the first day of the second month following exchange of instruments of ratification, will apply to other U.S. taxes and to U.K. petroleum revenue tax for tax periods beginning on or after January 1 of the year following exchange of instruments of ratification, will apply to U.K. corporation tax for financial years beginning on or after the first day of April following the exchange of instruments of ratification, and will apply to U.K. capital gains tax and other U.K. income tax not mentioned above for years of assessment beginning on or after the sixth day of April following the exchange of instruments of ratification.[2]

In general, the current treaty ceases to have effect on these effective dates. If, however, any person entitled to benefits under the current treaty would have been entitled to greater benefits thereunder than under the new treaty, such person can elect to have the current treaty continue in effect in its entirety for 12 months beyond the date on which the new treaty otherwise would take effect.[3]

---

[1]Although this summary discusses a number of the more significant aspects of the treaty, it is not intended to be a comprehensive review of all provisions of the treaty and diplomatic notes. Those documents contain many significant, and some novel, provisions that are not discussed herein due to space and time constraints.

[2]The mutual agreement provision and the information exchange provision are effective immediately on the exchange of instruments of ratification, without regard to the tax period to which the matter relates.

[3]Special grandfather rules are also included for some teachers, students, and trainees. *See* article 29(4).

III. Withholding Taxes

A. Dividends

Perhaps the most notable feature of the new treaty is that it contains, for the first time in any U.S. treaty, a complete exemption from withholding taxes on some dividends. In general, the complete exemption applies to dividends paid to U.K.-resident shareholders[4] that have owned shares representing 80 percent or more of the voting power of the payor for the 12-month period ending on the dividend declaration date and that meet one of three other criteria. Those criteria are: (a) the 80 percent ownership test has been met (directly or indirectly) since before October 1, 1998, (b) the recipient meets the "publicly traded" criteria for satisfying the treaty's "limitation on benefits" article, or (c) the recipient is entitled to benefits with respect to the dividends under either the "derivative benefits" provision or the "discretionary determination" provision of the treaty's "limitation on benefits" article. It should be noted that until the U.S. negotiates another treaty with a nil withholding rate for dividends, the derivative benefits provision would not appear to be a viable route for achieving nil withholding on dividends under the new treaty.[5]

The complete exemption also applies to dividends paid to pension schemes as long as the dividends are not derived from the carrying on of a business, directly or indirectly. Other dividends qualify for withholding tax relief as follows: A 5 percent cap applies to dividends if the beneficial owner is a company that owns shares representing (directly or indirectly) at least 10 percent of the voting power of the payor corporation, and a 15 percent cap applies to all other dividends.

The treaty also allows for the application of the U.S. branch profits tax (and any similar U.K. tax).[6] The treaty does, however, limit these taxes to a rate not exceeding 5 percent, and disallows the application of the tax entirely if the nonresident corporation that otherwise would be subject to the tax meets one of three criteria: (a) before October 1, 1998, the corporation was engaged in activities giving rise to profits attributable to the branch (or, if the relevant branch profits tax is potentially applicable due to real estate income or gains, then, before October 1, 1998, the corporation was engaged in activities giving rise to this income or gain), (b) the corporation meets the "publicly traded" criteria for satisfying the treaty's "limitation on benefits" article, or (c) the corporation is entitled to benefits with respect to the relevant income, profit, or gain under either the "derivative benefits" provision or the "discretionary determination" provision of the treaty's "limitation on benefits" article.

Effective April 6, 1999, U.K. law was amended with the effect that U.S. shareholders are denied substantially all of the economic benefit of refunds of U.K. advance corporation tax. As such, the new treaty eliminates the provision of the current treaty providing for such refunds.[7]

B. Interest and Royalties

Source-country withholding taxes on interest and royalties are generally prohibited under the treaty. A contingent interest provision is included in the interest article that is similar to the U.S. model treaty's. In general, that provision allows withholding tax, at a rate not exceeding 15 percent, on interest that is determined by reference to receipts, sales, income, profits, or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person, or to any dividend, partnership distribution, or similar payment made by the debtor to a related person. The provision is not to apply solely by virtue of the fact that interest rates can fluctuate with the creditworthiness of the debtor.

