EXPLANATORY MEMORANDUM

Title

The Double Taxation Relief (Taxes on Income) (The United States of America) Order 2002.

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 Double Taxation Convention and amending 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 do this by dividing the taxing rights that each treaty partner has under its domestic law over the same income and gains. They provide additional protection for taxpayers by specific measures combating discrimination in tax treatment. More generally, Conventions benefit the taxpayer by ensuring certainty of treatment and, as far as possible, by reducing compliance burdens. Double Taxation Conventions 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. They also encourage and maintain an international consensus on the appropriate tax treatment of cross border economic activity and thus promote international trade and investment.

Regulatory Impacts

There are no significant regulatory impacts but taxpayers may, in some cases, have to make a claim to the Inland Revenue or the other country's fiscal authority in order to benefit from the convention. However, taxpayers will benefit from reduced compliance burdens and, in many cases, from having to deal with just one fiscal authority.

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.

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 Convention continues that approach. In addition, it reflects changes in policy and legislation in the United Kingdom since the entry into force of the existing Convention between the two countries, which this new Convention replaces.

NOTES ON DETAILS

ARTICLE 1 – GENERAL SCOPE

This Article sets out the general scope of the Convention.

Paragraph 1 provides that the Convention is to apply to persons who are residents of one or both of the Contracting States (the United Kingdom and the United States of America).

Paragraph 2 provides that the Convention shall not in any way restrict any benefits provided under (a) the domestic law of either Contracting State or (b) any other agreement between the two countries.

Paragraph 3 provides that any question of the interpretation or application of the Convention, and in particular whether a taxation measure is within the scope of the Convention, is to be determined in accordance with Article 26 (Mutual Agreement Procedure) of the Convention. It also provides that the provisions of Articles II and XVII of the General Agreement on Trade in Services shall not apply to a taxation measure unless the competent authorities of the two countries agree that the measure is not within the scope of Article 25 (Non-discrimination) of the Convention. The paragraph gives a definition of "measure" for these purposes.

Paragraph 4 provides that either Contracting State may tax its residents and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. This overrides the other provisions of the Convention.

Paragraph 5 (as amended by Article I of the Protocol) limits the operation of paragraph 4 by providing that that paragraph shall not affect certain benefits conferred by other provisions of the Convention.

Paragraph 6 provides that where a citizen or long-term resident of a Contracting State has ceased to be a citizen or long-term resident of that State, and the loss of his status as such is motivated by tax avoidance, paragraph 4 shall continue to apply to him for a maximum of 10 years following his loss of that status. This provision is subject to two limitations: the paragraph applies only in respect of income from sources within that

Contracting State (including income deemed under its domestic law to have its source there), and paragraph 4 does not apply where a person ceased to be a citizen or long-term resident of that State before 6 February 1995.

Paragraph 7 provides for a limitation on the amount of relief to be allowed under the Convention where income or gains arising in one country are taxed in the other country on a remittance basis. In those circumstances, the source State is obliged to afford relief only in respect of income or gains which are taxed in the other State.

Paragraph 8 provides that an item of income, profit or gain derived through a person that is fiscally transparent under the laws of either Contracting State is to be considered to be derived by a resident of a Contracting State to the extent that the item is treated by that State for taxation purposes as the income, profit or gain of one of its residents.

ARTICLE 2 – TAXES COVERED

This Article gives a definition of the taxes to which the Convention is to apply.

Paragraph 1 applies the Convention to taxes on income and on capital gains, irrespective of how they are levied.

Paragraph 2 defines “taxes on income and on capital gains”; the term covers all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.

Paragraph 3 provides that the United Kingdom taxes to which the Convention applies are the income tax, the corporation tax, the capital gains tax and the petroleum revenue tax, and the United States taxes to which the Convention applies are the Federal income taxes imposed by the Internal Revenue Code, and the Federal excise taxes imposed on insurance policies issued by foreign insurers and with respect to private foundations.

Paragraph 4 provides that the Convention is to apply also to any identical or substantially similar taxes subsequently imposed by either country in addition to or in place of the taxes mentioned above. The paragraph also imposes an obligation on the competent authorities to notify each other of changes in their laws that significantly affect the Contracting States’ obligations under the Convention.

ARTICLE 3 – GENERAL DEFINITIONS

This Article contains definitions of words and phrases used in the Convention.

Paragraph 1 of this Article defines a number of terms used in the Convention.

Paragraph 2 provides a rule for determining the meaning of terms not defined in the Convention.

ARTICLE 4 – RESIDENCE

This Article establishes the meaning of “resident of” the United Kingdom or the United States and lays down detailed rules for resolving cases where individuals or other persons may be considered residents of both countries for tax purposes.

Paragraph 1 provides a general definition of “resident of a Contracting State”; any person who, under the laws of a Contracting State is liable to tax in that State by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other criterion of a similar nature is a resident of that State for the purposes of the Convention. However, a person who is liable to tax in a Contracting State in respect only of income from sources in that State, or of profits attributable to a permanent establishment in that State, is not a resident of that State for the purposes of the Convention.

Paragraph 2 provides a special rule for individuals who are (a) not resident in the United Kingdom and (b) either United States citizens or aliens admitted for permanent residence in the United States. Such an individual is a resident of the United States for the purposes of the Convention only if he has a substantial presence, permanent home or habitual abode in the United States and his centre of vital interests is closer to the United States than to any third country.

Paragraph 3 provides that the term “resident of a Contracting State” shall include pension schemes (as defined in Article 3(1)(o) of the Convention); other tax-exempt employee benefit schemes; charities; and qualified governmental entities (as defined in Article 3(1)(k) of the Convention).

Paragraph 4 sets out a series of rules for resolving the case where, applying the definition in paragraph 1, an individual is a resident of both Contracting States.

Paragraph 5 provides that where, applying the definition in paragraph 1, 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, the dual resident person will not, with some exceptions, be able to claim the benefits of the Convention.

Paragraph 6 enables an American wife of a man domiciled in the United Kingdom to have her domicile status for United Kingdom tax purposes determined separately from that of her husband.

ARTICLE 5 – PERMANENT ESTABLISHMENT

This Article defines the term “permanent establishment” for the purposes of the Convention. In general it follows Article 5 in the OECD Model Tax Convention. Taken together with Article 7, it prescribes in general terms the circumstances and manner in which enterprises of one country may be taxed on their business profits in the other.

Paragraph 1 provides a definition of the term “permanent establishment”; it is a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 specifies a number of things that are to be regarded as permanent establishments.

Paragraph 3 provides that a building site or a construction or installation project constitutes a permanent establishment only when it lasts for more than 12 months.

Paragraph 4 identifies a number of activities that do not constitute a permanent establishment even though they are carried on through a fixed place of business.

Paragraph 5 provides that an enterprise has a permanent establishment in a Contracting State where a dependant agent acts on behalf of the enterprise in that State and has, and habitually exercises, an authority to conclude contracts that are binding on the enterprise.

Paragraph 6 provides that an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an agent of independent status, provided that that agent is acting in the ordinary course of his business as an independent agent.

Paragraph 7 provides that the existence of a control relationship between two companies does not, of itself, mean that either company is a permanent establishment of the other.

ARTICLE 6 – INCOME FROM REAL PROPERTY

The Article is concerned with the taxation of income from real property. “Real property” is defined for the purposes of the Convention at Article 3(1)(m).

Paragraph 1 provides that income derived by a resident of one Contracting State from real property situated in the other Contracting State may be taxed by the State in which the property is situated.

Paragraph 2 extends the scope of paragraph 1 to cover income derived from the direct use, letting, or use in any other form of real property.

Paragraph 3 provides that paragraphs 1 and 2 apply to income derived from real property by an enterprise.

ARTICLE 7 – BUSINESS PROFITS

This Article sets out the rules for the taxation of business profits.

Paragraph 1 provides that the business profits of an enterprise of a Contracting State shall be taxed only in the Contracting State of which it is a resident unless the enterprise carries on business in the other Contracting State through a permanent establishment in that other State. Where the enterprise carries on business through such a permanent establishment, the State in which the permanent establishment is situated may tax the profits attributable to the permanent establishment. The rules for determining when a permanent establishment exists are contained in Article 5 (Permanent Establishment).

Paragraphs 2-4 lay down rules for attributing profits to a permanent establishment.

