

Eligibility for Treaty Benefits Under U.K.-U.S. Income Tax Treaty

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To be entitled to benefits under income tax treaties, companies must satisfy eligibility requirements. This article includes flowcharts to help practitioners navigate the eligibility requirements of the U.K.-U.S. income tax treaty applicable to companies, in particular the eligibility requirements for a 0 percent withholding tax rate on dividends.

Income tax treaties may exempt business income from source-country income taxes and may exempt from tax, or reduce domestic withholding tax rates on, some payments between residents of countries that are parties to an income tax treaty. U.S. income tax treaties contain eligibility requirements. A company claiming benefits must not only be a resident of the tax treaty partner, but must also satisfy at least one of the tests in the limitation on benefits provision included in most U.S. income tax treaties.

This article contains decision-making flowcharts that focus on the eligibility of companies claiming benefits from the United States under the U.K.-U.S. income tax treaty.¹ However, this article does not address the eligi-

bility for treaty benefits of entities that are partnerships or are otherwise transparent for U.S. or U.K. tax purposes. The article is based on the provisions of the U.K.-U.S. income tax treaty, the protocol to the treaty, and the U.S. Treasury technical explanation to the treaty.

This article is the fourth in a series of articles that provide flowcharts to help practitioners determine a company's eligibility for tax treaty benefits under the LOB provision of specific U.S. income tax treaties and, when applicable, determine eligibility for a 0 percent withholding tax rate on cross-border intercompany dividend payments to the company. This article addresses the eligibility of companies for a 0 percent withholding tax rate on dividends under article 10.3 and the LOB provision (article 23) of the U.K.-U.S. income tax treaty. (For prior coverage, see *Tax Notes Int'l*, Jan. 14, 2008, p. 181, *Doc 2007-27516*, or *2008 WTD 12-10*; *Tax Notes Int'l*, Feb. 11, 2008, p. 523, *Doc 2008-773*, or *2008 WTD 33-10*; and *Tax Notes Int'l*, July 21, 2008, p. 285, *Doc 2008-14359*, or *2008 WTD 142-8*.)

¹Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double

(Footnote continued in next column.)

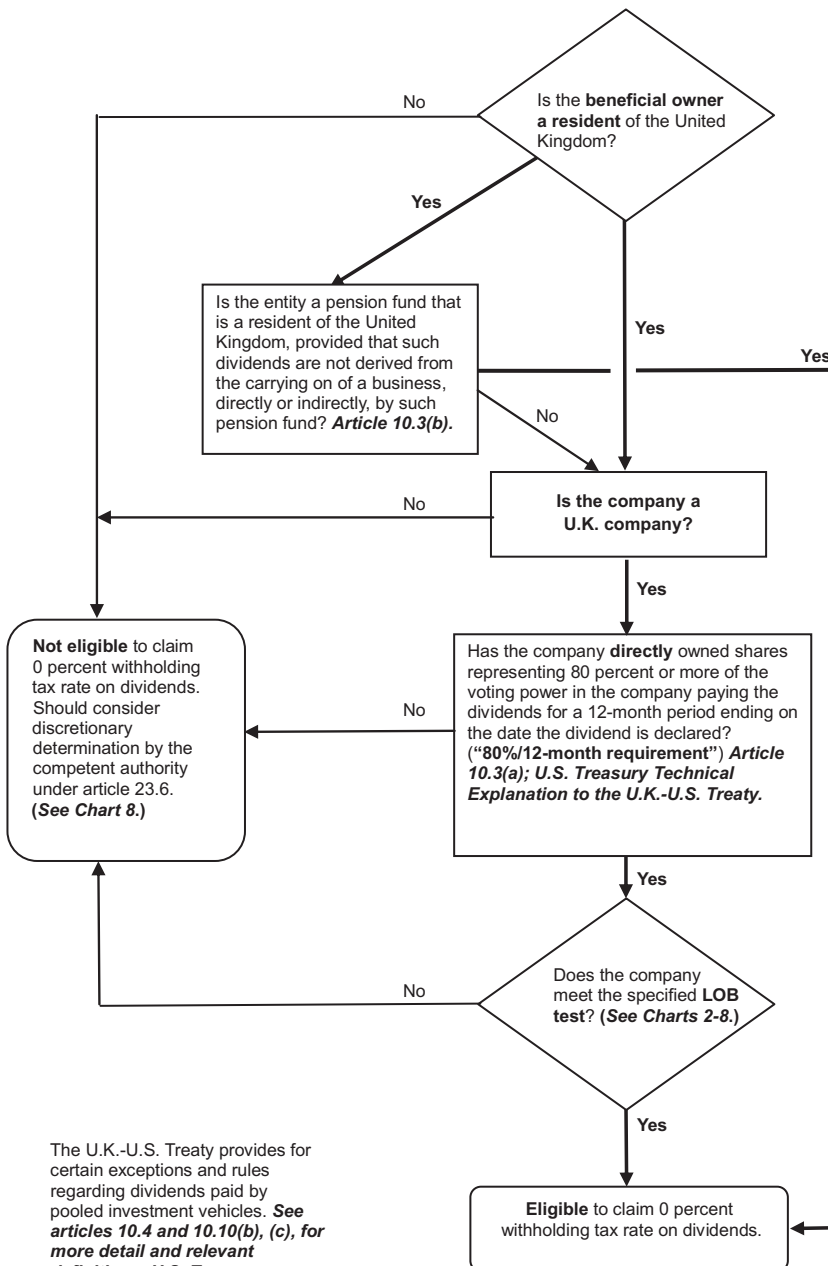
Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital, signed July 24, 2001. (For the income tax treaty, see *Doc 2001-20046* or *2001 WTD 143-14*.)