IV. Conduit Arrangements/Limitation on Benefits

A. Conduit Arrangements

The U.K. has included in many of its recent treaties an antiabuse rule similar to those that were included in the treaties recently signed by the U.S. with both Italy and Slovenia. These antiabuse rules, in general, would have denied some treaty benefits if one of the main purposes of entering into the relevant transaction was the receipt of treaty benefits. In 1999, the U.S. Senate rejected as overbroad these provisions of the Italian and Slovenian treaties, and signaled that it would not approve such provisions in the future. As such, the new treaty contains a less restrictive, narrower rule (the "conduit" rule).[8] If applicable, the conduit rule renders inapplicable the three aforementioned withholding tax articles (as well as the insurance excise tax exemption and the residual "other income" article, which generally provides an exemption from source-state taxation for income not elsewhere dealt with in the treaty). The conduit rule applies if the income at issue is paid under, or as part of, a conduit arrangement. A conduit arrangement is a transaction or series of transactions that (a) has as one of its main purposes obtaining such increased benefits as are available under the treaty and (b) is structured so that a treaty beneficiary receives income from the other jurisdiction, but pays, directly or indirectly, all

[4]In practice, the provision will be inapplicable to U.S. shareholders of U.K. corporations because they are in any event exempt from dividend withholding taxes under internal U.K. law.

[5]The derivative benefits route to compliance with the limitation on benefits article (discussed further below) would, however, appear to allow a dividend to qualify for the 5 percent rate applicable in other treaties.

[6]The current treaty precludes the application of the U.S. branch profits tax. *See* Treas. reg. section 1.884-1(g)(3).

[7]Some had speculated, because U.K. law appeared to retain the formality of a tax credit refund, that the treaty would have respected this formality with the effect that U.S. shareholders of U.K. corporations could receive the benefits of foreign tax credits. As stated in the text, this approach was not adopted.

[8]It should not be assumed that inclusion of even this less restrictive rule in the new treaty indicates that the U.S. will seek to include similar antiabuse rules in its future negotiations with other countries.

or substantially all of that income,[9] at any time or in any form, to a person who is not a beneficiary of the treaty and who would not be entitled to equivalent or better benefits under a treaty between that person's jurisdiction and the jurisdiction in which the income arises.

B. Limitation on Benefits Article

In addition to the conduit rule, which limits benefits under five specific articles of the treaty, the treaty contains a "limitation on benefits" (LOB) article, new to the U.S.-U.K. treaty relationship,[10] but broadly consistent with the U.S. model treaty and recent U.S. treaties, that precludes a person from obtaining treaty benefits more generally, unless that person meets certain criteria. Thus, even if a person satisfies all other treaty conditions for obtaining any particular treaty benefit (such as the requirement that a recipient of a dividend be its beneficial owner to obtain a treaty-based reduction in the dividend withholding tax rate), it must also satisfy the LOB article.[11]

A resident of a treaty jurisdiction can qualify for all the benefits of the treaty if that person is a "qualified person" under the LOB article. Alternatively, a resident of a treaty jurisdiction can qualify for benefits with respect to discrete items of income if that person meets, with respect to the relevant item of income, one of three other tests in the LOB article.

1. Qualified persons. A company[12] can be a qualified person if it is publicly traded, as that concept is defined in the treaty, or if it meets an "ownership / base erosion" test. In general, a company can be publicly traded if (a) its principal class of shares is listed in the U.S. or U.K., and is regularly traded on a recognized stock exchange, or (b) shares representing at least 50 percent of the voting power and value of the company are owned directly or indirectly by five or fewer companies meeting the test under clause (a) above, provided that in the case of indirect ownership, each intermediate owner is a resident for treaty purposes of the U.S. or U.K. In general, a company can meet the ownership-base erosion test if more than 50 percent of its voting power and value is owned by certain other qualified persons for at least half the tax year and less than 50 percent of its gross income for that year is paid or accrued in deductible form to persons who are not treaty residents of the U.S. or U.K.[13]

