

TECHNICAL EXPLANATION 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 CAPITAL GAINS SIGNED AT LONDON, ON DECEMBER 31, 1975, AS AMENDED BY THE NOTES EXCHANGED AT LONDON ON APRIL 13, 1976, THE PROTOCOL SIGNED AT LONDON ON AUGUST 26, 1976, AND THE SECOND PROTOCOL SIGNED AT LONDON ON MARCH 31, 1977

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It is the practice of the Treasury Department to prepare for the use of the Senate and other interested persons a Technical Explanation of the tax conventions and protocols, which are submitted to the Senate for its advice and consent to ratification. This technical Explanation was submitted to the Senate Foreign Relations Committee at hearings held on July 19-20, testimony of the Treasury Department before the same Committee on June 6, 1979 (Treasury News Release M-145, dated October 25, 1979) and to make minor corrections.

An Income Tax Convention with the United Kingdom of Great Britain and Northern Ireland was signed April 13, 1976, and an Exchange of Notes was signed April 13, 1976, and submitted by the President to the Senate on June 24, 1976. Two Income Tax Protocols to the Convention were signed August 26, 1976 and March 31, 1977. The Senate voted its advice and consent on June 27, 1978 and instruments of ratification were exchanged on March 25, 1980.

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## ARTICLE 1 Personal Scope

This Article delineates the persons who come within the scope of the Convention. Paragraph (1) states the general rule that the Convention is applicable to residents of one or both of the Contracting States. The term "resident" of a Contracting State is defined in Article 4 (Fiscal Residence). In several cases, the Convention is also applicable to residents of third states because of their relationship with a resident of a Contracting State. For example, Articles 9 (Associated Enterprises), 25 (Mutual Agreement Procedure) or 26 (Exchange of Information and Administrative Assistance), may apply with respect to persons who are residents of neither Contracting State, and paragraph 5 of Article 10 (Dividends) and paragraph 6 of Article 11 (Interest) apply to dividends and interest derived by residents of third countries.

This paragraph is similar to Article 1 of the Draft Double Taxation Convention on Income and Capital developed by the Fiscal Committee of the Organization for Economic Cooperation and Development as published in 1963 and as thereafter revised (hereinafter referred to as the "OECD Model Convention").

Paragraph (2) deals with the treatment of a corporation which is a resident of both the United Kingdom within the meaning of paragraph (1)(a)(ii) of Article 4 (Fiscal Residence) and the United States (under paragraph (1)(b)(ii) of Article 4). Under those paragraphs, a corporation which is a United States corporation as defined by paragraph (1)(b) of Article 3 (General Definitions) and is managed and controlled in the United Kingdom would be a resident of both states. This Article clarifies the status of such corporations (hereinafter referred to as "dual-resident" corporations) for purposes of the Convention by providing that dual-resident corporations may not claim the benefits of this Convention which are otherwise available to residents of a Contracting State, including the benefits of Articles 7 (Business Profits), 10 (Dividends), 11 (Interest), 12 (Royalties), 22 (Other Income) or 23 (Elimination of Double Taxation). However, a dual-resident corporation may claim the benefits of paragraph (2) of Article 8 (Shipping and Air Transport) with respect to profits derived from operating ships or aircraft, and of Article 23 (Elimination of Double Taxation) with respect to paragraph 1(c) thereof and with respect to payments of the United Kingdom petroleum revenue tax. A dual-

resident corporation may also claim the benefits of Articles 24 (Non-discrimination), and 28 (Entry Into Force), and the provisions of paragraph (7) of Article 11 (Interest) relating to the character of certain interest payments will apply to it. Thus, for example, a dual-resident corporation may not claim the exemption from tax with respect to interest derived from the United States under Article 11 (Interest) or claim a refund of advance corporation tax with respect to dividend received from a corporation which is a resident of the United Kingdom. In these cases, the dual-resident corporation is treated as a resident of neither Contracting State for purposes of the Convention.

On the other hand, interest, royalties, and dividends derived by a resident of a Contracting State from a dual-resident corporation will qualify for the exemptions or reductions in tax allowed by the Convention. For example, dividends received by a resident of the United Kingdom from a dual-resident corporation will qualify for the reductions in United States tax withholding under paragraph (1) of Article 10 (Dividends) and, a United States resident receiving dividends from a dual-resident corporation which, under the internal law of the United Kingdom, is a resident of the United Kingdom, will qualify for the refunds or credits of advance corporation tax under paragraph (2) of that Article.

Paragraph (3) contains the traditional "saving clause" under which each Contracting State reserves the right to tax its nationals (as defined by paragraph (1)(k) of Article 3 (General Definitions)) and residents (as determined under Article 4 (Fiscal Residence)) as if the Convention had not come into effect. A similar provision exists in Article XIII of the Convention now in effect (hereinafter referred to as the "1945 Convention") [T.D. 5569, 1945-2 C.B. 100]. The saving clause is of principal importance to the United States because the United States taxes its citizens, residents, and corporations on a worldwide basis, regardless of where they reside or derive income.

Paragraph (4) sets forth certain exceptions to the application of the saving clause where other provisions of the Convention reflect overriding policies. Thus, the saving clause does not affect the provisions dealing with the determination of domicile for United Kingdom tax purposes (paragraph (4) of Article 4), the exemption from United Kingdom tax of profits derived by United States nationals and corporations from operating ships or aircraft (paragraph (2) of Article 8), associated enterprises (Article 9), the elimination of double taxation (Article 23), non-discrimination (Article 24) or the mutual agreement procedure (Article 25). Moreover, the saving clause does not affect benefits of the Convention which are extended to an individual performing functions as an employee of a government of a Contracting State, as a teacher, as a student or trainee, or as diplomatic and consular official, who is neither a national (as defined in Article 3) of, nor has immigrant status in, the Contracting State imposing the tax. See Articles 19 (Government Service), 20 (Teachers), 21 (Students and Trainees), and 27 (Effect on Diplomatic and Consular Officials and Domestic Laws). In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence.

Although Article 1 is entitled "Personal Scope", the Convention is applicable to corporations and other persons as well as to individuals.

## ARTICLE 2 Taxes Covered

Paragraph (1) of this Article states the general rule that the Convention applies to taxes on income imposed by the governments of the Contracting States. The Convention also applies to taxes on income imposed by political subdivisions or local authorities of a Contracting State (as defined in paragraph (1) (i) of Article 3 (General Definitions)) where paragraph (4) of Article 9 (Associated Enterprises) applies. This Article is important because the relief from double taxation (i.e., tax credits) accorded by Article 23 (Elimination of Double Taxation) only extends to taxes covered by this Convention. Thus, credits for taxes paid to a Contracting State may be claimed under this Convention only with respect to the taxes specified in paragraphs (2) and (3) of this Article.

Paragraph (2) designates the existing taxes on income which are the subject of the Convention. In the case of the United States, the taxes on income included (referred to as "United States tax") are the Federal income taxes imposed by the Internal Revenue Code ("Code") and the tax under Code section 4371 on insurance company premiums paid to foreign insurers. The tax under Code section 4371 is not covered by the 1945 Convention. The Convention only applies to taxes on income contained in the Internal Revenue Code. Thus, the Convention does not, for example, apply to the excise tax under Code section 1491.

The Convention also does not apply to the taxes imposed under Code sections 531 (Accumulated Earnings Tax) or 541 (Personal Holding Company Tax), except as specified by paragraph (6) of Article 10 (Dividends). Under paragraph (6) of Article 10, a corporation which is a resident of the United Kingdom shall be exempt from the accumulated earnings or personal holding company tax if individuals (other than nationals of the United States) who are residents of the United Kingdom control, directly or indirectly, more than 50 percent of the voting power of such corporation.

In the case of the United Kingdom, paragraph (2) provides that the existing taxes on income covered by the Convention (referred to as "United Kingdom tax") are the income tax, the capital gains tax, the corporation tax, and the petroleum revenue tax.

For purposes of paragraph (4) of Article 9 (Associated Enterprises), this Convention also applies to taxes imposed on income by political subdivisions or local authorities of a Contracting State. For this purpose, the income taxes referred to include any franchise taxes measured by income which are imposed by a political subdivision or local authority of a Contracting State.

Under paragraph (3), the Convention will also apply to taxes substantially similar to those covered by paragraph (2), which are imposed in addition to, or in place of, the taxes referred to in paragraph (2) after the date of signature of the Convention (December 31, 1975).

The competent authorities of the Contracting States are to notify each other of any amendments of the laws imposing the existing taxes and of the adoption of any taxes which are imposed subsequent to the date of signature of the Convention.

For purposes of Article 24 (Non-discrimination), the Convention will also apply to taxes of every kind and description (whether or not the taxes are on income) imposed by the Contracting States, political subdivisions or local authorities thereof.

### ARTICLE 3 General Definitions

Paragraph (1) defines the principal terms used throughout the Convention. Unless the context otherwise requires, the terms defined in this paragraph shall have a uniform meaning throughout the Convention. It should be noted that a number of important terms are defined elsewhere in the Convention. For example, the term "resident" of a Contracting State and "permanent establishment" are defined in Articles 4 (Fiscal Residence) and 5 (Permanent Establishment), respectively. Moreover, certain terms which appear in Articles dealing with special categories of income, e.g., "Immovable Property" (Article 6), "Dividends" (Article 10), "Interest" (Article 11), and "Royalties" (Article 12), are defined within those Articles.

The Article defines the term "corporation" in subparagraph (a) as a United States corporation (defined in subparagraph (b)(i)) or a United Kingdom corporation (defined in subparagraph (b)(ii)), or any body corporate or entity of a third state which is treated as a body corporate for tax purposes by both Contracting States. Whether an entity is a corporation is relevant for purposes of paragraph (6) of Article 5 (Permanent Establishment), Article 10 (Dividends), Article 16 (Investment or holding companies), and Article 23 (Elimination of Double Taxation).

The term "United States corporation" means a corporation (or any unincorporated entity which is treated as a United States corporation for United States tax purposes) which is created or organized under the laws of the United States, any state thereof, or the District of Columbia.

A "United Kingdom corporation" is defined as any body corporate or unincorporated association created or organized under the laws of the United Kingdom, excluding for this purpose a partnership, a local authority, or a local authority association.

Whether a United States or United Kingdom corporation or any other corporation is a resident of a Contracting State for purposes of this Convention, or neither of them, or both of them, is to be determined in accordance with Article 4 (Fiscal Residence).

The term "person" includes an individual, a corporation, a partnership, an estate, a trust, or any other body of persons.

The term "enterprise of a Contracting State" means an industrial or commercial undertaking carried on by a resident of a Contracting State (as defined by Article 4).

The term "international traffic" is defined as any transport by a ship or aircraft operated by an enterprise of one of the Contracting States, except when the ship or aircraft is operated solely between places within a Contracting State. Thus, for example, coastal shipping along the

Atlantic coast of the United States is not international traffic. However, if a ship operated by an enterprise of the United Kingdom transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the transport between New York and Norfolk is international traffic. The definition of this term is relevant for purposes of Article 8 (Shipping and Air Transport) which provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that State.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to the United Kingdom, the term "competent authority" refers to the Commissioners of Inland Revenue or their authorized representative.

The term "United States" means the United States of America. When used in the geographical sense, the term means the states thereof and the District of Columbia. Thus, the Convention does not apply to possessions of the United States or the Commonwealth of Puerto Rico. The term "United States" also includes the territorial sea and, in general accord with the principles of section 638 of the Code, the continental shelf of the United States.

The term "United Kingdom" means Great Britain and Northern Ireland, including the area of the continental shelf which has or may be designated by the United Kingdom, in accordance with international law, as an area within which the rights of the United Kingdom relating to the seabed and subsoil and their natural resources may be exercised. The Convention does not apply to the Channel Islands or the Isle of Man.

The 1945 Convention does not include the continental shelf areas in the definition of the terms United States or United Kingdom. It is understood that when compared to the 1945 Convention, the United Kingdom regards the reference to its continental shelf in this Convention as an expansion of the scope of the Convention with respect to operations in these areas.

The term "Contracting State" means the United States or the United Kingdom, as the context of the Convention requires.

The term "third State" means any State or territory other than the United States or the United Kingdom and the term "enterprise of a third State" is to be construed accordingly.

In relation to the United States, the term "national" means an individual who is a citizen of the United States. In relation to the United Kingdom, the term "national" means all citizens of the United Kingdom and colonies, British subjects under sections 2, 13(1) or 16 of the British Nationality Act of 1948, and British subjects by virtue of section 1 of the British Nationality Act of 1965, provided they are patrial within the meaning of the Immigration Act of 1971, so far as these provisions are in force on the date of entry into force of this Convention or have been modified in minor respects so as not to affect their general character.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires or unless the competent authorities agree to a definition of the term pursuant to Article 25 (Mutual Agreement Procedure), have the meaning

which it has under the laws of the Contracting State where a tax is being determined. Under Article 25, where a term which is not defined in the Convention has a different meaning under the laws of the United Kingdom and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may, for purposes of the Convention, establish a common meaning of the term in order to prevent double taxation or to further any other purpose of the Convention.

#### ARTICLE 4 Fiscal Residence

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, except as otherwise provided in the Convention, only a resident may claim the benefits of the Convention.

The term "resident of the United Kingdom" is defined as a corporation (as defined in paragraph 1(a) of Article 3 (General Definitions)) whose business is managed and controlled in the United Kingdom, and any other person (except a corporation as defined in paragraph (1)(a) of Article 3), resident in the United Kingdom for purposes of its tax.

Similarly, the term "resident of the United States" is defined as a person (except a corporation as defined in paragraph (1)(a) of Article 3) who is resident in the United States for purposes of its tax. This includes a resident alien individual who is subject to tax in the United States on his worldwide income and a resident citizen. The term also includes a corporation (as defined in paragraph (1)(b)(i) of Article 3). A foreign corporation, regardless of the extent to which its income is effectively connected with the conduct of a United States trade or business, is not a resident of the United States.

It should especially be noted that an individual is not automatically a resident of the United States or the United Kingdom for the purposes of this Convention if he is a citizen of either country. To be a resident of a Contracting State, he must be subject to tax in that State on account of his residence therein. In the case of the United States, an individual will be considered to be a resident if, without regard to his citizenship, he would be taxable in the United States on his worldwide income as a resident. Residence for this purpose is to be determined in accordance with the principles of Treasury regulations under section 871 of the Internal Revenue Code.

