New U.S.-U.K. Income Tax Treaty Encourages Cross-Border Trade and Investment by Technology Companies

2003-04-01

A new income tax treaty and related protocol between the United States and the United Kingdom (the New Treaty) have been ratified and are now in effect. The New Treaty, like the existing treaty which dates back to 1975 (the 1975 Treaty), is intended to encourage trade and investment between the two countries by reducing tax costs and eliminating potential double taxation. Technology companies, their employees and others should consider how the New Treaty will affect them.

Cross-Border Investment: Subsidiary or Branch

The New Treaty contains provisions that will reduce tax costs for U.K. companies operating in the U.S. through a subsidiary. In particular, under the New Treaty, provided that certain conditions are satisfied, dividends paid by a U.S. subsidiary to a U.K. parent company will be exempt from U.S. withholding tax. In contrast, under the 1975 Treaty such dividends were subject to a 5% U.S. withholding tax. Similarly, profits derived by a qualified U.K. company through a U.S. branch will not be subject to the additional U.S. branch profits tax.

For some U.S. companies, the New Treaty will make the operation of a U.K. subsidiary marginally more expensive than before by eliminating the possibility which existed under the 1975 Treaty for U.S. companies to claim a foreign tax credit for the "notional" U.K. withholding tax on dividends from U.K. subsidiaries. U.S. companies with existing U.K. subsidiaries can elect to claim the foreign tax credit available under the 1975 Treaty for 12 months following the effective date of the New Treaty. A U.S. company operating in the U.K. through a subsidiary will enjoy the benefit of a slightly lower corporate tax rate than in the U.S. (30% in the U.K. vs. 35% in the U.S.), but will not be able to deduct any losses against its U.S. income. Otherwise, tax considerations should be a neutral factor in determining whether to conduct U.K. operations through a subsidiary or branch since the U.K. does not impose a withholding tax on dividends or a branch profits tax.

Withholding Taxes

Aside from the withholding tax exemption for dividends from a subsidiary discussed above, the New Treaty retains the 1975 Treaty's reduced rates of withholding taxes on dividends. The rates are 5%

on dividends paid to qualified corporate shareholders and 15% on dividends paid to all others. The U.K. currently does not impose any withholding tax on dividends. The New Treaty also generally retains the 1975 Treaty's source-country exemptions from withholding tax for cross-border payments of interest and royalties. The New Treaty does, however, include two new anti-abuse exceptions to the withholding tax exemption for interest. The first anti-abuse rule allows a 15% withholding tax on certain contingent interest payments (e.g., "equity kickers" sometimes found in real estate transactions). The second allows a 30% withholding tax on "excess" interest paid with respect to certain ownership interests in vehicles used for the securitization of real estate mortgages or other assets. In addition, the withholding tax exemptions and reductions generally applicable to dividends, interest and royalties will not apply if the payment is "part of a conduit arrangement".

Pension Plans and Stock Options

The New Treaty includes an extensive set of rules designed to facilitate retirement planning using the tax-favored vehicles available under U.K. and U.S. law in cases involving individuals who work for some period of time in both countries. Among other things, the New Treaty would allow U.S. citizens working in the U.K. to deduct contributions to a U.K. pension plan for U.S. tax purposes.

In addition, a diplomatic note accompanying the New Treaty addresses the allocation of income relating to stock options to ensure that employees who work for some period of time in both countries do not suffer double taxation on their income or gains resulting from the receipt and exercise of stock options.

Additional Changes

The New Treaty effects many additional changes from the 1975 Treaty, including the replacement of the 1975 Treaty's "Investment or Holding Companies" provision with a modern "Limitation on Benefits" provision which, among other things, allows certain privately held U.K. companies to qualify for treaty benefits if the item of income in question is derived in the active conduct of a trade or business in the U.K., or if they are owned by so-called "equivalent beneficiaries".

Further guidance about the New Treaty is available in the description prepared by the Joint Committee on Taxation, the Report of the Senate Foreign Relations Committee, and the Explanatory Memorandum prepared by the U.K. Inland Revenue.

Effective Dates

With respect to U.S. taxes withheld at source, the New Treaty generally will be effective for amounts paid or credited on or after May 1, 2003. With respect to other U.S. taxes, the New Treaty generally will be effective for taxable periods beginning on or after January 1, 2004.

With respect to U.K. taxes withheld at source, the New Treaty generally will be effective for amounts paid or credited on or after May 1, 2003. With respect to U.K. income taxes not described in the previous sentence and with respect to U.K. capital gains taxes, the New Treaty generally will be effective for any year of assessment beginning on or after April 6, 2003. With respect to the U.K.

corporation tax, the New Treaty generally is effective for any financial year beginning on or after April 1, 2003.

William Benjamin
william.benjamin@haledorr.com

Simon Court
simon.court@haledorr.com