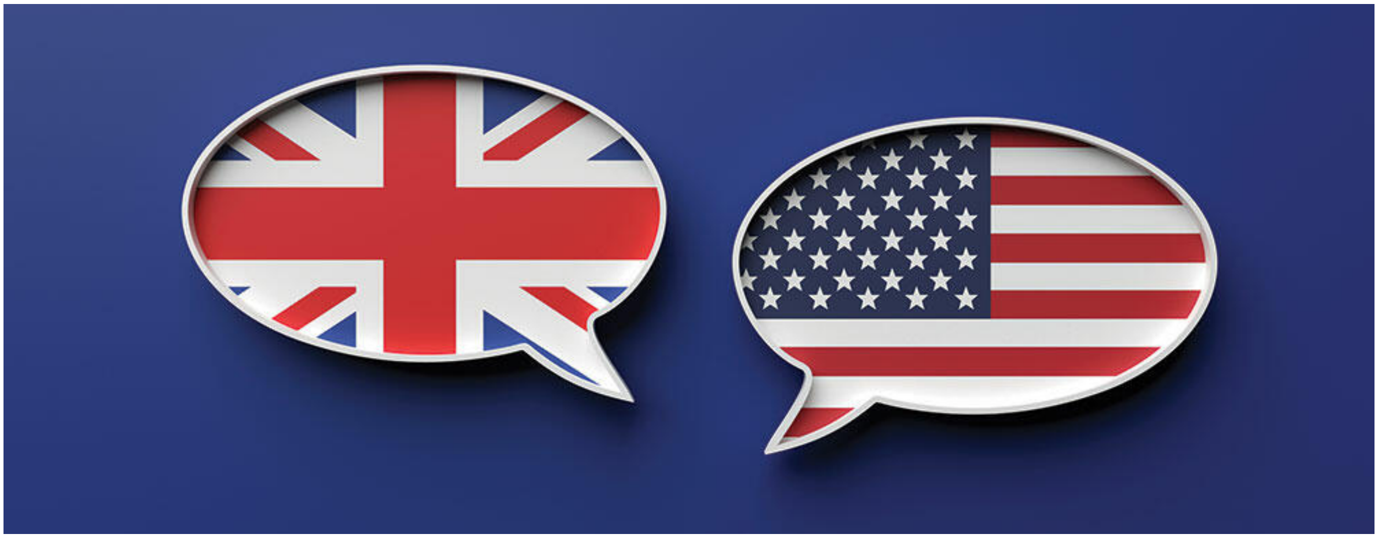
A special relationship

International Tax



29 November 2021

Jonathan Schwarz considers the significance and idiosyncrasies of the US-UK tax treaties

The importance of tax treaties between the UK and the United States cannot be underestimated.

The US has been the single largest source of foreign direct investment into the UK for decades and the UK is similarly the second biggest direct investor into the United States. The US is also the UK’s second largest trading partner.

As with all tax treaties, these treaties are best understood in the context of the tax and legal systems of the two countries. Double tax treaties between these two countries date back to 1945. The 1945 comprehensive income tax treaty was first replaced in 1975, and subsequently with the current treaty on income and capital gains that was concluded in 2001 and amended by protocol in 2002.

Very long gaps between the renegotiation of this important treaty relationship mean that the current treaty is applied in a very different tax environment of the domestic tax laws of the two countries from that which applied when the treaty was concluded. Some new taxes, such as the digital services tax, are designed to operate outside the treaty. The US is not a party to the OECD BEPS Multi lateral Instrument. The US-UK treaty does not benefit from arbitration provided in Part VI of the Multi lateral Instrument, despite the fact that both states favour arbitration as a dispute resolution mechanism.

That said, the US has frequently led the way in thinking about double tax treaties. For example, the treatment of fiscally transparent entities in Article 1(8) only appeared in 2017 in the Multilateral Instrument (as Article 3(1)) and the OECD Model (as Article 1(2)).

Despite this, difficulties continue in the UK with fiscally transparent US entities, such as limited liability companies, as demonstrated by the Supreme Court ruling in Anson v HMRC [2015] STC 1777, a decision which HMRC apparently still does not accept, other than in relation to the specific facts of that case. Fiscally transparent entities for US tax purposes were also at the heart of Bayfine UK v HMRC [2011] STC 717, one of the leading cases on treaty abuse.

Residence of entities

Where an entity, such as a company, is resident in both contracting states for purposes of the treaty, there is no tie-breaker mechanism to resolve that dual residence. Instead, the competent authorities of the two states must endeavour to agree on how the treaty should apply to the entity.

If they are unable to agree (as happened recently in G E Financial Investments Limited v HMRC [2021] UKFTT 210), then the entity is only entitled to credit for some tax paid, as well as access to the dispute resoluti on and non-discriminati on provisions of the treaty (Article 4(5).

In cases of non-agreement by the competent authorities, the UK must give credit for US tax paid by the entity on US source income. Thus, any tax payable on such income will be paid in the US and the UK will always be required to give double tax relief.