The definition of a resident of a Contracting State in the Convention differs from the definition of a resident in the 1945 Convention. Under paragraph (1)(g) of Article II of the 1956 Convention a resident of the United Kingdom is defined, in pertinent part, as "any person (other than a citizen of the United States or a United States corporation) who is resident in the United Kingdom for purposes of United Kingdom tax...." and under paragraph (1)(h) of Article II a resident of the United States is defined, in pertinent part, as "any individual who is resident in the United States for the purposes of United States tax and not resident in the United Kingdom for the purposes of United Kingdom tax. . . ." In the case of *Strathalmond (Lord) v. Inland Revenue* (Ch. D. June 23, 1972), a British court interpreted this definition, in applying Article XV of the 1945 Convention, to prevent the United Kingdom from taxing the United States source dividend

income of a United States citizen residing in the United Kingdom. This result is inconsistent with the principles of the OECD Model Convention. Accordingly, under this Article, a United States citizen who resides in the United Kingdom for purposes of its tax will be taxable therein as a resident and, subject to the provisions of United Kingdom law, the United Kingdom will be permitted to tax those citizens on their dividend and interest income regardless of the source of that income. However, where the income of the United States citizen has a source in the United States (as determined under the laws of the United Kingdom) the United Kingdom will allow a credit against the United Kingdom tax for any United States tax payable (on the basis of that person's United States citizenship) with respect to that income. See the discussion of paragraph (3) of Article 23 (Elimination of Double Taxation).

A corporation which is a resident of both Contracting States under this Article (i.e., a United States corporation whose business is managed or controlled in the United Kingdom), is dealt with by paragraph (2) of Article 1 (Personal Scope), and such a corporation may not claim any benefit under this Convention except as provided therein.

Paragraph (1) of this Article also provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, income received by a partnership, estate, or trust will be treated for purposes of the Convention as income received by a resident of the United States only to the extent such income is subject to tax in the United States as the income of a resident. Thus, for United States tax purposes, the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners rather than by whether the partnership is resident in the United States by reason of engaging in a trade or business here. To the extent the partners are subject to United States tax as residents of the United States, the income received by a partnership will be treated as income received by a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

The fact that a charitable organization or pension fund is exempt from tax in the country in which it is otherwise resident is not to be construed to deny such organization or fund resident status under this Convention.

Paragraph (2) provides that an individual who is a resident of both Contracting States under paragraph (1) will, for purposes of the Convention, be deemed to be a resident of the Contracting State in which he has a permanent home available to him (e.g., where an individual dwells with his family), his center of vital interests (e.g., close economic and personal relations), an habitual abode, or the State of which he is a national, in that order. If the issue cannot be settled by the application of these tests, the competent authorities shall decide by mutual agreement the one Contracting State of which he will be considered to be a resident. Thus, for purposes of the Convention, including paragraph (3) of Article 1 (Personal Scope) (the saving clause) an individual may be a resident of the United States or the United Kingdom, but not both.



Paragraph (3) provides that if an estate or trust (taxable as such) is a resident of both Contracting States under the provisions of paragraph (1), the competent authorities may settle the issue by mutual agreement.

Since the definitions of residence in this Article apply for purposes of the entire Convention, an individual who is deemed to be a resident of one Contracting State and not a resident of the other Contracting State by reason of paragraph (2) will be deemed to be a resident of the first-mentioned Contracting State for all purposes of the Convention. For example; if an individual is determined to be a resident of the United Kingdom under paragraph (2) but would apart from that paragraph also be considered a resident of the United States under the laws of the United States, such individual would continue to receive the exemptions and special benefits granted by the Convention to residents of the United Kingdom, unless the individual is a citizen of the United States (see the saving clause of paragraph (3) of Article 1 (Personal Scope)).

Paragraph (4) provides that for United Kingdom tax purposes the domicile, on or after April 6, 1976, of a woman who is a United States national and who was married before January 1, 1974 to a man domiciled in the United Kingdom will be determined as though such marriage had taken place on January 1, 1974. The foreign source income of a United Kingdom resident is subject to taxation in the United Kingdom to a different extent depending on the domicile of the resident. Thus, a United Kingdom resident domiciled in the United Kingdom is subject to full United Kingdom taxation on all income, whereas a United Kingdom resident domiciled outside the United Kingdom is generally subject to tax on foreign source income only to the extent that it is remitted to the United Kingdom.

Under United Kingdom law prior to January 1, 1974, the domicile of a woman was the same as the domicile of her husband. This rule has been repealed for future years. However, as a transitional rule, United Kingdom law treats a woman married before 1974 as retaining her husband's domicile unless and until she changes her domicile by acquisition or revival of another domicile after 1973.

As a consequence, under United Kingdom law a United States citizen woman married to a man domiciled in the United Kingdom prior to January 1, 1974 does not have the same opportunity to prove a domicile outside the United Kingdom as does a United States citizen man married to a woman domiciled in the United Kingdom. Paragraph (4) of the Convention puts the United States citizen woman in the same position as the United States citizen man.

Paragraph (5) provides a special rule for cases where income dealt with by this Convention (e.g., under Articles 7 (Business Profits), 8 (Shipping and Air Transport), 10 (Dividends), 11 (Interest), 12 (Royalties), and 22 (Other Income)), is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of the United Kingdom are not taxable on foreign source investment income, unless it is remitted to or received by them in the United Kingdom. If such income is received outside of the United Kingdom, or accumulated by the payer, a United Kingdom resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if

under the law in the other Contracting State income would only be taxed on a remittance basis, then any reduced rates of tax (e.g., as provided by Articles 10 (Dividends) ), or relief from taxation (e.g., Articles 7 (Business Profits) and 8 (Shipping and Air Transport), 11 (Interest), or 12 (Royalties)) provided by this Convention shall apply only to the extent such income is remitted to or received by the person in the year in which it accrues to the benefit of that taxpayer. This rule applies to all persons, including individuals, corporations, partnerships and trusts or estates taxable as such.

This provision is similar to paragraph (4) of Article II of the 1945 Convention.

## ARTICLE 5 Permanent Establishment

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 7 (Business Profits) where it is provided that the business profits of an enterprise of a Contracting State shall be taxable only in that State unless it carries on business in the other Contracting State through a permanent establishment situated therein.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which an enterprise of one of the Contracting States wholly or partly carries on business. Illustrations in paragraph (2) of a permanent establishment include a branch; an office; a factory; a workshop; a mine, oil or gas well, quarry or other place of extraction of natural resources; and a building site, or construction or installation project which exists for more than twelve months. Under the construction or installation project rule the twelve month period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the twelve months test. As a general rule, any fixed facility or premises through which a resident carries on business for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used only for one or more of the activities described in paragraph (3) of this Article.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used solely for one or more of the following activities:

"(a) the storage, display, or delivery of goods or merchandise belonging to the enterprise;

"(b) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery;

"(c) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another person;

"(d) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

"(e) the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise; or

"(f) a building or construction or installation project which does not exist for more

than 12 months."

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention.

Under paragraph (4), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the contracts are limited to the activities described in paragraph (3) of this Article.

On the other hand, paragraph (5) provides that an enterprise of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such enterprise carries on business in such other Contracting State through a broker, general commission agent, or any other agent of an independent status; where such broker or agent is acting in the ordinary course of his business.

Under paragraph (6), the fact that a corporation which is a resident of a Contracting State controls or is controlled by a corporation of the other Contracting State, or which carries on business in the other Contracting State, through a permanent establishment or otherwise shall not of itself constitute either corporation a permanent establishment of the other.

## ARTICLE 6

### Income from Immovable Property (Real Property)

Paragraph (1) provides that income from immovable property including income from agriculture or forestry, may be taxed in the Contracting State where the property is situated. This rule does not confer an exclusive right of taxation to the State where the property is located, but only confirms that the situs State has the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State.

Paragraph (2) provides that the term "immovable property" is to be defined under the laws of the Contracting State where the property is located. Generally, the term "immovable property" refers to real property for purposes of United States and United Kingdom law. Moreover, paragraph (2) also defines the term "immovable property" to include usufruct of immovable property and rights to variable or fixed payments (e.g., royalties) as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources (e.g., oil or gas wells). Ships, boats and aircraft shall not be regarded as immovable property.

This Article shall apply to income derived from the use in any form of immovable property, including income from leases of immovable property, but it does not include interest on indebtedness secured by real property (e.g., mortgages).

Where income is derived from immovable property through a permanent establishment in

a Contracting State, such income may be taxed in accordance with Article 7 (Business Profits).

Income from immovable property does not include gains from the sale of immovable property. Where those gains are capital gains within the meaning of Article 13 (Capital Gains), that Article shall apply.

This Article differs from the provisions of Article IX of the 1945 Convention. During the years since that Convention was ratified both the United States and the United Kingdom have enacted statutes permitting the taxpayer to elect to treat income in respect of real property, wells, mines and other natural resources, as income from a trade or business. In these cases, the taxpayer is taxed only on net income rather on the gross income derived from such operations. Thus, it was determined that this Convention need not continue the terms of the 1945 Convention.

## ARTICLE 7 Business Profits

Paragraph (1) provides that business profits (as defined in paragraph (7) of this Article) of an enterprise of one Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein, except where the enterprise is a national of that other Contracting State. (See the saving clause in paragraph (3) of Article 1 (Personal Scope).) The term "permanent establishment" is defined in Article 5 (Permanent Establishment). Where business is carried on through a permanent establishment in the other Contracting State, the business profits attributable to the permanent establishment can be taxed by that other Contracting State.

Business profits may be attributable to a permanent establishment which an enterprise of one Contracting State has in the other Contracting State, whether from sources within or without a Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code which are attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of business profits under the Convention to a permanent establishment, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity 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.

Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the enterprise as a whole (or the part which includes the permanent establishment), will be allowed as deductions in determining the business profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction generally will be limited to the

expense incurred without including a profit element for the head office.

Under paragraph (4) profits shall not be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment for the account of the enterprise. Paragraph (2) of the Article does not override paragraph (4). Thus, for example, where a permanent establishment purchases goods for its head office, the business profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a national figure for profits from purchasing.

For purposes of this Article, paragraph (5) provides that the profits attributed to a permanent establishment shall be determined by the same method every year unless there is a good reason to change such method. The purpose of this provision is to give assurance of continuous and consistent tax treatment.

Paragraph (6) provides that, where the profits of a permanent establishment include items of income which are dealt with separately in other Articles of the Convention, the provisions of those Articles will not be affected by the provisions of this Article. Thus, for example, the taxation of interest income will be controlled by Article 11 (Interest) and not by this Article unless, as provided by paragraph (4) of Article 11, the interest is effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other State. This same exception applies with respect to items of income dealt with in Article 8 (Shipping and Air Transport), dividends under paragraph (4) of Article 10 (Dividends), royalties under paragraph (4) of Article 12 (Royalties) or other income under paragraph (2) of Article 22 (Other Income).

Under paragraph (7), the term "business profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance (or reinsurance), agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting or from copyrights thereof. Thus, for example, income derived by a resident of the United States from the rental of tangible personal property to a person in the United Kingdom shall not be subject to tax in the United Kingdom unless that lessor has a permanent establishment in the United Kingdom to which such income is attributable. The term "business profits" also includes any other income which is effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State. The term "business profits" does not include income from the performance of personal services derived by an individual either as an employee or in an independent capacity. Income from such activities is dealt with under Articles 14 (Independent Personal Services), 15 (Dependent Personal Services) and 17 (Artistes and Athletes), as the case may be.

This Article is substantially similar to Article III of the 1945 Convention and is also based on Article 7 (Business Profits) of the OECD Model Convention.

## ARTICLE 8

## Shipping and Air Transport

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 Contracting State.

Paragraph (2) confirms that the United Kingdom grants to nationals of the United States and United States corporations the equivalent shipping and aircraft exemption required for application of Code sections 872(b) and 883. It should be noted that the exemption provided under this paragraph is available only with respect to the profits derived from operating ships documented or aircraft registered under the laws of the United States.

Under paragraph (3), this Article applies to profits derived from the rental of ships or aircraft under a bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to operations of the lessor described in paragraph (1). In these cases the lessee of the property need not be a resident of a Contracting State. For example, if an airline which is a resident of one Contracting State has excess equipment in the winter months and leases several of its aircraft which are not required by it during that period to another airline, the rental profits of the lessor are not subject to tax by that other Contracting State, regardless of the state of residence of the lessee.

Paragraph (4) provides that profits derived by an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers and related equipment for the transport of containers), used to transport goods or merchandise shall be taxable only in that State except to the extent that those goods or merchandise are transported solely between places within a Contracting State. The income covered by this provision need not be incidental to the operation of ships or aircraft. Thus, this Article applies to lessors of containers who do not own or operate the ships or aircraft upon which the containers are carried. This paragraph also applies to income derived by an enterprise from the use, maintenance, and lease of containers and other related equipment in connection with the operation of ships or aircraft described in paragraph (1).

Paragraph (5) provides that this Article shall also apply to profits derived by an enterprise of a Contracting State from participation in a pool, a joint business or an international operating agency.

Paragraph (6) provides that gains of an enterprise of a Contracting State from the alienation of ships, aircraft or containers owned and operated by the enterprise shall be taxable only in that State if the income from such ships, aircraft or containers is taxable only in that State.

Except for paragraph (2), this Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Therefore, a Contracting State may tax income from shipping or air transport, or from the use or rental of containers, derived by a resident of the other Contracting State without regard to this Article if such resident is a national of the first-mentioned Contracting State.

ARTICLE 9  
Associated Enterprises

Article 9 confirms the authority of the United States under section 482 of the Code. Thus, where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between them in their commercial or financial relations which are different from those which would be made between independent enterprises, under paragraph (1) any income, deductions, receipts or out-goings which would, but for those conditions, have been attributed to one of the enterprises, but by reason of those conditions have not been so attributed, may be taken into account in computing the profits and losses of that enterprise and taxed accordingly.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State. In such event, the other Contracting State shall make such corresponding adjustment as may be appropriate to the amount of tax charged to the related enterprise by the other Contracting State. In the case of the United States, assuming application within a reasonable time after notice of such adjustment, any refunds of tax in respect of such an adjustment shall be made notwithstanding the statute of limitations.

Under paragraph (3), if a Contracting State disagrees with a redetermination of tax by the other Contracting State, the two Contracting States will endeavor to resolve the matter in accordance with the mutual agreement procedure in Article 25 (Mutual Agreement Procedure).

Paragraph (4) deals with the methods by which a Contracting State or a political subdivision or local authority thereof may tax an enterprise which is controlled by an enterprise of the other Contracting State. Where an enterprise doing business in one Contracting State is a resident (as defined in Article 4 (Fiscal Residence)) of the other Contracting State, or is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State, the first-mentioned Contracting State, or political subdivision or local authority thereof, in determining the tax liability of the enterprise doing business therein, may not take into account the income, deductions, receipts, or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State. (Because a corporation is considered a single enterprise regardless of how many branches it has, a State may take into account the income and assets of all branches of that corporation, wherever located.) The taxing jurisdiction may, however, attribute income to the enterprise under the arm's-length principles contained in the other paragraphs of this Article. In addition, where the enterprise which is a resident of the other Contracting State is a corporation, the provisions of paragraph (4) of this Article will apply only if such corporation:

- (1) is not a controlled foreign corporation within the meaning of Code section 957;
- (2) is not created or organized under the laws of the first-mentioned Contracting State or any third State; and
- (3) is not controlled, directly or indirectly, by a corporation which is a resident of any third State.