Paragraph 2 sets out an "arm's length" rule for the attribution of profits: the profits to be attributed to the permanent establishment are those it would 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. Only profits derived from the assets used, risks assumed or activities performed by the permanent establishment may be attributed to the permanent establishment.

Paragraph 3 provides for deductions to be allowed in attributing profits in respect of expenses incurred for the purposes of the permanent establishment.

Paragraph 4 requires that the same method be used year on year to determine the profits of the permanent establishment unless there is good and sufficient reason to the contrary.

Paragraph 5 provides that the United States excise tax on insurance policies issued by foreign insurers shall not be imposed on insurance or reinsurance policies, the premiums payable on which are receipts of an insurance business carried on by a United Kingdom enterprise. However, this relief is not due if the policies in question are entered into as part of a conduit arrangement. The term "conduit arrangement" is defined in Article 3(1)(n). In no case, however, will the excise tax be chargeable if the premiums represent income of a United States permanent establishment of a United Kingdom enterprise.

Paragraph 6 clarifies the interaction between Article 7 and other provisions of the Convention. Where business profits include items of income dealt with separately in other Articles, those Articles take precedence over Article 7.

Paragraph 7 provides that a Contracting State may tax profits attributable to a permanent establishment situated in that State notwithstanding the fact that the permanent establishment may have ceased to exist.

ARTICLE 8 – SHIPPING AND AIR TRANSPORT

This article is concerned with the taxation of profits arising from the operation of ships and aircraft in international traffic.

Paragraph 1 provides that profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

Paragraph 2 provides that profits from the operation of ships or aircraft include profits from the rental of ships or aircraft. It also provides that profits derived by an enterprise from the inland transportation of property or passengers within either Contracting State shall be treated as profits from the operation of ships or aircraft in international traffic if the inland transportation is undertaken as part of the international traffic undertaken by the enterprise.

Paragraph 3 provides that profits of an enterprise of a Contracting State from the use, maintenance or rental of containers used in international traffic will be taxable only in that State.

Paragraph 4 extends the scope of paragraphs 1-3 to cover profits from participation in a pool, a joint business or an international operating agency.

ARTICLE 9 – ASSOCIATED ENTERPRISES

This Article is concerned with the evaluation for tax purposes of transfers of goods, services, finance and intangible property between associated enterprises. It is based upon the “arm’s length principle”, which requires such transfers to be evaluated as if they had taken place between independent enterprises.

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 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.

ARTICLE 10 – DIVIDENDS

This Article contains the rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a resident of the other Contracting State.

Paragraph 1 provides that dividends paid by a company resident in one Contracting State to a resident of the other Contracting State may be taxed in that other State.

Paragraph 2 provides that the Contracting State of which the company paying the dividends is a resident may also tax the dividends, but it places a limit on the amount of tax which may be charged by that State. The tax charged by that State may not exceed 5 per cent. of the gross amount of the dividends when the beneficial owner is a company which owns shares representing, directly or indirectly, at least 10 per cent. of the voting power in the company paying the dividends. In all other cases the tax is limited to 15 per cent. of the gross amount of the dividends. This does not affect the taxation of the paying company in respect of the profits out of which the dividend is paid.

Paragraph 3 provides exceptions to the rule in paragraph 2. Dividends paid by a company resident in one Contracting State to a resident of the other Contracting State shall not be taxed in the first State if the beneficial owner of the dividends is a company which meets the conditions set out in the paragraph. Those conditions are that the beneficial owner must have owned shares representing 80 per cent. or more of the voting power of the paying company for a period of 12 months ending on the date the dividend is declared and either have owned shares representing 80 per cent. or more of the voting power of the paying company before 1 October 1998 or be a qualified person by reason of Article 23(2)(c) (Limitation on Benefits) or be entitled to benefits of the Convention with respect to the dividends under Article 23(3) or (6). Similarly, if the beneficial owner of the dividends is a pension scheme, the dividends shall not be taxed in the source State, provided that the dividends are not derived from the carrying on of a business by the pension scheme.

Paragraph 4 (as amended by Article II of the Protocol) provides that dividends paid by a pooled investment vehicle, unless those dividends are paid to a pension scheme, may in no circumstances benefit from the rate of 5 per cent. or 0 per cent. as provided for in paragraph 2(a) and paragraph 3. Dividends paid by such vehicles will qualify for the rate of 15 per cent. provided for in paragraph 2(b) in the circumstances set out in the paragraph. However where those dividends are paid to a pension scheme they will qualify

for the rate of 0 per cent. provided for in paragraph 3. The term "pooled investment vehicle" is defined at paragraph 10(b).

Paragraph 5 provides that paragraphs 1 to 4 shall not apply where a resident of one Contracting State receives dividends from the other Contracting State and the dividends are attributable to a permanent establishment through which that resident carries on business in the Contracting State of which the payer is a resident. In such circumstances, the taxation of the dividends is governed by Article 7 (Business Profits).

Paragraph 6 prevents the extra-territorial taxation by one Contracting State of dividends paid by a company that is a resident of the other Contracting State. The first State may not tax the dividends unless they are attributable to a permanent establishment there or are paid to a resident of that State. There is a similar provision concerning undistributed profits.

Paragraph 7 provides that a Contracting State may impose a "branch profits tax" on the profits of a permanent establishment maintained in that State by a company which is resident in the other Contracting State. This tax is additional to any tax on the business profits of the permanent establishment to which Article 7 (Business Profits) applies. It is charged on the "dividend equivalent amount" which is broadly equivalent to the amount withdrawn by the company from the permanent establishment in any one year. This paragraph shall not, however, apply in the case of a company which maintained a permanent establishment in the source State before 1 October 1998 or which is a qualified person by virtue of Article 23(2)(c) (Limitation on Benefits) or which is entitled to benefits under Article 23(3) or (6) with respect to income, profits or gains described in the paragraph.

Paragraph 8 limits the rate at which branch profits tax may be charged to 5 per cent.

Paragraph 9, an anti-abuse provision, ensures that the provisions of the Article will not apply to any dividend paid under, or as part of, a conduit arrangement. The term "conduit arrangement" is defined at Article 3(1)(n). (For further details on the application of this provision see Appendix A)

Paragraph 10 defines the terms "dividends" and "pooled investment vehicle". It also explains when a "pooled investment vehicle" is to be regarded as "diversified".

ARTICLE 11 – INTEREST

This Article contains the rules for the taxation of interest paid by a resident of one Contracting State to a resident of the other.

Paragraph 1 provides that interest arising in one Contracting State and beneficially owned by a resident of the other shall be taxable only in that other State.

Paragraph 2 defines the term "interest".

Paragraph 3 provides that paragraph 1 shall not apply where a resident of a Contracting State receives interest from the other Contracting State and the interest is attributable to a permanent establishment through which that resident carries on business in that other State. In such circumstances, the taxation of the interest is governed by Article 7 (Business Profits).

Paragraph 4 provides that where, because of a special relationship between the payer and the recipient, the amount of interest paid exceeds, for whatever reason, the amount which would have been paid in the absence of that special relationship, the Article will apply only to the interest that would have been payable in the absence of the special relationship. The "excess" part of the payment shall remain taxable according to the laws of each country.

Paragraph 5 deals with interest which is determined by reference to the results of the borrower. Sub-paragraph (a) provides that such interest may be taxed in both Contracting States, but the tax which may be charged in the State of residence of the payer is limited to 15 per cent. of the gross amount of the interest. In effect, therefore, such interest is treated in the same way as a dividend paid to a portfolio shareholder. Sub-paragraph (b) provides an exception to this rule: sub-paragraph (a) does not apply to interest paid on "ratchet loans", that is, loans the interest on which varies inversely with the results of the borrower.

Paragraph 6 overrides paragraph 1 in the case of interest paid with respect to the ownership interests in a vehicle used for the securitisation of real estate mortgages or other assets, to the extent that the amount of interest paid exceeds the return on comparable debt instruments as specified in the domestic law of the Contracting State in which the vehicle is situated.

Paragraph 7, an anti-abuse provision, ensures that the provisions of the Article will not apply to any interest paid under, or as part of, a conduit arrangement. The term "conduit arrangement" is defined at Article 3(1)(n). (For further details on the application of this provision see Appendix A)

ARTICLE 12 – ROYALTIES

This Article contains the rules for the taxation of royalties arising in one Contracting State and derived by a resident of the other.

Paragraph 1 provides that royalties arising in one Contracting State and beneficially owned by a resident of the other shall be taxable only in that other State.

