# CHAPTER 3

# DOUBLE TAX TREATIES

## 3.1 Introduction

The UK has entered into bilateral international tax agreements, known as double tax treaties (or Double Tax Conventions), with over 100 countries. Many, but not all, of the tax treaties entered into by the UK follow the OECD model tax convention. The model treaty is a **bilateral** agreement between two contracting states that seeks to **eliminate double taxation**. In addition, it deals with tax evasion and non discrimination.

Note above the terminology that we will use in this chapter.

The model treaty is divided into chapters and articles and we will look at each of these in turn.

## 3.2 Chapter I: Scope of the convention

This chapter sets down the persons covered by the convention and the taxes covered.

Article 1 states that the convention covers residents of each contracting state. The term resident is defined in article 4.

The commentary to Article 1 limits the scope of the treaty where arrangements have been entered into which amount to an abuse of the treaty provisions.

Article 2 sets down the taxes covered, namely income and capital taxes.

## 3.3 Chapter II: Definitions

This chapter provides some important definitions.

**Article 3** provides some general definitions.

**Article 4** gives us the definition of **resident.** It is important to establish the state of residence as this will determine whether the person concerned comes within the scope of a tax treaty.

The article sets down various rules to determine residence and provides a **tie breaker** clause for companies:

"Where a company is a resident of both contracting states, then it shall be deemed to be a resident only of the contracting state in which its place of effective management is situated".

This is often referred to a P.O.E.M (Place of Effective Management).

The OECD Model commentary talks about "effective management" as follows:

"The "place of effective management" has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business **as a whole** are in substance made. **All** relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time. See para 24 of the commentary.

Note that the tie breaker clause uses effective management whereas UK case law has evolved the idea of **management and control**. They may be the same at times or they may be different. The tax treaty definition may allow a lower level of control than the case law definition. However the OECD model treaty commentaries going back to the 1988 Model Treaty acknowledge that the UK regards effective management as equating to management and control.

**Article 5** gives us the definition of **permanent establishment (PE)**. This is important when we come to look at the taxing of business profits later on.

The existence of a "permanent establishment" ("PE") in a state is analogous to the concept of a "branch" under company law. Indeed countries do place emphasis on the presence of a branch to determine taxability and this is reflected in the OECD Model Treaty.

Broadly an overseas resident has a substantive presence in a state if he meets the threshold of having a PE.

*At the same time* if that person is carrying on business through the PE then tax may be due in the state in which the PE is established as well as in the state of residence (Article 7 OECD Model Treaty).

Therefore on its own, without a business activity through it, a PE may not of itself give rise to a tax liability.

Article 5 OECD Model Treaty sets out the circumstances where a PE exists.

Article 5 (1) states

"the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. "

The commentary to the model treaty tells us that

"Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise."

It then goes on to provide examples by way of illustration.

The first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. The commentary states

" In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist)."

The second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company.

The commentary states: " In that case, the employee is carrying on activities related to the business of the former company and the office that is at disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article."

The fact that a PE is a fixed place of business suggests that there is some permanency and that there is a space of some kind taken up by the business. If it is possible to demonstrate that there is temporary nature to an operation, it may not be a PE. However, if the intent at the outset is one of permanence, then even in circumstances of a sudden curtailing of the operation in unforeseen circumstances (such as a death) then there is more likely to be a PE. Frequent use of an office/premises for short bursts of time is suggestive of permanence.

Broadly, use of different premises in a locality may also constitute a PE. Even the use of moveable (but substantially fixed and solid) premises may constitute a PE. The latter is illustrated by the fact that a drilling rig used in the exploration of oil may move from place to place and still be considered a PE.

Offshore activities raise important questions as to what constitutes a PE. Often in practice there are separate articles dealing with offshore activities. "Extraction" activities are covered in Article 5(2)(f). Arguably, exploration should be considered preparatory in nature (i.e. within Article 5(3)) but drilling rigs do give rise to a PE in many situations.

The OECD commentary makes reference to automated vending machines as constituting a PE if there are persons setting up and operating the machines – if not, it may not be a PE.

Equipment leased to a lessee in a state should not create a PE, even where staff operate the equipment, provided that the staff are not under the direction and control of the lessee.

Article 5(2) of the OECD model treaty tells us that the term Permanent Establishment includes:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop, and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Note this is **not an exhaustive list.**

A building site or installation project constitutes a PE only if it lasts more than 12 months (Article 5(3)). The commentary tells us that the twelve month test applies to each individual site or project. The time period we look at is to include preparatory work in the country where the construction project is to be carried on. Difficulties can arise with the identification of separate building projects.

