

EXPLANATORY MEMORANDUM

Title

The Double Taxation Relief (Taxes on Income) (Canada) Order 2003.

Legislative Powers

This Order is made under section 788 Income and Corporation Taxes Act 1988 and section 277 Taxation of Chargeable Gains Act 1992.

Affirmative Resolution

This draft Order is subject to affirmative resolution. Further details of the Protocol scheduled to the draft Order are annexed to this memorandum.

European Convention on Human Rights

The Paymaster General (Dawn Primarolo) has confirmed that advice provided to her confirms that the provisions of this draft Order are compatible with the European Convention on Human Rights.

Policy Background to the instrument

Double Taxation Conventions aim to eliminate the double taxation of income or gains arising in one State and paid to residents of another State. They also serve an Exchequer protection role by including provisions to combat avoidance and evasion - not least by measures providing for the exchange of information between Revenue authorities. It is important however that they are regularly reviewed to ensure that they continue to serve these aims in the context of a changing global economy. Such a review may indicate that, generally, a Convention is working well but that in certain areas it would benefit from some amendment. This may be because, for example, the domestic legislation of the partner countries has changed or that taxpayers

have gained an unforeseen and undesired benefit from the Convention. For this reason it may be appropriate to negotiate and bring forward an amending Protocol (rather than a full-scale renegotiation of the whole Convention) if otherwise the Convention is operating satisfactorily.

Regulatory Impacts

There are no significant regulatory impacts caused by the proposed further amendments to the UK/Canada Double Taxation Convention.

Financial Effects

The nature of a double taxation convention is that one or both of the contracting states gives up all or part of their taxing rights so that a given source of income is taxed only once. Measured against a baseline of single taxation only, conventions do not therefore generally have an exchequer cost; rather, by encouraging cross border activity, they can lead to an increase in tax revenue. But where double taxation is unrelieved, the economic activity in question, and hence the higher tax revenue attributable to it, will often be only temporary.

This protocol is expected to have a modest positive Exchequer effect, and in addition will protect the Exchequer against the actions of taxpayers who might otherwise seek to exploit the existing Convention. But it is not possible to provide reliable estimates of the amounts in question.

Extent

The draft Order applies to the whole of the United Kingdom of Great Britain and Northern Ireland.

GENERAL

All the United Kingdom's recent Double Taxation Conventions largely follow the approach adopted in the OECD's *Model Tax Convention on Income and on Capital*. This Protocol continues that approach and reflects changes in policy and legislation in the United Kingdom since the entry into force of the existing Convention between the two countries.

NOTES ON DETAILS

ARTICLE I

ARTICLE 3 - DEFINITIONS

This Article amends the definitions contained in the Convention of the term "person" and, in the case of the United Kingdom, the term "national".

ARTICLE II

ARTICLE 4 – RESIDENCE

This Article amends paragraph 3 of Article 4 of the Convention by providing that where, applying the definition in paragraph 1 of that Article, a person other than an individual is a resident of both Contracting States, the competent authorities shall attempt to resolve the matter by mutual agreement. The paragraph also provides that, if the competent authorities do not reach agreement on the question of residence, they shall attempt to agree how the Convention will be applied to that person.

ARTICLE III

ARTICLE 9 – ASSOCIATED ENTERPRISES

This Article deletes and replaces Article 9 of the Convention.

Paragraph 1 provides the authority for adjustments to be made in determining the profits of an enterprise of one Contracting State where conditions made or imposed between that enterprise and an associated enterprise of the other Contracting State differ from those that would be made between independent enterprises. The first State may increase the profits of its enterprise to the level of profits which would have been earned by the enterprise if it had transacted the business in question at arm's length.

Paragraph 2 provides that, where the profits of an enterprise are adjusted in accordance with paragraph 1, and the other Contracting State agrees that the adjustment is justified, that other State shall, subject to the provisions at paragraph 3, make a corresponding adjustment to the tax charged on the profits of its enterprise. The paragraph also provides for consultation between the competent authorities if necessary.

