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TAX CONVENTION WITH THE UNITED KINGDOM

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Mr. LUGAR from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 107–19]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed at London on July 24, 2001, together with an Exchange of Notes, as amended by the Protocol signed at Washington on July 19, 2002, having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

CONTENTS

		Page
I.	Purpose	1
II.	Background	2
III.	Summary	2
IV.	Entry Into Force and Termination	3
V.	Committee Action	4
VI.	Committee Comments	5
VII.	Budget Impact	16
VIII.	Explanation of Proposed Treaty	17
IX.	Text of Resolution of Ratification	17

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and the United Kingdom are to reduce or eliminate double taxation of income earned by residents of either

country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

II. Background

The proposed treaty was signed on July 24, 2001. The United States and the United Kingdom exchanged notes on the same day to provide clarification with respect to the application of the proposed treaty. The proposed protocol was signed on July 19, 2002. The proposed treaty, together with the proposed protocol and the exchange of notes, would replace the existing income tax treaty between the United States and the United Kingdom that was signed in 1975.

The proposed treaty, together with the proposed protocol and the exchange of notes, was transmitted to the Senate for advice and consent to its ratification on November 14, 2002 (see Treaty Doc. 107–19). The Committee on Foreign Relations held a public hearing on the proposed treaty on March 5, 2003.

III. Summary

The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the proposed treaty contains certain substantive deviations from these treaties and models.

As in other U.S. tax treaties, the purposes of the treaty principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited or eliminated by the proposed treaty (Articles 10, 11, and 12). In the case of dividends, the proposed treaty contains provisions that for the first time in a U.S. income tax treaty would eliminate source-country tax on certain dividends in which certain ownership thresholds and other requirements are satisfied.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 24).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty contains provisions which can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), the other income article (Article 22), and the insurance excise tax provision of the business profits article (Article 7(5)) with respect to amounts paid under, or as part of, a conduit arrangement. The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 23).

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty will enter into force upon the exchange of instruments of ratification. The effective dates of the treaty's provisions, however, vary.

With respect to the United States, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

With respect to the United Kingdom, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to income taxes not described in the preceding sentence and with respect to capital gains taxes, the proposed treaty will be effective for any year of assessment beginning on or after the sixth day of April next following the date on which the proposed treaty enters into force. With respect to the corporation tax, the proposed treaty will be effective for any financial year beginning on or after the first day of April next following the date on which the proposed treaty enters into force. With respect to petroleum revenue taxes, the proposed treaty will be effective for chargeable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

The present treaty generally will cease to have effect in relation to any tax from the date on which the proposed treaty takes effect

in relation to that tax. Taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For such a taxpayer, the present treaty would continue to have effect in its entirety for a twelve-month period from the date on which the provisions of the proposed treaty would otherwise take effect. The present treaty will terminate on the last date on which it has effect in relation to any tax in accordance with the provisions of this article.

Notwithstanding the entry into force of the proposed treaty, an individual who is entitled to the benefits of Article 21 (Students and Trainees) of the present treaty at the time the proposed treaty enters into force will continue to be entitled to such benefits as if the present treaty remained in force.

The notes provide that the provisions of Article 26 (Mutual Agreement Procedure) and Article 27 (Exchange of Information and Administrative Assistance) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

B. TERMINATION

The proposed treaty will remain in force until terminated by either country. Either country may terminate the proposed treaty by giving notice of termination to the other country through diplomatic channels. In such case, with respect to the United States, a termination is effective with respect to taxes withheld at source for amounts paid or credited after six months following notice of termination. With respect to other taxes, a termination is effective for taxable periods beginning on or after the date that is six months following notice of termination.

With respect to the United Kingdom, a termination is effective with respect to taxes withheld at source for amounts paid or credited after six months following notice of termination. With respect to income taxes not described in the preceding sentence and with respect to capital gains taxes, a termination is effective for any year of assessment beginning on or after the date that is six months following the notice of termination. With respect to the corporation tax, a termination is effective for any financial year beginning on or after the date that is six months following notice of termination. With respect to the petroleum revenue tax, a termination is effective for chargeable periods beginning on or after the date that is six months following notice of termination.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed treaty with the United Kingdom (Treaty Doc. 107–19) on March 5, 2003. The hearing was chaired by Senator Hagel.[1] The Committee considered the proposed treaty on March 12, 2003, and ordered the proposed treaty with the United Kingdom favorably reported by a vote of 19 in favor and 0 against, with the rec-