Paragraph 2 defines the term "royalties".

Paragraph 3 provides that paragraph 1 shall not apply where a resident of a Contracting State receives royalties from the other Contracting State and the royalties are attributable to a permanent establishment through which that resident carries on business in that other State. In such circumstances, the taxation of the royalties is governed by Article 7 (Business Profits).

Paragraph 4 provides that where, because of a special relationship between the payer and the recipient, the amount of royalties paid exceeds, for whatever reason, the amount which would have been paid in the absence of that special relationship, the Article will apply only to the amount that would have been agreed upon by the two parties in the absence of the special relationship. The "excess" part of the payment shall remain taxable according to the laws of each country.

Paragraph 5, an anti-abuse provision, ensures that the provisions of the Article will not apply in respect of any royalty paid under, or as part of, a conduit arrangement. The term "conduit arrangement" is defined in Article 3(1)(n). (For further details on the application of this provision see Appendix A)

ARTICLE 13 –GAINS

This Article contains the rules for the taxation of gains.

Paragraph 1 provides that gains derived by a resident of one Contracting State that are attributable to the alienation of real property situated in the other Contracting State may be taxed in the State in which the property is situated.

Paragraph 2 identifies a number of items which are to be considered as "real property situated in the other Contracting State" for the purposes of the Article. In particular it provides that "real property" includes rights to assets produced by the exploration or exploitation of the seabed and sub-soil and their natural resources, including rights to interests in or the benefit of such assets. The term also encompasses "real property" (as defined in Article 3(1)(m).

Paragraph 3 provides that gains derived by an enterprise of a Contracting State from the alienation of property (other than real property), forming part of the business property of a permanent establishment maintained by that enterprise in the other Contracting State may be taxed in that other State. The paragraph also applies to gains derived from the alienation (in whole or in part) of such a permanent establishment. The paragraph applies irrespective of whether the permanent establishment exists at the time of the alienation.

Paragraph 4 provides that gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic, of containers used in international traffic, or of property (other than real property)

pertaining to the operation or use of such ships, aircraft or containers shall be taxable only in that State.

Paragraph 5 provides that gains from the alienation of any property, other than that detailed in paragraphs (1) to (4), shall be taxable only in the Contracting State of which the alienator is a resident.

Paragraph 6 provides that paragraph 5 shall not prevent a Contracting State from levying, according to its law, a tax on gains from the alienation of any property derived by an individual who is a resident of the other Contracting State and who was a resident of the first-mentioned State at any time during the six years immediately preceding the alienation of the property.

ARTICLE 14 – INCOME FROM EMPLOYMENT

This Article contains the rules for the taxation of employment income.

Paragraph 1 provides that employment income of a resident of a Contracting State shall be taxed only in that State unless the employment is exercised in the other Contracting State. In the latter case, the income may be taxed in the State where the employment is exercised.

Paragraph 2 provides an exception to the rule in paragraph 1. Where a resident of a Contracting State derives remuneration from an employment exercised in the other Contracting State, the remuneration will be taxable only in the State of which the employee is a resident if the employee is present in the other Contracting State for not more than 183 days in any twelve-month period beginning or ending in the taxable year or year of assessment concerned and the remuneration is paid by or on behalf of an employer who is not a resident of the other State and the remuneration is not borne by a permanent establishment which the employer has in the other State.

Paragraph 3 provides that remuneration derived by a resident of a Contracting State from an employment as a member of the regular complement of a ship or aircraft operated in international traffic shall be taxed only in that State.

ARTICLE 15 – DIRECTORS' FEES

This Article contains the rule for the taxation of directors' fees.

It provides that directors' fees etc. may be taxed in the Contracting State of which the company paying them is a resident.

ARTICLE 16 – ENTERTAINERS AND SPORTSMEN

This Article contains the rules for the taxation of income derived from personal activities as an entertainer or sportsman.

Paragraph 1 provides that income derived by a resident of a Contracting State in respect of his personal activities as an entertainer or sportsman in the other Contracting State may be taxed in that other State.

Paragraph 2 provides that income in respect of activities exercised by an entertainer or sportsman in his capacity as such may be taxed in the Contracting State in which those activities are exercised irrespective of whether the income accrues to the entertainer or sportsman himself or to some other person.

ARTICLE 17 – PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT

This Article contains the rules governing the taxation of pensions, social security, annuities, alimony and child support payments.

Paragraph 1 provides that pensions and other similar remuneration (other than pensions in respect of government service), will be taxable only in the Contracting State of which the beneficial owner is a resident. However, the amount of any pension which would be exempt from tax in the source State if paid to a resident of that State shall be exempt from tax in the State of residence of the beneficial owner.

Paragraph 2 provides an exception to the rule in paragraph 1. A lump-sum payment derived from a pension scheme established in one Contracting State and beneficially owned by a resident of the other Contracting State shall be taxed only in the State in which the pension scheme is established.

Paragraph 3 provides another exception to the rule in paragraph 1. Payments made by a Contracting State under its social security legislation are to be taxed only in the Contracting State of which the beneficial owner is a resident.

Paragraph 4 provides that any annuity is to be taxed only in the Contracting State of which the beneficial owner is a resident. The paragraph also defines “annuity” for this purpose.

Paragraph 5 provides that alimony or maintenance payments are to be exempt from tax in both Contracting States, except that, if the payer is entitled to relief from tax in respect of the payments in the Contracting State of which he is a resident, they will be taxable only in the Contracting State of which the recipient is a resident.

ARTICLE 18 – PENSION SCHEMES

This Article is concerned with the taxation of the income, profits and gains accruing to pension schemes, and with the tax treatment of contributions to pension schemes. The term “pension scheme” is defined for the purposes of the Convention at Article 3(1)(o).

Paragraph 1 provides that income earned by a pension scheme may be taxed as the income of individual members or beneficiaries of, or participants in, the pension scheme only when and to the extent that it is paid to or for the benefit of such individuals from the pension scheme (and not transferred to another pension scheme). The taxation of such income in the hands of such individuals is subject to paragraphs 1 and 2 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support).

Paragraph 2 deals with the situation where an individual is a member or beneficiary of, or participant in, a pension scheme established in one Contracting State and exercises employment or self-employment in the other Contracting State. It provides that contributions to the scheme paid by or on behalf of the individual during the period of employment or self-employment in the other State shall be deductible (or excludable) in computing his taxable income in that State. It also provides that any benefits accrued under the pension scheme, or any contributions made by or on behalf of the individual's employer to the scheme during that period shall not be treated as part of the employee's taxable income and any such contributions shall be allowed as a deduction in computing the business profits of his employer in that State. Finally, the paragraph provides that the relief available under this paragraph shall not exceed the reliefs that would be allowed by the other State to its residents for contributions to, or benefits accrued under, a pension scheme established in that State.

Paragraph 3 sets out two conditions for the operation of paragraph 2. Paragraph 2 will only apply if contributions were made by or on behalf of the individual or his employer to the pension scheme before the individual began to exercise employment or self-employment in the other Contracting State, and if the competent authority of the other State agrees that the pension scheme generally corresponds to a pension scheme established in that other State.

Paragraph 4 provides for a restriction of the relief available under paragraph 2 where contributions to a pension scheme are deductible or excludable in computing an individual's taxable income in a Contracting State, and that individual is subject to tax in that State in respect only of amounts remitted to or received in that State. Relief is available only for that proportion of the pension contributions which corresponds to the proportion which the amount of the income remitted to or received in that State bears to the full amount of the income.

Paragraph 5 provides that where a citizen of the United States who is a resident of the United Kingdom exercises an employment in the United Kingdom the income from which is taxable in the United Kingdom and is borne by a United Kingdom resident employer or permanent establishment situated in the United Kingdom, and the individual is a member, beneficiary or participant in a United Kingdom pension scheme, then pension contributions paid by or on behalf of that individual during the period he exercises employment in the United Kingdom and that are attributable to the

employment shall be deductible (or excludable) in computing his taxable income in the United States.

The paragraph also provides that any benefits accrued under the pension scheme, or contributions made to it by or on behalf of the individual's employer during that period, and that are attributable to the employment, shall not be treated as part of the employee's taxable income in the United States.

The provisions of paragraph 5 only apply to the extent that the contributions or benefits qualify for tax relief in the United Kingdom.

