



INLAND REVENUE
Somerset House, London WC2R 1LB
Telephone 01-438 6601
From: Mrs. A.H. Smallwood

6 February 1976

PS 6869/74

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Dear Mr Thomas

DOUBLE TAXATION REVIEW

now see 2

Enclosed is a copy of a draft document for the Paymaster General which I hope fairly reflects your views.
I apologise for asking for comments as soon as possible - as you will realise the paper was held up because of various pressures here - but if anything is to be done this year about matching credit we shall have to move fast.

Yours sincerely
Anne Smallwood

Miss A E Mueller, Department of Industry
Mr R Hughes, Department of Trade
Mr C H W Hodges, Treasury
Mr B T Houghton, Treasury
Mr D M Kerr, FCO
Mr P A Bull, Bank of England

Mr Pollard
Mr B J Thomas
Mr Fawcett
Mr Marsh

Mr Steelton
For obs M.
WT 9/2

Mr Thomas
This all seems to be very reasonable. I have no other observation to make.
AS 5/2/76 9/2

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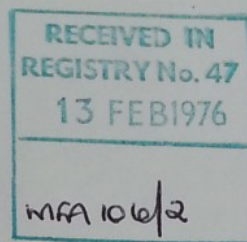


DEPARTMENT OF TRADE AND INDUSTRY
1 VICTORIA STREET
LONDON S W 1

Telephone Direct Line 01-2153564
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Mrs A H Smallwood
The Board Room
Inland Revenue
Somerset House
London W C 2

11 February 1976



Dear Nan

DOUBLE TAXATION REVIEW

1 Thank you for sending me a copy of your draft report to the Paymaster General. In view of the urgency that we both attach to this matter I will keep our comments, for both Trade and Industry, as brief as possible.

2 We feel that paragraph 14 goes rather far in claiming that "the effects of an agreement are marginal". Because the UK credit system, as you say in your note, effectively results in tax being paid at the higher of the overseas and the UK effective rates, reduction of withholding taxes under the agreement can be vitally important if there is not to be an excess of unrelieved foreign tax. This point links with the opening sentence of paragraph 15, which we feel to some extent overstates the neutrality of the credit system by ignoring the limitations on full credit imposed by the interaction of double taxation relief with group relief, ACT etc.

3 We agree fully with the conclusion in paragraph 26 concerning the expense method, but feel this should make clear that a change to the expense method would not only be a disincentive to further investment, but would also seriously affect the return on existing investment.

4 Again in paragraph 32 we agree with your general conclusion about the effects of pooling. However, would it not be more correct to say that pooling would remove the current disincentive to investment in countries where the tax rate is higher than the UK rate than to say it would actually be an incentive to seek out such countries for investment?

5 Paragraphs 38-41 are perhaps the most important from our point of view as they deal with a matter that we have been closely



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interested in for some considerable time. It seems to us that one point that is not given sufficient attention in paragraphs 40 and 41 is the fact that, as long as matching relief is only available as part of a comprehensive bilateral agreement, its benefits are not available to those countries, including maybe the least developed countries, with whom our trade flows are insufficient to justify a comprehensive agreement. While this point may not be of sufficient importance to affect your conclusion we nevertheless feel it should be mentioned in the paper. Finally, I would like to reserve our position a little more on the final sentence of paragraph 41, which I suggest should read "... would welcome this extension of our matching relief powers, although in the long run preferring to see powers taken to give some measure of matching credit unilaterally".

6 Apart from these items, on which I hope our comments will be helpful, we are quite content with the draft of your paper and its conclusions and have been pleased to be able to contribute to the review.

Yours sincerely

Anne Mueller

ANNE MUELLER

cc Mr C H W Hodges, Treasury
Mr B T Houghton, Treasury
Mr D M Kerr, FCO
Mr P A Bull, Bank of England
Mr J R Steele, Department of Trade
Mr M Wasilewski, Department of Industry
Mr R Hewes, Department of Industry
Mr Pollard)
Mr B J Thomas) Inland
Mr Fawcett) Revenue
Mr Marsh)



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Foreign and Commonwealth Office
London SW1A 2AH

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REGISTRY No. 47
12 FEB 1976

Telephone 01- 233 4019

MFA 106/2.

Mrs A H Smallwood
The Board Room
Inland Revenue
Somerset House
London WC2

Your reference PS 6869/74

Our reference MFA 13/3

Date 11 February 1976

Dear Mrs Smallwood -

DOUBLE TAXATION REVIEW

1. Thank you for sending me a copy of your draft report to the Paymaster General. I have incidentally replaced Desmond Kerr in Financial Relations Department.

2. We are in general content with your draft, subject to the comments of the Departments of Trade and Industry, with which we agree, which are contained in Miss Mueller's letter of 11 February.

Yours sincerely
Richard Thomas

R Thomas
Financial Relations Department

cc

Miss A E Mueller, DoI
Mr C H W Hodges, Treasury
Mr B T Houghton, Treasury
Mr P A Bull, Bank of England
Mr J F Steele, DoT
Mr M Wasilewski, DoI
Mr R Hewes, DoI
Mr Pollard
Mr B J Thomas
Mr Fawcett
Mr Marsh

} Inland Revenue
}



(4)
(5)

cc Principal Private Secretary
PS/Chief Secretary
PS/Financial Secretary
Sir Douglas Wass
Mr Lord
Mr Couzens
Mr Lovell
Mr Houghton
Mr Hodges
Lord Kaldor

PS/Inland Revenue
Miss Muller - Industry
Mr Thomas - FCO

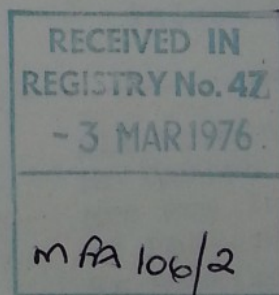
PRIVATE SECRETARY TO THE PAYMASTER GENERAL

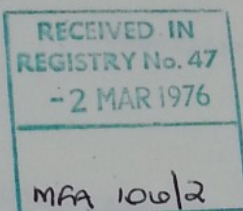
REVIEW OF DOUBLE TAXATION RELIEF

The Minister of State has seen the report on double taxation submitted under cover of Revenue's note of 25 February. He agrees with its general recommendations (page 23).

lh

M L WILLIAMS
1 March 1976





THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

25 February 1976

PRIVATE SECRETARY TO THE PAYMASTER GENERAL

1. Attached is the report commissioned in September 1974 by the Paymaster General on double taxation relief in relation to economic policy.

2. The officials who present the report are:-

Mrs A H Smallwood (Inland Revenue) (Chairman);
Mr C H W Hodges and Mr B T Houghton (Treasury);
Miss A E Muller, (Department of Industry);
Mr R Thomas (FCO);
Mr P A Bull, (Bank of England);
Mr B Pollard, Mr B J Thomas and Mr P W Fawcett
(Inland Revenue)

In the earlier stages Mr A J Wiggins and Mr P G Davies (Treasury), Mr D M Kerr (FCO), and Mr D Hopkins (Inland Revenue) were also concerned.