Paragraph 3 provides that an appropriate adjustment to the profits of an enterprise under paragraph 2 may only be made if the competent authority of the State proposing to make the adjustment notifies the competent authority of the other State of such a proposal or making of the adjustment within six years of the end of the taxation year, in relation to Canada or the chargeable period in relation to the United Kingdom.

Paragraph 4 provides that the provisions of paragraphs 2 and 3 of the Article shall not impose an obligation to make an adjustment in the case of Canada where it is determined that there has been fraud, wilful default or gross negligence or in the case of the United Kingdom where it is determined that there has been fraudulent conduct.

ARTICLE IV

ARTICLE 10 – DIVIDENDS

This Article makes further amendments to Article 10 of the Convention, which deals with the taxation of dividends.

Paragraph 1 deletes and replaces the provisions of paragraphs 1 and 2 of Article 10. Paragraph 1 of Article 10 provides that dividends paid by a company which is resident in one State to a resident of the other State may be taxed in that other State. Paragraph 2 provides that such dividends may also be taxed in the State where the company paying the dividends is resident. However, providing the beneficial owner of the dividends is a resident of the other State the tax so charged may not exceed 5% of the gross amount of the dividends if the beneficial owner of those dividends is a company that controls, directly or indirectly, 10% of the voting power in the company paying the dividends. In all other cases the tax so charged shall not exceed 15% of the gross amount of the dividends.

Paragraph 2 deletes the provisions at paragraph 3 of Article 10 and by so doing abolishes the requirement for the United Kingdom to pay tax credits to Canadian residents who are in receipt of dividends paid by United Kingdom resident companies.

Paragraph 3 deletes and replaces the provisions of paragraph 5 of Article 10 but only to the extent of the reference to paragraph 3, which has now been deleted.

Paragraph 4 deletes and replaces the provisions of paragraph 7 of Article 10. Paragraph 7 now provides an anti-abuse provision, which ensures that the

provisions of the Article will not apply if the shares or other rights in respect of which the dividend is paid were created or assigned mainly to take advantage of the Article.

ARTICLE V

ARTICLE 11 – INTEREST

This Article further amends Article 11 of the Convention, which deals with the taxation of interest payments.

Paragraph 1 amends paragraph 3 of Article 11 to give effect to the name change in Canada of the “Export Development Corporation” to “Export Development Canada”. It further amends paragraph 3 to exempt from tax in the State where the interest arises, payments in respect of debts in connection with the sale on credit of any equipment, merchandise or services by a resident of the other State as long as the sale or debt is not between related persons.

Paragraph 2 deletes and replaces paragraph 6 of Article 11 but only to the extent that the provisions of paragraph 3 are now included in the paragraph as not applying where the beneficial owner of the interest is a resident of one State and carries on a business through a permanent establishment or fixed base in the other State and the interest arises through that permanent establishment or fixed base.

Paragraph 3 adds a new paragraph, paragraph 11, to Article 11 which provides an anti-abuse provision, stipulating that the terms of the Article will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the relevant debt claim to take advantage of the provisions of the Article by means of that creation or assignment.

ARTICLE VI

ARTICLE 12 – ROYALTIES

This Article further amends Article 12 of the Convention, which deals with royalty payments.

Paragraph 1 amends paragraph 3 of Article 12 to expand the types of royalty payments which shall be exempt from tax in the State where they arise, provided that such payments are beneficially owned by a resident of the other State. The paragraph further includes payments for the use of, or right to use any patent, information concerning industrial, commercial or scientific experience (providing it is not in connection with a rental or franchise agreement) and payments for the use of, or the right to use, computer software.

Paragraph 2 amends paragraph 5 of Article 12 but only to the extent that the recipient of the royalty payment must also be the beneficial owner. This is to ensure consistency with the provision at paragraph 2 of Article 12.