Finally paragraph 5 provides that the reliefs available shall not exceed the reliefs that would be allowed by the United States to its residents for contributions to, or benefits accrued, under a generally corresponding United States pension scheme, and that for the paragraph to apply the United States competent authority must agree that the United Kingdom pension scheme generally corresponds with a United States pension scheme. It also contains rules for determining an individual's eligibility to participate in and receive tax benefits with respect to a United States pension scheme.

ARTICLE 19 – GOVERNMENT SERVICE

This Article contains rules for the taxation of remuneration and pensions paid in respect of Government Service.

Paragraph 1 provides that remuneration paid from the public funds of a Contracting State, or of one of its political sub-divisions or local authorities, to an individual in respect of services rendered to that State, political sub-division or local authority, will be taxable only in that State. However such remuneration will be taxable only in the other Contracting State if the services are rendered in that other State by a national of that other State who is resident there or by a resident of that State who, although not one of its nationals, did not become a resident solely to render the services.

Paragraph 2 provides that a pension paid out of the public funds of a Contracting State, or of one of its political sub-divisions or local authorities, in respect of services rendered to that State, political sub-division or local authority will be taxable only in that State. Such pensions may, however, be taxed in the other Contracting State if the recipient is a resident and a national of that other State.

Paragraph 3 provides that paragraphs 1 and 2 shall not apply to remuneration or pensions in respect of services rendered in connection with a business carried on by a Contracting State, or by one of its political sub-divisions or local authorities. Such income is dealt with under Article 14, 15, 16 or 17 as appropriate.

ARTICLE 20 – STUDENTS

This Article contains the rules for the taxation of maintenance, education and training payments received by students and business apprentices.

It provides that payments for the maintenance, education or training of a student or business apprentice who is present in a Contracting State for the purpose of his full-time education or training and who, immediately before

visiting that State, was a resident of the other Contracting State, will not be taxed in the first-mentioned State, provided the payments are made from sources outside that State. In the case of business apprentices, the relief afforded by the Article is available for a maximum of one year from the date of the apprentice's arrival in the host State.

ARTICLE 20 A – TEACHERS

Article III of the Protocol continues the provisions in the current treaty in relation to the taxation of teachers.

Paragraph 1 provides an exemption from tax for a period not exceeding two years on remuneration received by a professor or teacher who goes to work in the other country for the purpose of teaching or engaging in research.

Paragraph 2 provides that the exemption may be applied by the country in which they are working to current payments or by way of withholding and refund. In either case it is dependent upon the individual fulfilling the requirements of paragraph 1.

Paragraph 3 provides that the Article shall apply to income from research only if that research is undertaken in the public interest.

ARTICLE 21 – OFFSHORE EXPLORATION AND EXPLOITATION ACTIVITIES

This Article contains the rules for the taxation of offshore exploration and exploitation activities.

Paragraph 1 provides that this Article shall have precedence over all the other Articles in the Convention and states that it is concerned with activities carried on offshore in connection with the exploration and exploitation of the sea bed and sub-soil, and their natural resources situated in the Contracting States.

Paragraph 2 provides the general rule for the taxation of offshore exploration and exploitation activities. An enterprise of one Contracting State carrying on offshore exploration and exploitation activities in the other Contracting State is deemed to be carrying on business through a permanent establishment in that other State.

Paragraph 3 limits the application of paragraph (2) to exploration activities which last more than 30 days in any 12 month period. For this purpose similar exploration activities carried on by associated enterprises are to be aggregated, unless those exploration activities are carried on at the same time. This paragraph also sets the criterion by which an enterprise shall be regarded as associated with another enterprise.

Paragraph 4 provides that the taxation of income derived by a resident of a Contracting State from employment in respect of offshore exploration and exploitation activities in the other Contracting State may, to the extent that the duties are performed offshore, be taxed in that other State. However, the income is not taxable in that other State if the employment is exercised there for no more than 30 days in any twelve month period.

ARTICLE 22 – OTHER INCOME

This Article contains the rules for the taxation of income not dealt with elsewhere in the Convention.

Paragraph 1 provides that any item of income, wherever arising, not specifically covered elsewhere in the Convention, will be taxed only by the country of which the recipient is a resident. There is an exception to this rule in the case of income paid out of trusts or the estates of deceased persons in the course of administration.

Paragraph 2 provides that paragraph 1 shall not apply, except in the case of income from real property, where the beneficial owner of the income is a resident of a Contracting State and carries on business in the other Contracting State and the income is attributable to the permanent establishment. In such circumstances, the taxation of the income is governed by Article 7 (Business Profits).

Paragraph 3 provides that where, because of a special relationship between the payer and the recipient, the amount of the income referred to in paragraph 1 exceeds the amount (if any) which the two parties would have agreed upon in the absence of that special relationship, the Article will apply only to the amount that would have been agreed upon by them in the absence of the special relationship. The “excess” part of the income shall remain taxable according to the laws of each country.

Paragraph 4, an anti-abuse provision, ensures that the provisions of the Article will not apply to any income paid under, or as part of, a conduit arrangement. The term “conduit arrangement” is defined at Article 3(1)(n). (For further details on the application of this provision see Appendix A)

ARTICLE 23 – LIMITATION ON BENEFITS

This Article is designed to counter abusive arrangements intended to enable persons who would not otherwise be entitled to the benefits of the Convention to obtain such benefits.

Paragraph 1 provides that a resident of one Contracting State who derives income, profits or gains from the other Contracting State will be entitled to all the benefits of the Convention only if he is a "qualified person" (as defined in paragraph 2) and satisfies any other specified conditions for the obtaining of benefits.

Paragraph 2 lists categories of resident who will be "qualified persons". To be a qualified person, a resident must fall within one of these categories in the taxable or chargeable period in which the relevant income, profits or gains arise.

Under sub-paragraph (a), all individual residents of the Contracting States are qualified persons.

Under sub-paragraph (b), "qualified governmental entities" (as defined in Article 3(1)(k)) are qualified persons.

Under sub-paragraph (c)(i), a company will be a qualified person if the "principal class" of its shares (as defined in paragraph 7(b)(i)) is listed or admitted to dealings on a "recognised stock exchange" (as defined in paragraph 7 (a)) and is "regularly traded" (as defined in paragraph 7 (e)) on one or more recognised stock exchanges.

Under sub-paragraph (c)(ii), a company will be a qualified person if shares representing at least 50 per cent. of its aggregate voting power and value are owned, directly or indirectly, by five or fewer companies which are qualified persons by virtue of sub-paragraph (c)(i). In cases of indirect ownership, each intermediate owner must be a resident of one or other of the Contracting States.

Under sub-paragraph (d)(i), a person other than an individual or a company will be a qualified person if the "principal class" of units (as defined in paragraph 7 (c) in the person is listed or admitted to dealings on a "recognised stock exchange" (as defined in paragraph 7 (a)) and is "regularly traded" (as defined in paragraph 7 (e)) on one or more recognised stock exchanges.

Under sub-paragraph (d)(ii), a person other than an individual or a company will be a qualified person if at least 50 per cent. of the beneficial interests in the person are owned, directly or indirectly, by residents of one or other of the Contracting States who are qualified persons by virtue of sub-paragraph (c)(i) or (d)(i).

Under sub-paragraph (e), pension schemes (as defined in Article 3(1)(o)), certain other tax-exempt employee benefits schemes (as described in Article 4(3)(b)) and charities (as described in Article 4(3)(c)) will be qualified persons, provided, in the case of a pension or employee benefits scheme, that more than 50 per cent. of the scheme's beneficiaries, members or participants are individuals who are residents of one or other of the Contracting States.

Under sub-paragraph (f), a person other than an individual will be a qualified person if it meets the "ownership" and "base erosion" tests set out in the sub-paragraph.

The ownership test is satisfied if, on at least half the days of the taxable or chargeable period concerned, shares or other beneficial interests representing at least 50 per cent. of the aggregate voting power and value of the person are owned, directly or indirectly, by persons who are qualified persons by reason of sub-paragraph (a), (b), (c)(i), (d)(i) or (e).

The base erosion test is satisfied if less than 50 per cent. of the person's gross income (as explained in the Exchange of Notes) for the taxable or chargeable period concerned is paid or accrued, directly or indirectly, to persons who are residents of neither Contracting State in the form of payments which are tax-deductible in the person's State of residence. In calculating the proportion of gross income which has been so paid or accrued, arm's length payments for goods or services and payments in respect of financial obligations to a bank are to be left out of account.