[1] The transcript of this hearing will be forthcoming as a separate Committee print.

ommendation that the Senate give its advice and consent to ratification of the proposed treaty.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed treaty with the United Kingdom is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty and believes that the following comments may be useful to the Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. ZERO RATE OF WITHHOLDING TAX ON DIVIDENDS FROM 80-PERCENT-OWNED SUBSIDIARIES

In general

The proposed treaty would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (subparagraph 3(a) of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Unlike the United States, the United Kingdom currently does not impose withholding tax on dividends paid to foreign shareholders as a matter of domestic law. Thus, the principal immediate effect of this provision would be to exempt dividends that U.S. subsidiaries pay to U.K. parent companies from U.S. withholding tax. With respect to dividends paid by U.K. subsidiaries to U.S. parent companies, the effect of this provision would be to lock in the currently applicable zero rate of U.K. withholding tax, regardless of how U.K. domestic law might change in this regard.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, subsequent to the signing of the proposed treaty, the United States signed proposed protocols with Australia and Mexico that include zero-rate provisions similar to the one in the proposed treaty.

Description of provision

Under the proposed treaty, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 (Dividends)). Under the current U.S.-U.K. treaty, these dividends may be taxed at a 5-percent rate (although, as noted above, the United Kingdom

currently does not exercise this right as a matter of domestic law, whereas the United States does).

In certain circumstances, eligibility for the zero rate under the proposed treaty is subject to an additional restriction designed to prevent companies from reorganizing for the purpose of obtaining the benefits of the provision. Specifically, in cases in which a company satisfies the Limitation on Benefits article only under the "active trade or business" and/or "ownership/base-erosion" tests (paragraph 4 and subparagraph 2(f), respectively, of Article 23 (Limitation on Benefits)), the zero rate will apply only if the dividend-receiving company owned (directly or indirectly) at least 80 percent of the voting power of the dividend-paying company prior to October 1, 1998. In other cases, the Limitation on Benefits article itself is considered sufficient to prevent treaty shopping. Thus, companies that qualify for treaty benefits under the "public trading," "derivative benefits," or discretionary tests (subparagraph 2(c) and paragraphs 3 and 6, respectively, of Article 23 (Limitation on Benefits)) will not need to meet the October 1, 1998 holding requirement in order to claim the zero rate.

Benefits and costs of adopting a zero rate with the United Kingdom

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit, withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in the United Kingdom, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-

receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since the United Kingdom does not impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by U.K. companies, as opposed to direct investment in the United Kingdom by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.

Adopting a zero-rate provision in the U.S.-U.K. treaty would have uncertain revenue effects for the United States. The United States would forgo the 5-percent tax that it currently collects on qualifying dividends paid by U.S. subsidiaries to U.K. parent companies, but since the United Kingdom currently does not impose any tax on comparable dividends paid by U.K. subsidiaries to U.S. parent companies, there would be no offsetting revenue gain to the United States in the form of decreased foreign tax credit claims with respect to withholding taxes. However, in order to account for the recent repeal of the U.K. advance corporation tax and related developments, the proposed treaty also eliminates a provision of the present treaty requiring the United States to provide a foreign tax credit with respect to certain dividends received from U.K. companies. On balance, these two effects are likely to increase revenues for the U.S. fisc. Over the longer term, if capital investment in the United States by U.K. persons is made more attractive, total investment in the United States may increase, ultimately creating a larger domestic tax base. However, if increased investment in the United States by U.K. persons displaced other foreign or U.S. investments in the United States, there would be no increase in the domestic tax base.

Revenue considerations aside, the removal of an impediment to the import of capital from the United Kingdom into the United States is a not-inconsiderable economic benefit. Further, it should be noted that, although U.K. internal law currently does not impose a withholding tax on dividends paid to foreign persons, there is no guarantee that this will always be the case. Thus, the inclusion of a zero-rate provision in the treaty would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in the United Kingdom, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that the U.K. were to change its internal law in this regard.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary

Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed treaty is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

Committee conclusions

The Committee believes that every tax treaty must strike the appropriate balance of benefits in the allocation of taxing rights. The agreed level of dividend withholding for intercompany dividends is one of the elements that make up that balance, when considered in light of the benefits inuring to the United States from other concessions the treaty partner may make, the benefits of facilitating stable cross-border investment between the treaty partners, and each partner's domestic law with respect to dividend withholding tax.