2. Qualification under LOB with respect to discrete items of income. A company can qualify under LOB with respect to discrete items of income in one of three ways: (a) the derivative benefits route, (b) the active trade or business route, and (c) the discretionary determination route.

a. Derivative benefits. A company qualifies for the derivative benefits route with respect to an item of income, profit or gain if 95 percent of the vote and value of the company are owned, directly or indirectly, by seven or fewer "equivalent beneficiaries" and less than 50 percent of its gross income for that year is paid or accrued in deductible form to persons who are not equivalent beneficiaries.[14] An equivalent beneficiary is a resident of a member state of the EC or the EEA or a NAFTA party, but only if it either (a) would be entitled to all the benefits of a double tax treaty between an EC or EA member state (or NAFTA party) and the contracting state from which the benefits are being claimed[15] and, with respect to dividends, interest or royalties, would be entitled under that treaty to a rate of withholding tax on the class income with respect to which benefits are being claimed that is at least as low as the rate applicable under the new treaty, or (b) is a company resident in an EC member state entitled under an EC Directive to receive free of withholding tax the class of income for which benefits are being claimed.[16]

b. Active trade or business. A company (and any other resident) qualifies for the active trade or business route with respect to an item of income, profit, or gain if it is engaged in the active conduct of a trade or business in its residence state[17] and the income, profit, or gain is derived in connection with, or is incidental to that trade or business. Activities of some related parties count in determining whether a person is engaged in the active conduct of a trade or business in a particular state. And if the company carries on a trade or business activity in the source state that gives rise to the income, profit, or gain, then the active trade or business route applies to such item only if the trade or business activity in the residence state is substantial in relation to the trade or business activity in the source state.

c. Discretionary determination. If a resident of the U.S. or U.K. cannot satisfy the LOB article under any of the above-described provisions, the resident can, nevertheless, be granted treaty benefits with respect to

---

[9]The treaty does not define the term "substantially all" for this purpose.

[10]The current treaty's article relating to investment and holding companies may be viewed as a form of LOB provision, but it has significantly narrower scope than the new treaty's LOB provision.

[11]Conversely, the LOB article makes clear that even if a taxpayer satisfies the LOB article, it must also satisfy all other treaty conditions for obtaining any particular treaty benefit.

[12]Persons other than companies can also be "qualified persons." For example, individuals, "qualified governmental entities" and certain pension plans and charities are qualified persons as long as they are "residents" of one of the contracting states.

[13]For this purpose, some arm's-length payments in the ordinary course of business are excluded from the class of tainted payments.

[14]For this purpose, some arm's-length payments in the ordinary course of business are excluded from the class of tainted payments.

[15]If that treaty does not have a comprehensive LOB provision, the person must be one who would be a "qualified person" under the new treaty if that person were a treaty resident of the U.S. or U.K.

[16]The EC Directive provision is likely designed to apply only to U.K.-source payments, although the language may be susceptible of other interpretations.

[17]The making or managing of investments for the resident's own account is excluded, unless the activities are banking insurance or securities activities carried on by a bank, insurance company, or registered securities dealer.

a particular item of income, profit, or gain if the competent authority of the state from which benefits are sought determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the convention.

V. Cross-Border Arbitrage

Significant speculation preceded the signing of the treaty regarding the extent to which it would address issues relating to cross-border tax arbitrage, or transactions in which differences in tax rules applicable to the same item of income, gain, expense, or loss between or among tax systems are exploited for tax advantage. This speculation was fueled in part by reports of increased interest in such transactions on the part of the U.K. and U.S. revenue authorities.

Because, at least under the U.S. system, treaties cannot impose greater tax than is imposed under domestic law, there may be little a treaty can do to deny tax consequences from arbitrage transactions, if those consequences are properly claimed under domestic law. The new treaty does address arbitrage in at least four places, however.