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The article contains eight flowcharts analyzing the LOB provision as applied to companies. The flowcharts may serve as a useful practice tool for practitioners. Although the flowcharts provide a comprehensive review of applicable provisions in the U.K.-U.S. in-

come tax treaty, taxpayers and their tax advisers should carefully evaluate each case and determine whether the requirements of the treaty are met based on all facts and circumstances. ◆

Chart 1. Eligibility for 0 Percent Withholding Tax Rate on Dividend Under Article 10.3 of U.K.-U.S. Tax Treaty*



The U.K.-U.S. Treaty provides for certain exceptions and rules regarding dividends paid by pooled investment vehicles. See articles 10.4 and 10.10(b), (c), for more detail and relevant definitions; U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.

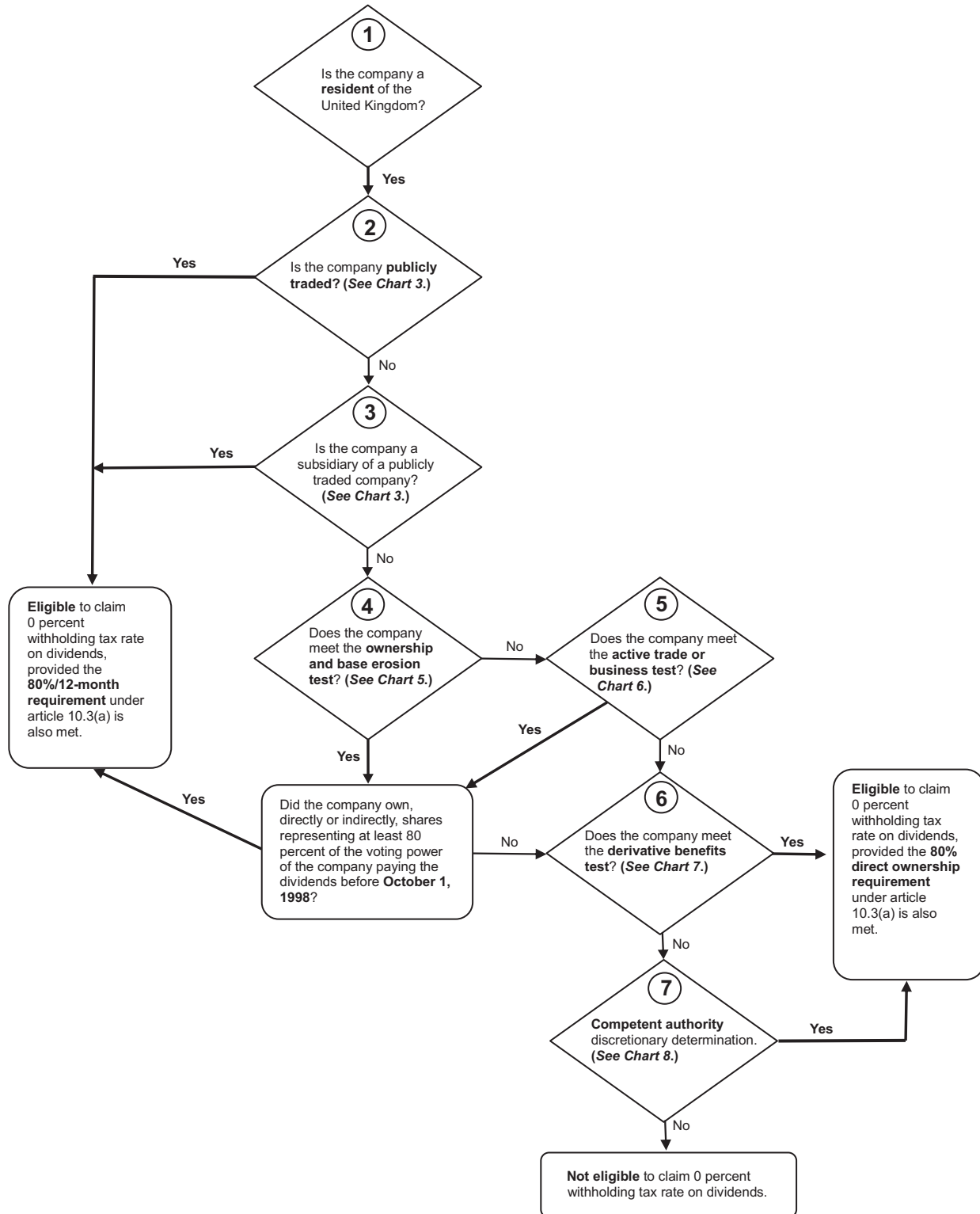
* Article references are to the articles of the U.K.-U.S. income tax treaty, as amended by protocol.