In the case of this treaty, considered as a whole, the Committee believes that the elimination of withholding tax on intercompany dividends appropriately addresses a barrier to cross-border investment. The Committee believes, however, that the Treasury Department should only incorporate similar provisions into future treaty or protocol negotiations on a case-by-case basis, and it notes with approval Treasury's statement that "[i]n light of the range of facts that should be considered, the Treasury Department does not view [elimination of withholding tax on intercompany dividends] as a blanket change in the United States' tax treaty practice."

The Committee encourages the Treasury Department to develop criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in future negotiations with other countries. The Committee expects the Treasury Department to consult with the Committee with regard to these criteria and to the consideration of elimination of the withholding tax on intercompany dividends in future treaties.

B. ANTI-CONDUIT RULE

In general

The proposed treaty includes an anti-conduit rule that can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), the other income article (Article 22), and the insurance excise tax provision of the business profits article (Article 7(5)). This rule is not found in any other U.S. treaty, and it is not included in the U.S. or OECD models. The rule is similar to, but significantly narrower and more precise than, the "main purpose" rules that the Senate

rejected in 1999 in connection with its consideration of the U.S.-Italy and U.S.-Slovenia treaties.[2]

The rule was included at the request of the United Kingdom, which has similar provisions in many of its tax treaties. The purpose of the rule, from the U.K. perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of U.K. tax provided under the treaty by channeling payments to a third-country resident through a U.S. resident (acting as a "conduit").

From the U.S. perspective, the rule is unnecessary outside the context of the insurance excise tax, because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.[3] Thus, apart from accommodating the request of a treaty partner, no apparent U.S. interest is served by adding a general anti-conduit rule to the treaty.

Description of provision

Under the proposed general anti-conduit rule, the benefits of the dividends, interest, royalties, and other income articles are denied in connection with any payment made under, or as part of, a "conduit arrangement" (Articles 10(9), 11(7), 12(5), and 22(4), respectively). Article 3(1)(n) defines the term "conduit arrangement" as a transaction or series of transactions that meets both of the following criteria: (1) a resident of one contracting state receives an item of income that generally would qualify for treaty benefits, and then pays (directly or indirectly, at any time or in any form) all or substantially all of that income to a resident of a third state who would not be entitled to equivalent or greater treaty benefits if it had received the same item of income directly; and (2) obtaining the increased treaty benefits is the main purpose or one of the main purposes of the transaction or series of transactions.

The inclusion of the first criterion above limits the scope of the rule to situations involving objectively defined conduit payments. Thus, the rule is less vague and more narrowly targeted than the similar rules that the Senate rejected in the proposed U.S.-Italy and U.S.-Slovenia treaties, which would have applied to any transaction that met a "main purpose" test similar to the second criterion described above.

Issues

The proposed general anti-conduit rule may create confusion, because it applies not only to conduit arrangements in which a reduction in U.K. tax is claimed, but also to conduit arrangements in which a reduction in U.S. tax is claimed, despite the fact that there is no apparent reason for the rule to apply in the latter circumstance, in view of the existence of anti-conduit provisions under U.S. domestic law. To the extent that the proposed treaty's anti-

[2] *See* Senate Committee on Foreign Relations, *Report, Tax Convention with Italy,* Exec. Rpt. 106–8, Nov. 3, 1999; Senate Committee on Foreign Relations, *Report, Tax Convention with Slovenia,* Exec. Rpt. 106–7, Nov. 3, 1999; *see also* Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic* (JCS-9-99), October 8, 1999; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty between the United States and the Republic of Slovenia* (JCS-11-99), October 8, 1999.

[3] *See* Code sec. 7701(l); Treas. Reg. sec. 1.881-3.

conduit rule and the U.S. domestic-law anti-conduit rules are not consistent in every particular, taxpayers may be confused as to which set of rules the United States will apply in certain situations.

In order to mitigate this potential confusion, as well as to provide guidance as to how the United Kingdom will apply the anti-conduit rule in situations in which a reduction in U.K. tax is claimed, the parties executed an exchange of letters in July 2002, in which they described in some detail how they intend to apply the anti-conduit rule.