Finally, the prohibition contained in paragraph (4) will not apply where the enterprise doing business in a Contracting State is a resident of that State to the extent that it owns, directly or indirectly, the capital of a related enterprise. Thus, this provision does not affect the application of the United States "subpart F" rules of Code sections 951-964.

The following is an illustration of the operation of this paragraph:

Corporation M, organized under the laws of the United Kingdom, is a resident of the United Kingdom, and all of its stock is owned by individuals residing in the United Kingdom who are not United States nationals.

Corporation M controls subsidiaries A, B, and C, which are incorporated in, and do business in, respectively, France, Germany, and Belgium.

Corporation M also controls a United States subsidiary, Z, which is incorporated in and conducts its business in X, a state of the United States.

In determining the tax liability of Z, to X or to the United States, neither X nor the United States, are permitted to allocate to, apportion to, or otherwise include in Z's tax base income earned by M, A, B, or C, except to the extent the dealings between Z and those persons require the application of the arm's-length principles of the other paragraphs of this Article.

Thus, in these circumstances, the United States or the states will be required to determine Z's tax liability solely on the basis of its income. The determination of Z's tax liability under any unitary or combined reporting basis is, therefore, prohibited by this Article.

The broad standard of tax jurisdiction embodied in United States tax treaties provides that one Contracting State will not tax the business profits of an enterprise of the other Contracting State unless that enterprise does business in the first-mentioned Contracting State through a permanent establishment located there. The purpose of this provision is to harmonize the tax jurisdiction under this Convention at the national, state and local levels by equating the tax base of an enterprise doing business in a state or political subdivision of the United States with the enterprise's Federal income tax base.

Paragraph (5) provides that for purposes of the Convention an enterprise is related to another enterprise if either owns or controls directly or indirectly the other, or if a third person or persons (related to each other or acting together) own or control, directly or indirectly, both. The term "control" is not limited to the ownership of the capital of an enterprise, and includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

## ARTICLE 10

### Dividends

Article 10 deals with the taxation of dividends derived from a corporation which is a resident of a Contracting State. Under Article VI of the 1945 Convention, the rate of tax on dividends derived by residents of one Contracting State from a corporation of the other Contracting State is limited to 15 percent of the gross amount of the dividends. In 1973 the



United Kingdom introduced a system of integrating corporate and shareholder taxation. Under the system adopted by the United Kingdom, a special "Advance Corporation Tax" ("ACT" hereafter), is collected at the corporate level on a distribution of dividends by the corporation. This tax is treated both as an advance payment of a portion of the corporate income tax, and also as a payment by an individual United Kingdom resident shareholder in satisfaction of his personal tax liabilities on the dividend. The introduction of this system rendered inapplicable the current provisions of the Convention relating to United Kingdom dividends. Accordingly, the proposed Article provides a mechanism by which United States shareholders of a United Kingdom corporation will receive the benefits of the shareholder credits which have heretofore not been granted to United States residents.

This Article contains two alternatives for the taxation of dividends, depending on whether the United Kingdom continues to allow a tax credit to individual shareholders in respect of dividends derived from a corporation which is a resident of the United Kingdom. Paragraph (1) will apply only if the United Kingdom modifies its current system of shareholder credits. This paragraph limits the tax on dividends paid by a corporation which is a resident of one Contracting State to a resident (who derives and beneficially owns the dividend) of the other Contracting State to 15 percent of the gross amount of the dividends. As noted above, this is the rule contained in the 1945 Convention.

Paragraph (2) applies where, as at the present time, an individual resident in the United Kingdom is entitled to a credit in respect of dividends paid by a corporation which is a resident of the United Kingdom. So long as this system remains in force, only paragraph (2), and not paragraph (1), shall apply. With respect to dividends paid by a corporation resident in the United Kingdom to a United States corporation which either alone or together with one or more associated corporations (defined below) controls, directly or indirectly, at least 10 percent of the voting stock of the United Kingdom resident corporation which is paying the dividend, the shareholder will be entitled to payment from the United Kingdom of a tax credit (hereinafter referred to as a refund) equal to one-half of the tax credit to which an individual resident in the United Kingdom would be entitled, less 5 percent of the aggregate amount of the cash dividend and the United Kingdom refund.

For United States tax purposes, the gross amount of the refund (without reduction for the tax withheld) will be considered as a dividend (see discussion under Article 23 (Elimination of Double Taxation)) and the 5 percent tax withheld will be considered as a tax on the shareholder receiving the dividend (see paragraph (1)(b) of Article 23 (Elimination of Double Taxation)). The unrefunded portion of the ACT paid in respect of the dividend will be regarded as an income tax imposed on the distributing corporation (see paragraph (1)(c) of Article 23).

In the case of United States shareholders other than corporations which control at least 10 percent of the voting stock of the United Kingdom resident corporation, the United Kingdom refund will equal the full credit payable to an individual resident in the United Kingdom, less 15 percent of the aggregate amount of the dividend and the U.K. refund. For United States tax purposes, the U.K. refund shall be treated as additional gross income and the 15 percent withholding shall be considered as a tax on the shareholder. In the case of a \$65 dividend, the result is as follows:

<i>Dividend for U.S. Tax Purposes</i>	
Dividend	\$ 65.00
U.K. refund	35.00
Gross Dividend	<u>100.00</u>
<i>United Kingdom Withholding Tax</i>	\$15.00
<i>Foreign Tax Credit</i>	\$15.00

With respect to dividends paid by a United States corporation to a corporation which is a resident of the United Kingdom, and which controls, directly or indirectly, at least 10 percent of the voting stock of the United States corporation paying the dividend, the United States tax shall not exceed 5 percent of the gross dividend.

In all other cases of dividends paid by a United States corporation to any other resident of the United Kingdom, the rate of tax imposed by the United States shall not exceed 15 percent.

For purposes of paragraph (2), two corporations are associated if one controls directly or indirectly more than 50 percent of the voting power in the other corporation, or a third corporation controls more than 50 percent of the voting power in both of them.

As noted above, a resident of a Contracting State may benefit from this Article only if he derives and beneficially owns the dividend paid by a corporation of one of the Contracting States. A nominee or agent which is a resident of a Contracting State may not claim the benefits of this Article if the dividend is received on behalf of a person who is not a resident of that Contracting State. Similarly, dividends received by a nominee for the benefit of a resident, as, for example, with respect to a depositary receipt, would qualify for the benefits of this Article. This is generally the case with respect to all income tax conventions of the United States.

Paragraph (3) defines the term "dividends" to include any item which is treated as a distribution under the laws of the United Kingdom for United Kingdom tax purposes or, as a distribution out of earnings and profits for United States tax purposes. Distributions which are not within this definition of "dividends," or covered by any other provision of this Convention, shall be treated as "other income" under Article 22 (Other Income) of this Convention.

Paragraph (4) provides that paragraphs (1) and (2) of this Article shall not apply if the person deriving the dividends, being a resident of a Contracting State, has a permanent establishment in the other Contracting State or performs personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with the permanent establishment or fixed base. In such a case, the dividend will be treated as business profits subject to the provision of Article 7 (Business Profits) or taxable in accordance with Articles 14 (Independent Personal Services) or 17 (Artistes and Athletes), as the case may be.

Paragraph (5) provides that dividends paid by a corporation which is a resident of a Contracting State, regardless of where it derives its income, to a person other than a resident of

the other Contracting State (and in the case of dividends paid by a corporation which is a resident of the United Kingdom, to a person other than a United States citizen), shall be exempt from tax by the other Contracting State unless the holding with respect to which such dividends are paid is effectively connected with a permanent establishment or a fixed base which the person deriving the dividends has in that other State. For example, if a corporation which is a resident of the United Kingdom and is doing business in the United States pays dividends to a resident of the United Kingdom, or to a resident of a third State, those dividends shall be exempt from United States tax unless they are paid to a citizen or resident of the United States, or unless the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base which the United Kingdom resident or resident of a third State maintains in the United States. This rule is contained in Article XV of the 1945 Convention. A dual-resident corporation which derives dividends from a resident of a Contracting State may not claim the benefits of this provision, although dividends received from a dual-resident corporation will qualify for the benefits of this Article.

Paragraph (6) continues the provisions of Article XVI of the 1945 Convention, and provides that a corporation which is a resident of the United Kingdom shall be exempt from the United States tax on accumulated or undistributed earnings (as provided by Code sections 531 (the accumulated earnings tax) and 541 (the personal holding company tax)), if individuals, other than citizens of the United States, who are residents of the United Kingdom, control, directly or indirectly, more than 50 percent of the entire voting power in such corporation.

Paragraph (7) prevents the application of paragraphs (1) and (2) of this Article in two circumstances where tax avoidance may occur. First, under subparagraph (a), where a resident of a Contracting State owns 10 percent or more of the shares of a corporation with respect to which dividends are paid, paragraphs (1) or (2) of this Article shall not apply to the extent that the dividends are paid out of profits which the corporation earned or other income which it received in a period ending 12 months or more before the date on which the shareholder became the owner of 10 percent or more of the corporation's stock. This rule is designed to prevent transactions where a 10 percent stock interest is acquired in order to obtain a distribution of the past earnings of a corporation at reduced rates of tax.

A second rule contained in subparagraph (b) is designed to deny the benefits of the Convention to tax exempt organizations if the recipient of a dividend is exempt from tax in the United States and the dividends are received in circumstances where if received by an exempt organization of the United Kingdom such interest or dividends would not be so exempt. Under United Kingdom law, if a resident of the United Kingdom sells securities to an exempt organization immediately before the payment of dividends, the organization will be taxable on the dividends paid in respect of the securities if the transaction was designed to accord the initial seller a preferential rate of tax on his sale. This rule is contained in Article VII A of the 1945 Convention.

The rules of paragraph (7), stated above, shall not apply if the beneficial owner of the shares satisfies the competent authorities of the respective States that the shares were acquired for *bona fide* commercial purposes and not to secure the benefits of the Convention.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, dividends derived by a citizen of a Contracting State may be taxed by that Contracting State without regard to this Article.

## ARTICLE 11

### Interest

Paragraphs (1) and (2) provide that interest derived and beneficially owned by a resident of one Contracting State shall be exempt from tax by the other Contracting State. In these cases, interest is taxable only in the taxpayer's State of residence. The exemption only applies where the person deriving the interest is a resident of a Contracting State (as defined in Article 4 (Fiscal Residence)) and is the beneficial owner of the interest. Thus, the exemption does not apply where an intermediary, which is a resident of a Contracting State, such as an agent or nominee, collects or receives the interest on behalf of a person who is not a resident of that Contracting State.

Paragraph (3) defines the term interest for purposes of this Article as income from Government securities, bonds or debentures, whether or not secured by mortgage or whether or not carrying a right to participate in profits, and debt claims of every kind, as well as all other income (such as original issue discount) which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent. Paragraphs (1) and (2) apply to all "interest", from whatever source derived. Penalty charges and late payment penalties shall not be regarded as interest. Such payments shall be regarded as "other income" dealt with by Article 22 (Other Income).

Paragraph (4) provides that the exemption from tax provided by paragraphs (1) and (2) shall not apply if the person deriving the interest, being a resident of a Contracting State, has a permanent establishment in the other Contracting State or performs personal services from a fixed base situated therein, and the indebtedness giving rise to the interest is effectively connected with the permanent establishment or fixed base. In such a case, the interest will be treated as business profits subject to the provisions of Article 7 (Business Profits) or will be taxable in accordance with Article 14 (Independent Personal Services) or 17 (Artistes and Athletes), as the case may be.

If excessive interest is paid pursuant to a special relationship between the payer and the person deriving the interest or between both of them and a third person, under paragraph (5) the provisions of Article 11 shall not apply to the excess portion of the payment. For this purpose, those persons need not be "related" within the meaning of paragraph (5) of Article 9 (Related Enterprises). The excessive portion may be taxed by each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excessive portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

Paragraph (6) provides that interest paid by a resident of a Contracting State, regardless of where it derives its income, to a person other than a resident of the other Contracting State

(and in the case of interest paid by a resident of the United Kingdom, to a person other than a United States citizen), shall be exempt from tax by the other Contracting State unless the debt claim in respect of which such interest is paid is effectively connected with a permanent establishment or a fixed base which the person deriving the interest has in that other State. For example, if a corporation which is a resident of the United Kingdom and is doing business in the United States pays interest to a resident of the United Kingdom, or to a resident of a third State, that interest shall be exempt from United States tax unless it is paid to a citizen or resident of the United States, or unless the debt obligation is effectively connected with a permanent establishment or a fixed base which the United Kingdom resident or resident of a third State maintains in the United States. A dual-resident corporation may not claim the benefits of this provision. A debt obligation is effectively connected with a permanent establishment in the United States when interest on that obligation is effectively connected with a trade or business in the United States within the meaning of Code section 864(c)(2) or 864(c)(4)(B)(ii), depending on the source of the interest under United States law.

Paragraph (7) is carried over from paragraph (5) of Article VII of the 1945 Convention. Under United Kingdom domestic law, interest payments by United Kingdom corporations to non-United Kingdom corporations which have 75 percent or more control, directly or indirectly, of the United Kingdom corporation are treated as distributions (dividends) rather than as deductible interest. This paragraph provides, in reciprocal terms, that this rule shall not apply where the payment is to a resident of the other Contracting State. By virtue of paragraph (2) of Article 1 (Personal Scope), a dual-resident corporation may claim the benefits of this provision with respect to interest payments it makes. However, this paragraph also provides that where the interest is paid to a corporation which is a resident of a Contracting State of which more than 50 percent of the voting power is directly or indirectly controlled by persons who are residents of the other Contracting State, the exemption shall not apply.

Paragraph (8) provides that the exemption from United Kingdom tax under paragraph (2) of this Article will not apply if the recipient of the interest is exempt from tax on such income in the United States and the recipient sells or makes a contract to sell the holding from which such interest is derived within three months after the date the recipient acquired such holding.

The provisions of this Article are subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, interest derived by a citizen of a Contracting State may be taxed by that Contracting State without regard to this Article.

## ARTICLE 12

### Royalties

Paragraphs (1) and (2) provide that royalties derived and beneficially owned by a resident of a Contracting State shall be exempt from tax by the other Contracting State. Such income, therefore, is taxable only in the State of residence. As in Article 10 (Dividends) and 11 (Interest), this exemption applies only where the person deriving the royalties is a resident of a Contracting State and is the beneficial owner of the royalty. Thus, the exemption does not apply where an intermediary, such as an agent or nominee, who is a resident of a Contracting State collects or

receives the royalties on behalf of a non-resident of that Contracting State. This Article deals with royalties from sources within a Contracting State or from sources within any third State, except as described below.

