EXPLANATORY MEMORANDUM TO

THE DOUBLE TAXATION RELIEF AND INTERNATIONAL TAX ENFORCEMENT (SAN MARINO) ORDER 2023

2023 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by His Majesty's Revenue and Customs (HMRC) and is laid before the House of Commons by Command of His Majesty.

2. Purpose of the instrument

2.1 The instrument brings into effect arrangements for a double taxation agreement set out in a Convention and Protocol (the Arrangements) made by the Government of the United Kingdom and the Government of San Marino.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is the jurisdiction(s) which the instrument forms part of the law of) is the United Kingdom.

4.2 The territorial application of this instrument (that is where the instrument produces a practical effect) is the United Kingdom.

5. European Convention on Human Rights

5.1 Victoria Atkins MP, Financial Secretary to the Treasury has made the following statement regarding Human Rights:

"In my view the provisions of the Double Taxation Relief and International Tax Enforcement (San Marino) Order 2023 are compatible with the Convention rights."

6. Legislative Context

6.1 The instrument is being made to give effect in United Kingdom legislation to the Arrangements, which have been signed by the two Governments. The Arrangements are specified in the Schedule to the instrument.

7. Policy background

What is being done and why?

7.1 The purpose of Double Taxation Agreements (DTAs) is to prevent income or gains being taxed both in the territory in which they arise and the territory in which the recipient is resident. They do this either by allocating an exclusive right to tax the income or gain to one of the territories, or by providing that one territory must give relief for the tax charged in the other territory in respect of the same income or gain.

DTAs also provide additional protection for taxpayers by including specific measures that combat discriminatory tax treatment. More generally, DTAs benefit taxpayers by ensuring certainty of treatment and, as far as possible, by reducing compliance burdens.

7.2 DTAs also protect the Exchequer by including provisions to combat tax avoidance and evasion. For example, measures providing for the exchange of information between revenue authorities make it more difficult for residents of both territories to evade taxation by concealing assets offshore.

7.3 This is a first-time DTA with San Marino and, like all of the United Kingdom's more recent DTAs, the Arrangements largely follow the Organisation for Economic Cooperation and Development's (OECD) latest Model Tax Convention on Income and on Capital (OECD Model). In doing so, they encourage and maintain international consensus on the appropriate tax treatment of cross-border economic activity, promoting international trade and investment.

7.4 The Arrangements include provisions relating to the exchange of information and introduce the minimum standards recommended by the OECD/G20 Business Erosion and Profit Shifting (BEPS) project, which are designed to prevent DTAs from being abused by people trying to reduce their tax liability where the DTA is not intended to apply. The BEPS project created a single set of consensus-based international tax rules to protect against tax avoidance while offering increased certainty and predictability to taxpayers.

The following paragraphs in this section explain the provisions of the Arrangements including the reasons for material departures from the OECD Model

7.5 The title and preamble of the Arrangements follow the latest OECD Model. The change to the OECD Model arose from the BEPS Action 6 Report on preventing the granting of treaty benefits in inappropriate circumstances. The statement in the preamble that the territories intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty shopping arrangements, is one of the elements of the minimum standard on preventing treaty abuse agreed under the BEPS project.

7.6 Article 1 (Persons covered) sets out the general scope of the Arrangements. The Arrangements include two provisions from the OECD Model that were introduced following the BEPS project. The first concerns the treatment of income or gains derived through fiscally transparent persons such as partnerships. This provision confirms that the benefits of the Arrangements are only due where such income is effectively taxed in the hands of a resident of one of the territories. The second provision clarifies that the Arrangements do not prevent a territory taxing its own residents except where they explicitly provide as such. This puts beyond doubt that the provisions of a DTA cannot be used to circumvent anti-avoidance rules in a territory's domestic tax law.

7.7 Article 2 (Taxes covered) lists the taxes to which the Arrangements are to apply. The existing United Kingdom taxes to which the Arrangements will apply are income tax, corporation tax and capital gains tax. The existing San Marino taxes to which the Arrangements will apply are the income tax on individuals, on bodies corporate and proprietorships.

7.8 Article 3 (General definitions) defines a number of terms used in the Arrangements and provides a rule for determining the meaning of terms not defined. The United Kingdom uses a definition of “national” that differs from the OECD Model in order to reflect more accurately the provisions of its domestic law. The Arrangements include a definition of a “pension scheme” that differs to the OECD definition of “recognised pension fund” to ensure that schemes not treated as a separate person fall within the definition. This definition is relevant to Articles 4 and 10.

7.9 Article 4 (Resident) establishes the meaning of “resident of a Contracting State” and lays down detailed rules for resolving cases where individuals or other persons may be considered residents of both territories for tax purposes under their domestic laws. Unlike the OECD Model, the provisions of paragraph 1 include reference to the “place of incorporation” as this is one of the conditions that establishes company residence under the domestic laws of the United Kingdom and San Marino respectively.