The U.S. letter suggests that the United States simply will continue to apply its domestic law, without regard to the treaty rule:

> With respect to the United States, we intend to interpret the conduit arrangement provisions of the Convention in accordance with U.S. domestic law as it may evolve over time. The relevant law currently includes in particular the rules of regulation section 1.881-3 and other regulations adopted under the authority of section 7701(l) of the Internal Revenue Code. Therefore, the inclusion of the conduit arrangement rules in the Convention does not constitute an expansion (or contraction) of U.S. domestic anti-abuse principles (except with respect to the application of anti-conduit principles to the insurance excise tax).[4]

An annex to the U.S. letter provides six examples illustrating how the United States intends to apply the rule in a manner consistent with current U.S. domestic law. This statement of intent from the U.S. perspective should substantially mitigate the potential uncertainty regarding how the United States will treat conduit arrangements.

The U.K. letter includes an annex that evaluates examples analogous to those set forth in the annex to the U.S. letter, reaching results consistent with those of the U.S. letter. The U.K. letter thus provides helpful guidance as to how the anti-conduit rules of the proposed treaty will be applied in cases in which a reduction in U.K. tax is claimed.

On balance, the Committee believes that the exchange of letters along with the attached examples provide adequate guidance as to the application of these anti-conduit rules that were included in the proposed treaty at the request of the United Kingdom.

C. CREDITABILITY OF U.K. PETROLEUM REVENUE TAX

Treatment under the proposed treaty

The proposed treaty extends coverage to the U.K. Petroleum Revenue Tax (paragraph 3(b)(iv) of Article 2 (Taxes Covered)). Article 24 of the proposed treaty (Relief from Double Taxation) further provides, among other things, that the U.K. Petroleum Revenue Tax is to be considered an income tax that is creditable against U.S. tax on income, subject to the provisions and limitations of that provision of the proposed treaty.

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[4] *See* Letter from Barbara M. Angus, International Tax Counsel, Department of the Treasury, to Gabriel Makhlouf, Director, Inland Revenue, International Division, July 19, 2002.

Specifically, the proposed treaty provides that the amount that the United States will allow as a credit against U.S. tax on income for U.K. Petroleum Revenue Taxes imposed on income from the extraction of minerals from oil or gas wells is limited to the amount attributable to U.K.-source taxable income. The proposed treaty further limits the creditable amount, however, to: (1) the product of the maximum statutory U.S. rate applicable to a corporation (i.e., 35 percent) and the amount of such extraction income; less (2) the amount of other U.K. taxes imposed on such extraction income. The proposed treaty provides that U.K. Petroleum Revenue Taxes from the extraction of minerals from oil or gas wells in excess of the above limitation may be used as a credit in the two preceding or five succeeding taxable years in accordance with the limitation described above. The proposed treaty further provides that its special rules on creditability apply separately and in the same way to the amount of U.K. Petroleum Revenue Tax imposed on income from the initial transportation, initial treatment, and initial storage of minerals from oil or gas wells in the United Kingdom.

To the extent that a taxpayer would obtain a more favorable result with respect to the creditability of the U.K. Petroleum Revenue Tax under the Code than under the proposed treaty, the taxpayer could choose not to rely on the proposed treaty. The Technical Explanation to Article 24 of the proposed treaty states that if a person chooses in any year not to rely on the proposed treaty to claim a credit for U.K. Petroleum Revenue Taxes, then the special limitations under the proposed treaty would not apply for that year. Instead, the current overall foreign tax credit limitations of the Code would apply, and U.K. Petroleum Revenue Taxes creditable under the Code could be used, subject to the Code's limitations, to offset U.S. tax on other income from U.K. and other foreign sources.

Thus, the proposed treaty operates to create a separate "per country" limitation with respect to each U.S. category of extraction income, and initial transportation, treatment, and storage income on which U.K. Petroleum Revenue Tax is assessed. Accordingly, U.K. Petroleum Revenue Tax paid with respect to extraction income cannot be used as a credit to offset U.S. tax on: (1) oil and gas extraction income arising in another country; (2) U.K.-source transportation, treatment, or storage income on which U.K. Petroleum Revenue Tax is assessed; or (3) other U.K.-source non-oil related income.