When it comes to construction sites under Article 5(3) there are a number of practical questions that are raised, including whether different parts of a locality can constitute different construction sites – these issues depend on facts and circumstances such as whether there is a commercial and geographic coherence to a project. The kind of sites and activity included for this purpose include that of the installation or construction of buildings, roads, bridges, canals, pipelines, excavating and dredging. Demolition and clearance of sites fall under this category as well. Even assembling movable property may be included.

Certain circumstances are deemed not to give rise to a PE (Article 5(4)):

1 facilities used solely for storage, display or delivery of goods or merchandise belonging to the enterprise;

2 maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

3 maintenance of stock of goods or merchandise belonging to the enterprise solely for the purposes of processing by another enterprise;

4 the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise;

5 the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; or

6 the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e) (of Article 5(3)), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Article 5 (5) tells us that even if the enterprise does not fall under para 1 and 2 there may still be a PE where:

"a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, "

The exception being if

"the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

Reference to agency arrangements that constitute a PE in Article 5(5) are often referred to as dependent agencies, and are to be distinguished from independent agency operations that carry out their own business in relation to a number of independent customers or clients. An important point to bear in mind is that the actions of a party should bind an enterprise in contractual terms for it to be considered the actions of a dependent agent and those actions should relate to the main activities of the principle. An employee of a company stationed in an overseas state may, if he has the authority, give rise to a dependent agency.

Article 5(6) states that an enterprise is not deemed to have a PE where it carries on business in a state through a broker, general commission agent or any other agent of *independent status provided that such persons are acting in the ordinary course of their business*

Article 5(7) acknowledges that where one company in one state controls another in the other state, the fact that there is control shall not of itself give rise to a PE in either state.

Thus a parent company may have a PE in the state of a subsidiary, by virtue of the fact that space owned by a subsidiary is at the disposal of the parent company and is used by it to carry on part of its own business in that state. A subsidiary can also act as a dependent agent (under Article 5(5)) of a parent

company. Similarly, the same comments can be made generally in relation to related companies in a multinational group.

The 2008 updated version of the commentary adds an alternative services PE definition. This addition does not amend the definition of a PE but allows states to include alternative wording into the PE article.

In some circumstances, OECD Model Article 5(6) deems there to be a permanent establishment where an agent habitually exercises "authority to conclude contracts in the name of the enterprise". The OECD has considered in the context of e-commerce whether an internet service provider (ISP) or an independent owner of a server would constitute a permanent establishment.

Where the ISP provides services to others and enables them to access the internet, or provides general hosting services or designs web-sites, then it is likely that the ISP will be regarded as an independent agent and therefore not a permanent establishment.

However, where the ISP provides a more pro-active part in the actual conduct of the trade or business of an enterprise then it may constitute a permanent establishment of the enterprise.

Further, the exceptions that apply to avoid a permanent establishment where "preparatory or auxiliary" functions are carried out (see Article 5(4)) are less easy to ascertain in the case of a server which allows digitised products/software to be downloaded.

The revised OECD commentary observes that, in broadly non-active/passive circumstances, auxiliary activities in the case of e-commerce can include provision of communication links, or relaying certain information through a mirror server, or advertising, or gathering market data or supply of certain information.

If head office itself has as its main purpose these activities then they cannot be considered auxiliary.

The UK has made clear that, of itself, a web-site and server will not give rise to a permanent establishment for domestic direct tax purposes. Clearly, if there are other operations/activities then there may be a permanent establishment. (See UK HMRC press releases dated 11 April 2000 and 12 February 2001.)

## 3.4 Chapter III: Taxation of income

This chapter sets down the taxing rights with regard to different types of income.

Article 6 deals with income from **immovable property** stating that it is taxable in the state where the property is **situated**. This applies to income from direct use, letting or any other form of immovable property.

Article 7 **Business Profits**: following a long period of discussion a new article 7 was adopted in July 2010 and included in the 2010 version of the model treaty.

The business profits article in a tax treaty sets out the limits of the source state's taxing rights in relation to business profits.

If an enterprise resident in a contracting state has a PE in the other state **through which it carries on business** it can be taxable in that other state, as well as the state of residence (subject to double taxation relief). The tax is limited in the source state to no more than the profits attributable to the PE. If, however, the enterprise does not have a PE in the other state it can only be taxed in the state of residence (Article 7(1) OECD Model Treaty).

This sets down a very important principle that not only does there need to be a PE in the other state but the business of the enterprise must be carried on through that PE. Thus a PE alone does not give rise to taxing rights.

The main change to article 7 by the revision in 2010 arises from the definition of "attributable profits".

The new para 2 of article 7 states

... the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
We can see that article 7 is using the arms length principle that we are familiar with from studying transfer pricing.

The commentary to article 7 makes reference to the 2010 Report on the attribution of profits to permanent establishments which puts forward a two step approach for applying paragraph 2.