Paragraph (3) defines the term "royalties" as payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (but not including copyrights of motion picture films or films or tapes used for radio or television broadcasting (which are treated as business profits under paragraph (7) of Article 7 (Business Profits)), patents, trademark, design or model, plan, secret-formula or process, or, other like right or property, or for information concerning industrial, commercial or scientific experience. This term includes "know-how" and similar experience or skill, including the supply of assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property. The term also includes gains derived from the alienation (e.g.; the exchange, or other disposition) of any such right or property to the extent the amounts realized on such alienation are contingent on the productivity, use, or disposition of the right or property. If the amounts realized are not so contingent, the provision of Article 13 (Capital Gains) may apply. The article does not apply to amounts which are characterized as interest pursuant to section 483 of the Code.

Paragraph (4) provides that paragraphs (1) and (2) will not apply if the royalty recipient, being a resident of one Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein or performs in that other Contracting State personal services from a fixed base situated therein, and the right or property giving rise to the royalty is effectively connected with such permanent establishment or fixed base. In such a case, the royalty will be treated as business profits subject to Article 7 (Business Profits) or will be taxable in accordance with Articles 14 (Independent Personal Services) or 17 (Artistes and Athletes) as the case may be.

If excessive royalties are paid pursuant to a special relationship between the payer and the person deriving the royalty or between both of them and a third person, paragraph (5) provides that the provisions of this Article shall not apply to the excessive portion of the payment. For this purpose, the persons covered by this paragraph need not be "related" within the meaning of paragraph (5) of Article 9 (Related Enterprises). The excessive portion may be taxed in each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excessive portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Therefore, royalties derived by a citizen of a Contracting State may be taxed by the Contracting State without regard to this Article.

### ARTICLE 13 Capital Gains

This Article provides that, except as provided in Article 8 (Shipping and Air Transport)

capital gains are taxable in accordance with the domestic laws of the Contracting States. This rule applies to the existing laws of a Contracting State respecting the taxation of capital gains and revisions of those laws subsequent to the effective date of this Convention. Thus, for example, capital gains in respect of the sale of immovable property described by Article 6 (Immovable Property) or the sale of a right or property giving rise to royalties described by Article 12 (Royalties) (which are not contingent on productivity, etc.) may be taxed in accordance with the respective domestic laws of the Contracting States. The provision of Article 7 (Business Profits) shall apply to gains attributable to a permanent establishment. Article 22 (Other Income) does not apply to capital gains.

Under current United States law, contained in Code sections 871 and 872, non-resident alien individuals are generally not taxable in the U.S. on their United States source capital gains unless they are present in the United States for 183 days or more during a taxable year, or if the gains are effectively connected with the conduct of a U.S. trade or business. Under Code sections 881 and 882 foreign corporations generally are taxable in the U.S. only on capital gains which are effectively connected with the conduct of a U.S. trade or business.

Notwithstanding the foregoing rules, under paragraph (6) of Article 8 (Shipping and Air Transport) gains which an enterprise of a Contracting State derives from the sale, exchange or other disposition of ships, aircraft or containers which the enterprise owns or operates (dealt with by Article 8 (Shipping and Air Transport)), shall be taxable only in the State in which the income from the ships, aircraft or containers was taxable.

Under paragraph (2) of Article 3 (General Definitions), whether an item of income constitutes capital gains shall be determined under the laws of the Contracting State seeking to tax those gains.

The representatives of the Contracting States will consult with each other upon the enactment or proposed enactment by either State of any laws which substantially change the manner in which capital gains derived by non-residents are taxed by the respective States.

#### ARTICLE 14 Independent Personal Services

In dealing with the taxation of income from personal services, the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "artistes or athletes" and for amounts received in certain circumstances in respect of the services of an artiste or athlete.

Personal services performed in an independent capacity, that is, independent personal services, are services performed by an individual for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, services rendered as a director of a

corporation, or rendered by physicians, lawyers, engineers, architects, dentists, consultants, and accountants, performing personal services as sole proprietors or partners, are independent personal services, whereas the income earned by the employees of such persons, or as an officer of a corporation, is considered to be income from dependent personal services.

Under this Article income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity may be taxed by that Contracting State. Except as permitted by subparagraphs (a) and (b) of this Article, such income will be exempt from tax by the other Contracting State.

Subparagraph (a) provides that income derived from services performed in the other Contracting State may also be subject to tax in that other Contracting State if the individual is present therein for a period or periods exceeding 183 days in the tax year, but only to the extent such income is attributable to services performed in that State. In addition, subparagraph (b) provides that income from personal services may be taxed in the other Contracting State if the individual has a fixed base regularly available to him for the purpose of performing his activities, but only to the extent such income is attributable to services performed in that State. The term fixed base is synonymous with the term "permanent establishment" as described in Article 5 (Permanent Establishment).

## ARTICLE 15 Dependent Personal Services

This Article deals with the taxation of income in respect of dependent personal services. The Article is based on Article 15 (Dependent Personal Services) of the OECD Model Convention. Under paragraph (1), subject to Articles 18 (Pensions) and 19 (Government Service), salaries, wages and other similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee (of any person) shall be taxed only by that Contracting State unless that employment is exercised in the other Contracting State. Except as provided by paragraph (2), remuneration derived with respect to services performed within the other Contracting State may also be taxed by that other Contracting State. It is intended that for purposes of the Convention the term "salaries, wages and other similar remuneration" includes income from services performed as an officer of a corporation.

Under paragraph (2), remuneration derived by an individual who is a resident of one Contracting State in respect of an employment exercised in the other Contracting State will be exempt from tax by the other Contracting State if:

- (a) the individual is present in that other Contracting State for a period or periods aggregating less than 183 days in the taxable year;
- (b) the employee's remuneration is paid by or on behalf of an employer who is not a resident of that other Contracting State; and
- (c) the remuneration is not borne as such by a permanent establishment or fixed base which the employer has in that other Contracting State.



Such income may nevertheless be taxed by that other Contracting State if the individual is a citizen or resident of that Contracting State, pursuant to the saving clause of paragraph (3) of Article 1 (Personal Scope).

In the United States, remuneration from the performance of dependent services will be viewed as not having been borne by the permanent establishment or fixed base maintained in the United States if the employee is performing stewardship or overseeing functions for the benefit of a resident of or a permanent establishment maintained in the United Kingdom. However, the remuneration will be considered to be borne by the permanent establishment or fixed base maintained in the United States if the remuneration is paid for activities other than stewardship or overseeing functions and the permanent establishment or fixed base is entitled to claim the employee's remuneration as a deduction in computing taxable income for United States purposes because the remuneration is definitely related and allocable to its gross income or a class of its gross income pursuant to Code section 861 and the regulations thereunder.

Paragraph (3) provides that, notwithstanding paragraphs (1) and (2) of this Article, remuneration derived by an individual employee in respect of an employment as a member of the regular complement of a ship or aircraft in international traffic may be taxed by the Contracting State of which the employer operating the ship or aircraft is a resident.

## ARTICLE 16 Investment or Holding Companies

This Article provides that a corporation which is a resident of one Contracting State and which derives dividends, interest or royalties arising within the other Contracting State shall not be entitled to claim the benefits of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), if the tax imposed by the first-mentioned Contracting State with respect to such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; and 25 percent or more of the capital of such corporation is owned directly or indirectly by persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

This Article also provides that a corporation which is a resident of the United States and which derives dividends, interest or royalties arising in the United Kingdom shall not be entitled to the benefits of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties) where more than 80 percent of its gross income (including such dividends, interest, or royalties) is derived from sources outside of the United States as determined by and for the purposes of Code Sections 861(a)(1)(B) and 861(a)(2)(A), and as they may be amended from time to time without changing their general principles. This limitation applies only if 25 percent or more of the capital of the corporation is owned directly or indirectly by persons who are not individual residents of the United States or nationals of the United States.

Paragraph (2) provides that nothing in this Article will prevent a claim under the provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) by a United States corporation; if 75 percent or more of the capital of that corporation is directly or indirectly

owned:

(a) by another United States corporation which receives 20 percent or more of its gross income from sources within the United States as determined by and for the period described in sections 861(a)(1)(B) and (a)(2)(A) of the Code, as they may be amended from time to time so as not to affect their general principle; or

(b) by a corporation other than a United States corporation which would not be treated as a close company under section 283 of the United Kingdom Income and Corporation Taxes Act of 1970 (as may be amended without changing the general principle thereof); or

(c) by a corporation, resident in the United Kingdom, more than 50 percent of the voting power of which is controlled directly or indirectly by individuals who are residents of the United Kingdom.

The purposes of this Article are, first, to prevent the potential abuse of the Convention which would occur if residents of a third country could take advantage of the reduced rates of withholding provided by this treaty in situations where one of the Contracting States provided preferential rates of tax for investment or holding companies deriving foreign source income. In the absence of this Article, residents of a third country could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first Contracting State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits.

The Article is also intended to prevent the use of United States corporations by residents of third countries to take advantage of the reduced rates of tax or exemptions from tax granted by the United Kingdom on dividends, interest and royalties paid to residents (including corporations) of the United States. Generally, under sections 861(a)(1)(B) and 861(a)(2)(A) of the Code, interest and dividends paid by U.S. corporation to non-residents of the United States are not subject to tax by the United States if more than 80 percent of the corporation's gross income is from sources outside the United States. Accordingly, were it not for this provision, a resident of a third country could establish a United States corporation solely to derive interest or dividends from the United Kingdom subject to the reduced rates and refunds allowed by the Convention. While such income would be subject to normal corporate taxes in the United States, the corporation's dividends or interest to the third country residents would be exempt from U.S. withholding taxes if the conditions of Code sections 861(a)(1)(B) and (a)(2)(A) are met. The Article prevents this abuse where the above mentioned share-ownership requirements apply. Since the purpose of this provision is only to prevent the use of United States corporations in cases where their income would otherwise qualify for reduced withholding rates in the United Kingdom and their distributions to third country residents would not attract United States withholding taxes, exceptions to the rule are given where that corporation is owned by another United States corporation whose distributions would attract United States withholding taxes; where that corporation is owned by a corporation which is not a close company under United Kingdom law; and where that corporation is owned by a corporation resident in the United Kingdom 50 percent or more of the voting power of which is controlled by United Kingdom resident individuals.

ARTICLE 17  
Artistes and Athletes

This Article deals with the taxation of income derived by entertainers, musicians, and athletes (sometimes referred to hereinafter as "artistes and athletes") in respect of the performance of services in a Contracting State. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that notwithstanding the provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services), income derived by entertainers such as theatre, motion picture, radio, or television artistes, and musicians or athletes, for their personal activities as such, may be taxed in the Contracting State where those services are exercised. Such income, however, is taxable under this Article only where the gross receipts derived by the artiste or athlete, including expenses reimbursed to him or borne on his behalf, in respect of such activities, exceed \$15,000 or its equivalent in pounds sterling for the tax year concerned. In computing the \$15,000 limitation, expenses borne on behalf of the entertainer include any expenditures for travel, meals and lodging, payments to persons such as band members or agents, and other amounts which are generally related to the activities of the artiste or athlete. This rule includes expenses borne by persons in the Contracting State where services are performed or borne by persons in the other or any third State if borne on behalf of the artiste or athlete. If the total of these expenses, including the amounts paid to the artiste or athlete, exceed \$15,000, the entire amount is taxable in the State where the activities are performed. For example, where an entertainer's gross income, including reimbursed expenses and expenses borne on his behalf, totals \$20,000, the full \$20,000 is subject to tax in the State where the services are performed.

Also, in computing the \$15,000 limitation, amounts paid in taxable years prior or subsequent to the year in which the services were performed shall be included in the determination of the amount of income attributable to the year in which the services were performed.

As noted above, this paragraph overrides the provisions of Articles 14 and 15, so that an artiste or athlete may be taxed in the State where his activities take place regardless of the period of time he is present in that State. Generally, however, income derived from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with the provisions of Article 14 (Independent Personal Services), or Article 15 (Dependent Personal Services), as the case may be.

Paragraph (2) deals with cases where income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. A common method employed by foreign entertainers is to perform services in the United States as an employee of, or a contractor for, a corporation or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the corporation may escape taxation in

respect of those services under the provisions of Article 7 (Business Profits) because it does not have a permanent establishment in the United States described in Article 5 (Permanent Establishment). The entertainer may also escape taxation by being paid a small salary while in the United States and by receiving payment in a later year when the income is subject to reduced rates of tax or no tax at all, or by liquidating the corporation after the services are performed.

Paragraph (2) is designed to deal with these situations by providing that where income in respect of the personal activities of an artiste or athlete accrues to the benefit of another person (including a corporation, trust, or partnership of either Contracting State or any third State), that income may, notwithstanding the provisions of Article 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete take place. Thus, for example, such other person could not claim the permanent establishment protection provided by Articles 5 (Permanent Establishment) and 7 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to the benefit of another person where that other person has control over or the right to gross income derived in respect of an entertainer or athlete's services as such. This rule applies regardless of whether the other person is a "sham" corporation or conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person, in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions or other distributions. Persons may be considered to be related to the artiste or athlete regardless of whether the persons are considered to be related under the provisions of paragraph (5) of Article 9 (Related Enterprises). For this purpose, a person may be considered to be related to the artiste or athlete if he is an employee or agent of the artiste or athlete, or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor.

This section is similar to provisions in other recent Conventions of the United States with Japan, Trinidad and Tobago, and Iceland, and follows Article 17 (Artistes and Athletes) of the OECD Model Convention. It differs from the 1945 Convention, which under Article XI exempts an entertainer or athlete from United States tax where he:

- (a) is present in the United States for a period or periods not exceeding 183 days of a taxable year and
- (b) services are performed for or on behalf of a person who is a resident of the United Kingdom.

The application of this section and Article III, regarding the industrial or commercial profits of an enterprise furnishing the services of an entertainer, was discussed in detail in Revenue Rulings 74-330 and 74-331. Both rulings considered cases where the services of foreign entertainers were "loaned" to United Kingdom corporations in order to benefit from the provisions of the 1945 Convention and to thereby avoid any taxation of the income derived in respect of their activities in the United States.

ARTICLE 18  
Pensions

Paragraph (1) provides that, subject to the provisions of paragraph (2) of Article 19 (Government Service), pension payments received in consideration of past employment and annuity payments paid to an individual who is a resident of a Contracting State shall be taxable only in that State. The term "pension" includes payments from qualified retirement plans as well as other forms of retirement benefits paid for services rendered, or by way of compensation for injuries or sickness incurred in connection with past employment. A pension does not include payments in respect of the cancellation or premature termination of employment contracts (e.g., "golden handshakes" or severance pay). Such payments are taxable under the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), or 17 (Artistes and Athletes), as the case may be.