U.K. internal law

The U.K. Petroleum Revenue Tax, introduced in 1975, is currently imposed at a rate of 50 percent on assessable profits from oil and gas extraction and certain other activities in the United Kingdom (including the North Sea) on a field-by-field basis. Under a separate Ring Fence Tax, oil and gas companies are required to segregate their income and expenses attributable to oil and gas related activities, and pay a separate corporate income tax for taxable income from unrelated activities. The U.K. Petroleum Revenue Tax is imposed in addition to, and separate from, this Ring Fence Tax. The amount of U.K. Petroleum Revenue Tax paid is allowed as a deduction for purposes of computing the Ring Fence Tax. The U.K. Petroleum Revenue Tax applies to fields approved for develop-

ment on or before March 15, 1993. Revenues from fields approved after March 15, 1993, are only subject to regular U.K. corporate income tax.

The U.K. Petroleum Revenue Tax is imposed on income relating to the extraction of oil and gas in the United Kingdom including such areas as the North Sea, income earned by taxpayers providing transportation, treatment, and other services relating to oil and gas resources in such areas, and income relating to the sale of such oil and gas related assets. With the exception of interest expense, most significant costs and expenses are currently deductible in determining taxable income. Operating losses may be carried back or forward without limit to income associated with a particular field.

Various other deductions and allowances are available against income assessed for these purposes, including: a supplemental uplift charge equal to 35 percent of most capital expenditures relating to a field; an oil allowance or exemption from the U.K. Petroleum Revenue Tax for each field up to a certain amount of metric tons of oil; a tariff receipts allowance for transportation receipts up to a certain amount, and certain non-field specific expenses such as research.

The proposed treaty treats the U.K. Petroleum Revenue Tax, and any substantially similar tax, as a creditable tax for U.S. foreign tax credit purposes. The United States Tax Court has recently addressed the creditability under the Code and the regulations under Code section 901 of the U.K. Petroleum Revenue Tax in the case of *Exxon* v. *Commissioner.*[5]

In *Exxon* v. *Commissioner,* the United Kingdom granted licenses to Exxon for the exploitation of petroleum resources in the U.K.'s segment of the North Sea. Under those licenses, Exxon paid royalties, upfront fees, and annual fees. After the grant of the licenses, the U.K. enacted a modified version of the U.K. corporate income tax (the Ring Fence Tax) and the U.K. Petroleum Revenue Tax for oil production activities. The Tax Court considered whether the U.K. Petroleum Revenue Tax satisfied the net income requirement under the section 901 regulations and whether the U.K. Petroleum Revenue Tax was paid in exchange for a specific economic benefit (e.g., a royalty and not a tax). With respect to the net income issue, the court held that, notwithstanding the nondeductibility of interest expense in computing taxable income, the various allowances against the U.K. Petroleum Revenue Tax (particularly the 35 percent uplift charge which based on the Court's findings significantly exceeded interest expense) resulted in the predominant character of the tax being in the nature of an income or profits tax in the U.S. sense. With respect to the specific economic benefit issue, the court held that the U.K. Petroleum Revenue Tax paid for the years in question (1983-1988) constituted taxes and not payments for specific economic benefits. In so holding, the court relied on the fact that Exxon acquired its licenses to extract oil from the North Sea before the U.K. Petroleum Revenue Tax was enacted and that it received no new or additional benefits as a result of paying the U.K.

[5] 113 T.C. 338 (1999).

Petroleum Revenue Tax.[6] The court thus found the U.K. Petroleum Revenue Tax paid by Exxon to be creditable under U.S. law.

The Internal Revenue Service acquiesced in the Exxon decision, but only as to its results.[7] The Internal Revenue Service indicated in its acquiescence that it will only follow the opinion in disposing of cases involving the U.K. Petroleum Revenue Tax where the facts are substantially similar to those in the Exxon case. Since such determinations are inherently factual, the determination of the creditability of the U.K. Petroleum Revenue Tax under U.S. law as a general matter is unclear.

If the U.K. Petroleum Revenue Tax would generally be considered creditable under the Code, then there may be a question as to the need for the additional limitations provided under the proposed treaty for determining the amount of creditable U.K. Petroleum Revenue Tax. Taxpayers are likely to rely on the proposed treaty only to the extent that it provides them with a more favorable foreign tax credit result than would otherwise result from the application of the Code. In addition, since the U.K. Petroleum Revenue Tax has been eliminated with respect to fields approved after March 15, 1993, it is unclear to what extent these creditability issues will remain important in future years.