Under sub-paragraph (g), a trust, or the trustee of a trust acting in their capacity as such, will be a qualified person if at least 50 per cent. of the beneficial interest in the trust is held either by persons who are qualified persons by virtue of sub-paragraph (a), (b), (c)(i), (d)(i) or (e) or by "equivalent beneficiaries" (as defined in paragraph 7(d)), and the trust satisfies a similar "base erosion" test to that set out in sub-paragraph (f).

Paragraph 3 sets out the "derivative benefits" test. This is a variant on the ownership/base erosion test in paragraph 2(f). It provides that a company which is not a qualified person may qualify for the benefits of the Convention with respect to an item of income, profit or gain if it satisfies any other specified conditions for the obtaining of the benefits in question and shares representing at least 95 per cent. of its aggregate voting power and value are owned, directly or indirectly, by seven or fewer persons who are "equivalent beneficiaries" (as defined in paragraph 7(d)) and it satisfies a similar "base erosion" test to that set out in paragraph 2(f). The base erosion test here, however, is framed in terms of payments to persons who are not equivalent beneficiaries, rather than to persons who are not residents of the Contracting States.

Paragraph 4 sets out the "active conduct of a trade or business" test.

Sub-paragraph (a) provides that a resident of a Contracting State which is not a qualified person shall nonetheless be entitled to benefits with respect to an

item of income, profit or gain derived from the other Contracting State if it satisfies any other specified conditions for the obtaining of such benefits and it is engaged in the active conduct of a trade or business in the State of which it is a resident and the income, profit or gain in question is derived in connection with, or is incidental to, that trade or business. The "active conduct of a trade or business" does not include the business of making or managing investments for the resident's own account, unless the resident is a bank, an insurance company (as defined in paragraph 7(f)) or a registered securities dealer.

Sub-paragraph (b) provides that sub-paragraph (a) shall apply to an item of income, profit or gain only if the trade or business activity in the Contracting State of which the person deriving the item is a resident is substantial in relation to the trade or business activity in the other Contracting State. This is to be determined on the basis of all the facts and circumstances.

Sub-paragraph (c) provides that, for the purpose of determining whether a person is engaged in the active conduct of a trade or business, activities conducted by a partnership of which that person is a member shall be deemed to be conducted by that person. Similarly activities conducted by persons connected to that person shall be deemed to be conducted by that person. For this purpose, a person is connected to another if one of them possesses at least 50 per cent. of the beneficial interest in the other, or, in the case of a company, shares representing at least 50 per cent. of the aggregate voting power and value of the company or of the beneficial equity interest in the company or if another person possesses at least 50 per cent. of the beneficial interest, shares or beneficial equity interest in each of them. Finally, the sub-paragraph provides that in any case a person shall be considered to be connected to another if, having regard to all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Paragraph 5 provides that if a company which is a resident of a Contracting State, or a company which controls such a company, has outstanding a class of shares which is subject to terms or other arrangements which entitle holders of such shares to a larger proportion of the income, profit or gain of the company (the "disproportionate part of the income") derived from the other Contracting State than they would receive in the absence of those terms or arrangements and 50 per cent. or more of the voting power and value represented by that class of shares is owned by persons who are not "equivalent beneficiaries" (as defined in paragraph 7(d)), then the benefits of the Convention shall not apply to the disproportionate part of the income.

Paragraph 6 gives discretion to the competent authority of a Contracting State from which the benefits of the Convention are claimed to grant such benefits with respect to an item of income, profit or gain to a resident of the other Contracting State who is not a qualified person and is not entitled to benefits with respect to that item under either paragraph 3 or paragraph 4. The competent authority shall grant such benefits if it considers that the establishment, acquisition or maintenance of that resident and the conduct of

its operations did not have as one of its principal purposes the obtaining of benefits under the Convention. The paragraph also provides that the competent authority shall consult with the competent authority of the other State before refusing to grant the benefits of the Convention.

Paragraph 7 is an interpretative provision which sets out a number of definitions and rules which apply for the purposes of the Article.

Sub-paragraph (a) defines the term “recognised stock exchange”; this term appears in paragraphs 2(c)(i) and 2(d)(i).

Sub-paragraph (b) defines the term “principal class of shares”; this term appears in paragraph 2(c)(i).

Sub-paragraph (c) defines the terms “units” and “principal class of units”; these terms appear in paragraph 2(d)(i).

Sub-paragraph (d) (as amended by Article IV of the Protocol) defines the term “equivalent beneficiary”; this term appears (in the plural) in paragraphs 2(g)(ii), 3(a) and (b) and 5(b).

Sub-paragraph (e) explains when shares or units are to be considered to be “regularly traded” for the purposes of paragraph 2(c)(i) and 2(d)(i).

Sub-paragraph (f) explains when a body corporate or unincorporated association is to be considered an insurance company for the purposes of paragraph 4(a).

ARTICLE 24 – RELIEF FROM DOUBLE TAXATION

This Article sets out the methods by which the Contracting States will relieve double taxation.

Paragraph 1 provides that the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income the income tax paid or accrued to the United Kingdom by or on behalf of that resident or citizen. In the case of a United States company which owns at least 10 per cent. of the voting stock of a United Kingdom company from which the United States company receives dividends, the United States shall allow a credit in respect of the income tax paid or accrued to the United Kingdom by or on behalf of the payer with respect to the profits out of which the dividend is paid.

Paragraph 2 sets out source rules for the purposes of paragraph 1.

Sub-paragraph (a) provides that an item of gross income, as determined under United States law, derived by a resident of the United States which may be taxed in the United Kingdom shall be deemed to be income from sources within the United Kingdom.

Sub-paragraph (b) sets out an exception to the rule in sub-paragraph (a). Gains derived by an individual while that individual was a resident of the United States, which are taxed in the United States in accordance with the Convention, and which may also be taxed in the United Kingdom solely by reason of Article 13(6), shall be deemed to be gains from sources within the United States.

Paragraph 3 sets out special rules for the allowance of credit for United Kingdom petroleum revenue tax by the United States. The amount of such credit is limited to the amount attributable to the United Kingdom source taxable income.

Sub-paragraph (a) provides that the amount of United Kingdom petroleum revenue tax on income from the extraction of minerals from oil or gas in the United Kingdom to be allowed as a credit for a taxable year shall not exceed the amount, if any, by which the product of the maximum statutory United States tax rate applicable to a corporation for such taxable year and the amount of such income exceeds the amount of other United Kingdom tax on such income.

Sub-paragraph (b) provides that the amount of such United Kingdom petroleum revenue tax that is not allowable as a credit under sub-paragraph (a) shall be deemed to be income taxes paid or accrued in the two preceding or five succeeding taxable years, to the extent not deemed paid or accrued in a prior taxable year, and shall be allowable as a credit in the year in which it is deemed paid or accrued subject to the limitation in sub-paragraph (a).

Sub-paragraph (c) applies the provisions of sub-paragraphs (a) and (b) to the amount of United Kingdom petroleum revenue tax on income from initial transportation, initial treatment and initial storage of minerals from oil or gas wells in the United Kingdom.

Paragraph 4 sets out how United States tax is to be allowed as a credit against United Kingdom tax.

Sub-paragraph (a) provides that United States tax payable under United States law and in accordance with the Convention on profits, income or chargeable gains from sources within the United States (excluding, in the case of a dividend, United States tax in respect of the profits out of which the dividend is paid) is to be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains.

Sub-paragraph (b) provides that, in the case of a dividend paid by a company resident in the United States to a company resident in the United Kingdom which controls at least 10 per cent. of the voting power in the paying company, the credit will take into account United States tax payable by the company in respect of the profits out of which the dividend is paid. This credit is additional to any credit which may be due under sub-paragraph (a).

Sub-paragraph (c) provides an exception to the rule in sub-paragraph (b). No credit shall be allowable for United States tax described in that sub-paragraph if, and to the extent that, the United Kingdom treats the dividend as beneficially owned by a resident of the United Kingdom and the United States treats the dividend as beneficially owned by a resident of the United States and the United States has allowed a deduction to a resident of the United States in respect of an amount determined by reference to that dividend.

Sub-paragraph (d) disapplies Article 1(2) with respect to sub-paragraph (c).

Paragraph 5 sets out a source rule for the purposes of paragraph 4.

Paragraph 6 sets out special rules for the relief of double taxation in cases where the United States invokes Article 1(4) in order to tax a United States citizen, or a former United States citizen or long-term resident who is a resident of the United Kingdom.