ANNE KIRKNESS
Private Secretary
Inland Revenue

cc Principal Private Secretary
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir Douglas Wass
Mr Lord
Mr Couzens
Mr Lovell
Mr Houghton
Mr Hodges
Lord Kaldor
Miss Muller (Industry)
Mr Thomas (FCO)

Sir Norman Price
Mr Dalton
Mrs Smallwood
Mr Pollard
Mr Hopkins
Mr Thomas
Mr Fawcett

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REVIEW OF DOUBLE TAXATION RELIEF

1. In September 1974, following a request by the Paymaster General officials began to carry out a study of double taxation relief and its implications for national economic policy objectives, in particular its effects on the balance of payments and inward and outward investment. This study was not to involve the review of the policy but was to take the existing policy and see how far the arrangements for relieving double taxation were consistent with it. The review was begun by officials of the Treasury and Inland Revenue, and representatives of the Bank of England, the Department of Trade, the Department of Industry and the Foreign and Commonwealth Office were later associated with the enquiry.

2. The completion of the study was delayed by developments during the past year in the taxation of oil companies in overseas countries which produce and export oil. Since the oil industry receives about three times as much double taxation relief as all other United Kingdom residents taken together, that industry is of crucial importance in any study of the question. With the agreement of the Paymaster General we therefore waited until a new pattern which evolved during 1975 of oil taxation in OPEC and certain other countries became sufficiently clear to enable conclusions to be drawn. In the event these conclusions did not affect our views about double taxation relief generally. They have been borne in mind in framing our recommendations, but because the subject of oil taxation involves various special considerations which would be more appropriately considered in another forum we make no recommendation on this question but take note that it is being considered elsewhere.

INTRODUCTION

3. Double taxation in this report means juridical double taxation which is the taxation of the same income in the hands of the same taxpayer in two countries. It can arise because many countries, including the United Kingdom charge tax on income arising within their territories wherever the recipient resides, and also tax their residents on their world incomes. Income arising in one country and received by a resident of another may therefore be taxed in both countries. It can also happen, although less frequently, that an individual may be resident for tax purposes in two countries for the same year because the rules differ from one country to the other, and if both charge tax on the world income of their residents he will suffer double taxation on the whole of his income.

4. Double taxation in this sense is distinct from "economic" double taxation which is tax on the same income or capital in the hands of two different persons both chargeable to tax. The term is most commonly used to describe the combined burden of tax on companies in respect of their profits and on the shareholder in respect of dividends paid out of those profits.

5. To prevent, or substantially to reduce, double taxation the United Kingdom has made double taxation agreements with many overseas countries, both inside and outside the Commonwealth, under which each country agrees to give up or to reduce its tax on specified kinds of income (eg dividends, interest and royalties) either by exemption or by reduction of the rate of tax, and to give relief for overseas tax on income which is not specifically exempted under the agreement and so is liable to double taxation. Where relief is not due under an agreement, it is given unilaterally under Section 498 of the Income and Corporation Tax Act 1970 against the United Kingdom tax on the income in question.

6. The effect of these arrangements is that the United Kingdom resident has broadly the same tax burden on income arising overseas as on income arising in this country provided that the overseas rate of tax is not higher than the United Kingdom rate. Arrangements for relieving double taxation cannot however produce this result where the overseas rate is higher than the domestic rate. For the United Kingdom the return on overseas investment is net after foreign tax while domestic investment produces a gross return before tax. From this standpoint neutrality would be achieved by treating overseas taxes as a deductible expense in earning the profits or income instead of by giving credit for overseas tax against United Kingdom tax.

7. The United Kingdom system is broadly in line with that of other developed countries and includes some 70 double taxation agreements not all of which are yet in force.

DOUBLE TAXATION AGREEMENTS

Limited Agreements

8. There are limited agreements dealing only with shipping and air transport profits which limit taxation of those profits to the country of residence of the operator.

Comprehensive Agreements

9. Comprehensive agreements generally cover all kinds of income and profits and capital gains. As was mentioned in paragraph 5 above they normally exempt or apply a reduced rate of tax to certain types of income. This is partly a matter of apportioning the tax take between the two countries concerned, and provides a benefit to the recipient of the income in cash flow terms. The more important types of income which may be exempted at source or charged at a reduced rate under an agreement are dividends, interest and royalties. Under the OECD Model Double

Taxation Convention which is the basis of most agreements entered into by developed countries and has a considerable influence on developing countries, the rate of withholding tax on portfolio dividends is 15% and on trade dividends 5%. Interest may be exempt or charged at rates not normally exceeding 10% and royalties are normally exempt. Higher rates are often incorporated in agreements with developing countries which tend to claim as much tax as they can on income arising within their countries and flowing to non-residents. Where income remains fully or partly taxable in both countries agreements provide for relief for double taxation; in the case of the United Kingdom this relief is provided by way of credit against United Kingdom tax on income for overseas tax charged on that income. Agreements also define the scope of the charge on branches of an enterprise of one country operating in the other country and give protection against fiscal discrimination.

10. The United Kingdom has comprehensive agreements either in force or agreed subject to ratification with approximately 70 countries, including other EEC member countries, most OECD member countries and the greater part of the Commonwealth. There is also an agreement of a different type which dates from 1926 with the Republic of Ireland under which tax is charged on the residence principle so that residents of one country pay tax only in that country, and there is special provision for double residents. Both Governments have indicated that the future of these arrangements is under review.

Unilateral Relief

11. Agreements - numerous though these are - do not cover every country from which United Kingdom traders and investors may derive income. Unilateral credit for overseas tax was therefore introduced in 1950 so that companies and others resident in the United Kingdom would not have to bear the burden of unrelieved double taxation on income derived from countries with which there was no agreement. Initially the relief was limited to one-half of the

($\frac{3}{4}$ for Commonwealth countries)
overseas tax/and was extended in 1953 to the full overseas tax suffered. Where there is no agreement the United Kingdom bears the full burden of relieving double taxation because the other country offers no exemptions or reductions in, for example, withholding tax rates. The taxes covered by unilateral relief are those which correspond to United Kingdom income tax, corporation tax and capital gains tax and may include taxes levied by provinces, states and municipalities.

"Matching" Credit

12. Since 1961 there has been statutory authority for including in double taxation agreements a provision under which the United Kingdom gives credit for tax which would have been payable in the overseas country on income arising there but for "pioneer" tax relief granted by that country and a number of United Kingdom double taxation agreements with developing countries provide for this relief. Until recently little advantage was taken of this provision but it is now a normal feature of agreements with developing countries. There is no statutory provision for unilateral matching credit.

Relief for "Underlying" Tax

13. A United Kingdom resident company with a controlling interest (defined in terms of 10% of the voting power) in an overseas subsidiary is entitled to credit not only for withholding tax imposed by the other country on dividends but also for the tax which the subsidiary has to pay on the profits out of which the dividend is declared, ie the profits "underlying" the dividend.

Double Taxation Agreements: the results

14. Because the United Kingdom domestic law provides full unilateral credit for foreign taxes the effects of an agreement although substantial for some taxpayers are on the whole less significant than they might appear at first sight. In the absence of an agreement there is no question of United Kingdom investors being doubly taxed and the main cash benefit for the investor is matching credit for pioneer reliefs (see paragraph above). For those who do not benefit from matching credit

the intangible benefits for an agreement may matter more; these include protection against fiscal discrimination, the establishment of a framework within which the two tax administrations can operate, and the expectation that an overseas authority which has negotiated a treaty will at least try to apply it reasonably. Some comments on the effects of the way in which double taxation is relieved by the United Kingdom may be helpful at this stage.