“Resident of a contracting state” generally means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. This term also includes certain pension funds, certain charitable entities, and qualified governmental entities. The term, however, does not include any person who is liable to tax in that state regarding only income from sources in that state or of profits attributable to a permanent establishment in that state. **Articles 4.1 and 4.3 of the U.K.-U.S. Treaty.**

The term “dividend” is defined “broadly and flexibly.” The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source (U.S.), as well as arrangements that might be developed in the future. As such, this term includes income from shares, or other corporate rights that are not treated as debt under the law of the source state (U.S.) that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the state of source (U.S.). Thus, a constructive dividend that results from a non-arm’s-length transaction between a corporation and a related party is a dividend. Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source state (U.S.). In the case of the United States, the term “dividend” includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, e.g., Rev. Rul. 92-85, 1992-2 C.B. 69. Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of article 10. However, a distribution by a limited liability company is not characterized by the United States as a dividend, provided the limited liability company is not characterized as an association taxable as a corporation under U.S. law. **Article 10.5; U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.**

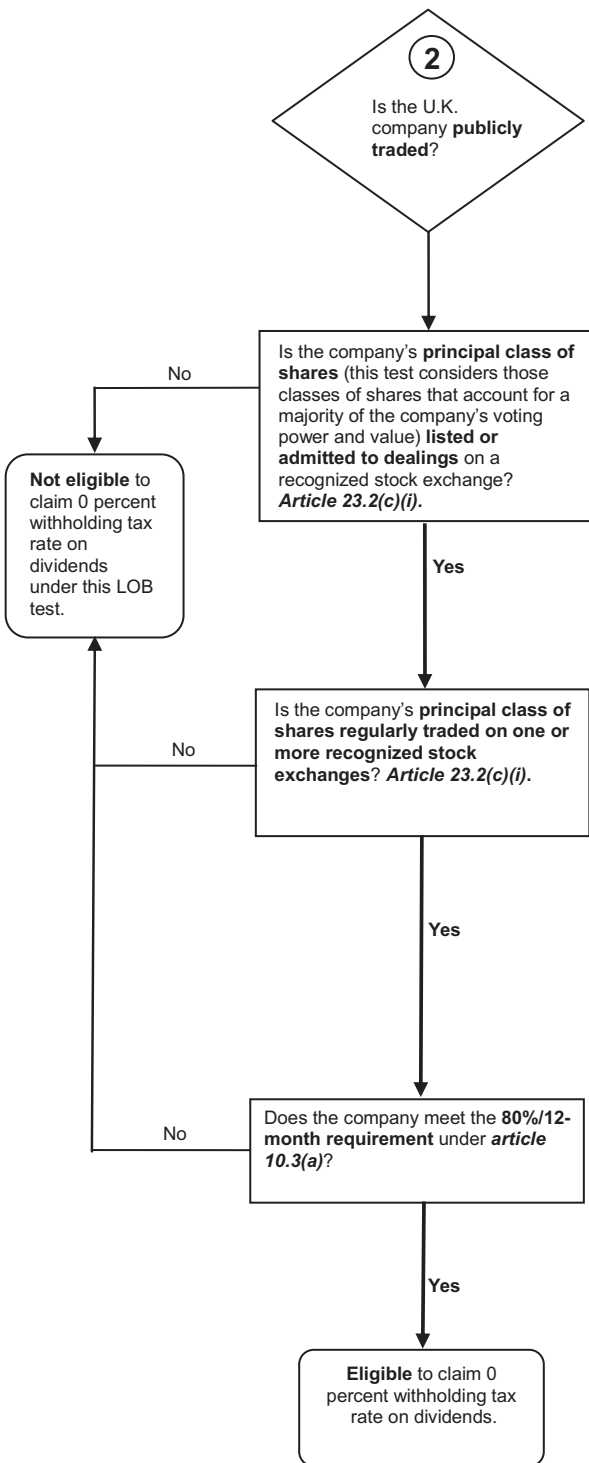
The term “beneficial owner” is not defined in the Treaty and is defined as under the internal law of the country imposing tax (i.e., the source country, the U.S.). The beneficial owner of the dividend for purposes of article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source state (U.S.). Thus, if a dividend paid by a corporation that is a resident of one of the states (as determined under article 4 (residence)) is received by a nominee or agent that is a resident of the other state on behalf of a person that is not a resident of that other state, the dividend is not entitled to the benefits of this article. However, a dividend received by a nominee on behalf of a resident of that other state would be entitled to benefits. These limitations are consistent with paragraph 12 of the OECD commentary to article 10. See also paragraph 24 of the commentary to article 1 of the OECD model. **U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.**

Chart 2. Eligibility for Treaty Benefits Under Article 23 (LOB) of U.K.-U.S. Tax Treaty (for the Purposes of Article 10.3)



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Chart 3. Publicly Traded Company Test Under Article 23.2(c)(I) (LOB) of U.K.-U.S. Tax Treaty



Note: The publicly traded company test is subject to article 23.5 of the U.K.-U.S. Treaty that relates to certain arrangements under which holders of a class of stock in a resident of a contracting state (U.K.) receive a disproportionate share of the income arising from the other contracting state (U.S.) (e.g., tracking stock).