Sub-paragraph (a) provides that, in such circumstances, the United Kingdom is not obliged to give credit for United States tax on profits, income or gains from sources outside the United States as determined under United Kingdom law. In other words, the United Kingdom is obliged to give credit only for United States tax on profits, income or gains from sources within the United States.

Sub-paragraph (b) provides that in the case of profits, income or gains from sources within the United States, the amount of United States tax for which the United Kingdom is required to give credit under paragraph 4 is limited to the amount of tax (if any) which the United States is permitted to impose under the Convention on a resident of the United Kingdom who is not a United States citizen.

Sub-paragraph (c) provides that, in computing the United States tax on profits, income or chargeable gains from sources within the United States, the United States shall give credit for any United Kingdom tax on the profits, income or chargeable gains as reduced by the credit referred to in sub-paragraph (b); the credit allowed by the United States shall not reduce the proportion of United States tax that is creditable against United Kingdom tax under sub-paragraph (b).

Sub-paragraph (d) provides that, for the exclusive purpose of relieving double taxation in the United States, profits, income and chargeable gains referred to in sub-paragraph (b) shall be deemed to arise in the United Kingdom to the extent necessary to relieve double taxation of such income, profits or chargeable gains under sub-paragraph (c).

ARTICLE 25 – NON-DISCRIMINATION

Subject to certain provisos and as recommended by OECD, this Article provides that neither State shall impose discriminatory taxes (or requirements) on nationals, permanent establishments or enterprises of the other.

Paragraph 1 sets out the basic principle: nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation, or any requirement connected with taxation, which is more burdensome than those imposed on nationals of the other State who are in the same circumstances, particularly with respect to taxation on world-wide income.

Paragraph 2 is concerned with the taxation of permanent establishments; it provides that a permanent establishment maintained by an enterprise of a Contracting State in the other Contracting State may not be exposed in that other State to taxation which is less favourably levied than the taxation levied on enterprises of that other State carrying on the same activities.

Paragraph 3 provides that interest, royalties and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall be deductible in computing the payer's taxable profits in the same way as if they had been paid to a resident of the first State. This rule does not apply, however, where certain other specified provisions of the Convention apply; these are the "special relationship" and "anti-conduit" provisions in Articles 7, 10, 11, 12 and 22, and paragraph 1 of Article 9.

Paragraph 4 provides that enterprises of a Contracting State which are wholly or partly owned or controlled, directly or indirectly, by residents of the other Contracting State shall not be subjected to any taxation, or any requirement connected with taxation, which is more burdensome than the taxation or requirements to which other similar enterprises of the first State are subjected.

Paragraph 5 makes it clear that the Article does not oblige a Contracting State to grant to individuals not resident in that State any of the personal allowances, reliefs and reductions for tax purposes which are granted to individuals who are residents or nationals of that State.

Paragraph 6 makes it clear that the Article does not prevent a Contracting State from imposing a branch profits tax as described in Article 10(7).

Paragraph 7 overrides Article 2 to apply this Article to taxes of every kind and description imposed by a Contracting State or by its political sub-divisions or local authorities.

ARTICLE 26 – MUTUAL AGREEMENT PROCEDURE

This Article authorises the competent authorities of the two Contracting States to endeavour, by mutual agreement, to resolve cases of taxation not in

accordance with the Convention and to settle points of doubt or difficulty in the application or interpretation of the Convention.

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States will result in taxation not in accordance with the Convention, he may present his case to the competent authority of the Contracting State of which he is a resident or national. This right applies irrespective of any remedies provided by domestic law. The paragraph also sets out time limits for the presentation of a case: a case must be presented within three years of the first notification of the action resulting in taxation not in accordance with the Convention or, if later, within six years from the end of the taxable or chargeable period in respect of which that taxation is imposed or proposed.

Paragraph 2 requires the competent authority to which the case is presented to endeavour, if it considers the objection justified and if it is unable to deal with the matter unilaterally, to resolve it by mutual agreement with the competent authority of the other Contracting State. The paragraph also provides that any agreement reached between the competent authorities shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States, except such limitations as apply for the purposes of giving effect to such an agreement.

Paragraph 3 provides that the competent authorities shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention, and it provides examples of matters which may be considered by the competent authorities.

Paragraph 4 permits the competent authorities to communicate directly with one another for the purposes of reaching agreement under the Article.

ARTICLE 27 – EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Article contains rules governing the exchange of information between the Contracting States, and the provision of administrative assistance by one State to the other.

Paragraph 1 provides that the competent authorities of the Contracting 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(1); this means that information relating to persons who are not residents of either Contracting State 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 proceeding or judicial decisions.

Paragraph 2 requires a Contracting State to obtain information requested by the other Contracting 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 Contracting State receiving the request may not need the information for the purposes of its own tax.

Paragraph 3 imposes certain limitations on the exchange of information. Paragraphs 1 and 2 cannot impose an obligation on a Contracting State to carry out administrative measures at variance with the laws and administrative practices of either Contracting State or to supply information which is not obtainable under the laws or in the normal course of the administration of either Contracting State or to supply information that would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Paragraph 4 places an obligation on a Contracting State to provide, at the specific request of the other Contracting State, information in the form of authenticated copies of unedited original documents, to the same extent such documents can be obtained under the domestic law of the State receiving the request.

Paragraph 5 imposes on each of the Contracting States the obligation to collect on behalf of the other such amounts as may be necessary to ensure that relief granted under the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled to such relief, although this does not require a Contracting State to carry out administrative measures which would be contrary to its sovereignty, security or public policy.

Paragraph 6 requires the competent authority of a Contracting State to notify the competent authority of the other Contracting State if the first State intends to send its officials to the other State to interview individuals and examine books and records with the consent of the persons subject to examination.

Paragraph 7 provides that the competent authorities shall consult together for the purpose of co-operating and advising in respect of any action to be taken in implementing the Article.

ARTICLE 28 – DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article contains rules for the taxation of diplomatic agents and consular officers.

It ensures that diplomatic or consular officials shall not receive less favourable treatment under the Convention than they are entitled to under international law or under the provisions of special agreements.

ARTICLE 29 – ENTRY INTO FORCE

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

Article VI of the Protocol contains the provision governing how and when the Protocol will enter into force and take effect.

Paragraph 1 provides that the Convention shall be subject to ratification.

Paragraph 2 provides that the Convention will enter into force upon the exchange of the instruments of ratification.

In the United Kingdom it will take effect in respect of withholding taxes from the first day of the second month next following the date on which the Convention enters into force, and for income tax and capital gains tax from 6 April, for corporation tax from 1 April and for petroleum revenue tax from 1 January in the calendar year next following that in which the Convention enters into force.

In the United States it will take effect in respect of withholding taxes from the first day of the second month next following the date on which the Convention enters into force, and in respect of other taxes from 1 January in the calendar year next following that in which the Convention enters into force.

Paragraph 3 (as amended by Article V (1) of the Protocol) explains when the existing Convention will cease to have effect but allows a person to elect to continue with the benefits of the existing Convention for a twelve month period if it is judged more beneficial to do so.

Sub-paragraph (a) provides that the existing Double Taxation Convention between the United Kingdom and the United States will cease to have effect in relation to any tax from the date on which the new Convention has effect in relation to that tax. In relation to tax credits in respect of dividends paid by companies which are residents of the United Kingdom, the prior Convention shall terminate and cease to be effective in respect of dividends paid on or after the first day of the second month next following the date on which this Convention enters into force.

Sub-paragraph (b) provides that any person for whom the existing Double Taxation Convention would be more beneficial may elect to have that Convention apply to them in its entirety for a twelve-month period from the date on which the new Convention would otherwise have effect in accordance with paragraph 2. The existing Convention will terminate on the last date on which it has effect in accordance with this paragraph.

Paragraph 4 has been deleted by Article V (2) of the Protocol.

Paragraph 5 (renumbered paragraph 4 by Article V (2) of the Protocol) enables an individual who, at the time of entry into force of the Convention, is

entitled to the benefits of Article 21 (Students and Trainees) of the existing Convention to continue to receive those benefits as if the existing Convention had remained in force.

ARTICLE 30 – TERMINATION

This Article contains provisions for the termination of the Convention.

Article VII of the Protocol contains the provision which details how long the Protocol shall remain in force.

This Article provides that the Convention may be terminated by either country giving notice of termination through diplomatic channels.