A. The giving of credit for overseas tax ensures that a United Kingdom taxpayer pays no more tax on profits or income from overseas than on equivalent profits or income arising within the United Kingdom, provided that the effective rate of overseas tax on the income or profits does not exceed the United Kingdom effective rate of tax on the income or profits. Neither the credit method nor the alternative exemption method can precisely equate the tax liability on domestic and overseas income if the overseas rate is higher than the domestic rate.

B. Incentives for investment in developing countries. Agreements with developing countries now normally provide for matching credit for reliefs granted by developing countries with a view to promoting industrial and other developments. The grant of matching credit is a direct benefit to the United Kingdom investor in the developing country, because his tax bill in both countries is reduced by the amount of the tax "spared" by the developing country. The scope of this relief is discussed in paragraphs 33-41 below.

C. Outward investment. Apart from the specific benefit of matching credit for pioneer reliefs, double taxation agreements are valued as a means of providing and of safeguarding satisfactory fiscal conditions for trade and investment overseas. Agreements normally have a non-discrimination article under which United Kingdom nationals (including corporations) are ensured the same tax treatment as the nationals (including corporations) of the other country; the scope of the charge on United Kingdom branch operations in the other country.

is defined while the very existence of an agreement contributes to a climate of business confidence. The machinery provisions, covering exchanges of information and necessary consultations, set up a framework within which the United Kingdom should be able to see that the agreement is properly operated, and if it is not so operated there is always the sanction of termination which carries considerable weight with any country which is anxious to have investment from the United Kingdom. An acceptable double taxation agreement will normally ensure that United Kingdom investors are treated no worse than those of overseas competitors.

D. Inward investment. Agreements are normally concluded on a basis of reciprocity so that inward investment to the United Kingdom benefits in much the same ways as outward investment by United Kingdom residents in the partner country. The residents from the other country normally obtain the same or similar reductions in United Kingdom withholding taxes and have similar protection from fiscal discrimination as is enjoyed by United Kingdom residents in the other countries. While United Kingdom fiscal legislation is in general non-discriminatory the guarantee of equal treatment under an international treaty is valued by the partner country.

15. To sum up, the United Kingdom system in principle neither encourages nor discourages overseas investment in fiscal terms compared with domestic investment, except where matching credit is provided for pioneer reliefs granted by an overseas country. In that case the tax payable on the overseas income will be less than the tax that would be payable on the same amount of income arising in the United Kingdom. (There will be cases where in practice for various reasons there is not enough UK taxed income available to allow the full credit to be effectively given, but that is not strictly a credit problem.) The system offers some encouragement to inward investment by way of exemptions from or reductions in withholding taxes on interest and royalties. Under the imputation system of corporation tax there is no withholding tax on dividends and non-residents are not entitled to the tax credit relating to dividends they receive. The credit may however be given to residents of a partner country under an agreement; agreements

have been concluded with a number of countries which allow to their residents the full tax credit on portfolio dividends less the normal 15% tax on the dividend plus the credit, while the recently signed agreement with the United States also gives half the tax credit on trade dividends less 5% tax on the total of the dividend and the half-tax credit.

INWARD AND OUTWARD INVESTMENT: THE POLICY

16. We now turn to the policy relating to inward and outward investment, in relation to which we shall then examine the United Kingdom system of relief for overseas taxes on income. It may be summarised as follows.

Inward Direct Investment

17. Inward direct investment financed by foreign currency or external sterling is regarded as desirable because it contributes to raising the productive capacity of the United Kingdom economy and may help to correct regional imbalances, to stimulate competition and to introduce new management skills and technology, as well as bringing net benefits to balance of payments; at present about half the profits of inward investment are reinvested in the United Kingdom.

18. It would not however be regarded as desirable for overseas interests to acquire control of, or a substantial interest in, a United Kingdom company regarded as vital to the national economy.

Inward Portfolio Investment

19. Inward portfolio investment financed from external sources is also generally welcomed as providing a useful in-flow of funds which helps to finance the balance of payments deficit. There are however arrangements for scrutinising any transaction which would give a non-resident investor 10% or more of the voting equity of a United Kingdom company . Above that limit it is more likely that the investment would be regarded as direct rather than portfolio and would be subject among other things to the constraint mentioned in the preceding paragraph.

The policy in relation to outward direct investment is not therefore to discourage investment but to minimise or eliminate its additional net cost to the reserves. This is done by requiring it in general to be financed by the use of such overseas profits as a company is allowed to retain abroad, with investment currency (now at an effective premium of about 65 per cent) or foreign currency borrowing. Some official exchange is permitted for special projects promising an early and continuing return to the balance of payments.

Outward Direct Investment

20. In his Budget statement on 26 March 1974, the Chancellor of the Exchequer made an announcement about the tightening of exchange control rules and said;

"I fully understand the importance of this investment and the valuable return it brings by way of interest, profit and dividends, which helps the balance of payments year by year. My object is not to stop it but only to ensure that it takes place without imposing undue strain on the balance of payments."

The policy in relation to outward direct investment is not therefore to discourage investment but to minimise or eliminate its additional net cost to the reserves. This is done by requiring it in general to be financed by the use of such overseas profits as a company is allowed to retain abroad, with investment currency (now at an effective premium of about 65 per cent) or foreign currency borrowing.

Some official exchange is permitted for special projects promising an early and continuing return to the balance of payments.

21. The Departments of Trade and Industry with their interest in the effect that policy and practice have on particular companies in their trading operations abroad and in the implications for competitiveness and export performance consider that international direct investment brings great benefits to the United Kingdom, the direct benefits being reflected in net earnings amounting to £m1,540 in 1974. They point out that the investments which give rise to these earnings place relatively little demand on domestic resources. The returns to the parent companies net of local interest and tax, are largely in respect of "intangible assets" invested, that is the techniques, trade marks and accumulated experience that companies can bring to bear. In so far as the investing companies will have already developed these assets in conducting their domestic business the return from overseas investment is something of a bonus to the United Kingdom.

22. There are also indirect benefits in a continuing beneficial effect on exports. A reduction in overseas investment could bring serious disadvantage to the United Kingdom, in particular in areas where investment in local manufacture is vital to securing a base for future exports or a source of supply for raw materials.

Outward Portfolio Investment

23. Outward portfolio investment is subject to exchange control restriction to ensure that it imposes no net cost on the United Kingdom balance of payments.

ECONOMIC POLICY AND METHODS OF RELIEVING DOUBLE TAXATION

24. Double taxation agreements provide certain exemptions from tax, for example, for interest or the earnings of visiting professors and teachers in the country where income arises. But the responsibility for eliminating any remaining double taxation rests with the country where the taxpayer is resident for tax purposes. If there is no agreement the country of residence may, if it chooses, act unilaterally to relieve double taxation. There are three main possibilities: to give no relief at all for overseas taxes, to allow a deduction for foreign taxes in computing profits or income, or to give full relief either by allowing credit for overseas tax against the domestic tax bill or by exempting overseas income. We look at these methods in turn.

No relief

25. It would in theory be possible to deny all relief for overseas taxes, but we see no case for it. Even if there are doubts about the authenticity of a certain "tax" as the equivalent of United Kingdom taxes on income or profits, payments made under the head of tax to an overseas government would on normal commercial and taxation principles be expenses of earning those profits and should be deducted in computing the liability for tax purposes.