Example. UKCo is a corporation resident in the United Kingdom. UKCo has two classes of shares: common and preferred. The common shares are listed on the London Stock Exchange and are substantially and regularly traded. The preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that UKCo receives from unrelated borrowers in the United States. The preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The common shares account for more than 50 percent of the value of UKCo and for 100 percent of the voting power. Because the owner of the preferred shares is entitled to receive payments corresponding to the U.S.-source interest income earned by UKCo, the preferred shares are subject to article 23.5. Because the owner of the preferred share is not an **“equivalent beneficiary”** (see definition on Chart 7), UKCo will be denied benefits regarding a portion of the interest payments. Benefits will be denied to the extent that the owner of the preferred shares receives a greater proportion of the U.S. income than the owner would have received had the owner owned comparable common shares. *U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.*

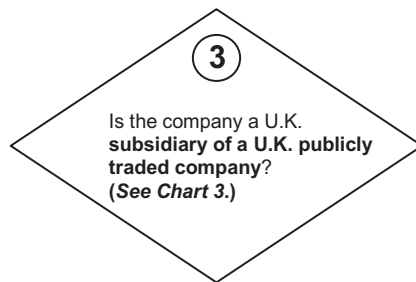
“Shares” include depository receipts for shares or trust certificates for shares. *Article 23.7(b)(ii).*

“Principal class of shares” means the ordinary or common shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. If no single class of ordinary or common shares represents the majority of the aggregate voting power and value of the company, the “principal class of shares” is that class or those classes that in the aggregate represent a majority of the aggregate voting power and value of the company. *Article 23.7(b)(1).*

“Recognized stock exchange” includes: (a) the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; (b) the London Stock Exchange and any other recognized investment exchange within the meaning of the Financial Services Act 1986 or the Financial Services and Markets Act 2000; (c) the Irish Stock Exchange, the Swiss Stock Exchange, and the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, and Vienna; and (d) and other stock exchange that the competent authorities of the United States and the United Kingdom agree to recognize for the purposes of article 23. *Article 23.7(a).*

The shares in a class of shares or the units in a class of units are considered to be **“regularly traded”** on one or more recognized stock exchanges in a chargeable or tax period if the aggregate number of shares or units of that class traded on such stock exchange or exchanges during the 12 months ending on the day before the beginning of that tax or chargeable period is at least 6 percent of the average number of shares or units outstanding in that class during that 12-month period. For this purpose, if a class of shares was not listed on a recognized stock exchange during this 12-month period, the class of shares will be treated as regularly traded only if the class meets the aggregate trading requirements for the tax period in which the income arises. *U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty; U.S. Treas. Reg. Section 1.884-5(d)(4)(i)(B).*

Chart 4. Subsidiary of a Publicly Traded Company Test Under Article 23.2(c)(ii) (LOB) of U.K.-U.S. Tax Treaty



Are five or fewer U.K. publicly traded companies the direct or indirect owners of at least 50 percent of the aggregate vote and value of the company's shares? This test considers the ownership of every class of shares outstanding. If the publicly traded companies are indirect owners, however, each of the intermediate companies must be a resident of either the United States or United Kingdom. **Article 23.2(c)(ii).**

No

Not eligible to claim 0 percent withholding tax rate on dividends under this LOB test.

Yes

Does the company meet the **80%/12-month requirement** under **article 10.3(a)**?