In the event of termination, the Convention shall cease to have effect in the United States in respect of withholding taxes for amounts paid or credited after the date which is six months after the date on which the notice of termination is given, and in respect of other taxes for taxable periods beginning on or after the date which is six months after the date on which notice of termination was given.

In the United Kingdom it will cease to have effect in respect of withholding taxes for amounts paid or credited after the date which is six months after the date on which the notice of termination is given; in respect of income tax other than withholding taxes and of capital gains tax for any year of assessment beginning on or after the date which is six months after the date on which notice of termination was given; in respect of corporation tax for any financial year beginning on or after the date which is six months after the date on which notice of termination was given; and in respect of petroleum revenue tax for chargeable periods beginning on or after the date which is six months after the date on which notice of termination was given.

EXCHANGE OF NOTES

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

ARTICLE 1 – GENERAL SCOPE

PARAGRAPH 3

This Note lists the agreements understood to be in force between the two Contracting States at the date the Convention was signed that may impose national treatment or most-favoured nation obligations. The note commits the two Contracting States to consider amending the Convention if it is determined that there were, at the date of signing, additional agreements in force that create such obligations, in order to ensure the proper interaction between the Convention and those other agreements.

PARAGRAPH 6

This Note describes when an individual shall be regarded as a former long-term resident of a Contracting State; the factors to be considered in determining whether or not tax avoidance was one of the principal purposes of an individual's ceasing to be a long-term resident of a Contracting State; and the factors to be considered in determining whether or not tax avoidance was one of the principal purposes of an individual's loss of citizenship of a Contracting State.

PARAGRAPH 8

This Note describes how the two Contracting States will apply Article 1(8) of the Convention, which relates to items of income derived through persons who are fiscally transparent under the laws of either Contracting State.

ARTICLE 2

This Note explains that, if a political sub-division or local authority of the United States seeks to impose tax on the profits of any enterprise of the United Kingdom from the operation of ships or aircraft in international traffic, in the circumstances where the Convention would preclude the imposition of a Federal tax on those profits, the United States Government will use its best endeavours to persuade that political sub-division or local authority to refrain from imposing tax.

ARTICLE 3 – GENERAL DEFINITIONS

PARAGRAPH 1 SUB-PARAGRAPH (o)

This Note indicates that the term “pension schemes“ as used in the Convention shall include any employment related-arrangements or personal pension schemes approved as retirement benefits schemes for tax purposes in the United Kingdom; and in the United States, Internal Revenue Code approved qualified plans, individual retirement plans, individual retirement accounts, individual retirement annuities and Roth IRAs.

The Note also explains that the United Kingdom and United States schemes listed are understood to correspond generally with each other.

ARTICLE 7 – BUSINESS PROFITS

This Note confirms that the OECD Transfer Pricing Guidelines will apply for the purposes of determining the profits attributable to a permanent establishment, and in particular that a permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. The Note specifies how capital may be attributed to the permanent establishments of financial institutions other than insurance companies.

ARTICLE 8 – SHIPPING AND AIR TRANSPORT

PARAGRAPH 2

This Note explains that income earned from the inland transport of property or passengers within either Contracting State falls within Article 8 if the transport is undertaken as part of the international transport of property and passengers by the enterprise.

ARTICLE 9 – ASSOCIATED ENTERPRISES

ARTICLE 11 – INTEREST
PARAGRAPH 4

ARTICLE 12 – ROYALTIES
PARAGRAPH 4

This Note confirms that where an amount of interest or royalties exceeds the amount that would have been paid in the absence of a special relationship the Contracting States will generally seek to adjust the deductible amount of the interest or royalties paid under the authority of the relevant Article but in

making such adjustments will not also impose its domestic rate of withholding tax in respect of the excess amount.

ARTICLE 10 – DIVIDENDS

PARAGRAPH 7

This Note explains that the concept of the “dividend equivalent amount” as used in United States law is intended to identify that portion of the income arising to a United States branch of a non-United States resident corporation that is comparable to the amount that would be distributed as a dividend if such income were earned by a subsidiary incorporated in the United States. For any year a foreign corporation’s dividend equivalent amount is equal to the after tax earnings attributable to the foreign corporation’s (i) income attributable to a permanent establishment in the United States, (ii) income from real property in the United States that is taxed in the United States, and (iii) gains from real property in the United States that are taxable in the United States, reduced by any increase in the foreign corporation’s net investment in United States assets or increased by any reduction in the foreign corporation’s net investment in United States assets.

ARTICLE 14 - INCOME FROM EMPLOYMENT

This Note confirms that the term “other similar remuneration” as used in Article 14 includes any benefits, income or gains enjoyed by employees under share/stock option plans. The Note explains that, where an employee is granted an option, exercises employment in both Contracting States between the dates of grant and exercise and would be taxable in both States in respect of any gains arising from the option, the Contracting State where the employee is not resident at the date of exercise will tax only that part of the option gain proportionate to the time spent there by the employee in the period between grant and exercise.

ARTICLE 17 – PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT

PARAGRAPH 1

This Note confirms that a payment shall be treated as a pension or other similar remuneration if it is a payment under a pension scheme as defined in Article 3.

ARTICLE 18 – PENSIONS

PARAGRAPH 3 SUB-PARAGRAPH (b)
PARAGRAPH 5 SUB-PARAGRAPH (d)

This Note confirms that the pension schemes listed with respect to each Contracting State in the Exchange of Notes at Article 3(1)(o) shall generally correspond to the pension schemes listed with respect to the other Contracting State.

ARTICLE 22 - OTHER INCOME

PARAGRAPH 1

This Note confirms that the purpose of the exclusion for income paid out of trusts or the estates of deceased persons in the course of administration is to allow a recipient of such income the relief that would have been available to him under the provisions of the treaty had he received the income direct instead of through the trust or estate.

ARTICLE 23 – LIMITATION ON BENEFITS

This Note confirms that the term “gross income” means the total revenues derived by a resident of a Contracting State from its principal operations, less the direct costs of obtaining such revenues.

PARAGRAPH 4

This Note confirms that an item of income is to be considered as derived “in connection” with an active trade or business in a Contracting State if the activity generating that income in the other Contracting State is a line of business which forms part of, or is complementary to, the trade or business conducted in the first-mentioned Contracting State.

It also confirms that an item of income derived from a Contracting State is considered “incidental” to the trade or business conducted in the other Contracting State if it is not produced by a line of business which forms part of, or is complementary to, the trade or business conducted in the other Contracting State, but is an item which facilitates the conduct of that trade or business.

PARAGRAPH 6

This Note explains that in exercising their discretion to grant treaty benefits under paragraph 6 of the Article, the competent authorities of the two Contracting States will consider the obligations imposed upon the United Kingdom by its European Community membership and by its being party to the European Economic Area Agreement, and on the United States by its

being a party to North American Free Trade Agreement. This requirement covers such matters as legal requirements relating to the facilitation of the free movement of capital and persons, the different internal tax systems, tax incentive regimes, and existing tax treaty policies among Member States of the European Community or European Economic Area states or parties to the North American Free Trade Agreement.

PARAGRAPH 7 SUB-PARAGRAPH (e)

This Note explains that a class of shares not listed on a recognised stock exchange in the twelve months referred to in the sub-paragraph will only meet the "regularly traded" test if that class of shares meets the aggregate trading requirements set out in the sub-paragraph for the taxable or chargeable period in which the income arises in respect of which the benefits of the Convention are sought.

ARTICLE 24 – RELIEF FROM DOUBLE TAXATION

This Note sets out the general principle (with specific exceptions in respect of income from real property and gains from the alienation of real property) that where under the treaty an item of income derived through a fiscally transparent person is treated as the income of another person who is then taxed in respect of it, it is that person who will be treated as having paid the tax for the purposes of determining the relief from double taxation to be allowed by the Contracting State of which he is a resident.

Rules for dealing with income and gains derived through a trust and for determining the source of dividends benefiting from Article 10(3)(a) are also included in the note.

ARTICLE 26 – MUTUAL AGREEMENT PROCEDURE

PARAGRAPH 2

This Note explains that where the competent authorities are endeavouring to resolve a case presented to them under the Article, neither Contracting State will seek to collect the tax that is in dispute until the mutual agreement procedure has been completed. Any tax which is payable following the completion of that procedure will however be subject to interest charges and, if appropriate, surcharges and penalties as long as it remains unpaid.