Deduction of overseas tax

26. If there were no double taxation agreements and no unilateral relief overseas taxes would be deducted under the general tax law as an expense of earning the overseas income or profits in respect of which they are paid. At current corporation tax rates the effect is normally to give relief for approximately half the overseas tax paid. There would therefore be a disincentive to investment overseas because the combined burden of overseas and United Kingdom tax on the profits would always exceed the charge to United Kingdom tax alone. This result would be in direct contradiction to the general policy set out in paragraphs 20 to 22 above, and we cannot therefore regard the giving of a deduction for overseas taxes as a satisfactory measure of relief. It is true that this would accurately reflect the fact that a receipt from overseas investment is net after overseas tax while the receipt from domestic investment includes the United Kingdom tax, but bearing in mind the importance of outward investment to the economy this consideration cannot be conclusive. We recognise that special considerations may apply to the taxes imposed overseas on the oil industry, which are discussed in paragraph 48 below. But as a general rule it would be contrary to the economic policy objectives to reduce the net return to the investor on overseas investment by limiting relief for overseas taxes to a deduction in computing profits. This would not only be a disincentive to further investment, but would also seriously affect the return on existing investment.

27. We note that the deduction or expense method of relieving double taxation has been abandoned in the international network of double taxation agreements and that reversion to that system would be generally regarded as retrograde and out of line with current international practice. If the United Kingdom wished to adopt this method it would be debarred from doing so in relation to countries with which there are existing agreements, and those agreements would have to be terminated and renegotiated on the basis of allowing a deduction instead of credits. This would be unacceptable to many partner countries and the Foreign and Commonwealth Office have advised that the United Kingdom could not expect to renegotiate its agreements on those lines unless it offered very much better terms in other respects and even then some countries might not acquiesce.

28. On various grounds we therefore reject this method. Estimates of cost must be very tentative but it is thought that for 1974 credit relief both unilaterally and under agreements was of the order of £m600, of which something less than half would be saved by switching to the deduction method.

Credit for Overseas Tax

29. The credit method in general ensures that a United Kingdom resident pays the same tax in total on income or profits arising overseas as he would pay on the same amount of income or profits arising in the United Kingdom, provided that the overseas tax on the income or profits does not exceed the United Kingdom tax. In effect with this method the income bears the higher of the two taxes involved, so that if the overseas tax is less than the United Kingdom tax some United Kingdom tax is payable.

30. The credit method is wholly consistent with the general United Kingdom rule that residents are liable to tax on world income, and compared with the exemption method it gives the tax administration a degree of control over the taxpayer's United Kingdom tax liability

which we accept as desirable. We make a specific recommendation in paragraph 41 about the scope of matching credit for pioneer reliefs, but as a general proposition we are satisfied that the credit system properly implements national economic policy.

31. We do not think that there is any case for tinkering with the credit rules so as to impose marginal restrictions on the amount of relief. For example, it would be possible to reduce or withdraw the relief for underlying tax but this would mean a substantial disadvantage to companies with subsidiaries operating overseas from which they draw dividends, and since most of the more important countries give relief for underlying tax its withdrawal or restriction would put our companies at a competitive disadvantage.

Pooling

32. The rules could be changed in favour of the taxpayer if credit were given on the basis of aggregating all overseas tax paid on all overseas sources of income instead of giving credit source by source. Tax from high rate sources would then be averaged with tax from low rate sources so that this system is particularly attractive to investors who operate in countries where the tax rate is higher than the United Kingdom rate and this method would remove a disincentive to investment in those countries. This system would also be an inducement to manipulation by diverting income to tax havens with low rates of tax by way of artificial transfer pricing. This could arise not only in relation to overseas operations through a subsidiary company but also to the operations of branches. ^{Both} legislation and the administration of legislation to correct artificial transfer pricing in this area would be extremely difficult and complicated. Further complication would arise from the fact that for double taxation relief purposes a company can allocate its distributions to various sources of income in whatever way is most advantageous, and could be better off by so doing than by pooling its overseas taxes in the credit computation. It would therefore

be necessary to allow it to choose the more favourable method and options^{tend} to complicate and delay tax computations and so to be unpopular with taxpayers and their advisers. We do not recommend the introduction of this basis of allowing credit for overseas taxes.

MATCHING CREDIT FOR OVERSEAS PIONEER RELIEFS

33. We now turn to the aspect of the credit system which in the view of the Departments of Trade and Industry and of the Foreign Office calls for change. At present there is power under Section 497(3) to give credit not only for tax actually paid in a partner country but for tax "spared" by that country under legislation providing special tax reliefs with a view to promoting "industrial, commercial, scientific, educational or other development" in that country. Matching credit for pioneer reliefs is granted only in agreements with developing countries, and until recently was given selectively only as part of an agreement which was entirely satisfactory to the United Kingdom. On this basis about ten agreements were concluded which incorporated matching credit. Currently, however, the practice is to offer matching credit for reliefs within the terms of Section 497(3) to any^{developing} country with which we conclude a generally acceptable agreement. We have in the last two years reached agreement with Indonesia, South Korea, the Philippines and Kenya, while negotiations with other developing countries including India and Sri Lanka are to take place in the course of this year. There are, however, other countries with which it has not been possible to conclude an agreement because the scope of our matching credit relief is too narrow. The clearest example of this is Brazil, which expects partner countries to give matching credit not only for tax spared under investment incentive legislation, but also for the normal reductions in withholding taxes which are a standard feature of double taxation agreements. It is generally accepted that the reduction by one country is the quid pro quo for the reduction by the other country. Brazil, however, is not prepared to give these reductions

unless they are covered by matching credit in the other country because if they do the benefit goes to the other country's exchequer and not to the individual investor or trader. If this proposition were accepted outward investment to Brazil would be stimulated, and would in fact be more favourably taxed than investment elsewhere including the United Kingdom. This would have not only tax cost consideration but also implications for the balance of payments, ^{within the limits described in para. 20 above,} and the effect could be significant if, as is likely, the Brazilian agreement set a precedent for other developing countries.

34. If we met the Brazilian demand it would mean that we had moved closer to the exemption method of relieving double taxation which is discussed in paragraphs 43 to 47 below. The United Kingdom has a strong preference for the credit method mainly because of the control it provides against tax avoidance but although it is easier to follow the Brazilian line for countries like France and Germany which exempt overseas trading income, they too are faced with giving credit for Brazilian tax in respect of withholding tax on portfolio dividends, interest and royalties which is given up by Brazil under their respective agreements. The exemption method reduces the scale of the problem but does not eliminate it.

35. The Departments of Trade and Industry and Foreign and Commonwealth Office attach considerable importance to our securing a double taxation agreement with Brazil. They would favour an extension of our enabling powers to allow matching credit so that we could have a treaty which would remove the disadvantage at which United Kingdom residents operate in Brazil compared with their competitors from countries which have met the Brazilian demands by way of matching credit relief.