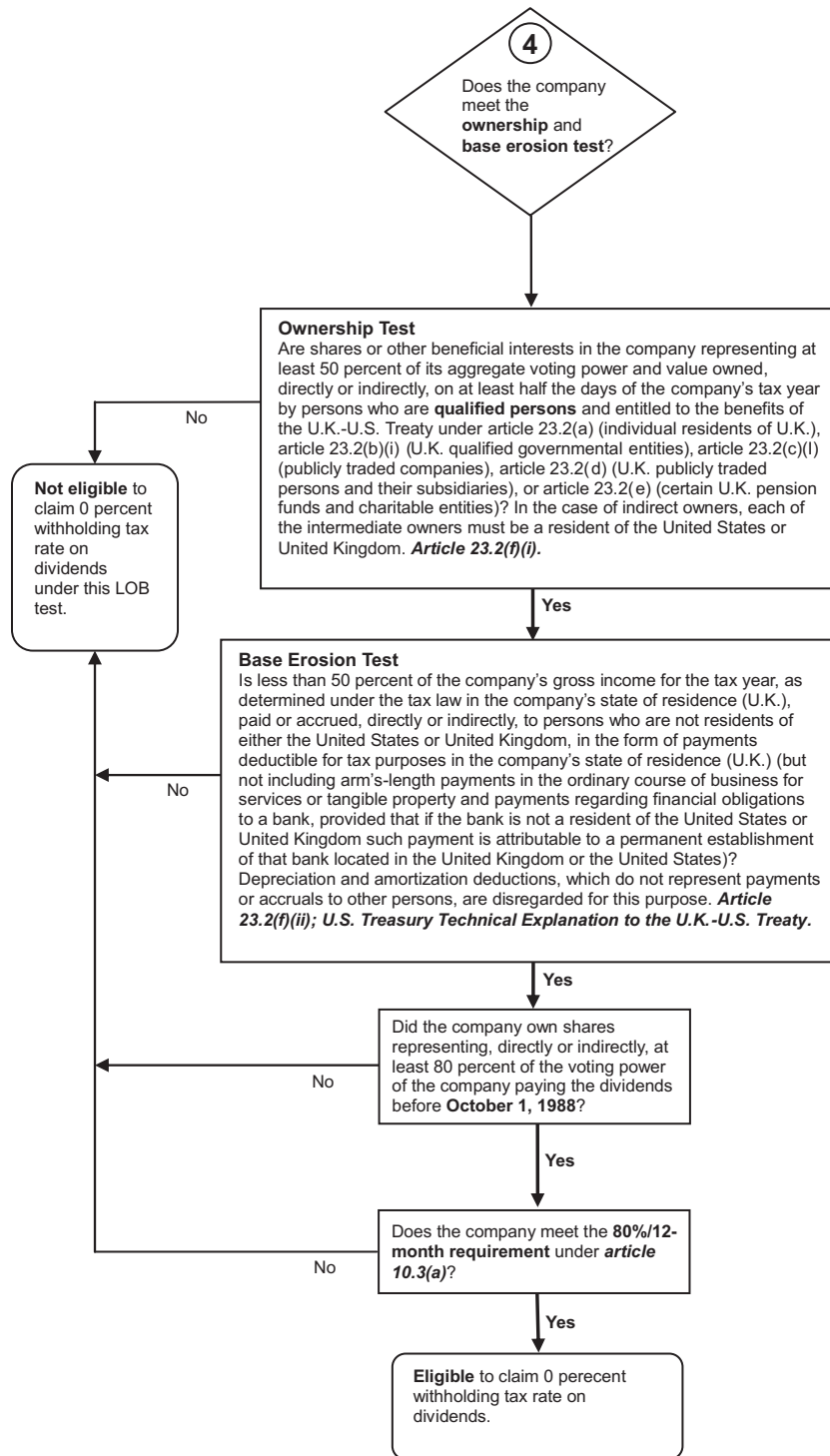
No

Yes

Eligible to claim 0 percent withholding tax rate on dividends.

Note: The subsidiary of a publicly traded company test is subject to article 23.5 of the U.K.-U.S. Treaty that relates to some arrangements under which holders of a class of stock in a resident of a contracting state (U.K.) receive a disproportionate share of the income arising from the other contracting state (U.S.). **Refer to Chart 3 for an example. U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.**

Chart 5. Ownership and Base Erosion Test Under Article 23.2(f) (LOB) of U.K.-U.S. Tax Treaty