A. Fiscally Transparent Entities

The current U.K. treaty deals with the status of partnerships, estates and trusts as residents. Numerous issues have arisen under the current language, however, not least of which is the tax treatment of limited liability companies. The new treaty resolves many of these issues by generally following the U.S. model treaty and the recent OECD report on the treatment of partnerships. It provides that an item of income, profit, or gain that is derived through a person that is fiscally transparent under the laws of either the U.S. or the U.K. shall be considered to be derived by a resident of one of the contracting states to the extent that the item is treated for tax purposes under the laws of that state as the income, profit, or gain of a resident. The diplomatic notes exchanged at signing elaborate on and describe the application of the provision in various circumstances, including where the income is paid through a so-called "domestic reverse hybrid" entity.

B. Dual Resident Corporations

The treaty clarifies the treatment of dual resident companies (DRCs). It does so, however, in a manner that will likely be unsatisfactory to those planning for dual treaty residency. The treaty provides that the competent authorities of the U.S. and U.K. shall agree on proper application of the treaty to dual resident companies (and other dual residents other than individuals[18]) and, failing such agreement, the DRC is not entitled to any treaty benefits other than those provided under the double tax relief provision, the nondiscrimination provision, and the mutual agreement provision.

C. Treatment of Remittance System

Consistent with the current treaty, the new treaty provides that source-state tax relief is denied proportionately, to the extent that the income with respect to which the treaty benefit is claimed is not subject to tax in the residence state due to its remittance system of taxation. In practice, this means that U.S. tax relief under the treaty is contingent on the relevant income not being exempted from tax under the U.K. remittance system. A similar provision is included in the pension article, which adjusts treaty benefits to account for remittance taxation.

D. Tax Credit Denial

In general, and with several notable deviations, the treaty provides customary confirmation of the creditability in one country of the covered taxes of the other country. In one such deviation, however, the treaty provides that U.K. tax credits[19] are denied for dividends paid by U.S. corporations in transactions in which the U.K. views the dividend as beneficially owned by a U.K. resident, the U.S. views the dividend as beneficially owned by a U.S. resident and the U.S. has allowed a deduction to a U.S. resident (as interest) in respect of an amount determined by reference to the dividend. It appears that this provision is an attempt to disallow the tax benefits of a cross-border repurchase agreement ("repo") in which the U.K. views the transaction as a sale of the "repo'd" shares by a U.S. person to a U.K. person, but the U.S. views the transaction as a secured loan, in which the U.S. borrower provides the repo'd shares as collateral to the U.K. lender, and the U.S. borrower claims deductions for interest on the loan.

VI. Business Profits

The treaty and diplomatic notes exchanged with the signing of the treaty contain interesting provisions, in particular for financial services businesses, relating to the computation of profits attributable to a permanent establishment (PE).[20] In particular, the diplomatic notes state that the OECD transfer pricing guidelines will apply by analogy for purposes of determining the profits attributable to a PE. They also provide that capital is attributed to the PE as if it were a distinct and separate enterprise, and the amount of its equity

[18]The ultimate tie-breaker clause for individuals provides that the competent authorities shall endeavor to settle by mutual agreement the residency of an ostensibly dual resident individual, but does not go on to deny treaty benefits in the absence of such agreement. Presumably, the difference relates to the comparatively smaller likelihood that individuals will intentionally be dual residents.

[19]Presumably only indirect credits are at issue because, under the treaty, there would be no withholding tax on the payment.