On the other hand, to the extent that it is unclear whether the U.K. Petroleum Revenue Tax is generally considered to be creditable under U.S. law, the primary issue is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be fully creditable and, in cases where a treaty does provide creditability, to what extent the treaty should impose limitations not contained in the Code. A related issue is whether a controversial matter in U.S. tax policy such as the tax credits to be allowed U.S. oil companies on their foreign extraction operations should be resolved through the treaty process rather than through the normal legislative process.

Similar provisions making Denmark's Hydrocarbon Tax, Norway's Submarine Petroleum Resource Tax, and the Netherlands's Profit Share creditable are contained in the U.S.-Denmark income tax treaty, the protocol to the U.S.-Norway income tax treaty, and the U.S.-Netherlands income tax treaty, respectively. Also at issue, therefore, is whether the United Kingdom should be denied a special treaty credit for taxes on oil and gas extraction income when Denmark, Norway, and the Netherlands, its North Sea competitors, now receive a similar treaty credit under the U.S. income tax treaties with those countries currently in force. On the one hand, it would appear fair to treat the United Kingdom like Denmark, Norway, and the Netherlands. On the other hand, the United States should not view any particular treaty concession to one country as requiring identical or similar concessions to other countries.The present treaty contains a similar provision providing for the creditability of the U.K. Petroleum Revenue Tax. During Senate consid-

[6] The Court further based its holding that Exxon did not pay the U.K. Petroleum Revenue Tax in exchange for specific economic benefits based on the following: (1) the royalties and other fees paid by Exxon represented substantial and reasonable compensation, (2) the U.K.'s purposes in enacting the U.K. Petroleum Revenue Tax was to take advantage of increases in oil prices and to assure itself of a share of those excess profits, and (3) the U.K. Petroleum Revenue Tax had all of the characteristics of a tax and was intended to be a tax.

[7] 2001–31 I.R.B. 98 (August 20, 2001).

eration of the third protocol to the present treaty, a reservation was proposed to apply similar per-country limitations to prevent U.S. oil companies from using the U.K. Petroleum Revenue Tax as a credit against their U.S. tax liability on extraction income from other countries.[8] The reservation was withdrawn and the per-country limitations were included in that protocol to the present treaty.

D. TEACHERS, STUDENTS, AND TRAINEES

Treatment under proposed treaty

The proposed treaty generally would not change the application of income taxes to certain individuals who visit the United States or United Kingdom as students, teachers, academic researchers, or so-called "business apprentices" engaged in full-time training. The present treaty (Article 20) provides that a professor or teacher who visits the United States from the United Kingdom or the United Kingdom from the United States for a period of two years or less to engage in teaching or research at a university or college is exempt from tax by the host country on any remuneration received for such teaching or research. In addition, the present treaty (Article 21) provides that certain payments that a student or business apprentice who visits the United States from the United Kingdom or the United Kingdom from the United States to pursue full-time education at a university or college or to engage in full-time training are exempt from taxation by the host country. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. Under Article 20 of the proposed treaty, U.S. taxpayers who are visiting the United Kingdom and individuals who immediately prior to visiting the United States were resident in the United Kingdom will be exempt from income tax in the host country on certain payments received if the purpose of their visit is to engage in full-time education at a university or college or to engage in full-time training. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. In the case of individuals engaged in full-time training, the exemption from income tax in the host country applies only for a period of one year or less.

Under Article 20A of the proposed treaty, U.S. taxpayers who are visiting the United Kingdom and individuals who immediately prior to visiting the United States were resident in the United Kingdom will be exempt from income tax in the host country on remuneration they receive for teaching or research at a university, college, or other recognized educational institution. The exemption is limited to visiting periods of two years or less.

Transition rule

Under the entry in force provisions of the proposed treaty (Article 29), taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the pro-

[8] The text of the proposed reservation is reprinted at 124 Cong. Rec. S9559 (daily ed., June 27, 1978).

posed treaty takes effect. For an individual engaged in full-time training, Article 21 of the present treaty would continue to have effect in its entirety until such time as the individual had completed his or her training. For some individuals this special rule may provide benefits under the present treaty that exceed those available under the general transition rule. The general transition rule would provide that an individual would have the benefits of the present treaty for twelve months from the date on which the proposed treaty comes into force.