Payments which are not covered by any other Article of this Convention (e.g., Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), or 19 (Government Service) ), are taxable in accordance with Article 22 (Other Income) in the recipient's State of residence.

For purposes of this Article, the term "pension" does not include social security payments and other public pensions, e.g., railroad retirement benefits. Such items are taxable pursuant to Article 22 (Other Income).

Paragraph (2) provides that alimony paid to an individual who is a resident of a Contracting State is taxable only in that State. The term "alimony" is not defined, but with respect to the United States, means periodic payments made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement which is taxable to the recipient under the internal laws of the United States. Thus, for the United States, the term "alimony" would not include a payment which would not be taxable to the recipient even though such payment is made pursuant to a decree of divorce or of separate maintenance agreement. Payments for child support within the meaning of the Code are not covered by this Article and are, accordingly, taxable in the State where the recipient resides under Article 22 (Other Income). In the case of the United States, under present law, a recipient of child support is not taxable on such payments.

Paragraph (3) defines the term "annuity" to mean a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, individuals who are nationals of a Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 19

## Government Service

This Article generally follows Article 19 (Government Service) of the OECD Model Convention and is similar to Article X of the 1945 Convention.

Paragraph (1)(a) provides that remuneration, other than a pension, paid by a Contracting State to an individual for services rendered to that State will be taxable only in that State. This paragraph only applies to individuals who are employees of a Contracting State, and not to employees of a political subdivision or local authority of a Contracting State. Under paragraph (1)(b), such remuneration will be taxable only in the State in which the services are being performed if the recipient is a resident of that State and either is a national of that State or did not become a resident of that State solely for the purpose of performing the services.

Under paragraph (2)(a), any pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof will be taxable only in that State. An exception similar to the one contained in paragraph (1)(b) is incorporated in paragraph (2)(b) with respect to pensions. That paragraph provides that a pension described in paragraph (2)(a) will be taxable only in the other Contracting State if the recipient is both a national of and a resident of that State.

Paragraphs (1) and (2) do not apply if the services are rendered in connection with any business carried on by or on behalf of one of the Contracting States or one of its political subdivisions, or local authorities paying the remuneration. In such cases, the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), and 18 (Pensions), as the case may be, shall apply.

If an individual acquires immigrant status in the State in which he performs the services or receives the pension, that Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 1 (Personal Scope).

## ARTICLE 20 Teachers

Paragraph (1) provides that a professor or teacher who visits one of the Contracting States for a period not exceeding two years, for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution in that Contracting State, and who was immediately before that visit a resident of that other Contracting State, will be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for the purpose of teaching or engaging in research. Since this two year period is determined from the date he first visits the Contracting State, periodic vacations outside the first-mentioned Contracting State, or a brief return to the other Contracting State will not toll the running of the two-year period. Unlike the existing Convention, if the two-year period beginning from the date of his arrival is exceeded, the exemption will be lost retroactively. Thus, if a person comes to a

Contracting State for the purpose of teaching and stays for a period in excess of two years, the exemption will not apply for the first two years. A person who meets the qualifications of this provision may again claim its benefits if he first reestablishes his residence in the other Contracting State. In such case, the person claiming these benefits on a subsequent occasion must first satisfy the competent authority of the first-mentioned Contracting State that he had become a bona fide resident of the other State for a substantial period of time (normally at least one year).

Under paragraph (2), the Contracting State in which the teaching or research is performed may apply this exemption either to current payments to a professor or teacher in anticipation of fulfillment of the requirements of paragraph (1) or by way of withholding and refund. Thus, the recipient may be required to report and pay taxes on such income on a current basis and seek a refund of taxes paid upon fulfillment of the requirements of paragraph (1).

If an individual becomes a national of, or acquires immigrant status in, the State where he is visiting, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4) (b) of Article 1 (Personal Scope).

Pursuant to paragraph (3), this Article only applies to income from research undertaken in the public interest which is not primarily for the benefit of a private person or persons. For example, research projects which are undertaken to discover or perfect product processes, designs, etc., which are expected to be commercially exploited by the researcher or his present (or former) employer do not qualify under this Article.

## ARTICLE 21 Students and Trainees

This Article corresponds generally to Article XIX of the 1945 Convention and Article 20 (Students) of the OECD Model Convention. Under this Article, payments which a student or business apprentice, who immediately before Visiting a Contracting State was a resident of the other Contracting State receives for his maintenance, education or training, will not be taxed in the first-mentioned State if the recipient of the payments is engaged in a full-time education or training program and the payments are made from sources outside the State in which the education or training takes place. Payments will be considered to have been made from sources outside a State when they are borne by a person who is not a resident (as defined in Article 4 (Fiscal Residence)) of the Contracting State in which the education or training takes place. Like other articles referred to in paragraph 4(b) of Article 1, this Article will not apply to payments to students or business apprentices who are nationals of or residents with immigrant status in the first-mentioned Contracting State.

## ARTICLE 22 Other Income

This Article follows Article 21 (Other Income) of the OECD Model Convention. It

contains the general rule that income of a resident of a Contracting State, from any source, which is not dealt with by any specific Article in the Convention, shall be taxable only in that person's State of residence. This is the first United States tax convention to follow this rule. The scope of this Article is not confined to income having a source in the other Contracting State, but applies to a resident's income from sources in third countries. Moreover, this rule applies irrespective of whether the State of residence exercises its right to tax the income covered by this Article. Specific items of income not dealt with by other Articles of this Convention include child support payments, prizes or awards, and social security payments. These items are subject to the provisions of this Article and are taxable only in the State of residence.

This Article also makes it clear that the United Kingdom may continue to impose its tax on discretionary and accumulation trusts. United Kingdom law currently provides that discretionary and accumulation trusts are subject to the basic rate of income tax (35 percent) and to an additional tax of 15 percent. Trustees are eligible to claim double taxation relief in the respect of foreign tax paid on the income. Under United Kingdom law a distribution of income from a discretionary or accumulation trust is treated in the hands of the beneficiary as a payment from which tax has been deducted at the aggregate of the two rates (35 and 15) in force for the year of payment. That is, the distribution is grossed-up by 100 percent and the amount of the gross-up is treated as tax paid by, and creditable to, the distributee in the year of distribution.

Under paragraph (1) of Article 22 (Other Income) and paragraph (3) of Article 25 (Mutual Agreement Procedure), the United Kingdom will continue to impose its taxes on discretionary and accumulation trusts and will not be obligated to refund these taxes at the time of distributions to United States residents. However, to give double taxation relief, the United Kingdom will treat a United States person taxable on the income as if he were entitled to receive the income of the trust directly. Thus, the beneficiary will be given the benefit of relief provisions in United Kingdom domestic law (e.g., government securities held by non-residents). Additionally, any income covered by the Convention, such as dividends and interest, will receive the benefits of the Convention to the extent that the payments from the trust are made out of this income.

This Article is subject to the saving clause provisions of paragraph (3) of Article 1 (Personal Scope).

This Article does not apply if the resident deriving the income carries on business in the other Contracting State through a permanent establishment situated therein or performs independent personal services from a fixed base therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such cases, the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), or 17 (Artistes and Athletes) as the case may be, apply. As in the case of paragraph (1), this paragraph applies to income from all sources.

It should be noted that the proposed Convention specifically covers most types of income.



ARTICLE 23  
Elimination of Double Taxation

In order to prevent the double taxation of income covered by this Convention, each Contracting State agrees in this Article to provide a credit against its taxes for taxes paid to the other Contracting State.

Under paragraph (1), the United States agrees to allow a United States citizen or resident as a credit against United States tax the appropriate amount of taxes paid or accrued to the United Kingdom in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting stock of a United Kingdom corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to the United Kingdom by the United Kingdom corporation paying such dividends with respect to the profits out of which such dividends are paid. The rules for calculating the appropriate amount of taxes creditable in such a case are set forth below. However, the amount of tax credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within the United Kingdom or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect.

For the purpose of applying the United States credit in relation to taxes paid to the United Kingdom, the taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) shall be considered to be income taxes. In the case of dual-resident corporations described by paragraph (2) of Article 1 (Personal Scope), the United Kingdom petroleum revenue tax and the unrefunded portion of the ACT referred to in paragraph (1)(c) of this Article shall be regarded as an income tax for purposes of this Article. (See paragraph (2) of Article 1 (Personal Scope).) Any other taxes imposed by the United Kingdom on such corporation shall be treated as income taxes for purposes of the United States tax credit only in accordance with the laws of the United States.

Under paragraphs (2)(a)(i) and (2)(a)(ii) of Article 10 (Dividends), the United Kingdom allows residents of the United States certain tax credits or refunds in respect of dividends paid by a corporation which is a resident of the United Kingdom, subject to taxes withheld of 5 or 15 percent on the aggregate amounts received as dividends and tax credits. Subparagraph (1)(b) of this Article provides that the amounts withheld (5 or 15 percent) by the United Kingdom pursuant to paragraph 2 (a)(i) or (ii) of Article 10 (Dividends) from the refund paid to residents of the United States shall be regarded as an income tax imposed on the recipient of the dividend. Thus, the United States foreign tax credit with respect to those amounts shall be computed in accordance with Code section 901.

In the case of tax credits allowed to corporate shareholders of a corporation which is a resident of the United Kingdom pursuant to subparagraph (2)(a)(i) of Article 10, only one-half of the credit otherwise paid to individual shareholders is paid to those corporate shareholders. Subparagraph (1)(c) of this Article provides that the portion of the credit not paid to these

corporate shareholders, i.e., one-half of the ACT paid in respect of the distribution, shall be treated as an income tax imposed on the corporation paying the dividend.

In the United Kingdom tax system, ACT serves a dual function. To the extent that it offsets the United Kingdom corporate income tax imposed without regard to distributions (hereinafter referred to as "mainstream tax"), it is analogous to a payment of regular corporate income tax. To the extent that it does not offset mainstream tax, it is more analogous to a tax imposed on distributions which are income to the shareholders.

To reflect this hybrid nature of ACT, ACT which offsets mainstream tax will be attributed to the earnings of the year in which it offsets such tax and treated as if it were regular corporate tax. ACT which does not offset mainstream tax will generally be attributed to the accumulated profits of the year of distribution.

In order that the derivative foreign tax credit be computed as intended under the Convention, corporate shareholders receiving the benefits of subparagraph 2 (a)(i) of Article 10 (Dividends) must apply the following rules:

1. ACT paid with respect to a distribution shall be treated as attributable to the accumulated profits (determined under U.S. principles) of the year of distribution, except in two circumstances:

(a) to the extent the ACT reduces mainstream tax for a prior or subsequent year (see *Example 4* below); and

(b) if, after attribution of ACT which does not reduce mainstream tax, accumulated profits would not exceed corporate taxes for the year (see *Example 5* below).

ACT which reduces mainstream tax in any year or years shall be attributable to any accumulated profits of the year or years for which the mainstream tax is reduced. Where ACT is used to offset mainstream tax, the offset will be viewed as a refund of the ACT initially allowed as a credit and as a tax paid in respect of the year for which the ACT is applied as an offset. Consequently, a reduction in the foreign tax credit for the year from which the ACT is carried must be made in accordance with section 905(c) of the Code.

Mainstream tax will be considered offset first by ACT incurred with respect to the current distribution. Additional offset will be considered to be attributable to ACT incurred in the earliest year from which the ACT can be carried.

Where attribution to a year of ACT which does not offset mainstream tax leaves no accumulated profits for that year, the more exact attribution method set forth in *Example 5* should be used.

2. A distribution in respect of which the ACT paid reduces mainstream tax for the current taxable year may be treated by the Internal Revenue Service as made first out of the entire profits of that year (computed as of the close of the year). This rule, which applies regardless of whether the distribution is made in the first 60 days of the taxable year, will be applied where necessary

to prevent crediting of a prior year's mainstream tax unreduced by ACT, while at the same time using such ACT to reduce the current year's mainstream tax.

3. Where a United States corporation owns less than all the stock of a corporation resident in the United Kingdom, the derivative tax credit will be calculated with reference solely to the proportionate interest in accumulated profits attributable to the United States shareholder. Thus, for example, the ratio which the distribution to the United States shareholder bears to accumulated profits in excess of income taxes, as well as the amount of mainstream tax and ACT paid with respect thereto, will be calculated as if the United States shareholder's proportionate interest in the accumulated profits were the entire accumulated profits of a corporation of which it was the sole owner. The amount of foreign tax credit will not vary according to either

- (1) the status of any other shareholder; or
- (2) the imposition or refund of ACT with respect to a distribution to any other shareholder.

In the case of dividends paid by a United Kingdom corporation wholly owned by a United States parent corporation, the determination of the appropriate amount of creditable taxes is illustrated by the following examples:

*Example 1.* A United Kingdom resident corporation wholly owned by a United States parent corporation has \$100 of pre-tax earnings in year 1 and pays a dividend equal to 50 percent of the amount available for distribution in year 1.

1.	Accumulated profits-----	\$100.00
2.	British mainstream tax at 52% rate-----	52.00
3.	Available for distribution-----	48.00
4.	Distribution-----	24.00
5.	ACT with respect to distribution before refund-----	12.92
6.	Net mainstream tax, reduced by ACT*-----	39.08
7.	Refund of one-half ACT pursuant to paragraph (2)(a)(i) of Article 10-----	106.46
8.	Unrefunded one-half of ACT treated as corporate tax pursuant to paragraph (1)(c) of Article 23-----	6.46
9.	Total corporate tax (39.08 mainstream plus 6.46 unrefunded ACT) -----	45.54
10.	Total dividend received before withholding tax (24.00 declared plus 6.46 refund treated as dividend pursuant to paragraph (1)(a)(iii) of Article 10-----	30.46
11.	Accumulated profits in excess of British corporate taxes (100 - 45.54)-----	54.46
12.	Derivative tax credit (30.46 / 54.46) x 45.54-----	25.47
13.	British withholding tax (5 percent of total dividend of 30.46)----	1.52
14.	Total foreign tax credit-----	26.99
15.	Taxable income (30.46 dividend plus 25.47 “gross-up” of derivative tax credit)-----	55.93
16.	United States tax before credit (48% of 55.93)-----	26.85

17. Amount by which foreign tax credit exceeds U.S. tax-----0.14

\* It is assumed in this example, as is generally the case, that ACT is fully credited against mainstream tax.

*Example 2.* Assume the same facts as in the previous example, except that in year two the British corporation makes a distribution out of what, under United States tax law principles, are the remaining \$24.00 of earnings from year one. Assume further that there are no earnings in year two for United Kingdom purposes, and that the ACT with respect to the distribution is carried back and credited against mainstream tax of year one.