Unilateral matching credit

36. We reviewed the case which has often been put by representatives from industry with support from other departments for introducing unilateral credit for tax spared by way of pioneer relief so that UK investors

would not be at a disadvantage compared with those from countries which either have a double taxation agreement with a particular developing country or which exempt overseas trading profits from tax and so automatically pass on to their investors the benefit of any reliefs from or reductions in tax given by the overseas country. We were impressed by the difficulties in the way of this course. For one thing there would be real problems in obtaining information about the overseas tax and the tax sparing legislation. In theory relief could be given at the discretion of the Board of Inland Revenue but even if that were acceptable politically it would merely amount to saying in practice that relief would be given only in cases where there happened to be sufficient information about the law of the overseas country. This would be arbitrary and unfair. In those circumstances the right of appeal against the failure to grant matching credit relief would not be a remedy because the reason for withholding relief would simply be that not enough was known about the foreign law to say whether the pioneer relief in the foreign country qualified for United Kingdom relief or not. There could also be a tax avoidance aspect because if relief were given unilaterally there would be some risk of being compelled to give the relief for taxes imposed in tax havens, some of which might not satisfy the normal criteria. There is also the possibility that a developing country would frame its tax code so as to attract investment from developed countries at the expense of the Revenue in those countries. If the final result were acceptable to the companies engaged in the investment it is unlikely that they would object merely in order to protect the United Kingdom Revenue. It is not unknown for arrangements to be made to suit both a developing country and United Kingdom investors there at some cost to the United Kingdom Revenue; it has happened in relation to Middle East oil taxation, as the PAC explained in its First Report, 1972-73 (see para 48). It would be undesirable to offer further scope for possibilities of this kind. While poorer developing countries are in a

different category from OPEC states, unilateral pioneer relief would be an inefficient unselective and probably expensive way to encourage them. It is noteworthy that no other country so far as we know gives matching credit relief under its domestic law and the lack of control over various possibilities of avoidance and exploitation may well be one of the main reasons for their taking this line. The Revenue have discussed the question with representatives of the CBI and the ICC, who accepted the force of these arguments while indicating that UK investors were still left at a disadvantage in some countries compared with foreign competitors who could benefit from pioneer relief either by way of an agreement or by the exemption of overseas trading profits in their home country.

37. A further disadvantage of introducing unilateral matching credit is that matching credit is often the only concession which the United Kingdom can give under an agreement with a developing country which that country regards as a substantial and acceptable benefit flowing from a treaty, so that if it were given unilaterally an important bargaining counter in negotiations would have been lost.

Possible compromises

38. We accept the arguments against unilateral matching credit and we therefore considered the possibility of moving over to a two-tier system of matching credit relief under which matching credit could be granted unilaterally on the lines of Section 497(3) for specific incentive reliefs; there would also be the power to go further in agreements than can be done at present and to give the type of matching credit which the Brazilians are demanding. In this way the United Kingdom would retain a bargaining counter in treaty negotiations, but although the scheme is attractive for that reason it has all the other disadvantages of unilateral relief.

39. We also considered having some compromise arrangement which would enable the United Kingdom to give matching credit relief otherwise than by treaty but by some means which fell short of full-blooded unilateral

relief. This would be a kind of half-way house on the lines of giving the Board of Inland Revenue power to allow relief unilaterally by regulation on a discretionary basis. Developing countries which for one reason or another felt unable to enter into a treaty with the United Kingdom could ask for matching credit if we were satisfied that their domestic legislation was suitable. The United Kingdom would also be able to refuse to give relief if for any reason that course was felt to be inappropriate.

40. We do not favour this approach. In the first place it is difficult to see why countries which want to encourage United Kingdom investment in their territory by way of United Kingdom fiscal measures should object to having what they want from this country embodied in a treaty. More importantly, however, we do not think that it would be politically acceptable for the Board of Inland Revenue to be given wide discretionary powers in this field; and if the discretion were to be fettered by an elaborate set of criteria which had to be met before the relief could be given there would in effect be a full scale set of unilateral relief provisions. We should however record that so long as matching credit is allowed only as part of a comprehensive bilateral agreement, the benefit will not be available for investment in countries which for a variety of reasons do not have a comprehensive agreement with the United Kingdom and are unlikely to do so. The obstacles could be political; or it could simply be that the trade flows do not justify a comprehensive agreement. This may well be the case for some of the least developed countries.

Matching Credit; Conclusion

41. We conclude that the proper approach to the problem of matching credit would be to continue to grant the relief only under a double taxation agreement, but to amend the enabling legislation so that matching credit could be given for tax "spared" under an agreement in addition to tax "spared" under domestic incentive legislation. This relief would be incorporated in an agreement only if the terms were generally acceptable and the agreement would be subject to parliamentary approval in the normal way. If legislation on those lines were enacted it should make it possible to secure agreements with a number of developing countries which are important in terms of United Kingdom trade and investment. The Departments of Trade and Industry and the Foreign and Commonwealth Office, which cannot press too strongly the importance of securing such agreements would welcome this extension of our matching relief powers, although in the long run preferring to see powers taken to give some measure of matching credit unilaterally.

42. The cost of this proposal cannot be estimated because it would depend on the extent of matching credit granted under treaties and the concessions made to the United Kingdom by partner countries. An estimate of the cost of any one matching credit provision in a particular treaty could be made so far as possible when the terms of the treaty were brought before the House of Commons for consideration. The cost of existing matching credit relief is however small, being of the order of £m5 and it is likely that the cost of the extension we recommend would also be relatively modest.

Exemption of Overseas Income

43. In its simplest form the exemption method is the total exemption from tax in the country where the taxpayer is resident of any income arising overseas which is liable to tax in the country of origin. It would mean that, for example, a United Kingdom resident company would be exempt from corporation tax on the profits of its foreign branches and on dividends from overseas subsidiaries. Credit is normally given for tax which an agreement allows a partner country to charge, eg reduced withholding taxes on dividends and interest. Conversely there would be no relief against United Kingdom tax for overseas branch losses. A variant of the exemption method and the one most commonly adopted is "exemption with progression" where the country which has given up its right to tax income retains the right to take that income into account when determining the rate of tax to be imposed on the rest of the taxpayer's income.

44. The main advantage of the exemption method is its simplicity of concept. It is also a consequence of the method that pioneer reliefs given in overseas territories automatically accrue to the benefit of the taxpayer and are not frustrated by an extra tax charge in the taxpayer's country of residence. It would tend therefore to stimulate outward investment to areas

which provided generous pioneer reliefs.

45. Serious problems would however arise under the exemption method in the United Kingdom and the necessary solutions would inevitably complicate the system and so remove or reduce the advantage of simplicity. Because it would give the United Kingdom no means of checking or controlling profits arising overseas it would facilitate avoidance of tax by the manipulation of transfer prices and other devices for profit shifting to countries with low tax rates or low effective rates, eg where there were generous pioneer and other reliefs. Legislation to counter this manipulation would be elaborate and would involve work on computations and detailed enquiries of a kind which are not normally welcome to taxpayers and their professional advisers. In particular the exemption method offers scope for artificial transfer pricing between an overseas branch and its headquarters, an area in which such manipulations are particularly difficult to detect and to rectify and in which there are at present no problems for the United Kingdom. This change would produce much unwelcome work both outside and in the Revenue.

46. There would also be complications in adapting the basic corporation tax rules to the exemption method, for example, in relation to group relief. The close company legislation would require elaboration and provision would have to be made for relieving overseas losses. The net result would be that the attractive simplicity of the basic concept would be obscured by the necessary consequential legislation. In short the theory of the exemption method is more simple than ^{the} practice and there would be no ultimate gain in simplicity of administration. The exemption method is the chosen system for the original six member countries of the Community, but doubts are occasionally expressed about its effectiveness. The credit method is used in the United States.

