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The relationship between treaties and domestic anti-abuse provisions

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Monday, June 22nd, 2020

In last month's blog I promised to address the treaty aspects of *Davies and Others v HMRC* [2020] UKUT 67 (TCC). The case concerned UK resident individuals who each took out a life insurance policy with a Bermuda insurer under which their entitlements were linked to a Mauritian company that developed land in the UK.

In 2003, the OECD introduced controversial commentary on the relationship between domestic anti-abuse measures and tax treaties. It asserted that a general rule, there is no conflict between such rules and tax treaties (2003 Commentary to article 1, paras 9.1 to 9.6 and 22 to 22.2). This discussion is expanded considerably in the 2017 OECD Commentary (Commentary to article 1, paras 66 to 80). The later Commentary distinguishes between specific and general legislative anti-abuse rules.

In large measure, this Commentary is made redundant by the PPT introduced in the MLI and new treaties that adopt article 29(9) of the 2017 OECD Model, at least in relation to misuse of treaties.

Specific domestic anti-deferral rule

These issues were faced squarely in the *Davies* case. Under the "Transfer of Assets Abroad" legislation in Income Tax Act 2007, Part 13, Chapter 2, the income of a non-UK person is deemed to be the income of a UK resident who transferred assets directly or indirectly to the non-UK person, if that transferor has a broadly defined, "power to enjoy" the income of the non-UK person resulting from the transfer.

It was common ground that the treaty prevented the UK from taxing the Mauritian company on the profits from land development because it had no permanent establishment in the UK.

The taxpayers argued that they had no tax avoidance motive (see my previous blog). They also argued that Article 7 of the Mauritius – UK treaty prevented them from liability under the Transfer of Assets Abroad legislation. This was because the income which was attributed to them was the income of the Mauritian company and that, as such, it does not lose its tax-free character. It was business profit of a Mauritian enterprise that had no UK permanent establishment.

The Upper Tribunal however upheld HMRC arguments that the treaty did not prevent the UK from taxing the income on two grounds:

(a) Article 7 only applies to the “enterprise” and not to anyone else and,

(b) the Transfer of Assets Abroad legislation charges the income to tax as income of a miscellaneous character and not as trading profits” arising to the taxpayers.

In my view the taxpayer, HMRC and the Tribunal all analysed the treaty provisions and the relationship between the treaty and domestic law incorrectly. A better approach is:

- Firstly, apply the domestic law. In this case, it is clear that the profits from land development are income which the Transfer of Assets Abroad legislation treats as the income of the UK resident transferors unless they show the transfer was not to avoid tax (which they could not).
- Secondly, apply the treaty to the resulting UK tax liability. Once it is accepted that the treaty overrides domestic law (which UK law does, by s 6 of the Taxation (International and Other Provisions) Act 2010 and its predecessors), then this stage is purely a question of treaty interpretation.

Article7(1) which follows the OECD Model reads:

“The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.”

Whose income?

If Article 7(1) is expressed to apply to profits rather than to the person, then only the state of residence of the enterprise may tax it. If the article applies to the person, then the interpretation issue is whether the fact that UK domestic law deems the profits to be those of the UK resident transferors means that those profits cease to be the “profits of a [Mauritian] enterprise”. Applying the general principle of treaty interpretation in Article 31(1) of the Vienna Convention on the Law of treaties, the ordinary meaning is clear and unambiguous: the profits in question were those of the Mauritian company. The domestic law deeming of the profits to be those of the transferors has no impact on the treaty meaning unless article 3(2) requires a domestic meaning of undefined terms to be applied.

The only authority cited for the HMRC view was, what is now, para. 14 of the OECD Commentary to Article 7 of the Model). The cogency of that view is somewhat undermined by the introduction of the savings clause in the MLI and the 2017 OECD Model to permit states to tax their own residents. A savings clause was added to the capital gains article of the Mauritius – UK treaty in 2003 to read:

“13(5) The provisions of paragraph (4) of this Article shall not affect the right of a Contracting State to levy according to its law a tax on capital gains from the alienation of any property derived by an individual who is a resident of the other Contracting State and has been a resident of the first-mentioned Contracting State at any time during the five years immediately preceding the alienation of the property.”

The addition would be surprising if the contracting states thought they thought they were entitled to tax their own residents anyway. Why would they only extend this right to the capital gains article if other articles were in contemplation?

What kind of income?

Does the domestic classification as income of a miscellaneous character and not as trading profits change the classification for treaty purposes? In *Fowler v HMRC* [2020] UKSC 22, the Supreme Court said that "the question is whether [the domestic provision] gives a different meaning to the relevant terms."

HMRC and the Tribunal relied, in particular, on *Bricom Holdings Inc v Commissioners of Inland Revenue* (1997) 70 TC 272. There, the Court of Appeal held that the UK CFC legislation imposed tax on a "conventional or notional sum which exists only as the product of a calculation", and therefore interest earned by a company resident in the Netherlands was not interest within the interest article of the Netherlands – UK treaty. As a result, the CFC charge, was not protected by that article. The Transfer of Assets Abroad legislation merely deems the income of the non-resident to be that of a UK resident without changing its character.

The PPT

The adoption of the PPT as a minimum standard in double tax treaties, clearly changes the discussion. If the purpose of the arrangement is to take advantage of a treaty provision, then the PPT provides the framework for assessing entitlement.

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