



BDO Seidman, LLP
Accountants and Consultants

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Subject:

US, UK Enter Competent Authority Agreement to Prevent Double Taxation

International Tax Alert

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Issue:

The competent authorities of the United States (“U.S.”) and United Kingdom (“U.K.”) (“Contracting States”) have entered into a Competent Authority Agreement (the “Agreement”) to prevent double taxation, which may result from the application of both countries’ domestic loss rules under the U.S. – U.K. Income Tax Treaty (the “Treaty”).

Affecting:

Potentially, U.S. corporations and their shareholders doing business in the U.K.

Background:

Internal Revenue Code Section 1503(d) and corresponding Treasury Regulations provide federal tax guidance on dual consolidated losses of a corporation. The U.K. has its own set of rules which provides guidelines regarding trading losses of U.K. permanent establishments (“PE”) of foreign companies, which are effective on or after April 1, 2000. In general, neither Contracting State allows relief for loss in certain instances.

The interaction of the Contracting States’ domestic rules may cause double taxation as no relief for loss in either Contracting State is allowed in certain circumstances. Such double taxation is in conflict with the Treaty.

Details:

Under U.S. rules, a DCL of a U.K. PE can not reduce the taxable income of any domestic affiliate defined under IRC Sec. 1503(d)(1). A DCL is a net operating loss of a domestic corporation that is subject to an income tax of a foreign country without regard to the source of its income. Except in certain instances, a DCL may only be used to offset income earned by the domestic corporation.

The U.K. rules generally allow for the surrender of trading losses of a U.K. PE of a foreign corporation to another UK corporation except when that loss is deductible against profits which are outside the U.K.'s tax jurisdiction. As a result of the application of both Contracting State's DCL rules, a taxpayer may be subject to double taxation since it may not be able to use its loss in either State.

In order to avoid this result, the competent authorities of the U.S. and U.K. have entered into a Competent Authority Agreement (the "Agreement"). The Agreement allows taxpayers to opt to use its dual consolidated loss ("DCL") either in the U.S. or U.K. by making an annual election. The election may not be made for both States and is required to be made in accordance with the procedures and conditions set for each respective country. Once the election is made, it becomes irrevocable and it is applicable to losses incurred in a specific taxable year.

The Agreement applies to a domestic member of a consolidated group or an unaffiliated domestic owner having a PE in the U.K., as per Article 5 of the Treaty, which incurs losses subject to either State's domestic tax rules discussed above. The Agreement also lists out to whom the Agreement may not apply, including but not limited to, a dual resident corporation within the meaning of Treas. Reg. 1.1503-2(c)(2) and a hybrid entity separate unit, within the meaning of Treas. Reg. 1.1503-2(c)(4).

For U.S. tax purposes, the Agreement is generally effective for U.K. PE's which incurred a loss relating to U.K. accounting periods on or after April 1, 2000. The Agreement may be terminated by either party after December 31, 2011. Prior to this date, the Agreement may be terminated by joint agreement.

Although the Agreement contains rules which limit its use in situations where the statute of limitations for the loss year has closed in one or both States, planning opportunities exist for certain taxpayers for years which remain open. These opportunities include filing retroactive elections to obtain a refund for overpaid tax, as well as financial accounting benefits for the use of certain net operating losses previously unavailable.

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