47 . If it were accepted that the tax system should offer more positive encouragement to outward investment then exemption of trading profits arising overseas would be an effective means of doing so. We have already said (paragraph 30 above) that the credit method gives about the right treatment to outward investment, and given the risks and difficulties inherent in the exemption method we conclude that there is not a case for its introduction.

OIL

48 . The double taxation relief given by the United Kingdom for foreign taxes paid on oil production profits is about three times as large as the total of relief given on all other overseas income. The 1974 tentative estimates are of the order of £m2,000 for oil and £m600 for the rest. The United Kingdom has double taxation agreements with only a handful of oil producing and exporting countries, ie Nigeria, Indonesia, Malaysia and Norway. Thus tax paid on oil production profits to OPEC countries (other than Nigeria) qualifies for unilateral relief and not for credit under agreement, the amounts being the same as agreement relief. The official evidence to the Public Accounts Committee in 1972 explained how under the posted price system which was then in operation in Middle Eastern oil companies the companies paid no United Kingdom tax (First Report from the Select Committee of Public Accounts 1972-1973 Paragraphs 57 to 58; and see Annex 14 to the Memorandum by the Department of Trade and Industry at pages 57 to 58). That was because the oil ^{was} transferred from the production company in a United Kingdom group to the group trading company at posted prices, which were above the open market price. The trading company sold at a loss created by its artificially high acquisition price, and the United Kingdom did not benefit from the artificially high production profits (created by the use of the posted price as the transfer price from the production company) because that tax was extinguished

by the credit allowed for the taxes paid on production profits to Middle East producer countries. Legislation in the Oil Taxation Act 1975 and the 1975 Finance Acts changed the rules for oil companies. There are now provisions under which open market value will be substituted for posted or other artificial transfer prices, so that a fair profit will be allocated to the trading operations. The production profit will be correspondingly reduced and this will automatically reduce the foreign tax which will qualify for credit against United Kingdom tax, because the rule is that credit is allowable for foreign tax on profits only up to the amount of the United Kingdom tax payable on those profits. This legislation represented a major improvement from the United Kingdom point of view, and until recently it seemed likely that OPEC policies would drastically reduce the tax payable in producing countries, because as the degree of participation increased so foreign companies would contribute to OPEC Governments through the price they paid to buy back nationalised oil and not by way of taxes on profits. The position is still changing, but it has recently been established that arrangements have been concluded or are under discussion between the major oil companies and producer governments under which the companies will continue to pay taxes on the profits to those governments even where there is one hundred per cent participation. The problem of the foreign tax credit to oil companies is therefore continuing and unlikely to disappear.

49. The ramifications are complex and the policy considerations of great importance. A separate submission is being made for consideration in the tax and oil policy context. The options in effect are to keep the present system or to treat foreign taxes on oil profits as an expense of earning the profits instead of allowing credit for the overseas taxes. Because the tax paid in OPEC countries is very high, the difference in yield to the United Kingdom Revenue between the two methods is estimated

at only some 5 per cent of the total and to be of the order of £m100 out of £m2,000. Outside the sphere of oil taxation we advise (paragraph 30) that it would be inconsistent with Government policy to replace credit for foreign tax by a deduction. The oil industry is however a highly special case and we make no recommendation about the extent to which it should have relief from United Kingdom tax for overseas taxes it pays, but take note of the fact that the question is being separately considered.

SUMMARY OF RECOMMENDATIONS

- A. We conclude that the credit method gives the appropriate degree of encouragement to outward investment, and should not be replaced by the system of treating overseas taxes as an expense of earning the overseas profits (paragraph 30).
- B. We do not think that the case has been made out for relief from double taxation by way of the exemption method (paragraph 47).
- C. We do however recommend that given the desirability of enabling United Kingdom investors to compete on equal terms with competitors from other countries, legislation should be introduced to enable matching credit relief to be given for tax reductions made under agreements by developing countries (paragraph 41).
- D. We make no recommendation about the treatment of overseas taxes paid by the oil industry but note that this question is receiving separate consideration.

Further recommendation

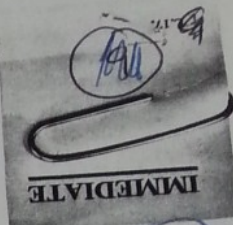
There can be no final determination of the proper scope of double taxation relief, and changes in economic policy considerations, in the law and the attitudes of other countries and of international bodies including the European Community, as well as experience of the operation of agreements and the UK domestic law could lead to different conclusions over time. The operation of the system is kept under review by the Inland Revenue and we further suggest that it should be considered again interdepartmentally in three to five years.

(Writing IN CONFIDENCE)

Reference

Mr. Stadden F.R.D.

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BOTB: Double Taxation

I attach copies of the BOTB Agenda, BOTAC draft Agenda and supporting papers.

This is the first time in my experience that the BOTB has taken this subject. I believe the initiative for it has come from the Committee on Invisible Exports. I would be grateful if you could let me a draft brief to include with the general briefing for Mr. Statham who will be the FCO representative at next Tuesday's meeting.

The papers have only just reached me and I am sorry to have to ask for something by midday if at all possible on Monday 10 May. You may wish to consult Economists Dept, to whom I am copying this and the papers.

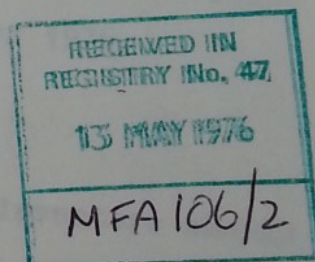
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R.G. MARLOW

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Copy Mr. Alexander
Economists Dept.

Mr Thomas

Wt w/s

I regret that I am unfamiliar with this subject, but I have had a shot at a short brief.

R. Statham
10/5



IN CONFIDENCE

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13 MAY 1976
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BRITISH OVERSEAS TRADE BOARD

DOUBLE TAXATION AGREEMENTS

The Board is asked to consider the attached papers on Double Taxation Agreements with a view to presenting them at the 4th meeting of BOTAC on 15 June.

The first paper has been prepared by the Taxation Sub-Committee of the Committee on Invisible Exports; the second was prepared by the Inland Revenue and was first considered by the Board in February 1976.

BOTB Secretariat
April 1976

SHIPPING

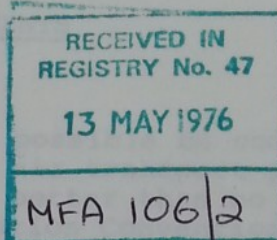
The normal shipping article in an agreement provides that profits from international shipping operations will only be taxed in the operator's country of residence. Some developing countries are unwilling to negotiate a double tax agreement which contains such an article or, if there is an agreement, providing for the conventional treatment of shipping, appear determined to recover any loss of revenue by the means of turnover taxes. The latter cannot be offset against UK corporation tax and must be treated as a business expense. This places UK lines at a competitive disadvantage because UK tax can readily be avoided by foreign operators.

It is not possible to charge non-resident shipping companies because of administrative and staff problems. It is also not practicable to extend unilateral relief to taxes of a turnover nature as this could affect a wide range of other industries. British shipping companies are thus left highly vulnerable in their trade with certain developing countries. Any success in imposing turnover taxes by such countries without retaliation by the United Kingdom is bound to result in similar revenue raising by countries with which conventional double tax agreements are in force.