7.10 Paragraph 2 deviates slightly from the OECD Model: in the OECD Model, pensions schemes are included in paragraph 1, but in the Arrangements paragraph 2 confirms that a “pension scheme” and certain non-profit organisations of either territory will be considered to be a resident. This reflects the United Kingdom preference for confirming that certain non-profit organisations will enjoy the benefits of the Arrangements even if they are generally exempt from taxation. Paragraph 3 follows the OECD model at Paragraph 2.

7.11 Paragraph 4 provides a tiebreaker for persons other than individuals which are resident in both territories under paragraph 1 of the Article. Under the Arrangements the competent authorities will determine the residence status of such persons by mutual agreement. This change was introduced to the OECD Model following the BEPS project and prevents companies manipulating their tax residence for tax avoidance purposes.

7.12 Article 5 (Permanent establishment) defines the term “permanent establishment” (PE) for the purposes of the Arrangements. Taken together with Article 7, it describes the circumstances and manner in which enterprises of one territory may be taxed on their business profits arising in the other. It also includes a rule that prevents companies fragmenting their activities in order to avoid the PE threshold. This rule was recommended by the BEPS project. The United Kingdom and San Marino agreed to only adopt the features of the OECD Model definition of PE that are consistent with their overlapping positions adopted under the Multilateral Convention to Implement Treaty Related Measures to Prevent Base Erosion and Profit Shifting

7.13 Article 6 (Income from immovable property) allows the territory in which the property is situated to tax income from immovable property. It also defines immovable property. The Article replicates the equivalent provisions of the OECD Model.

7.14 Article 7 (Business profits) provides that unless an enterprise of one territory carries on business in the other through a PE situated there, its profits will be taxable only in its territory of residence. Where the enterprise has a PE in the other territory, that territory will be entitled to tax profits attributable to the PE. The provisions of the Article in the Arrangements follow the latest OECD Model provisions first adopted in 2010. The 2010 provisions ensure that the attribution of profits to PEs is more closely aligned with the “arm’s length” principle used to allocate profits between associated enterprises under Article 9. In line with the OECD Model, income from professional services or similar activities will be dealt with under Article 7 of the Arrangements.

7.15 Article 8 (International shipping and air transport) governs the taxation of shipping and air transport operated in international traffic. In general, and in line with the OECD Model, it provides that profits of an enterprise of one territory from the operation of ships or aircraft in international traffic shall be taxable only in that territory. Paragraph 2 of the Protocol to the Arrangements clarifies that certain incidental income will be included in profits from the operation of ships and aircraft in international traffic. There is further detail about the treatment of these forms of incidental income at paragraph 7.39.

7.16 Article 9 (Associated enterprises) governs the evaluation for tax purposes of transfers of goods, services, finance and intangible property between associated enterprises. It is based on the "arm's length" principle, which requires such transfers to be evaluated as if they had taken place between independent enterprises. Where an adjustment is made to the profits of an enterprise by one territory, the other territory will make an appropriate adjustment to the amount of tax charged on those profits, in order to relieve the double taxation which might otherwise arise as a result of an adjustment by only one territory. The Article replicates the 2017 OECD Model.

7.17 Article 10 (Dividends) contains the rules for the taxation of dividends paid by a company that is a resident of one territory to a resident of the other territory. In line with United Kingdom's preferences, it departs from the OECD Model by providing that dividends paid by a company resident in one territory to a beneficial owner resident in the other territory are to be exempt from tax in the paying territory. Paragraph 2(b) disapplies this exemption and allows for a territory to tax payments from a resident Real Estate Investment Trust. The definition of dividends in the Article differs slightly from the OECD Model in the manner in which it aligns the definition with income categorisation under domestic law. In other respects, the provisions of the Article follow the OECD Model.

7.18 Article 11 (Interest) contains the rules for the taxation of interest arising in one territory and paid to a resident of the other territory. In line with United Kingdom preferences, the provision in the Arrangements provides that interest arising in one territory and beneficially owned by a resident of the other territory shall be taxable only in that other territory. The definition of interest is in line with the OECD Model and the United Kingdom's preferences. It also reflects the United Kingdom's preference for clarifying that the Article does not apply to amounts that are within the definition of a dividend in Article 10. Unlike the OECD Model, the "special relationship" provision at paragraph 6 applies where the amount of interest paid is excessive "for whatever reason". This permits the territories to take into account both the rate of the interest and the amount of the debt in determining whether interest paid is excessive. In other respects, the Article largely follows the OECD Model.