1.	Distribution in year two-----	\$ 24.00
2.	ACT-----	12.92
3.	Reduction in mainstream tax for year one-----	12.92
4.	Net mainstream tax for year one, reduced by ACT-----	26.16
5.	Refund of one-half ACT-----	6.46
6.	Unrefunded ACT-----	6.46
7.	Total corporate tax (26.16 mainstream + 6.46 unrefunded ACT in respect of distribution in year one + 6.46 unrefunded ACT in respect of distribution in year two)-----	39.08
8.	Total dividend received before withholding tax-----	30.46
9.	Accumulated profits in excess of British corporate taxes (100-39.08)	60.92
10.	Derivative tax credit (30.46 / 60.92) x 39.08-----	19.54
11.	Taxable income (30.46 dividend plus 19.54 “gross up” of derivative tax credit)-----	50.00

It should be noted that the total taxable income in respect of the two distributions is \$105.93 (\$55.93 + \$50), which is \$5.93 more than the accumulated profits of \$100; and the total derivative tax credit is \$45.01, which is \$5.93 more than the corporate tax of \$39.08. The disparity occurs for two reasons: first, that the Convention treats refunded ACT as a dividend, but does not treat ACT that is potentially refundable as profits out of which future dividends can be paid \* ; and second, that \$6.46 of the \$45.54 mainstream tax considered paid in respect of the accumulated profits in *Example 1* is subsequently refunded.

\*If that were done, the fraction for computing the derivative tax credit in respect of the distribution in *Example 1* would be (30.46 / 54.46 + 6.46 potentially refundable ACT) or (30.46 / 60.92) x taxes paid.

The above result is considered appropriate in order to ensure that, with reference to a 50 percent distribution, the British refund substantially benefits the United States shareholder. An adjustment is necessary, however, when tax which has been taken into account in computing derivative foreign tax credit in respect of a prior distribution - of whatever percentage of the accumulated profits - is refunded in the form of ACT. The refunded ACT must, with respect to such distribution, both

(a) increase accumulated profits in excess of income taxes, and

(b) decrease taxes paid in respect of accumulated profits.

By reason of the \$6.46 refund of ACT in *Example 2*, therefore, the derivative foreign tax credit in *Example 1* must be recalculated as follows:

1. Calculation before adjustment (see (12) of *Example 1*)  $(30.46 / 54.46) \times 45.54$
2. Addition of \$6.46 to accumulated profits in excess of income taxes  $(30.46 / 60.92)$
3. Subtraction of \$6.46 from taxes paid  $(\$45.54 - 6.46) = \$39.08$
4. Derivative foreign tax credit  $(30.46 / 60.92) \times 39.08 = \$19.54$

The adjusted result in *Example 1* is the same as in *Example 2*. Both the taxable income and tax credit in respect of the prior distribution will therefore be decreased by \$5.93, in accordance with section 905(c) of the Internal Revenue Code.

The determination of the appropriate amount of creditable taxes in the case of dividends paid by a less-than-wholly-owned United Kingdom corporation is illustrated by the following example:

*Example 3.* A United Kingdom resident corporation, *W*, is owned by U.S. corporation *X* (25%), U.K. corporation *Y* (60%), corporation *Z* (10%), and individual *A* (5%). *W* has \$400 of pre-tax earnings in year 1 and pays a dividend of 50 percent of the amount available for distribution in year 1. *Z* is organized in country *M* and has no right to receive a refund of ACT from the United Kingdom. *A*, a United Kingdom resident, receives a tax credit equal to the entire ACT imposed, and *Y* makes an election under U.K. law to eliminate ACT with respect to distributions to itself.

1.	Accumulated profits-----	\$400.00
2.	Mainstream tax imposed at a 52% rate-----	208.00
3.	Available for distribution-----	192.00
4.	Total distribution-----	96.00
5.	Portion of accumulated profits attributable to <i>X</i> 's shareholding - 25%-----	100.00
6.	<i>Determination of X's United States foreign tax credit:</i>	
A.	Accumulated profits-----	100.00
B.	British mainstream tax at 52% rate-----	52.00
C.	Available for distribution-----	48.00
D.	Distribution to U.S. corporation <i>X</i> -----	24.00
E.	For remainder of computation see <i>Example 1</i>	

In the above examples it has been assumed that the earnings and profits used in calculating the indirect tax credit for United States tax purposes approximate the earnings and profits of the United Kingdom corporation as computed in the United Kingdom for United Kingdom tax purposes. This assumption, of course, is not always valid and there will be situations where the earnings and profits differ for United Kingdom and United States tax purposes. Accordingly, it will be necessary for United States shareholders to maintain separate records to reflect these differences. Such records must currently be maintained by United States shareholders of foreign corporations where the amount of earnings and profits of that corporation

differ under the rules of the respective countries. Separate records will be especially important where United States shareholders do not own all of the shares of a United Kingdom corporation. Quite often the shares of a United Kingdom corporation are owned by both United States and foreign shareholders. In these cases, the payment of an ACT credit to the United States shareholders will require a separate computation of earnings and profits for United States tax purposes which reflects that shareholder's proportionate interest in the corporation.

*Example 4.* A United Kingdom resident corporation is wholly owned by a U.S. corporation. The accumulated profits (according to United States standards), taxable profits (according to United Kingdom standards), and distributions of the subsidiary are as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
1. Accumulated profits-----	\$120	\$100	\$100
2. Taxable profits-----	0	50	50
3. Distribution-----	0	26	130

With respect to year 1, the U.S. parent corporation has no taxable income for U.S. purposes, no U.S. tax, and no foreign tax credit.

As of the end of year 2, the year 2 taxes of the parent are calculated as follows:

1. Accumulated profits-----	\$100.00
2. U.K. taxable profits-----	50.00
3. British mainstream tax at 52% rate-----	26.00
4. Distributions-----	26.00
5. ACT with respect to distribution before refund-----	14.00
6. Net mainstream tax, reduced by ACT-----	12.00
7. Refund of one-half of ACT-----	7.00
8. Unrefunded one-half of ACT-----	7.00
9. Total corporate rate (\$12.00 plus \$7.00)-----	19.00
10. Total dividend received before withholding tax (\$26.00 plus \$7.00)-	33.00
11. Accumulated profits in excess of British corporate taxes (\$100 minus \$19)-----	81.00
12. Derivative tax credit (33 / 81) x 19-----	7.74
13. British withholding tax (5% of \$33.00)-----	1.65
14. Total foreign tax credit (\$7.74 + \$1.65)-----	9.39
15. Taxable income (\$33.00 + \$7.74)-----	40.74
16. United States tax before credit (48% of \$40.74)-----	19.56
17. United States tax after credit (\$19.56 minus \$9.39)-----	10.17

As of the end of year 3, the year 3 taxes are calculated as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
1. Accumulated profits-----	\$120.00	\$100.00	\$100.00
2. U.K. taxable profits-----	-0-	50.00	50.00
3. Year 2 U.K. corporate tax			

	before year 3 ACT (line 9 above)----	---	19.00	---
4.	Year 3 British mainstream tax at 52% rate-----	---	---	26.00
5.	Year 3 ACT before adjustment-----	---	---	70.00
6.	Year 3 ACT offset to mainstream tax	-0-	(3.50)*	(17.50)*
7.	Year 3 ACT carried back and deemed mainstream tax-----	-0-	3.50	(3.50)
8.	Year 3 ACT refund before adjustment	---	---	(35.00)
9.	Year 3 ACT refund carried back-----	-0-	(1.75)	1.75
10.	U.K. corporate tax after year 3 ACT (sum of lines 3 through 10)-----	-0-	17.25	41.75
11.	Accumulated profits in excess of British corporate taxes (line 1 minus line 10)-----	120.00	82.75	58.25
12.	Year 2 dividend-----	—	33.00	---
13.	Accumulated profits available for distribution in year 3 (line 11 minus line 12)-----	120.00	49.75	58.25
14.	Year 3 dividend before § 78 gross up (130 + 35 ACT refund)-----	—	---	165.00
	a. From year 3 accumulated profits (line 13)-----	—	—	58.25
	b. From year 2 accumulated profits (line 13)-----	—	---	49.75
	c. From year 1 accumulated profits (balance)-----	---	---	57.00
15.	Year 3 foreign tax credit			
	a. British withholding tax (5% of 165)-----	---	—	8.25
	b. Year 3 derivative tax credit (from line 10)-----	---	---	41.75
	c. Year 2 derivative tax credit (49.75/82.75) x 17.25-----	---	---	10.37
16.	Taxable income (165 + 41.75 + 10.37)-----	---	---	217.12
17.	United States tax before credit (48% of 217.12)-----	—	---	104.22
18.	Total foreign tax credit (8.25 + 41.75 + 10.37)-----	—	---	60.37
19.	United States tax after credit (104.22 less 60.37)-----	—	---	43.85

\* Under U.K. rules, the maximum amount of ACT that can be credited against mainstream tax is 35/52 of mainstream tax, and excess ACT is carried back two years, and then carried forward indefinitely. Thus, since \$26 of mainstream tax was payable for each of years 2 and 3, the offset for ACT for each of years 2 and 3 cannot exceed \$17.50 (26 x 35/52). For year 2, this means an

increased offset of \$3.50 (17.50 minus 14 previously offset).

As of the end of year 3, the year 2 taxes are recalculated as follows:

1.	Total dividend received before withholding tax-----	\$33.00
2.	British withholding tax (5% of 33)-----	1.65
3.	Derivative tax credit (33 / (81+1.75)) x (19-1.75)-----	6.88
4.	Taxable income (33 + 6.88)-----	39.88
5.	United States tax before credit (48% of 39.88)-----	19.14
6.	Total foreign tax credit (1.65 + 6.88)-----	8.53
7.	United States tax after credit (19.14 minus 8.53)-----	10.61
8.	United States tax previously paid-----	10.17
9.	Additional United States tax due (10.61 minus 10.17)--	.44

*Example 5.* This example, showing a more exact attribution of non-offset ACT, is to be used *only* if, after attribution of non-offset ACT, there are no accumulated profits in excess of British corporate tax.

The facts are the same as in *Example 4*, except that the accumulated profits for year 3 are \$30 rather than \$100.

The calculation of the year 2 taxes as of the end of year 2 is the same as in *Example 4*. As of the end of year 3, the year 3 taxes are calculated as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	
1.	Accumulated profits-----	\$120.00	\$100.00	\$ 30.00
2.	Taxable profits-----	-0-	50.00	50.00
3.	Year 2 U.K. corporate tax before year 3 ACT (line 9 of <i>Example 4</i> calculation of year 2 taxes as of the end of year 2)-----	---	19.00	---
4.	Year 3 British mainstream tax at 52% rate-----	---	---	26.00
5.	Year 3 Act before adjustments-----	---	---	70.00
6.	Year 3 ACT offset to mainstream tax	-0-	(3.50)	(17.50)
7.	Year 3 ACT carried back and deemed mainstream-----	-0-	3.50	(3.50)
8.	Year 3 ACT refund before adjustment	---	---	(35.00)
9.	Year 3 ACT refund carried back-----	-0-	(1.75)	1.75
10.	U.K. corporate tax after year 3 ACT (sum of lines 3 through 9)	-0-	17.25	41.75
11.	Accumulated profits in excess of British corporate taxes (line 1 minus 10)-----	120.00	82.75	(11.75)

Since attribution of the non-offset ACT to year 3 eliminates any excess of accumulated profits over British corporate tax, the calculation must be redone, taking in account only offset



ACT, and then attributing non-offset unrefunded ACT only the extent of \$17.50\* for every \$82.50 of accumulated profits considered distributed (determined under U.S. rules before taking into account non-offset ACT).

\*\$17.50 represents the amount of unrefunded ACT which would result from an actual distribution of \$65 (one-half of \$65 x 35 ) / 65. With an actual distribution of \$65, the \$17.50 of refunded ACT would be deemed distributed, thus increasing the total distribution to \$82.50.

In year 3, only \$17.50 of ACT offset mainstream tax. One-half of this is refunded. In year 3, therefore, U.K. corporate tax after the offset ACT is:26.00

$$\begin{array}{r} (17.50) \\ \underline{8.75} \\ 17.25 \end{array}$$

Accumulated profits in excess of British corporate tax other than non-offset ACT is \$30.00 minus \$17.25, or \$12.75. Non-offset unrefunded ACT is \$24.50.  $(70 - 17.50 - 3.50) / 2$ .

In determining the maximum amount of \$24.50 non-offset unrefunded ACT to be attributed to year 3, no ACT should be attributed to deemed distributions, since they do not incur ACT. Thus, of the \$12.75, the \$8.75 of refunded ACT attributable to the \$17.50 offset is excluded from the amount to which unrefunded non-offset ACT is attributable. The maximum amount of non-offset unrefunded ACT attributed to the remaining \$4.00 of accumulated profits in year 3 is \$0.85. The \$0.85 is calculated as  $(17.5 / 82.5) \times 4.00$ .

Thus, of the \$12.75, \$8.75 is deemed distributed as offset refunded ACT; \$0.85 is non-offset unrefunded ACT; \$0.85 is non-offset refunded ACT deemed distributed; and \$2.30 is the remaining actual distribution considered to have been made from year 3.

In year 2, the accumulated profits available for distribution before adjustment for year three non-offset ACT are \$49.75 (from line thirteen of *Example 4* calculation of year 3 taxes). Of that amount, \$1.75 is deemed distributed as offset refunded ACT. The non-offset unrefunded ACT attributable to the remaining \$48.00 is \$10.18  $(\$48.00 \times 17.5) / 82.5$ . Thus, the accumulated profits available for actual distribution in year 2 are \$27.64 (\$49.75 less \$1.75 (deemed distribution)) less \$10.18 (non-offset unrefunded ACT); and the U.K. corporate tax is 27.43 (\$17.25 + \$10.18).

A similar attribution procedure is followed in attributing ACT to distributions from year 1.

The carryback of non-offset unrefunded ACT is limited to two years, and there is no carryforward.

Paragraph (2) of this Article parallels paragraph (1) with respect to the treatment of United States taxes paid by a resident of the United Kingdom. Under this paragraph, the United Kingdom will allow a resident of the United Kingdom as a credit against United Kingdom taxes paid to the United States in accordance with the provisions of the law of the United Kingdom for the allowance of credits for taxes to territories outside the United Kingdom (as it may be

amended from time to time without changing the general principle of paragraph (2)). Such credit shall be allowed with respect to taxes payable in accordance with this Convention on profits or income from sources within the United States, as determined by subparagraph (3) of this Article (excluding, in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid).

In the case of a dividend paid by a United States corporation to a corporation which is a resident of the United Kingdom which controls directly or indirectly 10 percent or more of the voting power of that paying corporation, the United Kingdom shall also allow a credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid.