[20]The U.S. and U.K. have focused extensively on both the profit of a permanent establishment, in part due to their involvement in the OECD project on the subject, and the expenses of a permanent establishment, in part due to the *Nat West* litigation. *See National Westminster Bank PLC v. United States*, 44 Fed. Cl. 120, *Doc 1999-23444 (21 original pages)*, *1999 TNT 131-5* (1999), *appeal denied* 232 Fed. 3d 906 (Fed. Cir. 2000).

capital is determined based on the proportion of risk-weighted assets attributable to the PE and the other offices of the entity. In all of these provisions, the notes follow the recent OECD discussion draft on the attribution of profits attributable to a PE.[21]

The business profits article also provides that the U.S. insurance excise tax shall not be imposed on insurance or reinsurance policies issued by a U.K. insurance business, unless such policies are entered into as part of a conduit arrangement and the premiums thereon are not part of the income of a U.S. PE of a U.K. enterprise. In addition, consistent with recent changes to the OECD model treaty, the new treaty drops the separate treaty treatment of independent personal services as well as the fixed base concept, and includes the treatment of independent personal services in the business profits article.

VII. Stock Options and Pensions

The treaty tries to clarify an area of increasing difficulty, the treatment of stock options exercised after employment in more than one country. The approach taken by the treaty is first to clarify that income or gains under stock option plans are employment remuneration. As such, to the extent the options are currently taxable on grant, they are taxable in the country of employment as long as the employment lasts 183 days in a 12-month period or the remuneration is paid by or on behalf of an employer in the state of employment or the remuneration is borne by a PE of the employer in the state of employment. On later exercise of the option, the treaty allows the country in which the employee is not resident at the time the option is exercised to tax the employee only on the portion of the "option gain" that relates to the period of employment in that country between the date of option grant and option exercise. As such, on grant, the value of the option will generally be taxable in the state of employment,[22] and the appreciation between grant and exercise will generally be taxable only in the state of residence at the time of exercise, except to the extent that services were performed between grant and exercise in the other state.

The treaty also deals with contributions to, distributions from, and rollovers between pension plans such as U.S. qualified plans. In general, pension distributions (except for lump-sum distributions), annuities, and social security payments are taxable only in the state of the taxpayer's residence. Concerning contributions, a person working in one state generally will not be taxed in that state on contributions to a plan in the other state or on benefits accruing in, or employer contributions to, that plan. Special rules are provided for tax-free rollovers of earnings and accretions of plans established in one jurisdiction and owned by residents of the other jurisdiction, and for U.S. tax exemption with respect to contributions, benefit accruals, and employer contributions with respect to U.S. citizens who are resident in the U.K., working in the U.K., paid by a U.K. employer and participants in a U.K. plan.[23] Various limitations apply to these benefits, broadly consistent with the U.S. model treaty.

VIII. Exchange of Information/Mutual Agreement

It is significant that the treaty expressly provides that information is to be provided even if the requested state does not itself have need, for purposes of enforcing its own tax laws, of the information sought by the other state. It may also be significant that the treaty appears to drop the current treaty's limited collection assistance provision. The information exchange provision of the treaty is explicit on the point that it is not limited to information concerning criminal violations of the tax law. And the diplomatic notes provide that the requested state shall have the authority to obtain information held by financial institutions, nominees, and fiduciaries.

The diplomatic notes include a provision that should help address recently expressed concerns regarding the extent to which competent authority proceedings should be confidential or public. It provides that any principle of general application established by agreement between the competent authorities shall be published by both competent authorities.

IX. Conclusion

The new treaty contains numerous modifications to the current treaty. In addition to the above-described changes, the new treaty alters the treatment of capital gains, includes a broadened article on the treatment of offshore activities, and makes other modifications. All of these developments should be considered in analyzing the impact of the new treaty in specific cases.

[21]In addition, the treaty text itself provides, in a sentence similar to, but slightly different from, the corresponding sentence in the U.S. model treaty, that profits attributed to a PE include only the profits derived from the assets used, risks assumed and activities performed by the PE. Presumably, this is designed to clarify that profitability of the PE is not to be controlled by whether or not the enterprise as a whole is profitable.

[22]This assumes that an election under section 83(b) has been made.

[23]Although this latter novel provision would appear to grant U.S. tax benefits to U.S. citizens, it is not identified as an exception to the treaty's "saving" clause, which provides generally that the U.S. retains the right to tax its citizens (and residents) as if the treaty had not come into force.