Personal taxation

The treaty provisions relating to the taxation of individuals are among the most complex found in UK treaties. The first source of complexity is the fact that the US taxes its citizens and Green Card holders on worldwide income, even if they are resident elsewhere. The result is that US persons living in the UK, or simply falling foul of the statutory residence test in Finance Act 2013 Sch 45, are automatically dual resident and, in principle, liable to tax on worldwide income in both the UK and the US.

Special provisions in Article 4 (Residence) are required to address this situation. Similarly, detailed provisions of Article 24 that deal with UK credit for US tax paid limit the scope of this relief in the case of US citizens and others who are taxed in a similar way in the US.

The second area where specific provisions are required is in relation to the UK treatment of resident but non-domiciled individuals. These are addressed by way of restrictions on the availability of treaty relief for UK remittance-based taxpayers in Article 1(7) and clarification of the domicile of women married before 1974 in Article 4(6).

Pensions

The treaty follows a common pattern in taxing pensions only in the state of residence of the pensioner, apart from lump-sum payments which are taxable only in the state where the pension schemes are established. Article 17 applies this treatment to all pensions and not just to pensions from employment. It also extends to annuities.

Cross-border pension arrangements are facilitated by rules that explicitly exempt beneficiaries of pension schemes established in one of the contracting states from tax in the state of the beneficiary’s residence until payments are made to the beneficiary and then only as pension income. In addition, deductions for contributions to pension schemes established in the state other than where the beneficiary is resident are generally deductible on the same basis as contributions to a scheme in the same state as the beneficiary.

Complex rules address the position of US citizens and UK resident but not domiciled individuals in relation to cross-border pension arrangements (Article 18).

Treaty shopping

The US-UK Treaty was one of the first to adopt the US style limitation of benefits article that restricts treaty benefits to qualifying persons. Although included at the request of the US, it also applies to exclude UK benefits. This is illustrated by the Court of Appeal decision in Aozora GMAC Investment Ltd, R (oAo) v HMRC [2018] STC 11, where a UK resident company was denied relief from US withholding tax and thus paid full US tax on interest. The company was also disqualified from claiming credit under the treaty in the UK for any US tax.

Departure from the EU by the UK meant that a UK person could not qualify as an ‘equivalent beneficiary’ under Article 23(7)(d)). As a result, while the derivative benefits test in Article 23(3) would permit certain UK companies controlled by residents of an EU member state to qualify for treaty benefits, the same UK companies controlled by UK residents would not qualify. However, on 28 July 2021 the UK and the US competent authorities agreed that UK residents would be treated as residents of an EU member state for this purpose.

This agreement allows those UK companies controlled by UK residents now to qualify for treaty benefits. The agreement does not apply to companies in the remaining EU member states which are controlled by UK residents that before Brexit qualified for US treaty benefits under treaties between those states and the US.

Treaty interpretation

An Exchange of Notes agreed concurrently with the conclusion of the treaty in 2001 sets out extensive agreement on the interpretation and application of the treaty. This agreement has not, however, always been helpful in casting light on the more difficult questions of interpretation. Macklin v HMRC [2015] STC 1102 is an example of where the Upper Tribunal found exchange of notes to be inconclusive.

Differences in the approach of the courts in the two countries to the interpretation of treaties may give rise to inconsistent views. In the UK, the Vienna Convention on the Law of Treaties is clearly the cornerstone of tax treaty interpretation even though the US has signed, but not ratified, the Convention (Anson v HMRC [2015] STC 1777). UK courts have also rejected decisions of the US courts where the US court has relied on statements made by the US Treasury (the so-called executive preference) on the basis that such statements are unilateral and do not reflect the agreement of the two contracting states (IRC v Commerzbank AG [1990] STC 285).

Dispute resolution

Presenting a case under the mutual agreement procedure in Article 26 follows the traditional OECD approach. This treaty does not, however, include the BEPS minimum standard that permits a taxpayer to present the case in either state. Thus, a case can only be presented in the state of residence or nationality. Latest OECD statistics on mutual procedure cases (2019) show that nearly 120 non-transfer pricing and nearly 20 transfer pricing cases between the US and the UK were presented in 2019.

In contrast, only about 70 non-transfer pricing and fewer than five transfer pricing cases were concluded by the competent authorities in that year.

The absence of binding mandatory arbitration found in more modern treaties, which permits a taxpayer to require arbitration, if the case is not resolved within two years of being presented, may contribute to the significant inventory of open cases.

Inheritance tax

The United States is also a party to one of the few estate and gift tax treaties that the UK has concluded. The 1978 tax treaty on this topic limits the ability of the UK to impose inheritance tax and the US to impose federal estate and gift taxes, as well as providing for credit relief where such double taxation arises. This rather old atypical treaty contains its own particular provisions resolving fiscal domicile and allocating taxing rights between the two contracting states.

FATCA Agreement

The US-UK agreement to improve international tax compliance and to implement FATCA was concluded in 2014 to give effect to the US Foreign Account Tax Compliance Act of 2010. Many of its provisions have been replicated in the Common Reporting Standard given effect by other international instruments such as the EU Mutual Assistance Directive and the multilateral Convention on Administrative Cooperation.

The FATCA agreement is unique in that the detailed obligations on HMRC to exchange financial information and on financial institutions to collect and report such information are not reciprocated by the US.