Step 1 - apply a functional and factual analysis to the PE (based on the guidance in the OECD transfer pricing guidelines) in order to:

- Attribute to the PE as appropriate the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;

- Determine the functions of the hypothesised separate and independent enterprise and the economically relevant characteristics (both internal and external conditions) relating to the performance of those functions;

- Attribute risks among the different parts of the single enterprise, based on the identification of significant people functions relevant to the assumption of risks;

- Attribute economic ownership of assets among the different parts of the single enterprise, based on the identification of the significant

people functions relevant to the attribution of economic ownership of assets;

- Recognise and determine the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test ; and

- Attribute capital based on the assets and risks attributed to the PE

Step 2 - the dealings of the hypothesized separate enterprise will be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar assets, assuming the same or similar risks, and possessing the same or similar economically relevant characteristics.

In applying step 2 the report uses the terminology "dealings" to refer to transactions between the PE and the Enterprise of which it is part. Stating that the approach is to "undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises."

Para 3 of Article 7 requires the resident state to give DTR under article 23 of the model treaty and Para 4 states that where profits include items of income dealt with by other articles in the model treaty they are unaffected by the provisions of article 7.

Article 8 tackles the taxation of shipping, inland waterways transport and air transport. Generally such activities are taxed where the effective management of an enterprise is situated.

Article 9 is the associated enterprises article and links into the transfer pricing issues discussed in the last chapter, requiring arm's length prices.

Article 10 looks at **dividends**. It allows dividends paid by a company resident in a contracting state to residents of another contracting state to be taxed in that other state i.e. where they are **received.** In addition, they may also be taxed (normally by way of withholding tax) in the contracting state of the **payer**. However there are **limits** on withholding tax as follows:

a) **5%** of the gross dividend if the beneficial owner is a company which owns at least **25%** of the capital of the paying company;

b) **15%** of the gross dividend in all other cases.

**Illustration 1**

Torrence Ltd, a UK resident company, receives a dividend of £95,000 from its wholly-owned overseas subsidiary, Parnavik SA.

Parnavik SA is resident in a country which has a double tax treaty based on the OECD model convention.

Under the terms of the double tax treaty, Parnavik SA is allowed to withhold a maximum amount of 5% of the gross dividend. Thus the gross dividend will be £100,000.

This £100,000 will be taxable on Torrence Ltd in the UK, subject to DTR.

Article 11 deals with **interest**, stating that interest is taxable in the contracting state where the recipient is **resident**. However, it may also be taxed in the state where it arises, thus a **withholding** tax (WHT) of up to **10%** is allowed.

It is important to note that the benefits of this article are only available to the beneficial owner of the interest, thus if the recipient is not the beneficial owner he will not be able to claim the reduced rate of WHT.

This article also includes a paragraph which seeks to limit the reclassification of interest as equity under the **thin capitalisation** rules. The article limits the reclassification to the amount of interest charged and does not provide for a consideration of the amount lent.

Article 12 deals with income from **royalties.** Income from royalties is taxable in the state of **residence** of the beneficial owner. This does not apply if the royalties are part of a **PE** in the other state, in which case they will be taxed as part of the business profits of the PE. The interest article also treats interest earned through a PE in a similar way.
Again the recipient must be the beneficial owner of the royalty to benefit from this article.

The term royalty is defined as:

"any payment of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, any patent trademark design or model, plan, secret formula or process or for information concerning industrial commercial or scientific experiment"

Thus the use of **software** can come within this definition. However, this is not a straightforward area and will depend on the facts. The commentary to the convention gives some guidance. The payment for the acquisition of partial or full rights to the copyright on software will be a royalty. However the right to copy the software on to the user's hardware alone will not constitute a royalty. Likewise site licenses, enterprise licenses and network licenses which allow multiple copying, but only to the extent necessary for the operation of the user's network will not be royalties. In each case it will depend on the facts.

The commentary clarifies that electronic ordering and downloading of goods may give rise to a royalty. This will arise where the ordering and downloading is for commercial exploitation by the recipient.

Where the customer is paying for acquisition of data that is transmitted digitally, a royalty does not arise. However if a book publisher purchases the right to reproduce a picture, and that picture is digitally downloaded, then he has paid for the right to reproduce the picture, rather than just acquiring the digital content. As a result a royalty will arise.

Article 13 deals with **capital gains**. Gains from **immoveable property** are taxable in the state where the property is **situated**. Gains from **moveable property** are taxable in the state where the owner is **resident**, unless they are part of a **PE** in another state, in which case they are taxed in that other state.