Paragraph 3 adds a new paragraph, paragraph 8, to Article 12, which provides an anti-abuse provision, stipulating that the terms of this Article will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the royalties are paid to take advantage of the provisions of this Article by means of that creation or assignment.

ARTICLE VII

ARTICLE 13 – CAPITAL GAINS

This Article contains provisions clarifying the taxation of gains from the disposal of property.

Paragraph 1 replaces paragraph 9 of Article 13. It provides that paragraph 8 of that Article shall not prevent a Contracting State from levying, according to its law, a tax on gains from the disposal of any property on a person who is a resident of that State at any time during the fiscal year in which the property is disposed of, or has been so resident at any time during the six years immediately preceding the year in which disposal of the property takes place.

Paragraph 2 adds a new paragraph, paragraph 10, to Article 13. This provision relates to a situation where an individual ceases to be resident in one State but under the laws of that State is treated as having disposed of property before ceasing to be a resident. If, at any time in the future, that individual becomes a resident of the other State, that other State may tax the gains of the property disposed of but only to the extent that the gains had not accrued to the individual during the period of residency in the first State. The provision will not apply to gains from the disposal of the property which the other State could have taxed in accordance with any of the other provisions in the Article, if the individual had realised those gains before becoming a resident of the other State. The provision also provides for the competent authorities of the two States to consult each in order to determine how to apply the paragraph.

ARTICLE VIII

ARTICLE 17 – PENSIONS AND ANNUITIES

This Article clarifies the treatment of the taxation of pension payments and amends the definition of what constitutes a “pension” and an “annuity”.

Paragraph 1 amends paragraph 1 of Article 17 to the extent that the paragraph now refers to “periodic pension payments arising” rather than just

“pensions arising”. This change has been made in order to counter an abuse which has arisen in relation to the payment of “lump sums” from Canadian pension arrangements to UK residents.

Paragraphs 2 and 3 amend paragraphs 3 and 4 respectively of Article 17 in relation to the definition of what constitutes a “pension” and an “annuity” for the purposes of the Convention. It abolishes the “carve out” of pensions and payments in consideration of settlement of all future pension entitlements or payments under an income-averaging annuity contract.

ARTICLE IX

ARTICLE 20A – OTHER INCOME

This Article inserts a new Article, Article 20A, into the Convention to deal with income which is not specifically dealt with elsewhere.

Paragraphs 1 and 3 of Article 20A provide that any item of income, wherever arising, not specifically covered elsewhere in the Convention, will be taxed by the State in which the owner is a resident, and may also be taxed in the other State if it is derived from a source in that other State.

Paragraph 2 provides that the provisions of paragraph 1 will not apply, other than to income from immovable property, if the right or property in respect of which the income is paid is effectively connected with a permanent establishment or fixed base maintained in the country of source. In that case, the provisions of Articles 7 or 14 will apply.

ARTICLE X

ARTICLE 21 – ELIMINATION OF DOUBLE TAXATION

This Article amends the method by which Canada will eliminate double taxation on tax payable in the United Kingdom on profits, income and gains arising in the United Kingdom.

Paragraph 4 of Article 21 has been deleted, as the provision is no longer required following the revision of Article 9 dealing with associated enterprises.

ARTICLE XI

ARTICLE 22 – NON-DISCRIMINATION

Paragraph 3 of Article 22 of the Convention is amended to take account of the reduction in the direct investment withholding tax rate from 10% to 5% which affects the rate at which Canada levies branch profits tax.

ARTICLE XII

ARTICLE 24 – EXCHANGE OF INFORMATION

This Article deletes and replaces Article 24 of the Convention.

Paragraph 1 provides that the competent authorities of the two States shall exchange such information as is necessary for carrying out the provisions of the Convention or of their domestic laws concerning the taxes covered by the Convention, including the administration of statutory provisions against legal avoidance. The exchange of information is not restricted by Article 1; this means that information relating to persons who are not residents of either of the two States may be exchanged. Information exchanged in accordance with the Article is to be treated as secret, although it may be disclosed to certain specified persons or authorities. Such information may be disclosed in public court proceedings or judicial decisions.