IN CONFIDENCE

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BRITISH OVERSEAS TRADE BOARD

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BOTB Secretariat
April 1976

DOUBLE TAXATION AGREEMENTS

Insurance

Agreements should whenever possible be comprehensive and not restricted to shipping and air transport profits, though such limited agreements are better than no agreements at all. The OECD Draft Double Taxation Convention on Income and Capital provides a suitable model for new or renegotiated agreements. There are dangers through the creation of precedents in departing from the model.

Agreements should cover all taxes for which relief is currently granted unilaterally. The definition of permanent establishment should not discriminate against insurance business. Taxable profits from insurance business should be limited to those attributable to a permanent establishment overseas, and a reasonable allowance should be made for the expenses of the head office outside the overseas territory. Agreements should limit withholding tax as provided in the OECD Draft Convention, and should also contain the Convention's standard non-discrimination article.

As regards Brazil, it is important that provisions departing from OECD Draft Convention which would set dangerous precedents in future negotiations with other countries should not be accepted.

Shipping

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It is not possible to charge non-resident shipping to tax because of administrative and staff problems. It is also not practicable to extend unilateral relief to taxes of a turnover nature as this could affect a wide range of other industries. British shipping companies are thus left highly vulnerable in their trade with certain developing countries. Any success in imposing turnover taxes by such countries without retaliation by the United Kingdom is bound to result in similar revenue raising by countries with which conventional double tax agreements at present exist.

Export Finance

In Brazil, the rate of withholding tax on lending for overseas loans is much higher in the case of the UK than it is for competitor countries such as Japan. The effect is that credit offered under ECGD cover at 7% costs local buyers 9.33%, whereas the equivalent rate for a similar Japanese credit is 7.78%. (These figures relate to the situation as it was in 1973). This puts the British exporter at a disadvantage which should be remedied in any double taxation agreement that may be concluded with Brazil. It is believed that similar situations may exist in other countries such as Singapore where a double taxation agreement exists. Such agreements should contain provisions which eliminate any competitive disadvantages of this kind that may exist.

Banking

Overseas banks with branches in the UK have in the past suffered from disparities of treatment because of their non-resident status under which they have not been allowed to set off tax credits in respect of foreign withholding taxes. The Government have recently announced that this disadvantage is being rectified.

The only outstanding problem of which COIE is aware arises in relation to the Anglo-American Double Taxation Agreement recently concluded. This has corrected certain disparities between the treatment of US portfolio investors in UK companies and that of US direct investors. Refunds of UK tax are, however, in the case of direct investors still limited to investments through UK companies. This leaves UK branches of American banks with no benefit under the Agreement. It would be desirable for this anomaly to be corrected, as otherwise there might be diversion of business from the UK and consequent loss of invisible earnings.

BRITISH OVERSEAS TRADE BOARD

DOUBLE TAXATION AGREEMENTS

A member of the British Overseas Trade Advisory Council has suggested that the Council consider the current operation of Double Taxation agreements, particularly in the light of the difficulties experienced in making such an agreement with Brazil.

The attached factual paper has been forwarded by the Inland Revenue, who stress that there have been no major Ministerial decisions on the subject in recent years. The Board is invited to decide whether the papers should be presented for consideration by the Council, or whether it wishes first to discuss the issues involved with representatives of the Inland Revenue.

BOTB Secretariat
February 1976

IN CONFIDENCE

NOTE ON DOUBLE TAXATION RELIEF

1. Double taxation occurs when the same income is taxed in the hands of the same taxpayer in two countries. This happens because many countries, including the United Kingdom, charge tax on income arising within their territories wherever the recipient resides, and also tax their residents on all their income wherever it arises. Thus income which arises from a source in one country and is received by a resident of another may be taxed in both countries. Moreover, an individual may be resident in the technical income tax sense in two countries for the same year; if both countries charge tax on the world income of their residents, he will suffer double taxation on the whole of his income.

2. The double taxation discussed in this note is taxation of the same income or capital in the same hands. It should be distinguished from 'economic double taxation' which is tax on the same income or capital in the hands of two different persons both chargeable to tax. It is most commonly used in the context of the combined burden of tax on companies in respect of their profits and on the shareholder who is taxed in full on dividends paid out of taxed profits.

3. To prevent, or substantially reduce, double taxation the United Kingdom has done two things. First, it has made double taxation agreements with many overseas countries, both inside and outside the Commonwealth, under which each country agrees to give up, or reduce, its tax in certain specified kinds of case either by exemption, reduction of rate, and to give credit for overseas tax on income which is not exempted and so remains double taxed. Secondly, where relief is not due under an agreement, relief for overseas tax is given unilaterally.

BRIEF ACCOUNT OF THE PRESENT UK SYSTEM

4. Agreements There are limited agreements dealing with shipping and air transport profits and comprehensive agreements. Limited agreements provide that, where a concern resident in one country carried on the business of shipping or air transport in the other, only the country in which the concern is resident is to tax the profits. Comprehensive agreements usually cover all forms of income. Double taxation is relieved by a combination of two methods:

- a. some types of income flowing from one country to the other are, subject to certain conditions, exempted or charged at a reduced rate in one of the countries;
- b. in general, where income remains fully or partially taxable in both countries, the tax charged in one country is allowed as a credit against the tax charged in the other country on the same income.

The more important articles, apart from the credit article, are the non-discrimination article and those dealing with the treatment of business profits, dividends, interest and royalties. We have comprehensive agreements with over 60 countries, including the other members of EEC, most of the other members of OECD and many of our dependent territories and former dependent territories. There is a comprehensive agreement with the Republic of Ireland which for historical reasons is on a different basis from other comprehensive agreements and exempts a resident of one of the countries from tax in the other country for income arising there, with special arrangements for double residents.

5. Unilateral relief Credit is given against the United Kingdom tax on overseas income for tax charged on the income in an overseas country even though there is no double taxation agreement between the United Kingdom and that country. The overseas taxes for which unilateral relief may be given are those which correspond to United Kingdom income tax, corporation tax and capital gains tax, and may include not only central government taxes but also taxes levied by provinces, states and municipalities.

6. "Matching" credit Since 1961 there has been statutory authority for including in double taxation agreements provisions under which the United Kingdom gives credit for tax which would have been payable in the overseas country on income arising there but for pioneer tax relief granted by that country, and a number of double taxation agreements concluded since that time have included such provisions. There is however no statutory provision under which this relief can be given unilaterally.

7. Relief for underlying tax A shareholder company resident in the United Kingdom and receiving dividends from an overseas company is in certain circumstances (broadly where it can be regarded as a direct rather than a portfolio investor) entitled to credit not only for the overseas country's withholding tax on dividends but also for the tax which the company has to pay on the profits out of which it pays the dividend (ie the profits "underlying" the dividend).