## 3.5 Chapter IV: Taxation of capital

Article 22 provides for capital represented by immoveable property to be taxed in the state where it is situated

Capital represented by moveable property which forms part of a PE will be taxed in the state of the PE. Otherwise moveable property is taxed in the state of residence of the owner.

This article is not frequently met in practice since tax on holding or having capital, e.g. net worth, is comparatively rare.

## 3.6 Chapter V: Method of elimination of double taxation

This chapter provides two methods of giving relief from double taxation and leaves the choice to the contracting state.

Article 23A sets down the **exemption** method. Under this method the income is exempted in the state of residence, although it may be taken account of in calculating total income in computing the tax liability, i.e. where there are progressive tax rates.

Article 23B sets down the **credit** method. A deduction is given from the tax due in the state of residence for the tax paid in the other state. This may be a full credit for the tax paid or credit only to the amount of tax that would be due in the home state.

The difference between the two is that the exemption method focuses on income and the credit method focuses on tax.

## 3.7 Chapter VI: Special Provisions

This chapter looks at non-discrimination, mutual agreement procedures and exchange of information.

Article 24 provides for **non-discrimination**, stipulating that the burden of tax for a non-national should not be any greater than that of a national in the same circumstances. Likewise, it also provides that a PE should not be treated less favourably then an enterprise of the other state.

Article 25 lays down a **mutual agreement** procedure. It states that where a person considers that the action of one or both contracting states will result in him being taxed not in accordance with the convention, he may apply to the **competent authority** in his state of residence to resolve the issue. The competent authority will seek to resolve the issue by dealing with the other competent authority. The article provides that they **can communicate directly** or through a joint committee.

The competent authorities are to endeavour to resolve by mutual agreement any difficulties or doubts arising from interpretation of the treaty and so they may also consult in elimination of double taxation in cases not provided for in the convention.

A typical area where the mutual agreement procedure is used is under the associated enterprises Article (Article 9 OECD Model) affecting transfer prices of goods and services supplied across borders. Either the competent authorities try to resolve a past issue, or they may try to come to an agreement as to the future treatment (i.e. "advance pricing agreements" – backed up by domestic legislative procedures), or both.

A new paragraph was added to article 25 which, if adopted by the parties to the treaty, provides for arbitration for matters that have not been agreed within 2 years.

Article 26 deals with **exchange of information**. It provides that the competent authorities shall exchange such information as necessary for carrying out the provisions of the convention or domestic law, and is not restricted by article 1 to those persons covered by the convention.

The information received shall be treated as secret and only disclosed to authorities concerned with tax.

The rules on exchange of information have been codified and expanded by the Finance Act 2006. Agreements may now be made that cover information in relation to direct and indirect taxes and the recovery of tax debts.

Article 27 was added in January 2003. It deals with the assistance in the **collection of taxes**. This article provides that the contracting states will lend assistance to each other in collecting tax. The assistance is not limited to the taxes covered by the treaty - it can extend to all taxes levied by the contracting states. If tax is owed to one contracting state, then the other contracting state can be asked by the competent authority of the first contracting state to collect it. The tax will then be collected under the rules for collection of tax in the other contracting state.

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## 3.8 Chapter VII: Final provisions

These chapters deal with entry into force and termination.

Entry into force happens when the instruments setting down the bilateral agreement are ratified and exchanged by the contracting states.

A double tax treaty will terminate in accordance with Article 30 when either contracting state gives notice through diplomatic channels of the termination, at least 6 months before the end of any calendar year. It is left open for the contracting states to give an earliest year by which termination can be given.

**Example 1**

**Which of the following statements is true**:

1) The OECD model tax convention covers all taxes.
2) The OECD model tax convention covers taxes on income and capital.
3) The OECD model convention covers taxes on income, capital and VAT.

**Example 2**

McGinley Ltd, a UK resident company, has won a contract to install thermal insulation in all government buildings in Ruritania. The company will send a team of 8 men to Ruritania in January 2012. They envisage that all installation work will be complete by November 2012.

**Will McGinley have a permanent establishment in Ruritania under the terms of the OECD model treaty?**

**Example 3**

Clarke Limited, a UK resident company, has 10% of the share capital in Overseas Ltd, a company resident in a country that has a tax treaty with the UK in line with the model convention.

Overseas Ltd declares a dividend of £500,000.

**You are required to explain the rules set out in article 10 of the double tax treaty in relation to the taxing of this dividend.**

**Answer 1**

Only the second statement is true.

**Answer 2**

Provided the installation is completed within 12 months there will not be a PE.

**Answer 3**

Article 10 provides that the dividend will be taxable in the UK, as this is where the recipient Clarke Ltd is resident. In addition the dividend may also be subject to tax where it arises - the withholding tax permitted for a 10% holding is 15%.

Thus Clarke may receive its share of the dividend net of 15% withholding tax.