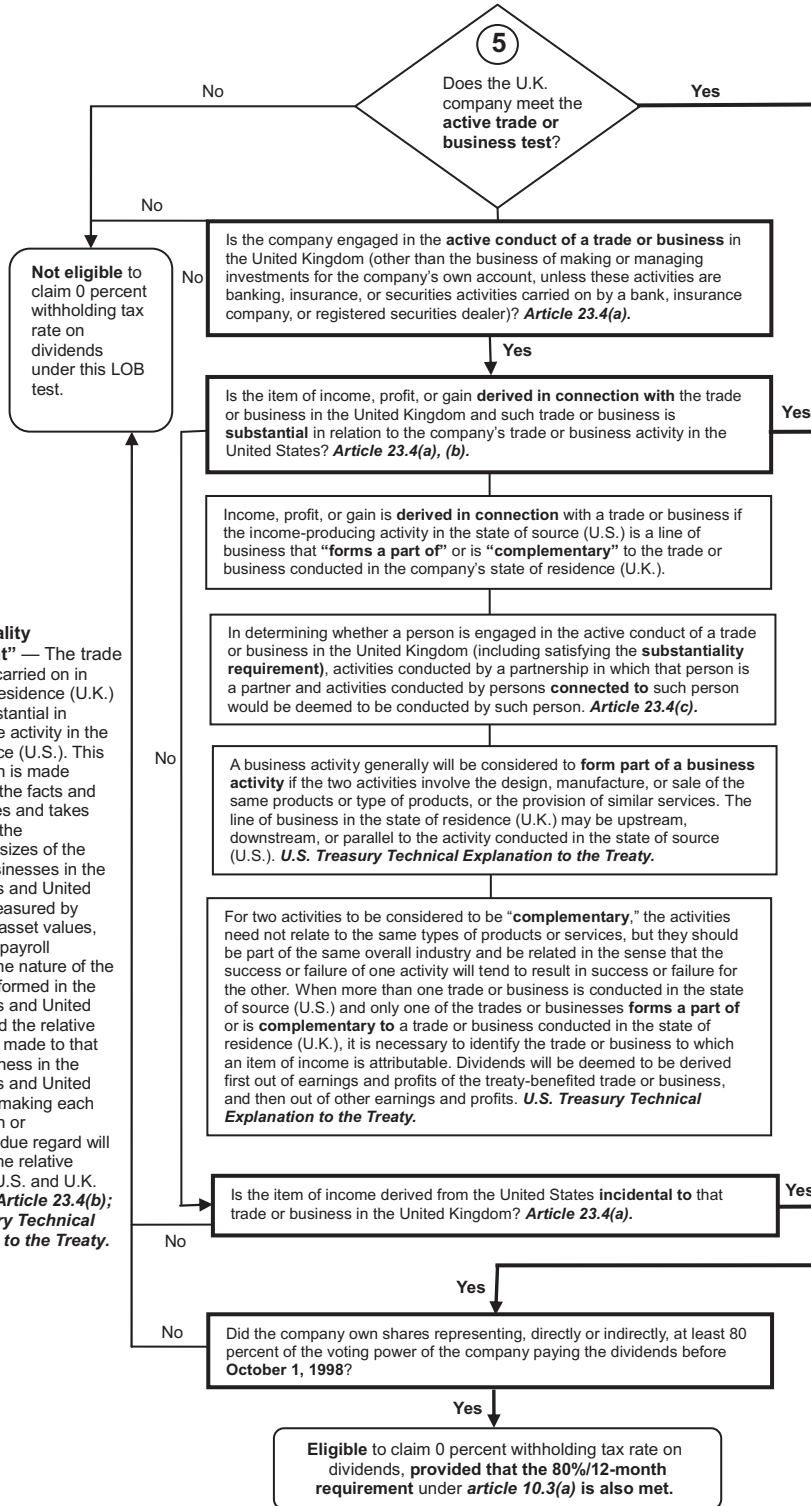


Note: The ownership and base erosion test is subject to article 23.5 of the U.K.-U.S. Treaty that relates to some arrangements under which holders of a class of stock in a resident of a contracting state (U.K.) receive a disproportionate share of the income arising from the other contracting state (U.S.).

Example. A group of U.K. resident individuals established an investment club. The investment club purchases stocks through HoldCo, a U.K. company owned by the U.K. resident individuals in proportion to their contributions to the investment club. The rules of the investment club prevent the club from borrowing. One of the club's investments was an 80 percent interest in a U.S. biotech company, USCo, which was purchased in early 1997. USCo developed an unusual gene therapy, resulting in a substantial increase in the value of USCo stock. The members of the club wanted to sell some of the shares of USCo to diversify their holdings but did not want to be subject to capital gains tax in the United Kingdom. Instead, HoldCo issued a class of preferred shares that track the dividends paid by USCo to HoldCo in exchange for a capital contribution from Investor. Investor is an individual resident in another EU member country. HoldCo meets the test for eligibility for the zero rate of withholding tax under article 10.3(a) because it qualifies for benefits under the ownership and base erosion test and it has owned a direct 80 percent interest in USCo since before October 1, 1998. However, HoldCo would not be entitled to a zero rate of withholding tax on a portion of the dividends paid by USCo to the extent the preferred shares result in Investor receiving its proportionate share of the income of HoldCo because Investor is not an "equivalent beneficiary." (See definition on Chart 7.) *U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.*

The term "gross income" means total revenues derived by a resident of a contracting state (U.K.) from its principal operations, less the direct costs of obtaining such revenues. In the case of the United States, the term "gross income" has the same meaning as such term in section 61 of the Internal Revenue Code and associated Treasury regulations. *U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.*

Chart 6. Active Trade or Business Test Under Article 23.4 (LOB) of U.K.-U.S. Tax Treaty (Only benefits regarding a particular item of income can be granted)



“Substantiality requirement” — The trade or business carried on in the state of residence (U.K.) must be substantial in relation to the activity in the state of source (U.S.). This determination is made based on all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in the United States and United Kingdom (measured by reference to asset values, income, and payroll expenses), the nature of the activities performed in the United States and United Kingdom, and the relative contributions made to that trade or business in the United States and United Kingdom. In making each determination or comparison, due regard will be given to the relative sizes of the U.S. and U.K. economies. *Article 23.4(b); U.S. Treasury Technical Explanation to the Treaty.*

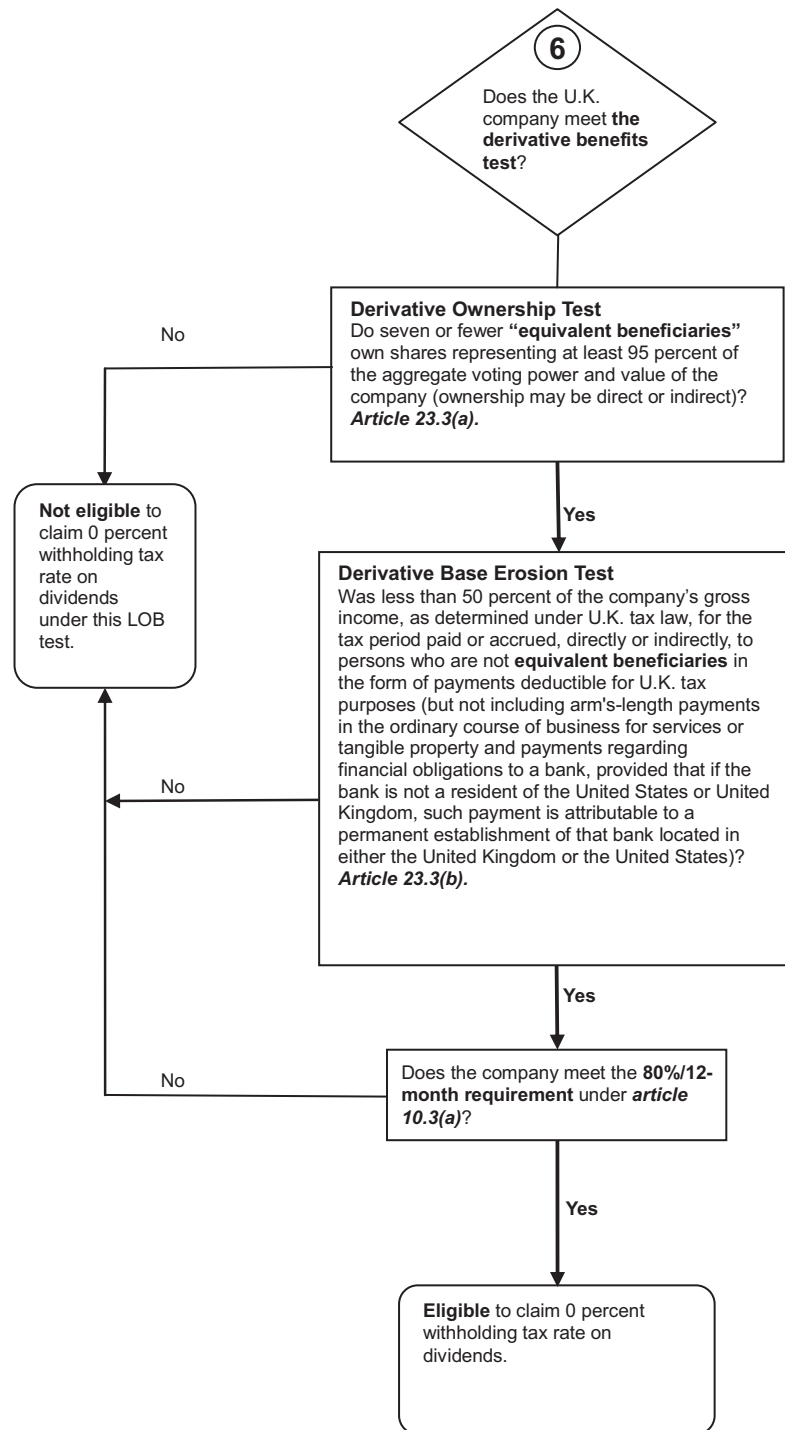
“Trade or business” — In general, U.S. income tax principles, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities. *E.g.*, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business.