Paragraph (3) sets forth the source of income rules applicable for purposes of determining the allowance of tax credits under this Article. For purposes of the preceding paragraphs, income or profits derived by a resident of a Contracting State which are taxed in the other Contracting State in accordance with the Convention (other than by reason of the saving clause referred to below) shall be deemed to arise from sources within that other Contracting State. However, where a United States citizen is subject to tax in the United States by reason of his citizenship under the saving clause of paragraph (3) of Article 1 (Personal Scope), the United Kingdom will allow that person a tax credit for any United States tax paid with respect to income which under the internal laws of the United Kingdom has its source in the United States; and the United States will allow that person, subject to limitations of the Internal Revenue Code to claim a credit for taxes paid to the United Kingdom with respect to income which under the internal laws of the United States has its source in the United Kingdom. This paragraph has particular relevance with respect to a United States citizen who is a resident of the United Kingdom for purposes of this Convention (see Article 4 (Fiscal Residence)).

In the case of third country income earned by a United States citizen who is a resident of the United Kingdom, (e.g., dividends from Germany), the United Kingdom is not required to allow a credit for United States taxes on that income. Double taxation of income may be avoided, however, under the overall method for computing foreign tax credits. In such case, the United States will allow under its internal law a credit for both the United Kingdom and third country taxes.

Finally, paragraph (4) makes it clear that the credit allowed for taxes paid to the United Kingdom, especially the petroleum revenue tax, shall be subject to the tax credit limitations of the Tax Reduction Act of 1975 which apply to foreign oil and gas extraction income.

#### ARTICLE 24 Non-discrimination

Paragraph (1) provides that individuals who are nationals of a Contracting State and who are residents of the other Contracting State will not be subjected in that other Contracting State to taxation or any other requirement connected therewith which is other or more burdensome than the taxation or requirements connected therewith to which nationals of that other Contracting State in the same circumstances are or may be subjected. Thus, for example, a national of the

United Kingdom who is a resident of the United States and who meets the requirements specified in Code section 911 would, under this Article, be entitled to the benefits of that section even though he is not also a national of the United States. On the other hand, just as a United States citizen who becomes a non-resident alien at any time during a taxable year or whose spouse is a non-resident alien cannot in the absence of an election file a joint return for that year, a United Kingdom national would not be entitled to file a joint return with his spouse in the absence of such election if either is a non-resident alien at any time during the taxable year.

Paragraph (2) provides that a permanent establishment which an enterprise of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to less favorable taxation than an enterprise of that other Contracting State carrying on the same activities.

Subject to the provisions of paragraph (4), discussed below, paragraph (3) provides that interest, royalties, and other disbursements paid by an enterprise of a Contracting State to an enterprise of the other Contracting State shall, if reasonable in amount, be deductible for purposes of determining the taxable profits of the enterprise in that Contracting State under the same conditions as if they had been paid to a resident of that Contracting State. This rule is not limited to payments to related parties.

For purposes of this paragraph, the term "other disbursements" includes charges for amounts expended by a resident of the other Contracting State for the benefit of the enterprise. The term "other disbursements" is to be broadly defined, to include charges or allocations by such resident for the benefit of such enterprise, including reasonable allocations of executive and general administrative overhead (except to the extent such expenses are not for the benefit of the enterprise, but are for "stewardship" or "overseeing" functions for the resident's own benefit as an investor in the enterprise). The term also includes charges and allocations of research and development expenses where the enterprise has the benefits of such activities under a cost or risk sharing agreement and other expenditures by the resident of a group of enterprises which includes such enterprise.

Paragraph (4) states that paragraph (3), above, does not apply to interest, royalties, or other disbursements to which the provisions of Article 9 (Associated Enterprise), paragraphs (5) and (7) of Article 11 (Interest), or paragraph (5) of Article 12 (Royalties) apply with respect to transactions between related parties.

Paragraph (5) prohibits one Contracting State from subjecting an enterprise of such Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, to any taxation or any requirement connected with taxation which is other or more burdensome than is applicable to enterprises of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Paragraph (6) provides that nothing in this Article obliges a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its

own residents.

This Article is similar to Article XXI of the 1945 Convention and Article 24 (Non-Discrimination) of the OECD Model Convention.

## ARTICLE 25 Mutual Agreement Procedure

This Article generally extends the mutual agreement procedures found in Article XXA of the 1945 Convention and is similar to Article 25 (Mutual Agreement Procedure) of the OECD Model Convention.

Under paragraph (1), when a resident or national of a Contracting State considers that the actions of one or both Contracting States results or will result in taxation which is not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. A resident or national of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure.

Under paragraph (2), if the claim is considered to be justified by the competent authority and if it cannot alone arrive at an appropriate solution to the issue involved, that competent authority shall endeavor to resolve the case by agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is contrary to the Convention. In cases in which the competent authorities reach an agreement, taxes will be imposed, and refunds or credits of taxes will be allowed, as appropriate, by the Contracting States in accordance with such agreement. In the case of the United States, where an agreement is reached between the competent authorities which requires the United States to make a refund of tax or to extend any other similar credit, such refund or credit will be made, assuming presentation of his case to the competent authority within a reasonable period, notwithstanding any procedural barriers otherwise existing under United States law, including any statute of limitations. In cases where an agreement cannot be reached between the competent authorities, the United States will not be required to provide any relief for double taxation on a unilateral basis.

Paragraph (3) permits the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may reach agreement on the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State; the allocation of income, deductions, credits, or allowances between persons; the nature of particular items of income; the meaning of terms not otherwise defined in this Convention; the place where a particular item of income has its source; and the elimination of double taxation in respect of income paid out of trusts. In the case of trust distributions, the competent authorities may conclude that elimination of double taxation requires that the character of the income giving rise to such distributions must be determined. In such a case, taxpayers will be expected to have the records necessary to

demonstrate the character of income underlying a trust distribution.

Under paragraph (4), the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions, for the purpose of reaching an agreement.

## ARTICLE 26

### Exchange of Information and Administrative Assistance

This Article extends without change the exchange of information Article (Article XX) and the assistance in collection Article (Article XIXA) of the 1945 Convention.

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for the carrying out of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is in accordance with the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information need be exchanged, however, only if it is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

The information exchanged must be treated as secret. However, such information may be disclosed to any persons or authorities (including a court or administrative body) concerned with the assessment, collection, or enforcement of, or prosecution with respect to, the taxes which are the subject of the Convention. No information may be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

Paragraph (2) provides that one Contracting State will give the other Contracting State limited assistance in collecting its taxes. Thus, each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by such other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by such other Contracting State is not enjoyed by persons not entitled to such benefits.

Paragraph (3) makes clear that a Contracting State is not obligated to carry out measures which are at variance with its laws or the administrative practice with respect to the collection of its own taxes; or which would be contrary to its sovereignty, security or public policy. A Contracting State may also consider, in determining the administrative measures it will use, the administrative measures utilized by the other Contracting State in a comparable situation.

Paragraph (4) provides that the competent authorities will consult to cooperate and advise each other on the implementation of these provisions.

## ARTICLE 27

### Effect on Diplomatic and Consular Officials and Domestic Laws

Paragraph (1) of this Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

Paragraph (2) provides that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State. This rule reflects the principle that a Convention should not increase the tax burden on residents of the Contracting States.

## ARTICLE 28 Entry into Force

Paragraph (1) provides that the proposed Convention shall be ratified and that the instruments of ratification shall be exchanged at Washington, D.C. as soon as possible after both States have ratified the Convention.

Paragraph (2) provides that the Convention will enter into force on the thirty-first day following the date of exchange of the instruments of ratification. With respect to the United Kingdom, the proposed Convention will take effect in the following manner. In relation to any dividend to which subparagraph (2)(a)(ii) of Article 10 (Dividends) applies, the provisions of that Article shall apply to any year of assessment beginning on or after April 6, 1973. For this purpose, a dividend paid on or after April 1, 1973, and before April 6, 1973, shall be treated for tax credit purposes (i.e., for purposes of any refund of the ACT) as paid on April 6, 1973. United States shareholders who derived dividends from corporations which were residents of the United Kingdom during this period will be entitled to claim refunds from the United Kingdom in respect of those dividends and in accordance with the provisions of paragraph 2(a)(ii) of Article 10. It is anticipated that the United Kingdom will prescribe the procedures for claiming those refunds upon ratification of this Convention.

In the case of dividends to which subparagraph (2)(a)(i) of Article 10 (Dividends) applies (i.e., dividends received from a corporation which is a resident of the United Kingdom by a United States corporation owning 10 percent or more of the voting stock thereof), and any other provision of the Convention in respect of income tax and payments of tax credits (i.e., refunds of ACT), and in respect of the United Kingdom capital gains tax, those provisions shall be effective for any year of assessment beginning on or after April 6, 1975. Refunds of tax may be claimed in the manner to be prescribed by the United Kingdom.

The Convention will be effective in respect of the United Kingdom corporation tax, for any financial year beginning on or after April 1, 1975, in respect of the United Kingdom petroleum revenue tax, for any chargeable period beginning on or after January 1, 1975, and (in accord with Article V of the Protocol of [March 31], 1977) in respect of the special domicile rule of paragraph (4) of Article 4 (Fiscal Residence) for any year of assessment beginning on or after April 6, 1976.

For the United States, tax credits for taxes paid to the United Kingdom on or after April 1, 1973, shall be allowed for the period subsequent to that date in accordance with paragraph (1)

of Article 23 (Elimination of Double Taxation). In the case of dividends received for any year of assessment beginning on or after April 6, 1973, and before any year of assessment beginning on or after April 6, 1975, by a United States corporation described by paragraph (2)(a)(i) of Article 10 (Dividends), the full amount of ACT paid in respect of such dividends shall be regarded as a tax imposed on the distributing corporation.

With respect to taxes withheld at source, this Convention shall become effective in the United States on January 1, 1975, for taxes withheld on or after that date and with respect to all other taxes, this Convention will be effective in the United States for taxable years beginning on or after January 1, 1975.

Subject to the provisions of paragraph (4) of this Article, the 1945 Convention, as amended by the Supplementary Protocol of June 6, 1946, by the Supplementary Protocol of May 25, 1954, by the Supplementary Protocol of August 19, 1957, and by the Supplementary Protocol of March 17, 1966, will cease to have effect in respect of taxes to which this Convention in accordance with the provisions of paragraph (2) of this Article applies.

Where any provision of the 1945 Convention would have afforded any greater relief from tax, any such provision will continue to have effect for any year of assessment or financial year in the United Kingdom and for any taxable year in the United States beginning, in either case, before January 1, 1976.

The 1945 Convention will terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article. In addition, this Convention will not affect any Agreement in force extending the 1945 Convention in accordance with Article XXII thereof. In those cases, the 1945 Convention will continue to apply to those territories. The United States has requested the United Kingdom to advise territories to which the 1945 Convention has been extended that the United States desires to renegotiate the Convention as it affects those territories so as to reflect the principles of this Convention.

The amendments to this Convention effected by the Notes exchanged at London on April 13, 1976 shall enter into force on the same date as determined under paragraph (2) of this Article and, in accord with the provisions of Article V of the Protocol of August 26, 1976 and of Article VI of the Protocol of [March 31], 1977, the amendments to this Convention effected by those protocols shall, upon ratification, enter into force on the thirty-first day following the date of the exchange of the instruments of ratification of those Protocols. Once in force, the provisions of the Notes and the two protocols shall have effect in accordance with this Article.

## ARTICLE 29 Termination

This Article is drafted in substantially the same manner as the termination Article of the 1945 Convention.

Paragraph (1) provides that the Convention will remain in force indefinitely, but that either Contracting State may, on or before June 30 in any year after the year 1980, give to the

other Contracting State through diplomatic channels notice of termination. When notice is properly given, the Convention ceases to be effective for taxable years beginning on or after January 1 of the following year for United States tax; for a year of assessment beginning on or after April 6 of the following year for United Kingdom income tax and capital gains tax; for a financial year beginning on or after April 1 of the following year for United Kingdom corporation tax; and for a chargeable period beginning on or after January 1 of the following year for United Kingdom petroleum revenue tax.

Under paragraph (2), the termination of the proposed Convention will not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting States.

### TECHNICAL EXPLANATION PROTOCOL 3

#### TECHNICAL EXPLANATION OF THE THIRD PROTOCOL SIGNED AT LONDON ON MARCH 15, 1979 (THE "THIRD PROTOCOL" OR THE "PROTOCOL") FURTHER AMENDING 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 CAPITAL GAINS SIGNED AT LONDON, ON DECEMBER 31, 1975, AS AMENDED BY THE NOTES EXCHANGED AT LONDON ON APRIL 13, 1976, AND THE PROTOCOLS SIGNED AT LONDON ON AUGUST 25, 1976 AND MARCH 31, 1977 (THE CONVENTION AS AMENDED BY THE NOTES AND THE TWO PROTOCOLS BEING REFERRED TO AS THE "CONVENTION")

It is the practice of the Treasury Department to prepare for the use of the Senate and other interested persons a Technical Explanation of the tax protocols, which are submitted to the Senate for its advice and consent to ratification.

An Income Tax Protocol with the United Kingdom of Great Britain and Northern Ireland was signed on March 15, 1979, and submitted by the President to the Senate on April 12, 1979. On June 6, 1979, the Senate Committee on Foreign Relations held hearings and this Technical Explanation was presented. The Senate voted its advice and consent on July 9, 1979, and instruments of ratification were exchanged on March 25, 1980.

The Third Protocol contains seven articles which modify Articles 2 (Taxes Covered), 7 (Business Profits), 9 (Associated Enterprises), 10 (Dividends), 19 (Government Service), 23 (Elimination of Double Taxation), and 28 (Entry into Force) of the Convention. In addition, Article VI of the Protocol adds a new Article 27A (Offshore Activities) to the Convention. Set forth below is an explanation of each article of the Protocol.

### ARTICLE I



Article I contains three paragraphs serving to conform the text of the Convention to the United States Senate's reservation which was made a part of its June 27, 1978 resolution of advice and consent to ratification. The references to income taxes imposed by political subdivisions or local authorities are deleted from paragraphs (2) and (3) of Article 2 (Taxes Covered) and from paragraph (4) of Article 9 (Associated Enterprises). The other provisions of those paragraphs are restated. Taxes imposed by political subdivisions and local authorities remain subject to the provisions of Article 24 (Non-discrimination) of the Convention, by reason of paragraph (4) of Article 2 (Taxes Covered).

## ARTICLE II

Article II adds a new subparagraph (6A) to Article 7 (Business Profits) of the Convention. The new subparagraph provides that the United States excise tax on insurance premiums paid to foreign insurers, imposed by section 4371 of the Internal Revenue Code (the "Code"), will not apply to insurance or reinsurance premiums received by a business of insurance conducted by a United Kingdom enterprise regardless of whether that business is carried on through a permanent establishment in the United States.