PARAGRAPH 3

This note confirms that any principle of general application established by an agreement between the competent authorities will be published by both competent authorities.

ARTICLE 27 – EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Note confirms that it is understood that both countries have the power to obtain information (other than legally privileged information), held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity, and information relating to the ownership of legal persons, and that they are able to exchange such information under the treaty.

ARTICLE 29 – ENTRY INTO FORCE

This Note explains that Article 26 (Mutual Agreement Procedure) and Article 27 (Exchange of Information and Administrative Assistance) shall have effect from the date of entry into force of the treaty without regard to taxable periods.

IN GENERAL

This Note states that the two Governments shall consult each other at regular intervals regarding the terms, operation and application of the treaty to ensure it continues to serve the purposes of avoiding double taxation and preventing fiscal evasion. The first such consultation will take place no later than 31 December in the fifth year following the date on which the treaty enters into force and thereafter at intervals of no greater than five years.

The “Conduit Arrangement” provision in articles 10, 11, 12 and 22.

The UK does not have domestic tax rules relating to conduit arrangements although many of its Double Taxation Conventions do feature provisions aimed at dealing with conduit-type arrangements.

The “conduit arrangement” provision that appears in Articles 10, 11, 12 and 22 of this Convention is new; it has not appeared in this form in any other UK Double Taxation Convention.

As a general principle, in applying and interpreting the provision the UK will, subject to the limitations in Article 3(1)(n) of the Convention which defines a “conduit arrangement”, act in a manner consistent with its practice under those other Conventions. And as always, the UK will consider the particular fact pattern in any given case when considering whether the provision will apply to deny treaty benefit.

The following six examples illustrate the operation of the provision.

Example 1. USCo, a publicly traded company organized in the United States, owns all of the outstanding stock of UKCo. XCo, a company organized in a country that does not have a tax treaty with the United Kingdom, would like to purchase a minority interest in UKCo. USCo proposes that UKCo issue preferred stock to USCo, paying a fixed return of 4% plus a contingent return of 20% of UKCo's net profits. The maturity of the preferred stock is 20 years. XCo will enter into a separate contract with USCo pursuant to which it pays to USCo an amount equal to the issue price of the preferred stock and will receive from USCo after 20 years the redemption price of the stock. During the 20 years, USCo will pay to XCo 3 ¾% plus 20% of UKCo's net profits.

The U.K. considers this arrangement would meet the objective definition of a conduit arrangement at Article 3(1)(n)(i) but because the U.K. has no withholding tax on dividends the motive test at Article 3(1)(n)(ii) would not be met because no increased treaty benefit would be obtained by the routing through the U.S. Therefore the arrangement would not constitute a conduit arrangement as defined by the treaty.

Example 2. UKCo has issued only one class of stock, common stock that is 100% owned by USCo, a company organized in the United States. USCo also has only one class of common stock outstanding, all of which is owned by XCo, a company organized in a country that does not have a tax treaty with the United Kingdom. USCo is engaged in the manufacture of electronics products, and UKCo serves as USCo's exclusive distributor in the United Kingdom under paragraph 4 of Article 23 (Limitation on Benefits), USCo will be entitled to benefits with respect to dividends received from UKCo, even though USCo is owned by a resident of a third country.

This seems to be a perfectly acceptable and normal commercial structure with real economic activity in both the U.S. and the U.K. The payment of dividends by subsidiary companies is a normal feature of commercial life. Accordingly, in the absence of evidence that dividends were flowed through to XCo, these transactions would not constitute a conduit arrangement.

Example 3. XCo, a company organized in a country that does not have a tax treaty with the United Kingdom, loans $1,000,000 to UKCo, its wholly-owned U.K. subsidiary in exchange for a note issued by UKCo. XCo later realizes that it can avoid the U.K. withholding tax by assigning the note to its wholly-owned subsidiary, USCo. Accordingly, XCo assigns the note to USCo in exchange for a note issued by USCo. The UKCo note pays 7% and the USCo note pays 6 ¾%.

The loan note was assigned to avoid U.K. income tax on the payment of interest. The transaction constitutes a conduit arrangement as defined in the treaty as both the objective definition and the motive test at Article 3(1)(n)(i) and (ii) respectively are met.

Example 4. XCo, a company organized in Country X, which does not have a tax treaty with the United Kingdom, owns all of the stock of UKCo, a company resident in the United Kingdom. XCo has for a long time done all of its banking with USCo, a company organized in the United States, because the banking system in Country X is relatively unsophisticated. As a result, XCo tends to maintain a large deposit with USCo. USCo is unrelated to XCo and UKCo. When UKCo needs a loan to fund an acquisition, XCo suggests that UKCo deal with USCo, which is already familiar with the business conducted by XCo and UKCo. UKCo discusses the loan with several different banks, all on terms similar to those offered by USCo, but eventually enters into the loan with USCo, in part because interest paid to USCo would not be subject to U.K. withholding tax, while interest paid to banks organized in Country X would be.

The fact that UK/US treaty benefits are available if UKCo borrows from USCo, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in UKCo's decision (which may be influenced by advice given to it by its 100% shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favour of borrowing from USCo rather than from another lender. However, whether the obtaining of treaty benefits was "the main purpose or one of the main purposes" of the transaction would have to be determined by reference to the particular facts and circumstances.

Similarly, for the anti-conduit provision to apply it would have to be established that the interest paid by UKCo was "flowing through" USCo to XCo. The fact that XCo has historically maintained large deposits with USCo might, if anything, be a counter-indication. Against that, there is the question why a cash-rich company would want to increase its overall debt exposure in this way. XCo could redirect its balance with USCo and lend it to UKCo – in which case it would face U.K. withholding tax. It chooses not to, so there is a possible argument that the transactions were structured to avoid U.K. withholding tax by obtaining benefits under the treaty.

On the specific facts as presented, the transactions would not constitute a conduit arrangement as defined by the treaty.

However, if USCo's decision to lend to UKCo was dependent on XCo providing a matching collateral deposit to secure the loan, the indication would be that XCo was in substance lending to UKCo direct but in form routing the loan through a bank with whom it has a close relationship in order to obtain the benefit of the treaty. In such circumstances the transactions would constitute a conduit arrangement as defined by the treaty.

Example 5. USCo, a publicly-traded company organized in the United States, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to USCo, which then licenses the technology to its subsidiaries that need it. USCo keeps only a small spread

with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. XCo, a company located in a country with which the United Kingdom does not have a tax treaty, has developed a process that will substantially increase the profitability of all of USCo's subsidiaries, including UKCo, a company organized in the United Kingdom. According to its usual practice, USCo licenses the technology and sub-licenses the technology to its subsidiaries. UKCo pays a royalty to USCo, substantially all of which is paid to XCo.

Because XCo is conforming to the standard commercial organization and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favorable benefits, the inference would be that the absence of a treaty between country X and the UK is not influencing the motive for the transactions described.

Therefore even though the specific fact pattern, as presented, meets the first part of the definition of a "conduit arrangement" at Article 3(1)(n)(i), on balance the conclusion would be that "the main purpose or one of the main purposes" of the transactions was not the obtaining of UK/US treaty benefits. So the structure would not constitute a conduit arrangement.

Example 6. XCo is a publicly traded company resident in Country X, which does not have a tax treaty with the United Kingdom. XCo is the parent of a worldwide group of companies, including USCo, a company resident in the United States, and UKCo, a company resident in the United Kingdom. UKCo is engaged in the active conduct of a trade or business in the United Kingdom. USCo is responsible for coordinating the financing of all of the subsidiaries of XCo. USCo maintains a centralized cash management accounting system for XCo and its subsidiaries in which it records all inter-company payables and receivables. USCo is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. USCo enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of USCo are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. USCo has 50 employees, including clerical and other back office personnel, located in the United States.

XCo lends to USCo DM 15 million (worth $10 million) in exchange for a 10-year note that pays interest annually at a rate of 5% per annum. On the same day, USCo lends $10 million to UKCo in exchange for a 10-year note that pays interest annually at a rate of 8% per annum. USCo does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

UKCo appears to be a real business performing substantive economic functions, using real assets and assuming real risks. USCo appears to be

bearing the interest rate and currency risk It is assumed that the transactions are typical of USCo's normal treasury business and that that business was carried on in a commercial manner.

So, on the specific facts presented, the transactions would not constitute a conduit arrangement as defined by the treaty.