The business of making or managing investments for the resident’s own account will be considered to be a trade or business only when part of banking, insurance, or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company, or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company, or registered securities dealer but not as part of the company’s banking, insurance, or dealer business. *U.S. Treasury Technical Explanation to the Treaty; U.S. Treas. Reg. Section 1.367(a)-2T(b)(2).*

“Incidental to” — An item of income, profit, or gain derived from the state of source (U.S.) is “incidental to” the trade or business carried on in the state of residence (U.K.) if production of the item facilitates the conduct of the trade or business in the state of residence (U.K.). An example of incidental income is the temporary investment of working capital of a person in the state of residence (U.K.) in securities issued by persons in the state of source (U.S.). *U.S. Treasury Technical Explanation to the Treaty.*

“Connected to” — A person will be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, shares representing at least 50 percent of the aggregate voting power and value of the company or of the beneficial equity interest in the company) or another person possesses, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, shares representing at least 50 percent of the aggregate voting power and value of the company or of the beneficial equity interest in the company) in each person. In any case, a person will be considered to be connected to another if, on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons. *Article 23.4(c).*

Chart 7. Derivative Benefits Test Under Article 23.3 (LOB) of U.K.-U.S. Tax Treaty



Note: The derivative benefits test is subject to article 23.5 of the U.K.-U.S. Treaty that relates to some arrangements under which holders of a class of stock in a resident of a contracting state (U.K.) receive a disproportionate share of the income arising from the other contracting state (U.S.).

Example. UKCo is a U.K. holding company, all the issued and outstanding stock of which is owned 50 percent by a privately held Danish company, DCo, and 50 percent by a privately held French company, FCo. UKCo, in turn, owns 75 percent of the issued and outstanding stock of USCo, a U.S. company engaged in the manufacture of wallpaper and jet fuel. UKCo pays less than 50 percent of its gross income to other persons in the form of payments deductible under U.K. law. DCo and FCo are approached by a Thai company, TCo, engaged in the business of wallpaper manufacture in Southeast Asia. DCo, FCo, and TCo arrange for UKCo to issue a class of preferred stock to TCo, in exchange for a capital contribution. Payments regarding this class of preferred stock will be set at a fixed rate increased by the excess of the internal rate of return on USCo's wallpaper business over the yield on 30-year U.S. Treasury bonds. UKCo would be entitled, under paragraph 3, to a 5 percent withholding rate regarding distributions from USCo because DCo and FCo would have been entitled to the same withholding rate on a direct payment from USCo. However, UKCo will not be entitled to a 5 percent withholding rate on a portion of the dividends paid by USCo because of the preferred shares issued to TCo. TCo is not an "equivalent beneficiary." *U.S. Treasury Technical Explanation to the U.K.-U.S. Treaty.*

"Equivalent beneficiary" is a resident of a member state of the European Community or of a European Economic Area state or of a party to the North American Free Trade Agreement but only if that resident:

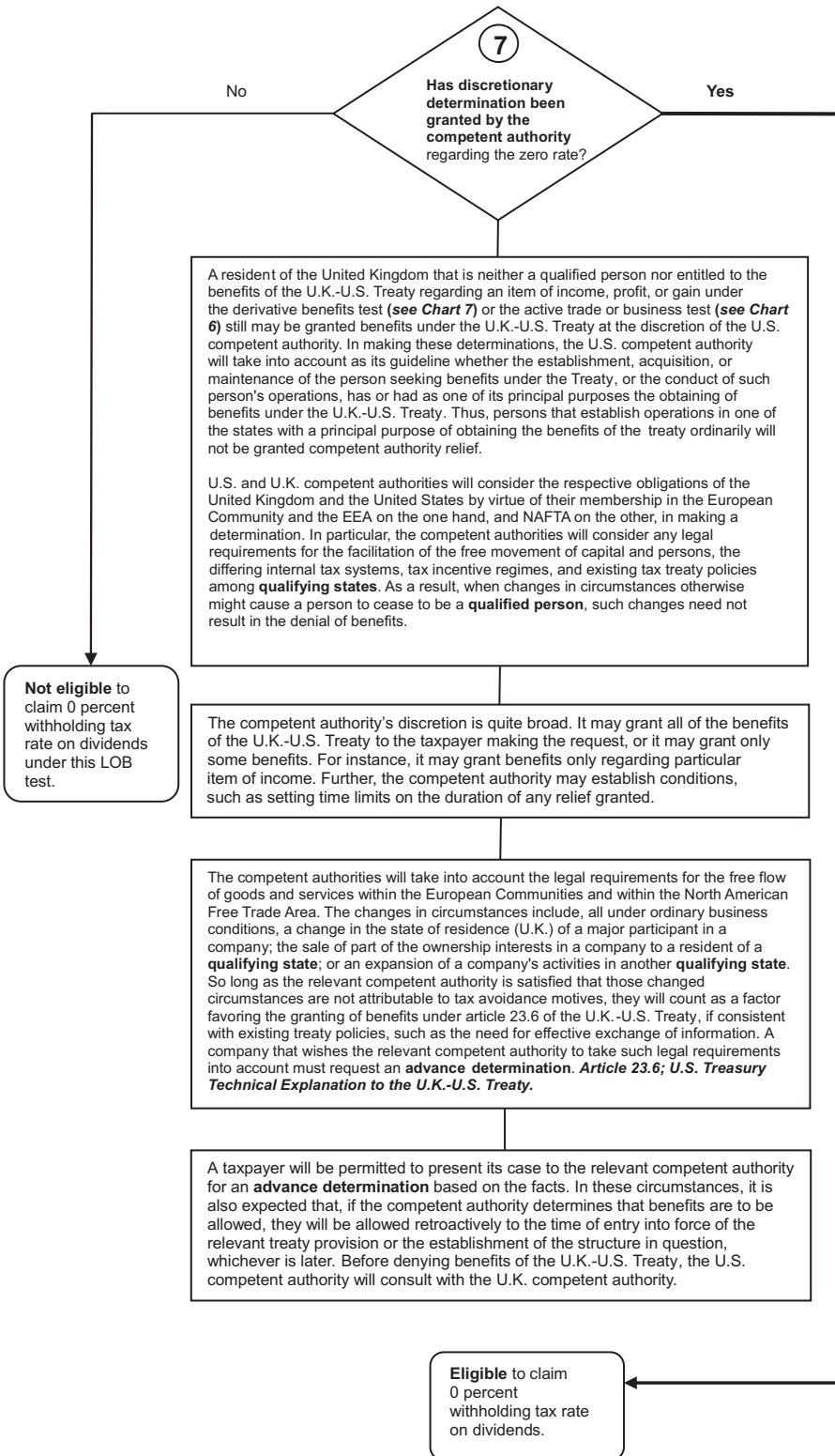
(i)(A) would be entitled to **all** the benefits of a comprehensive convention for the avoidance of double taxation between any member state of the European Community or an EEA state or any party to NAFTA and the contracting state from which the benefits of the U.K.-U.S. Treaty are claimed (U.S.), provided that if such convention does not contain a comprehensive LOB article, the person would be a **qualified person** under article 23.2 of the U.K.-U.S. Treaty if such person were a resident of the United States or United Kingdom under article 4 (residence) of the U.K.-U.S. Treaty; **and**

(B) regarding income referred to in article 10 (dividends), article 11 (interest), or article 12 (royalties) of this convention, would be entitled under such convention to a rate of tax regarding the particular class of income for which benefits are being claimed under this convention that is at least as low as the rate applicable under this convention; **or**

(ii) is a **qualified person** by reason of article 23.2 (a) (individual residents of U.K. and/or U.S.), article 23.2 (b)(i) (U.K. and/or U.S. qualified governmental entities), article 23.2(c)(i) (publicly traded companies), article 23.2(d) (U.K. and/or U.S. publicly traded persons and their subsidiaries), or article 23.2(e) (certain U.K. and/or U.S. pension funds and charitable entities).

In order to determine whether a direct or indirect owner of shares is an equivalent beneficiary, such owner will be deemed to hold the same voting power in the company paying the dividend as the company claiming the benefits holds in such company.

Chart 8. Discretionary Determination by the Competent Authority Under Article 23.6 (LOB) of the U.K.-U.S. Tax Treaty



Requesting competent authority assistance — A taxpayer may request the assistance of the U.S. competent authority under Rev. Proc. 2006-54. The U.S. competent authority may determine in its own discretion that the taxpayer qualifies for benefits under article 28 (LOB) of the U.K.-U.S. Treaty (including the 0 percent withholding tax rate on dividends; provided that requirements under article 10.3(a) are also met).

There is a US \$15,000 user fee for requesting a discretionary determination under the LOB provision. If a request is submitted for more than one entity, a separate user fee will be charged for each entity. Rev. Proc. 2006-54 section 14.2.

"Qualifying States" means member states of the European Community or European Economic Area States, or parties to the North American Free Trade Agreement.