Under paragraph (1) of Article 7 (Business Profits) and subparagraph (2)(a) of Article 2 (Taxes Covered) of the Convention, no insurance excise tax (or income tax) is payable with respect to premiums paid to a United Kingdom enterprise if the enterprise does not have a permanent establishment in the United States. In the case of an enterprise with a permanent establishment in the U.S., the United States will tax the income effectively connected with a U.S. trade or business, under section 864 of the Code, as is permitted by paragraphs (1) and (7) of Article 7.

In the case of a United Kingdom enterprise with a permanent establishment in the United States, there was some uncertainty over the applicability of the insurance excise tax. The intention of the Convention was that the excise tax would not be imposed in addition to the income tax on premiums or income arising from the insurance of United States risks. However, since the income tax and the insurance excise tax are not necessarily mutually exclusive under the Code, and since the application of the non-discrimination provisions of Article 24 (Non-discrimination) was not entirely clear in the circumstances, it was thought desirable to provide explicitly that only the income tax would apply in the case of a British enterprise with a United States permanent establishment.

## ARTICLE III

A corporation organized under the laws of the United States, one of the states, or the District of Columbia is a United States resident under subparagraph (1)(b)(ii) of Article 4 (Fiscal Residence). Such a corporation may also be a resident of the United Kingdom, however, under subparagraph (1)(a)(ii) of that Article if its business is managed and controlled in the United Kingdom. Paragraph (5) of Article 10 (Dividends) of the Convention, which corresponds to Article XV of the 1945 Convention, prohibits (with certain exceptions) a Contracting State from

taxing dividends paid by a corporation which is a resident of the other Contracting State. Although paragraph (2) of Article 1 (Personal Scope) precludes a dual resident corporation from claiming relief under Article 10, a question arose over whether paragraph (5) of Article 10 of the Convention would prohibit the United States from withholding tax on dividends paid by such a dual resident corporation, since the relief granted by paragraph (5) extends to the recipient of a dividend and not to the paying corporation. Article III of the Protocol amends paragraph (5) to provide clearly that the United States is not prohibited from applying its withholding tax in cases where the corporation paying the dividends is a resident of both the U.K. and the U.S.

#### ARTICLE IV

Under United Kingdom law (sections 367 or 373, Income and Corporation Taxes Act 1970), United States nationals, who are not also United Kingdom nationals, are not subject to U.K. income tax on their remuneration received from the United States government (or any agency or instrumentality thereof) for services rendered to the United States in the United Kingdom. Although U.K. internal law does not provide for taxation in those circumstances, concern has been expressed that paragraph (1) of Article 19 (Government Service) of the Convention would permit the U.K. to impose a tax if the U.S. national did not become a resident of the U.K. solely for the purpose of performing the services.

To allay this concern, Article IV of the Protocol modifies subparagraph (b) of paragraph (1) of Article 19 (Government Service) to permit a Contracting State to tax remuneration (other than a pension) paid by the other Contracting State for services rendered to it only where the services are rendered in the first-mentioned State and the recipient is a resident and national of that State.

#### ARTICLE V

Article V replaces paragraph (4) of Article 23 (Elimination of Double Taxation) with a new paragraph (4). The new paragraph limits the credit for the United Kingdom petroleum revenue tax allowed against United States tax by subparagraph (2)(b) of Article 2 (Taxes Covered) and subparagraph (1)(a) of Article 23 (Elimination of Double Taxation). The limit prescribed by new paragraph (4) of Article 23 is to be applied before applying the provisions and limitations relating to the foreign tax credit contained in the Code. These provisions include, among others, the rules in section 907 of the Code pertaining to foreign oil and gas extraction income and foreign oil related income. Application of the provisions of United States law as they now exist or as they may be amended from time to time (without changing the general principle of allowance of a credit) may limit the amount of PRT allowable as a credit in any taxable year to an amount less than that arrived at by applying the rules of new paragraph (4) of Article 23.

The limit for a taxable year prescribed by subparagraph (a) of new paragraph (4) is arrived at by making the computations explained in steps (1) - (4) below.

*Step (1).* The first step involves multiplying the maximum statutory United States tax rate applicable to the taxable income of a corporation for the taxpayer's taxable year by the amount of

the taxpayer's taxable income (computed under United States standards) from the extraction of minerals from oil or gas wells in the United Kingdom.

The maximum statutory United States tax rate applicable to the taxable income of a corporation is the highest rate of tax specified in section 11 of the Code. This rate is currently 46 percent for taxable years beginning after December 31, 1978.

In arriving at taxable income from extraction for purposes of computing the limit, principles similar to those under section 907(c)(1)(A) and section 907(c)(3) of the Code shall be applied. Taxable income from extraction includes taxable income derived by a person holding a royalty or other economic interest in an oil or gas well, even though the extraction is physically performed by a person other than the taxpayer.

*Step (2).* From the product arrived at under *Step (1)* is subtracted other United Kingdom tax on income from the extraction of minerals from oil or gas wells in the United Kingdom. Because other United Kingdom tax may be calculated under United Kingdom law on a base which includes income from non-extraction activities, it may be necessary to allocate other United Kingdom tax to the income from extraction. In making this allocation, principles similar to those under section 907(c)(5) of the Code are to apply. The difference between the product computed under *Step (1)* above and the other United Kingdom tax computed here is the limit with respect to the PRT on income from extraction.

*Step (3).* Under the United Kingdom's Oil Taxation Act of 1975, as amended on March 15, 1979 ("OTA"), which imposes the PRT, it is possible for PRT, to be levied on what under United States standards would be income from activities other than extraction. Specifically, the base on which PRT is computed is determined by reference to the value of oil or gas after initial transportation to the place in the United Kingdom (on land) at which the seller could reasonably be expected to deliver it, and after initial treatment and initial storage. (These terms shall have the meaning specified in the OTA.) Because of this, total PRT paid or accrued will have to be allocated to

- (a) income from extraction, and
- (b) income from initial transportation, initial treatment, and initial storage.

The allocation of PRT is to be made by multiplying total PRT (other than amounts deemed to have been paid or accrued in the year by reason of the carryback or carryforward provisions set forth in new subparagraphs (b) and (c) of paragraph (4)) by a fraction, the numerator of which is taxable income from extraction (computed under U.S. standards, i.e. the same number as that determined under *Step (1)*) and the denominator of which is taxable income from extraction, initial transportation, initial treatment, and initial storage. If the denominator so computed is less than taxable income from extraction alone, then the denominator shall be taxable income from extraction.

*Step (4).* The lesser of the PRT paid or accrued with respect to extraction income under *Step (3)* or the limit determined under *Step (2)* is treated as an income tax paid or accrued for the taxable year for purposes of computing the credit allowable under section 901. Such amount will also be treated as oil and gas extraction taxes for purposes of section 907(c)(5) of the Code. Amounts in excess of the limit determined under *Step (2)* are not deductible if the taxpayer

chooses to take to any extent the benefits of paragraph (1) of Article 23 for the taxable year.

Subparagraph (b) of paragraph (4) applies in cases where the PRT allocable to extraction income (determined under *Step (3)* above) exceeds the credit limit provided under subparagraph (a) (determined under *Step (2)* above). In such cases, the lesser of such excess or 2 percent of the taxable income from extraction (see *Step (1)* above) shall be treated as income tax paid or accrued in the second preceding taxable year, the first preceding taxable year, and in the first, second, third, fourth, or fifth succeeding taxable year in that order and to the extent not deemed paid or accrued in a prior taxable year. In determining the year in which such PRT carried back or forward shall be deemed to have been paid, the limitation of subparagraph (a) of new paragraph (4) shall apply.

If an amount of PRT which does not exceed the limit of subparagraph (a) is limited by application of sections 907 or 904 and is carried to another taxable year pursuant to sections 907 or 904, the amount treated as paid or accrued in such other taxable year will be treated as an income tax and will not be again subject to the limitation of new paragraph (4).

Subparagraph (c) of paragraph (4) applies to determine the limit on the PRT with respect to income from initial transportation, initial treatment, and initial storage. These three items of income are to be combined for this purpose. The limit is computed by applying *mutatis mutandis*, *Steps (1), (2) and (4)* described with respect to subparagraph (a) above. As with extraction, taxable income is to be determined by United States standards. The PRT allocable to initial transportation, treatment, and storage is the PRT paid or accrued in the current year not allocable to extraction income. The PRT allocated to initial transportation, initial treatment, and initial storage is not treated as oil and gas extraction tax under section 907(c)(5) of the Code but will be treated as income tax on foreign oil related income within the meaning of section 907(c)(2) of the Code.

Where the PRT allocable to initial transportation, initial treatment, and initial storage exceeds the limit of subparagraph (c) for the taxable year such excess shall be deemed paid or accrued under subparagraph (c) in the second preceding taxable year, the first preceding taxable year and in the first, second, third, fourth, or fifth succeeding taxable years in that order and to the extent not deemed paid or accrued in a prior taxable year by reason of the limitation of subparagraph (c).

If an amount of PRT which does not exceed the limit of subparagraph (c) is limited by application of section 907 or 904 and is carried to another taxable year pursuant to sections 907 or 904, the amount treated as paid or accrued in such other taxable year will be treated as an income tax and will not be again subject to the limitation of new paragraph (4).

*Miscellaneous Rules:* In the case a United States corporation owning at least 10 percent of the voting stock of a corporation which is a resident of the United Kingdom from which it receives dividends in any taxable year, the appropriate amount of PRT paid to the United Kingdom by that U.K. resident corporation with respect to the profits out of which such dividend are paid shall be a ratable portion the PRT attributable to the accumulated profits out of which the dividend is paid.

## ARTICLE VI

Article VI adds a new Article 27A (Offshore Activities) to the Convention, to deal with activities carried on in connection with the exploration or exploitation of the seabed or subsoil and their natural resources. The new Article 27A has particular relevance activities in the United Kingdom sector of the North Sea. It would apply reciprocally, however, to activities conducted by United Kingdom enterprises with respect to exploration or exploitation of the seabed or subsoil of United States.

Except in cases where the *de minimis* rule in paragraph (2) applies, paragraph (1) of Article 27A treats a resident of one State as carrying on a business in the other State through a permanent establishment or fixed base with respect to activities in the other State (whether physically carried out on land or offshore) in connection with the exploration or exploitation of the seabed or subsoil and their natural resources situated in that other State. This permanent establishment or fixed base is deemed to exist notwithstanding the provisions of Article 5 (Permanent Establishment) and Article 14 (Independent Personal Services). This provision is not intended to apply in the case of a determination under Article 15 (Dependent Personal Services)\* A permanent establishment is a prerequisite for taxation of business profits in the State of source under paragraph (1) of Article 7 (Business Profits) and a "fixed base" is one of the prerequisites for taxation of income derived from services performed in an independent personal capacity in the State or source under Article 14 (Independent Personal Services).

\* Corrected.

In determining the business profits or income from independent personal services that are attributable to the permanent establishment or fixed base, the United Kingdom Inland Revenue would normally rely on a taxpayer's branch accounts if they accurately and realistically measure the commercial profits generated by the activities of the permanent establishment or fixed base and reflect generally accepted accounting principles. In the case of offshore activities such accounts would normally include, as income, the gross receivables attributable to the services and trading activities performed on the United Kingdom Continental Shelf and, as expenses, the direct expenditures together with such indirect costs as are properly attributable to these activities, apportioned in a fair and reasonable manner in light of the particular facts of the case. The profit or loss shown by such accounts is then subject to adjustment in the usual way in accordance with the general rules for computing United Kingdom taxable profits of a trade. In particular, a deduction would be allowed for depreciation of plant and machinery based on the length of time during which the activities are performed on the United Kingdom Continental Shelf. A deduction would also normally be allowed for any interest paid on borrows from third parties in respect of such assets.

In the United States, the business profits or income from independent personal services that are attributable to a permanent establishment or fixed base deemed to exist by reason of Article 27A would be the enterprise's effectively connected income determined under the rules of section 864 of the Code. Gross income would include amounts which are effectively connected with the conduct of the trade or business within the United States. Under section 638(1) of the Code the term "United States" when used in the geographical sense includes the Continental

Shelf. The deductions allowable in arriving at taxable income would include all deductions generally allowable by the Code to the extent they are connected with effectively connected gross income.

Paragraph (2) of Article 27A establishes the minimum threshold for application of the Article. Activities carried on in connection with exploration or exploitation of the seabed or subsoil will not be treated as giving rise to a permanent establishment or fixed base if the activities are carried on for 30 days or less in the aggregate in any 12 month period. In making this computation, the time spent by an enterprise engaged in activities described in paragraph (1) of Article 27A, and the time spent by any related enterprise on activities which are substantially the same, will be aggregated. This rule is designed to prevent abuse of the 30 day rule. Aggregation of time spent by related persons will be applied only for the purpose of determining whether the requirement of presence for more than 30 days is met. The profits or income which can be taxed, once the threshold is met, will reflect the actual time spent by each taxpayer.

Paragraph (3) of new Article 27A provides that the exemption provisions of Article 8 (Shipping and Air Transport) will not prevent a State from taxing earnings from the operation of a drilling rig or any vessel the principal function of which is the performance of activities other than the transportation of goods or passengers. Rentals received under a bareboat charter of a drilling rig or other vessel are not considered activities within the scope of new Article 27A, even if the vessel is used in connection with exploration or exploitation of the seabed or subsoil.

## ARTICLE VII

The delay in ratification of the Convention has raised administrative questions under United States and United Kingdom internal law relating to refund claims which may arise upon the entry into force of the Convention by reason of its retroactive effect under Article 28 (Entry into Force) upon taxes paid for prior years. Article VII adds a new paragraph (7) to Article 28, providing for a specific three-year time limit during which such claims may be filed and relief granted.

For example, a calendar year taxpayer who paid the insurance excise tax imposed by section 4371 for the year 1975 with respect to insurance premiums remitted to a United Kingdom enterprise could file a timely claim for refund of such taxes under the Protocol within the three-year period after the calendar year in which the Convention enters into force, notwithstanding the expiration of the period set forth in section 6511 of the Code for filing claims for refunds. Similarly, the United Kingdom Inland Revenue will make payments of the United Kingdom tax credit on dividends under its imputation system of company taxation, to the extent it is required to do so under subparagraph (2)(a) of Article 10 (Dividends), notwithstanding the expiration of the period under internal law during which claims for relief must be filed.

## ARTICLE VIII

The Third Protocol will enter into force immediately upon the expiration of 30 days following the date on which the instruments of ratification are exchanged. Upon its entry into

force, it will have effect, with the exception of new Article 27A (Offshore Activities) in accordance with Article 28 (Entry into Force) of the Convention.

The provisions of new Article 27A (Offshore Activities) will only have effect as of the date of entry into force of the Protocol. In determining whether the *de minimis* threshold of paragraph (2) of Article 27A is met, periods of time spent in the State of source before the date on which the Protocol enters into force will not be counted.