7.19 Article 12 (Royalties) contains the rules for the taxation of royalties paid by a resident of one territory to a resident of the other territory. In line with the OECD Model and United Kingdom preferences, it provides that royalties arising in one territory and beneficially owned by a resident of the other territory shall be taxable only in that other territory. The definition of royalties reflects the OECD Model. Unlike the OECD Model, the "special relationship" provision at paragraph 4 applies where the amount of royalties paid are excessive "for whatever reason". This allows the territories to consider all factors in determining whether royalties paid are excessive. In other respects, the Article follows the OECD Model.

7.20 Article 13 (Capital gains) contains the rules for the taxation of gains deriving from the alienation of property situated in one territory by a resident of the other. The Article includes a “securitised land provision”, which allows a territory to tax a disposal of shares or comparable interests where those shares or interests derive more than 50% of their value from immovable property in that territory. Unlike the “securitised land provision” in the OECD Model, the provision in the Article does not include a 365-day holding test. The Government believes that the holding test could lead to double taxation and is unnecessary due to the introduction of the anti-abuse rule at Article 27 of the Arrangements. In other respects, the Article follows the OECD Model.

7.21 Article 14 (Income from employment) contains the rules for the taxation of employment income which follow the OECD Model, except that it is also subject to the application of Article 19, which is not an OECD Model Article.

7.22 Article 15 (Directors’ fees) follows the OECD Model and provides that directors’ fees may be taxed in the territory of which the company paying them is a resident.

7.23 Article 16 (Entertainers and sportspersons) contains the rules for the taxation of income derived from personal activities as an entertainer or sportsperson. The provisions are in line with the current OECD Model

7.24 Article 17 (Pensions) contains the rules for the taxation of pensions. Paragraph 1 provides that all pensions, other than those in respect of government service, may be taxed in the territory from which they are paid. This departs from the OECD Model, which only applies to pensions paid in respect of past employment. Notwithstanding that general rule, paragraph 2 provides that pensions paid under the social security legislation of either State will be taxable only in that State.

7.25 Article 18 (Government Service) contains rules for the taxation of remuneration paid to an individual in respect of government service, including pensions. The general rule is that the remuneration is only taxable in the territory to which the services are rendered. However, there is an exception for remuneration, other than pensions and other similar remuneration, paid to locally engaged staff. Such remuneration is taxable only in the territory where the individual is resident, provided that the individual is subject to tax there. The provisions are generally in line with the OECD Model, apart from the amendment to subparagraph 1(b) to ensure that remuneration other than pensions and other similar remuneration paid to locally engaged staff in a territory will not be exempt from tax in both territories.

7.26 Article 19 (Professors, teachers and researchers) is included as a preference of San Marino and is not an OECD Model provision. It is based on considerations mentioned in the commentary on the UN Model tax convention. It applies where an individual from one territory visits the other territory for no more than two years for the purpose of teaching or carrying out research at an educational or cultural institution there. It ensures that remuneration from these activities is exempt from tax in the territory of visit where it is paid from a source outside that territory. The exemption in the Article does not apply where the remuneration arises from a source within the territory of visit, for instance where paid by the institution itself, or where the first mentioned territory does not tax that income.

7.27 Article 20 (Students and business apprentices) contains the rules which govern the taxation of visiting students and business apprentices. Its provisions follow the OECD Model.

7.28 Article 21 (Other income) contains the rules for the taxation of income not dealt with elsewhere in the Arrangements. In line with the UK preferences there are some deviations from the OECD model. Paragraph 1 confirms that the benefits of the Article are only due where the recipient of the income is the beneficial owner. This is in line with the equivalent condition in Articles 10, 11 and 12. Paragraph 2 clarifies the treatment of income derived through trusts and estates and confirms that it will be taxed in accordance with the rules applying to the underlying source of the income. Paragraph 4 includes a "special relationship" provision equivalent to those found in Articles 11 and 12.

7.29 Article 22 (Elimination of double taxation) sets out the methods by which each territory will relieve double taxation. Paragraph 1 sets out the provision applying to San Marino and provides for relief by way of credit. Paragraph 2 details the provisions applying to the United Kingdom which generally provide for relief by way of credit, but also include provisions that exempt from tax dividends and the profits of PEs in line with domestic law. Paragraph 3 applies only to the United Kingdom because the effect is replicated in paragraph 1 for San Marino. Its effect is to remove the United Kingdom's obligation to give credit where both territories can tax the income, but San Marino is taxing the income solely because it is income derived by a resident of San Marino.

7.30 Article 23 (Non-discrimination) provides that, subject to certain conditions, neither territory shall impose discriminatory taxes or connected requirements on the nationals, PEs and enterprises of the other. In line with United Kingdom preferences, paragraph 5 deals separately with personal allowances granted to residents and nationals, confirming that the Article does not require them to be granted to persons not resident in the territory in question.