In addition, agreement has been reached with the following countries but the conventions are not yet in force:

Indonesia
Kenya
Korea
Philippines
Poland
Romania
Spain
Sweden

List of Countries with which the United Kingdom has concluded Double
Taxation Agreements

Antigua
Argentina (shipping and air
transport profits)
Australia
Austria
Barbados
Belgium
Belize
Botswana
Brazil (shipping and air
transport profits)
British Solomon Islands
Brunei
Burma
Canada
Cyprus
Denmark
Dominica
Falkland Islands
Faroe Islands (extension of the
convention with Denmark)
Fiji
France
Finland
Gambia
Federal Republic of Germany
Ghana
Gilbert and Ellice Islands
Greece
Grenada
Guernsey
Hungary
Iran (air transport profits)
Irish Republic
Isle of Man
Israel
Italy
Jamaica
Japan
Jersey
Lebanon (shipping and air
transport profits)

Lesotho
Luxembourg
Malawi
Malaysia
Malta
Mauritius
Montserrat
Netherlands
Netherlands Antilles (extension
of the Convention with
Netherlands)
New Zealand
Nigeria
Norway
Pakistan
Portugal
Rhodesia
St Christopher and Nevis
St Lucia
St Vincent
Seychelles
Sierra Leone
Singapore
South Africa
South West Africa (extension of
the 1962 Convention with South
Africa)
Soviet Union (air transport under-
takings and their employees)
Spain (air transport profits)
Swaziland
Sweden
Switzerland
Tanzania
Trinidad and Tobago
Uganda
United States of America
Zambia

In addition, agreement has been reached with the following countries
but the conventions are not yet in force:

Indonesia
Kenya
Korea
Philippines
Poland
Romania
Spain
Sudan



BRITISH OVERSEAS TRADE BOARD

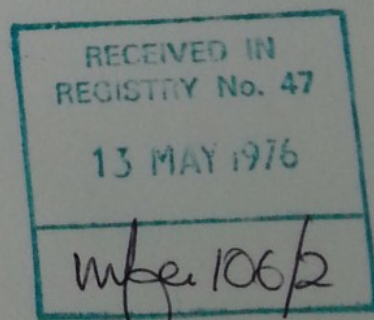
AGENDA

The 50th meeting of the British Overseas Trade Board will be held at 16.30 on Tuesday, 11 May 1976 in the Board Room (Room 227), 1 Victoria St., SW1. The following matters will be discussed. Relevant papers are attached.

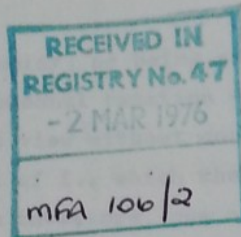
1. Apologies for Absence
2. Minutes of 49th Meeting and Matters Arising
3. Chairman's Report
4. Chief Executive's Report
5. Finance Committee Report Oral report by Lord Limerick
6. Steering Group Report Oral report by Mr Scott
7. BOTAC Agenda including draft papers BOTB(76)14
8. Export Conferences - a paper by the Chief Executive BOTB(76)13*
9. Report by AAG Chairman - Sir Derek Ezra BOTB(76)12**
Chairman of the European Trade Committee
10. Any Other Business

- * Already circulated for April meeting
- ** Circulated to Board members only

BOTB Secretariat
April 1976



PS/PAYMASTER GENERAL



cc PPS
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir Douglas Wass
Mr Couzens
Mr Lovell
Mr Houghton
Mr Hodges
Lord Kaldor
Miss Mueller (DOI)
Mr R Thomas (FCO)
PS/Inland Revenue
Mrs Small (Inland Revenue)

REVIEW OF DOUBLE TAXATION RELIEF

I have now read the report attached to the Inland Revenue minute of 25 February. It seems to me an excellent analysis of a by no means easy problem and I agree with all its recommendations.

2. There are really four points of importance. First, as paragraph 26 of the report observes, the way to equalise the benefit to the United Kingdom (although not to the United Kingdom resident investor) from outward investment would be to treat overseas tax as a deduction in arriving at the amount on which the United Kingdom tax is charged. But even if we thought that tax neutrality for the UK economy rather than for the UK investor was the criterion which ought to govern our actions, thirty years of history since the London and Mexico draft double taxation conventions effectively preclude us from taking that course. We cannot now go back to square one and treat overseas tax as no more than a deduction for UK tax purposes.

3. Second, the choice is between the credit method and the exemption method. The European Community arguments point wholly in the direction of the latter, but I do not myself find that particularly compelling. Within the European Community only the Dutch have anything like our experience of home-based companies operating through subsidiaries and branches in the third world, and even they have nothing like our number of such companies. It follows that, at least within Europe, we should be uniquely exposed to the kind of avoidance problems which the report mentions in paragraph 45. Moreover, I am bound to say that even if there were not serious avoidance and evasion problems of this kind associated with the exemption method, I would not myself regard the merits of that method, as against the credit

method which we already employ, as being sufficient to justify the enormous upheaval in company and personal taxation which its introduction would require. What is more, I reach that view without considering the problems of horizontal equity, or rather the lack of it, which the exemption method would imply as between two United Kingdom investors, one of whom put his money in Nigeria and the other lodged it in the Bahamas, although I should have thought that that would be a consideration which would weigh heavily with Ministers.

4. Third, there is the problem of matching credit for overseas pioneer reliefs to which the report draws attention in paragraphs 33 et seq. I understand the FCO position on this; it is no doubt the lineal successor of the attitude which used to be expressed by the Department for Overseas Development. I sympathise with the Department of Trade and Industry's position; they see considerable opportunities for British Companies to get in on the ground floor and expanding economies like that of Brazil (although I am bound to say that I think the Brazilian demand which has so far prevented an agreement with that country is really a pretty greedy one). Both the FCO and the DTI have a preference for new statutory powers which would authorise unilateral action by the Inland Revenue in cases of this kind because they say, with some justice, that the renegotiation of double taxation agreements to incorporate pioneer relief provisions is proving rather slow. The Inland Revenue position, which I support, is that they ought to have wider powers to deal with claims like that expressed by Brazil but still to make any relief conditional on a double taxation agreement in the negotiation of which the new powers would no doubt give the Revenue additional leverage. There are, in my view, great dangers in the alternative unilateral approach; it is an invitation to Bongo land to impose a 70% tax on all profits and income, with a £1m exemption limit for local residents and a pioneer relief rate of 20% for any inward investment which is approved in the sense that there is an appropriate kick-back to the local Finance Minister. We have seen all this before; it is, within broad limits, the history of the taxation of oil companies in the Middle East and I do not need to remind the Paymaster General, as a former Chairman of the PAC, where that got us.

Fourth, this leads on to the final question, namely whether in a situation where three quarters of all relief for overseas tax goes unilaterally to oil companies there is any real place for double taxation agreements at all. In my view the

answer to that question is very strongly in the affirmative. Double taxation agreements do more than regulate the distribution of taxable capacity between countries. Above all, they impose acceptable standards for allocating profits to branches and subsidiaries and for dealing with transfer pricing in countries (some of them within the EEC) where such standards would otherwise be absent. In addition they provide for non-discrimination and for consultation, ie for difficult cases to be settled between experts in the respective Revenue Departments rather than through diplomatic machinery. Of course, the agreements take a good deal of skilled manpower to negotiate and maintain but in my view they are worth it. Any attempt to dismantle the network of agreements which we already have or to let it fall into disrepair would have adverse effects on business confidence; per contra, anything we can do to increase our leverage in negotiating agreements must be to our overall commercial advantage even though, as in the Brazilian kind of case, it may appear to impose short-term costs.

ALAN LORD
1 March 1976