Issues

Unlike the U.S. model, but like the present treaty, the proposed treaty would provide an exemption from the host country income tax for income an individual receives from teaching or research in the host country. Prior to amendment by the protocol, the proposed treaty would have followed the U.S. model and no such exemption would have been provided. Article 20 of the present treaty and Article 20A of the proposed treaty provide that a teacher who visits a country for the purpose of teaching or engaging in research at a recognized educational institution generally is exempt from tax in that country for a period not exceeding two years. Under the proposed treaty, a U.S. person who is a teacher or professor may receive effectively an exemption from any income tax for income earned related to visiting the United Kingdom for the purpose of engaging in teaching or research for a period of two years or less. Under the terms of the treaty, the United Kingdom would exempt any such income of a U.S. person from U.K. income tax. Under Code sec. 911, $80,000 would be exempt from U.S. income tax in 2003 through 2007,[9] and in addition certain living expenses would be deductible from income. To the extent the U.S. teacher's or professor's remuneration related to his or her visit to the United Kingdom was less than $80,000, the income would be tax free. Likewise, under the proposed treaty, a U.K. person who is a teacher or professor may receive effectively an exemption from any income tax for income earned related to visiting the United States for the purpose of engaging in teaching or research for a period of two years or less. Under the terms of the treaty, the United States would exempt any such income from U.S. income tax. Under the terms of U.K. tax law, such income generally would not be taxable by the U.K. as the individual would not be resident in the United Kingdom.

The effect of the proposed treaty is to make such cross-border visits more attractive financially. Ignoring relocation expenses, a U.S. citizen or permanent resident may receive more net, after-tax remuneration from teaching or research from visiting the United Kingdom as a teacher or researcher than if he or she had remained in the United States. Likewise a U.K. resident may receive more net, after-tax remuneration from teaching or research from visiting the United States as a teacher or researcher than if he or she had remained in the United Kingdom. Increasing the financial reward may serve to encourage cross-border visits by academics. Such

[9] For years after 2007, the $80,000 amount is indexed for inflation after 2006 (Code sec. 911(b)(2)(D)).

cross-border visits by academics for teaching and research may foster the advancement of knowledge and redound to the benefit of residents of both countries.

On the other hand, complete exemption from income tax in both the United States and the United Kingdom may be seen as unfair when compared to persons engaged in other occupations whose occupation or employment may cause them to relocate temporarily abroad. For a U.S. citizen or permanent resident who is not a teacher or professor, but who temporarily takes up residence and employment in the United Kingdom, his or her income is subject to income tax in the United Kingdom and may be subject income tax in the United States. Likewise, for a U.K. resident who is not a teacher or professor, but who temporarily takes up residence and employment in the United States, his or her income is subject to income tax in the United States. In other words, the proposed treaty could be said to violate the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

The proposed treaty reverses the position of the originally proposed treaty with respect to visiting teachers and professors. Prior to amendment by the protocol, the proposed treaty would have followed the U.S. model and no such exemption would have been provided. While this is the position of the U.S. model, an exemption for visiting teachers and professors has been included in many bilateral tax treaties. Of the more than 50 bilateral income tax treaties in force, 30 include provisions exempting from host country taxation the income of a visiting individual engaged in teaching or research at an educational institution, and an additional 10 treaties provide a more limited exemption from taxation in the host county for a visiting individual engaged in research. Although the proposed protocols with Australia and Mexico would not include similar provisions, three of the most recently ratified income tax treaties did contain such a provision.[10]

Committee conclusions

The Committee notes that while the provision regarding the taxation of visiting teachers and professors is inconsistent with the U.S. Model, over half of the bilateral income tax treaties in force contain a similar provision. The provision in the U.K. treaty was included in three of the seven income tax treaties reported by the Committee in 1999. However, the provision was not included in the proposed protocols with Mexico and Australia under consideration by the Committee. The Committee encourages the Treasury Department to develop criteria for determining under what circumstances this provision is appropriate.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to cause

[10] The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, contain provisions exempting the remuneration of visiting teachers and professors from host country income taxation. The treaties with Denmark, Estonia, Latvia, and Lithuania, also considered in 1999, did not contain such an exemption, but did contain a more limited exemption for visiting researchers.

a negligible change in Federal budget receipts during the fiscal year 2003–2012 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and the United Kingdom can be found in the pamphlet of the Joint Committee on Taxation entitled Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom (JCS-4-03), March 3, 2003.

IX. Text of Resolution of Ratification

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed at London on July 24, 2001, together with an Exchange of Notes, as amended by the Protocol signed at Washington on July 19, 2002 (Treaty Doc. 107–19).

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