7.31 Article 24 (Mutual agreement procedure) establishes a procedure for resolving difficulties arising from the interpretation or application of the Arrangements and meets the minimum standard on improving dispute resolution agreed under Action 14 of the BEPS project. The Article includes a deadline of three years for a person to present their case to a competent authority, confirmation that mutual agreements will be implemented notwithstanding time-limits in domestic law and a provision confirming that the competent authorities may consult to eliminate double taxation in cases not covered by the Arrangements. The Article also provides for mandatory binding arbitration.

7.32 Article 25 (Exchange of information) follows the latest OECD Model and provides for the exchange of certain information between the competent authorities of the two territories in compliance with international standards.

7.33 Article 26 (Members of diplomatic missions and consular posts) ensures that diplomatic or consular officials shall not receive less favourable treatment under the Arrangements than they are entitled to under international law or under the provisions of special agreements (such as the Vienna Convention on Diplomatic Relations). The Article follows the OECD Model.

7.34 Article 27 (Entitlement to benefits) includes the "the principal purpose test" (PPT) which denies treaty benefits to those seeking to take advantage of the provisions of the

Arrangements to secure a result which is contrary to their object and purpose. The PPT is one of the elements of the minimum standard on preventing treaty abuse agreed under Action 6 of the BEPS project. The Article also allows a State to grant a different benefit where the Competent Authority determines such benefit would have been granted but for the transaction or arrangement that results in the application of the first paragraph. This is alternative text included in the Commentary to the OECD Model.

7.35 Article 28 (Entry into force) contains the provisions governing how and when the Arrangements will enter into force and take effect. Its provisions follow the preferences of both jurisdictions and are in line with similar provisions in other DTAs entered into by the United Kingdom.

7.36 Article 30 (Termination) contains the provisions that govern how the Arrangements can be terminated and how that termination has effect. Its provisions follow the preferences of both jurisdictions and are in line with similar provisions in other DTAs entered into by the United Kingdom.

7.37 The Protocol contains clarificatory material relating to the Articles above and forms an integral part of the Arrangements.

7.38 Paragraph 1 effectively removes, for the purposes of these Arrangements only, an observation made by the UK to the OECD Commentary in respect of the extent to which a server located in a territory may form a Permanent Establishment for the purposes of Article 5.

7.39 Paragraph 2 confirms that part of the OECD Commentary on some forms of incidental income related to the shipping and air transport industry shall be taxable in the same way as shipping income generally. The United Kingdom usually adopts this text in the body of Article 8 in other DTAs entered into by the United Kingdom.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 Consolidation is not appropriate as the Arrangements do not amend another statutory instrument.

10. Consultation outcome

10.1 HMRC does not consult on the contents of individual DTAs, the details of which are treated as confidential until the agreement is signed. However, HMRC regularly consults with external interested parties, including business representatives, about the United Kingdom’s network of DTAs.

11. Guidance

11.1 General guidance on the operation of the United Kingdom’s double taxation agreements can be found on the HMRC pages of the gov.uk website at:

https://www.gov.uk/hmrc-internal-manuals/international-manual/intm150000

or in the Double Taxation Relief Manual at:

https://www.gov.uk/hmrc-internal-manuals/double-taxation-relief

This Manual will be updated once the Arrangements enter into force.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies. The provisions of the Arrangements do not introduce new tax burdens; rather, they ensure that relief from United Kingdom tax under the arrangements is only granted in circumstances where it was intended.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note has not been produced for the Order as it gives effect to a double taxation agreement. Double taxation agreements impose no obligations on taxpayers, rather they seek to eliminate double taxation and fiscal evasion.

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses.

13.2 No specific steps are proposed to minimise the impact of the requirements on small businesses (employing up to 50 people).

13.3 The basis for the final decision on what action to take to assist small businesses is that the DTA only applies if they have taxed income arising in San Marino. As with other businesses, the impact is negligible. No special approach for small businesses is therefore necessary.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is that both Governments will keep the arrangements scheduled to the instrument under consideration to ensure that it continues to meet the policy objectives set out above in Section 7.

14.2 The instrument does not include a statutory review clause. None is required under section 28(3)(a) of the Small Business, Enterprise and Employment Act 2015 because the power by which this instrument is made is being exercised so as to make or amend provisions imposing, abolishing, or varying any tax duty, levy, or other charge or provisions in connection with such provisions.

15. Contact

15.1 Jo Hammersley at HMRC Telephone: 03000 563904 or email: jo.hammersley@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 James Dunstan, Deputy Director, International Relations and Capacity Building at HMRC can confirm that this Explanatory Memorandum meets the required standard.

15.3 Victoria Atkins MP, Financial Secretary to the Treasury, can confirm that this Explanatory Memorandum meets the required standard.