Paragraph 2 imposes certain limitations on the exchange of information. Paragraph 1 cannot impose an obligation on a State to carry out administrative measures at variance with the laws and administrative practices of either of the States or to supply information which is not obtainable under the laws or in the normal course of the administration of either of the States or to supply information that would disclose any trade, business, industrial, commercial or professional secret or trade process, or information whose disclosure would be contrary to public policy.

Paragraph 3 requires each of the States to obtain information requested by the other State in the same manner and to the same extent as if the tax of the requesting State were its own tax. This obligation applies even though the State receiving the request may not need the information for the purposes of its own tax.

ARTICLE XIII

ARTICLE 27 – MISCELLANEOUS RULES

This Article further amends Article 27 of the Convention, which deals with certain miscellaneous rules that are not dealt with elsewhere in the Convention.

Paragraph 2 of Article 27 is deleted and replaced by a provision which provides for a limitation on the amount of relief to be allowed under the Convention where income arising in one State is taxed in the other State on a remittance basis. In those circumstances, the source State is obliged to afford relief only in respect of income which is taxed in the other State.

Paragraph 3 of Article 27 is deleted and replaced with a provision which takes account of changes to the Canadian Income Tax Act in relation to the taxation of partnerships, trusts and controlled foreign affiliates. It preserves Canada's right to tax Canadian residents on their share of any income or capital gain of

a partnership, trust or controlled foreign affiliate in which that resident has an interest.

Paragraph 4 of Article 27 is deleted by virtue of the deletion of paragraph 3 of Article 10 which abolishes the requirement for the United Kingdom to pay tax credits to Canadian residents who are in receipt of dividends paid by United Kingdom resident companies.

Paragraph 3 of the Protocol adds a new paragraph, paragraph 7, to Article 27. This provision relates to the way contributions to pension arrangements, designed to secure retirement benefits, shall be treated for tax purposes in the two States.

ARTICLE XIV

ENTRY INTO FORCE

This Article contains the provisions governing how and when the Protocol will enter into force and take effect.

This Article provides that each State will notify the other that it has completed the procedures required by its law to bring the Protocol into force. The Protocol will enter into force on the date of the later of these notifications.

Sub-paragraph (a) provides that the Protocol shall have effect in Canada for both tax withheld at source and for taxation years beginning on or after 1 January in the calendar year next following that in which the Protocol enters into force.

Sub-paragraph (b) provides that the Protocol shall have effect in the United Kingdom in respect of income tax and capital gains tax for any year of assessment beginning on or after 6 April and for corporation tax for any financial year beginning on or after 1 April in the calendar year next following that in which the Protocol enters into force.

EXCHANGE OF NOTES

The Exchange of Notes constitutes a formal agreement between the Governments of both States which clarifies and explains certain Articles of the Protocol. The Exchange of Notes refers specifically to the following Articles.

ARTICLES IV, V AND VI

This Note commits Canada to consulting the United Kingdom at the earliest opportunity if it should conclude a Convention or a Protocol with another country which is a member of the Organisation for Economic Co-operation and Development which provides for a lower rate of tax on dividends, interest or royalties than that which is provided for by this Protocol. The purpose of the consultation would be with a view to making further such reductions to the withholding taxes provided for in the Convention.

ARTICLE VII

PARAGRAPH 1

This Note clarifies the application of paragraph 9 of Article 13 in respect of the taxation of chargeable gains in relation to an individual who disposes of property following the date of arrival and the establishment of residency for tax purposes in the United Kingdom.

ARTICLE XII

This Note clarifies the date on which the provisions of Article 24 – Exchange of Information as amended by Article XII of the Protocol, shall take effect and in relation to which taxable or chargeable periods.